



## Part

# INTERNAL CAPITAL ADEQUACY ASSESSMENT

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## Chapter content

- 1 APPLICATION AND DEFINITIONS
- 2 ADEQUACY OF FINANCIAL RESOURCES
- 3 STRATEGIES, PROCESSES AND SYSTEMS
- 4 CREDIT AND COUNTERPARTY RISK
- 5 RESIDUAL RISK
- 6 CONCENTRATION RISK
- 7 SECURITISATION RISK
- 8 MARKET RISK
- 9 INTEREST RISK ARISING FROM NON-TRADING BOOK ACTIVITIES
- 10 OPERATIONAL RISK
- 11 RISK OF EXCESSIVE LEVERAGE
- 12 STRESS TESTS AND SCENARIO ANALYSIS
- 13 DOCUMENTATION OF RISK ASSESSMENTS
- 14 APPLICATION OF THIS PART ON AN INDIVIDUAL BASIS, A CONSOLIDATED BASIS AND A SUB-CONSOLIDATED BASIS

## Links

Legislation.gov.uk	<a href="http://www.legislation.gov.uk/">http://www.legislation.gov.uk/</a>
Eur-Lex	<a href="http://eur-lex.europa.eu/en/index.htm">http://eur-lex.europa.eu/en/index.htm</a>
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PS7/13 Strengthening Capital Standards: Implementing CRD IV, feedback and final rules	<a href="http://www.bankofengland.co.uk/pru/Pages/publications/implemcrdiv.aspx">http://www.bankofengland.co.uk/pru/Pages/publications/implemcrdiv.aspx</a>
SS 6/13 Stress testing, scenario analysis and capital planning	<a href="http://www.bankofengland.co.uk/pru/Pages/publications/stresstesting.aspx">http://www.bankofengland.co.uk/pru/Pages/publications/stresstesting.aspx</a>
SS5/13 The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP)	<a href="http://www.bankofengland.co.uk/pru/Pages/publications/icAAP.aspx">http://www.bankofengland.co.uk/pru/Pages/publications/icAAP.aspx</a>

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## 1 APPLICATION AND DEFINITIONS

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1.1 This Part applies to every *firm* that is a *CRR firm*.

1.2 In this Part the following definitions shall apply:

### *Article 12(1) relationship*

means a relationship where undertakings are linked by a relationship within the meaning of Article 12(1) Directive 83/349/EEC.

### *business risk*

means any risk to a *firm* arising from:

- (1) changes in its business, including:
  - (a) the acute risk to earnings posed by falling or volatile income; and
  - (b) the broader risk of a *firm's* business model or strategy proving inappropriate due to macroeconomic, geopolitical, industry, regulatory or other factors; or
- (2) its remuneration policy.

### *consolidation group*

means the undertakings included in the scope of consolidation pursuant to Articles 18(1), 18(8), 19(1), 19(3) and 23 of the CRR and Groups 2.1- 2.3.

### *central counterparty*

has the meaning given in point (1) of Article 2 of Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC Derivatives, central counterparties and trade repositories.

### *financial conglomerate*

has the meaning given in point (14) of Article 2 of Directive 2002/87/EC on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate.

### *group*

means in relation to a *person* ("A"), A and any *person*:

- (a) who has relationship with A of the kind specified in s. 421 of *FSMA*;
- (b) who is a member of the same *financial conglomerate* as A;
- (c) who has a *Article 12(1)* relationship with A;
- (d) who has a *Article 12(1)* relationship with any *person* who falls into (a);

- (e) who is a *subsidiary* of a person in (c) or (d) ;
- (f) who is member of the same *consolidation group* as A; or
- (g) whose omission from an assessment of the risks to A of A's connection to any person coming within (a)-(f) or an assessment of the financial resources available to such persons would be misleading.

*group risk*

means the risk that the financial position of a *firm* may be adversely affected by its relationships (financial or non-financial) with other entities in the same *group* or by risk which may affect the financial position of the whole *group*, including reputational contagion.

*ICAAP rules*

means the rules in Chapter 3 (Strategies, processes, and systems), Chapter 12 (Stress test and scenario analysis) and Chapter 13 (Documentation of risk assessments).

*liquidity risk*

means the risk that a *firm* although solvent, either does not have available sufficient financial resources to enable it to meet its obligations as they fall due, or can secure such resources only at excessive cost.

