



# **A response by UK Finance to the PRA's Consultation Paper 14/24**

on changes to the Large  
Exposures regime

January | 2025

# Introduction

UK Finance<sup>1</sup> is pleased to respond to the PRA's [CP13/24](#) on its planned changes to its Large Exposures framework which propose:

- *removing internal model (IM) methods to calculate exposure values to securities financing transactions (SFTs); and*
- *introducing a mandatory substitution approach to calculate the effect of the use of credit risk mitigation (CRM) techniques.*

In the CP the PRA also proposes to:

- *remove the option for firms to exceed LE limits for trading book exposures to third parties;*
- *allow firms to exceed LE limits for trading book exposures to intragroup entities, and to simplify the calculation of the additional capital requirements;*
- *allow firms to apply for higher LE limits to exposures to intragroup entities;*
- *remove the exemption from LE limits to firms' exposures to the UK deposit guarantee scheme (DGS);*
- *remove the option for firms to use immovable property as CRM; and*
- *remove the stricter requirements on exposures to certain French counterparties*

Our consultation response builds on the very productive round table that was held between members and the PRA team before Christmas.

## Key Messages

### 1. Implementation Date

It would be helpful if the *implementation date* of the whole package of changes could be contemporaneous and no earlier than 1 Jan 2026. Of course, our strong preference would be that it should be aligned with the now revised implementation date of 1 January 2027. Firms should be given at least one year after finalisation of the PRA's new rules for planning and implementation. This is particularly important for the mandatory substitution approach which would require system changes and also, potentially, business changes, including possible

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<sup>1</sup> UK Finance is the collective voice for the banking and finance industry. Representing 300 firms, we are a centre of trust, expertise and collaboration at the heart of financial services, championing a thriving sector and building a better society.

migration of exposures from the UK. A number of linked factors lead us to make this recommendation, including:

- Delivering the required changes in a short period of time when firms change programmes are simultaneously focusing on Basel 3.1 delivery will dilute effective implementation of both.
- New methodologies under Basel 3.1, particularly with respect to Securities Financing Transactions (SFT), would result in firms implementing changes, with a minimal shelf, life to comply with current rules which would then require re-working to align with Basel 3.1 requirements. This would not be a good use of members' scarce resource.
- Firms' management of the capital and business impacts of the proposed changes to LE requirements, coupled with the need to potentially renegotiate collateral agreements with clients, will all take time.

## **2. Removal of the IM method for SFTs**

Our members generally understand the conceptual underpinning behind the removal of the Internal Models (IM) method. But some firms are expecting a large increase in exposure from *removal of the IM method for SFTs* as a result of having to calculate exposure under the financial collateral comprehensive method (FCCM), even though the underlying economic risk remains the same. This is particularly the case for international groups operating centralised booking arrangements. The increase in intragroup exposures following the change will result in many firms exceeding the maximum 250% non-core LE group (NCLEG) limit the PRA is proposing in BaU.

The NCLEG limit should therefore be removed or increased to at least 350% to factor in the impact of removal of IM and the reflect the overall intragroup trading book points under 4 below.

## **3. Loss of trading book exposure “soft” limit for third parties**

The PRA should consider implementing a *short-term allowance for trading book exposures in excess of the 25% limit* which, should be capitalised in the same way as proposed for intragroup trading book exposure excesses (i.e. an additional RWA requirement of 100% but which would only be applied to an exposure in excess for less than 10 days. Exposures still in excess of the 25% limit after 10 days would then be considered a breach of large exposure limits and would be reported to the PRA as such, along with details of the outstanding plan of action and timeline for resolution. We consider this to be a pragmatic approach that