*market risk*

means the risk that arises from fluctuations in values of or income from assets or in interest or exchange rates.

*parent financial holding company in a Member State*

means (in accordance with point (26) of Article 1(1) of the *CRD*) a *financial holding company* which is not itself a *subsidiary* of an *institution* authorised in the same *EEA State*, or of a *financial holding company* or *mixed financial holding company* set up in the same *EEA State*.

*parent institution in a Member State*

means (in accordance with point (24) of Article 1(1) of the *CRD*) an *institution* authorised in an *EEA State* which has an *institution* or *financial institution* as *subsidiary* or which holds a *participation* in such an *institution* or *financial institution*, and which is not itself a *subsidiary* of another *institution* authorised in the same *EEA State* or of a *financial holding company* or *mixed financial holding company* set up in the same *EEA State*.

*parent mixed financial holding company in a Member State*

means (in accordance with point (28) of Article 1(1) of the *CRD*) a *mixed financial holding company* which is not itself a *subsidiary* of an *institution* authorised in the same *EEA State*, or of a *financial holding company* or *mixed financial holding company* set up in the same *EEA State*.

*pension obligation risk*

means:

- (1) the risk to a *firm* caused by its contractual or other liabilities to or with respect to a pension scheme (whether established for its employees or those of a related company or otherwise); or
- (2) the risk that the *firm* will make payments or other contributions to or with respect to a pension scheme because of a moral obligation or because the *firm* considers that it needs to do so for some other reason.

*residual risk*

means the risk that credit risk mitigation techniques used by the *firm* prove less effective than expected.

*risk control rules*

means the rules in Chapter 4 to Chapter 11 of this Part.

- 1.3 Unless otherwise defined, any italicised expression used in this Part and in the *CRR* has the same meaning as in the *CRR*.

## **2 ADEQUACY OF FINANCIAL RESOURCES**

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Overall financial adequacy rule

- 2.1 A *firm* must at all times maintain overall financial resources, including *own funds* and liquidity resources, which are adequate both as to amount and quality, to ensure there is no significant risk that its liabilities cannot be met as they fall due.

## **3 STRATEGIES, PROCESSES AND SYSTEMS**

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Overall Pillar 2 rule

- 3.1 A *firm* must have in place sound, effective and comprehensive strategies, processes and systems:
- (1) to assess and maintain on an ongoing basis the amounts, types and distribution of financial resources, *own funds* and internal capital that it considers adequate to cover:
    - (a) the nature and level of the risks to which it is or might be exposed;
    - (b) the risk in the overall financial adequacy rule in 2.1; and
    - (c) the risk that the *firm* might not be able to meet the obligations in Part Three of the *CRR* in the future;
  - (2) that enable it to identify and manage the major sources of risk referred to in (1) including the major sources of risk in each of the following categories where they are relevant to the *firm* given the nature and scale of its business:

- (a) credit and counterparty risk;
- (b) *market risk*;
- (c) *liquidity risk*;
- (d) *operational risk*;
- (e) concentration risk;
- (f) *residual risk*;
- (g) *securitisation risk*, including the risk that the *own funds* held by a *firm* in respect of assets which it has securitised are inadequate having regard to the economic substance of the transaction including the degree of risk transfer achieved;
- (h) *business risk*;
- (i) interest rate risk in the non-trading book;
- (j) *risk of excessive leverage*;
- (k) *pension obligation risk*; and
- (l) *group risk*.

**[Note: Art 73 (part) of the CRD]**

- 3.2 As part of its obligations under the overall Pillar 2 rule in 3.1, a *firm* must identify separately the amount of *common equity tier one capital*, *additional tier one capital* and *tier two capital* and each category of capital (if any) that is not eligible to form part of its *own funds* which it considers adequate for the purposes described in the overall Pillar 2 rule.
- 3.3 The processes, strategies and systems required by the overall Pillar 2 rule in 3.1 must be comprehensive and proportionate to the nature, scale and complexity of the *firm's* activities.
- 3.4 A *firm* must:
  - (1) carry out regularly the assessments required by the overall Pillar 2 rule in 3.1; and
  - (2) carry out regularly assessments of the processes, strategies and systems required by the overall Pillar 2 rule in 3.1 to ensure they remain comprehensive and proportionate to the nature, scale and complexity of the *firm's* activities.

**[Note: Art 73(part) of the CRD]**

- 3.5 As part of its obligations under the overall Pillar 2 rule in 3.1, a *firm* must:
  - (1) make an assessment of the firm-wide impact of the risks identified in accordance with that rule, to which end a *firm* must aggregate the risks across its various business lines and units, taking appropriate account of any correlation between risks; and
  - (2) take into account the stress tests that the *firm* is required to carry out under the general stress test and scenario analysis rule in 12.1 and any stress tests that the *firm* is required to carry out under the *CRR*.

## 4 CREDIT AND COUNTERPARTY RISK

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- 4.1 A *firm* must base credit-granting on sound and well-defined criteria and clearly establish the process for approving, amending, renewing and re-financing credits.

**[Note: Art 79(a) of the CRD]**

- 4.2 A *firm* must have internal methodologies that:
- (1) enable it to assess the credit risk of exposures to individual obligors, securities or *securitisation positions* and credit risk at the portfolio level;
  - (2) do not rely solely or mechanically on external credit ratings; and
  - (3) where its *own funds* requirements under Part Three of the *CRR* are based on a rating by an *ECAI* or based on the fact that an exposure is unrated, enable the *firm* to consider other relevant information for assessing its allocation of financial resources and internal capital.

**[Note: Art 79(b) of the CRD]**

- 4.3 A *firm* must operate through effective systems the ongoing administration and monitoring of its various credit risk-bearing portfolios and exposures, including for identifying and managing problem credits and for making adequate value adjustments and provisions.

**[Note: Art 79(c) of the CRD]**

- 4.4 A *firm* must adequately diversify credit portfolios given its target markets and overall credit strategy.

**[Note Art 79(d) of the CRD]**

## 5 RESIDUAL RISK

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- 5.1 A *firm* must address and control, by means which include written policies and procedures, the risk that recognised credit risk mitigation techniques used by it prove less effective than expected.

**[Note: Art 80 of the CRD]**

## 6 CONCENTRATION RISK

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- 6.1 A *firm* must address and control, by means which include written policies and procedures, the concentration risk arising from:
- (1) exposures to each counterparty including central counterparties, groups of connected counterparties and counterparties in the same economic sector, geographic region or from the same activity or commodity;

- (2) the application of credit risk mitigation techniques; and
- (3) risks associated with large indirect credit exposures such as a single collateral issuer.

**[Note: Art 81 of CRD]**

## **7 SECURITISATION RISK**

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- 7.1 A *firm* must evaluate and address through appropriate policies and procedures the risks arising from *securitisation* transactions in relation to which the *firm* is investor, *originator* or *sponsor*, including reputational risks, to ensure in particular that the economic substance of the transaction is fully reflected in risk assessment and management decisions.

**[Note: Art 82(1) of CRD]**

- 7.2 A *firm* which is an *originator* of a revolving *securitisation* transaction involving *early amortisation provisions* must have liquidity plans to address the implications of both scheduled and early amortisation.

**[Note Art 82(2) of the CRD]**

## **8 MARKET RISK**

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- 8.1 A *firm* must implement policies and processes for the identification, measurement and management of all material sources and effects of market risks.

**[Note: Art 83(1) of the CRD]**

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

**[Note: Art 83(2) of the CRD]**

- 8.3 A *firm's* financial resources and internal capital must be adequate for material market risks that are not subject to an *own funds* requirement.
- 8.4 A *firm* which has, in calculating *own funds* requirements for position risk in accordance with Part Three, Title IV, Chapter 2 of the *CRR*, netted off its positions in one or more of the equities constituting a stock-index against one or more positions in the stock-index future or other stock-index product, must have adequate financial resources and internal capital to cover the basis risk of loss caused by the future's or other product's value not moving fully in line with that of its constituent equities.
- 8.5 A *firm* using the treatment in Article 345 of the *CRR* must ensure that it holds sufficient financial resources and internal capital against the risk of loss which exists between the time of the initial commitment and the following working day.

**[Note: Art 83(3) of the CRD]**

- 8.6 As part of its obligations under the overall Pillar 2 rule in 3.1, a *firm* must consider whether the value adjustments and provisions taken for positions and portfolios in the *trading book* enable



the *firm* to sell or hedge out its positions within a short period without incurring material losses under normal market conditions.

**[Note: Art 98(4) of the CRD]**

## 9 INTEREST RISK ARISING FROM NON-TRADING BOOK ACTIVITIES

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9.1 A *firm* must implement systems to identify, evaluate and manage the risk arising from potential changes in interest rates that affect a *firm's* non-trading activities.

**[Note: Art 84 of the CRD]**

9.2 As part of its obligations under the overall Pillar 2 rule in 3.1, a *firm* must carry out an evaluation of its exposure to the interest rate risk arising from its non-trading activities.

9.3 The evaluation under 9.2 must cover the effect of a sudden and unexpected change in interest rates of 200 basis points in both directions.

9.4 A *firm* must immediately notify the *PRA* if any evaluation under this *rule* suggests that, as a result of the change in interest rates described in 9.3, the economic value of the *firm* would decline by more than 20% of its *own funds*.

9.5 A *firm* must carry out the evaluation under 9.2 as frequently as necessary for it to be reasonably satisfied that it has at all times a sufficient understanding of the degree to which it is exposed to the risks referred to in 9.2 and the nature of that exposure. In any case it must carry out those evaluations no less frequently than once a year.

**[Note: Art 98(5) of the CRD]**

## 10 OPERATIONAL RISK

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10.1 A *firm* must implement policies and processes to evaluate and manage the exposure to operational risk, including model risk and to cover low-frequency high severity events. Without prejudice to the definition of *operational risk*, a *firm* must articulate what constitutes *operational risk* for the purposes of those policies and procedures.

**[Note: Art 85(1) of the CRD]**

10.2 A *firm* must have in place adequate contingency and business continuity plans aimed at ensuring that in the case of a severe business disruption the *firm* is able to operate on an ongoing basis and that any losses are limited.

**[Note: Art 85(2) of the CRD]**

## 11 RISK OF EXCESSIVE LEVERAGE

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- 11.1 A *firm* must have in place policies and procedures for the identification, management and monitoring of the *risk of excessive leverage*.
- 11.2 Those policies and procedures must include, as an indicator for the *risk of excessive leverage*, the leverage ratio determined in accordance with Article 429 of the *CRR* and mismatches between assets and obligations.

**[Note: Art 87(1) of the *CRD*]**

- 11.3 A *firm* must address the *risk of excessive leverage* in a precautionary manner by taking due account of potential increases in that risk caused by reductions of the *firm's own funds* through expected or realised losses, depending on the applicable accounting rules. To that end, a *firm* must be able to withstand a range of different stress events with respect to the *risk of excessive leverage*.

**[Note: Art 87(2) of the *CRD*]**

## 12 STRESS TESTS AND SCENARIO ANALYSIS

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### General stress test and scenario analysis rule

- 12.1 As part of its obligation under the overall Pillar 2 rule in 3.1, a *firm* must, for the major sources of risk identified in accordance with that rule, carry out stress tests and scenario analyses that are appropriate to the nature, scale and complexity of those major sources of risk and to the nature, scale and complexity of the *firm's* business.
- 12.2 In carrying out the stress tests and scenario analyses in 12.1, a *firm* must identify an appropriate range of adverse circumstances of varying nature, severity and duration relevant to its business and risk profile and consider the exposure of the *firm* to those circumstances, including:
- (a) circumstances and events occurring over a protracted period of time;
  - (b) sudden and severe events, such as market shocks or other similar events; and
  - (c) some combination of the circumstances and events described in (a) and (b), which may include a sudden and severe market event followed by an economic recession.
- 12.3 In carrying out the stress tests and scenario analyses in 12.1, the *firm* must estimate the financial resources that it would need in order to continue to meet the overall financial adequacy rule in 2.1 and the obligations laid down in Part Three of the *CRR* under the adverse circumstances being considered.
- 12.4 In carrying out the stress tests and scenario analyses in 12.1, the *firm* must assess how risks aggregate across business lines or units, any material non-linear or contingent risks and how risk correlations may increase in stressed conditions.

## 13 DOCUMENTATION OF RISK ASSESSMENTS

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- 13.1 A *firm* must make a written record of the assessments required under this Part. These assessments must include assessments carried out on a consolidated basis and on an individual basis. In particular it must make a written record of:
- (a) the major sources of risk identified in accordance with the overall Pillar 2 rule in 3.1;
  - (b) how it intends to deal with those risks; and
  - (c) details of the stress tests and scenario analyses carried out, including any assumptions made in relation to scenario design, and the resulting financial resources estimated to be required in accordance with the general stress test and scenario analysis rule in 12.1.
- 13.2 A *firm* must maintain the records referred to in 13.1 for at least three years.

## 14 APPLICATION OF THIS PART ON AN INDIVIDUAL BASIS, A CONSOLIDATED BASIS AND A SUB-CONSOLIDATED BASIS

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The ICAAP rules

- 14.1 A *firm* that is neither a *subsidiary* of a *parent undertaking* incorporated in or formed under the law of any part of the *UK* nor a *parent undertaking* must comply with the *ICAAP rules* on an individual basis.
- 14.2 A *firm* that is not a member of a *consolidation group* must comply with the *ICAAP rules* on an individual basis.
- [Note: Art 108(1) of the CRD]**
- 14.3 A *firm* which is a *parent institution in a Member State* must comply with the *ICAAP rules* on a consolidated basis.
- 14.4 A *firm* controlled by a *parent financial holding company in a Member State* or a *parent mixed financial holding company in a Member State* must comply with the *ICAAP rules* on the basis of the *consolidated situation* of that holding company, if the *PRA* is responsible for supervision of the *firm* on a *consolidated basis* under Article 111 of the *CRD*.

**[Note: Art 108(2) and 108(3) of the CRD]**

- 14.5 A *firm* that is a *subsidiary* must apply the *ICAAP rules* on a *sub-consolidated basis* if the *firm*, or the *parent undertaking* where it is a *financial holding company* or *mixed financial holding company*, have an *institution* or *financial institution* or an *asset management company* as a *subsidiary* in a *third country* or hold a *participation* in such an undertaking.

**[Note: Art 108(4) of the CRD]**

- 14.6 If the *ICAAP rules* apply to a *firm* on a *consolidated basis* or on a *sub-consolidated basis* the *firm* must carry out consolidation to the extent and in the manner prescribed in Articles 18(1), 18(8), 19(1), 19(3), 23 and 24(1) of the *CRR* and Groups 2.1-2.3.
- 14.7 For the purpose of the *ICAAP rules* as they apply on a *consolidated basis* or on a *sub-consolidated basis*:
- (1) the *firm* must ensure that the *consolidation group* has the processes, strategies and systems required by the overall Pillar 2 rule in 3.1;
  - (2) the risks to which the overall Pillar 2 rule in 3.1 and the general stress test and scenario analysis rule refer are those risks as they apply to each member of the *consolidation group*;
  - (3) the reference in the overall Pillar 2 rule in 3.1 to amounts and types of financial resources, *own funds* and internal capital (referred to in this *rule* as resources) must be read as being to the amounts and types that the *firm* considers should be held by the members of the *consolidation group*;
  - (4) other references to resources must be read as being to resources of the members of the *consolidation group*;
  - (5) the reference in the overall Pillar 2 rule in 3.1 to the distribution of resources must be read as including a reference to the distribution between members of the *consolidation group*;
  - (6) the reference in the overall Pillar 2 rule in 3.1 to the overall financial adequacy rule in 2.1 must be read as being to that *rule* as adjusted under 14.14-14.16 (level of application of the overall financial adequacy rule);
  - (7) a *firm* must be able to explain how it has aggregated the risks referred to in the overall Pillar 2 rule in 3.1 and the financial resources, *own funds* and internal capital required by each member of the *consolidation group*; and
  - (8) in particular, to the extent that the transferability of resources affects the assessment in (2), a *firm* must be able to explain how it has satisfied itself that resources are transferable between members of the group in question in the stressed cases and the scenarios referred to in the general stress test and scenario analysis rule in 12.1.
- 14.8 A *firm* must allocate the total amount of financial resources, *own funds* and internal capital identified as necessary under the overall Pillar 2 rule in 3.1 (as applied on a *consolidated basis* or on a *sub-consolidated basis*) between different parts of the *consolidation group*.
- 14.9 The *firm* must carry out the allocation in 14.8 in a way that adequately reflects the nature, level and distribution of the risks to which the *consolidation group* is subject.
- 14.10 A *firm* must also allocate the total amount of financial resources, *own funds* and internal capital identified as necessary under the overall Pillar 2 rule in 3.1 as applied on a *consolidated basis* or on a *sub-consolidated basis* between each *firm* which is a member of the *consolidated group* on the following basis:
- (a) the amount allocated to each *firm* must be decided on the basis of the principles in 14.9; and
  - (b) if the process in (a) were carried out for each group member, the total so allocated would equal the total amount of financial resources, *own funds* and internal capital

identified as necessary under the overall Pillar 2 rule in 3.1 as applied on a *consolidated basis* or on a *sub-consolidated basis*.

The risk control rules

14.11 The *risk control rules* apply to a *firm* on an individual basis whether or not they also apply to the firm on a *consolidated basis* or *sub-consolidated basis*.

**[Note: Art 109(1) (part) of the CRD]**

14.12 Where a *firm* is a member of a *consolidation group*, the *firm* must ensure that the risk management processes and internal control mechanisms at the level of the *consolidation group* of which it is a member comply with the obligations set out in the *risk control rules* on a *consolidated basis* (or a *sub-consolidated basis*).

14.13 Compliance with the obligations referred to in 14.12 must enable the *consolidation group* to have arrangements, processes and mechanisms that are consistent and well integrated and that any data relevant to the purpose of supervision can be produced.

**[Note: Art 109(2) (part) of the CRD]**

Level of application of the overall financial adequacy rule

14.14 The overall financial adequacy rule in 2.1 applies to a *firm* on an individual basis whether or not it also applies to the *firm* on a *consolidated basis* or *sub-consolidated basis*.

14.15 The overall financial adequacy rule in 2.1 applies to a *firm* on a *consolidated basis* if the *ICAAP rules* apply to it on a *consolidated basis* and applies to a *firm* on a *sub-consolidated basis* if the *ICAAP rules* apply to it on a *sub-consolidated basis*.

14.16 When the overall financial adequacy rule in 2.1 applies on a *consolidated basis* or *sub-consolidated basis*, the *firm* must ensure that at all times its *consolidation group* maintains overall financial resources, including *own funds* and liquidity resources, which are adequate, both as to amount and quality, to ensure that there is no significant risk that the liabilities of any members of its *consolidation group* cannot be met as they fall due.



Part

## INTERNAL CAPITAL ADEQUACY ASSESSMENT

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Externally defined glossary terms

<b>Term</b>	<b>Definition source</b>
<i>Operational risk</i>	<i>Article 4(1)(52) CRR</i>
<i>risk of excessive leverage</i>	<i>Article 4(1)(94) CRR</i>
<i>ECAI</i>	<i>Article 4(1)(98) CRR</i>
<i>originator</i>	<i>Article 4(1)(13) CRR</i>
<i>sub-consolidated basis</i>	<i>Article 4(1)(49) CRR</i>
<i>Consolidated basis</i>	<i>Article 4(1)(48) CRR</i>
person	<i>Schedule 1 Interpretation Act 1978</i>
subsidiary	<i>Article 4(1)(16) CRR</i>
institution	<i>Article 4(1)(3) CRR</i>
financial holding company	<i>Article 4(1)(20) CRR</i>
mixed financial holding company	<i>Article 4(1)(21) CRR</i>
EEA State	<i>s425 FSMA</i>
own funds	<i>Article 4(1)(118) CRR</i>
securitisation	<i>Article 4(1)(61) CRR</i>
common equity tier one capital	<i>Article 50 CRR</i>
additional tier one capital	<i>Article 61 CRR</i>
tier two capital	<i>Article 71 CRR</i>
securitisation positions	<i>Article 4(1)(62) CRR</i>
sponsor	<i>Article 4(1)(14) CRR</i>
early amortisation provisions	<i>Article 242(14) CRR</i>
trading book	<i>Article 4(1)(86) CRR</i>
parent undertaking	<i>Article 4(1)(15) CRR</i>
financial institution	<i>Article 4(1)(26) CRR</i>
consolidated situation	<i>Article 4(1)(47) CRR</i>
asset management company	<i>Article 4(1)(19) CRR</i>
participation	<i>Article 4(1)(35) CRR</i>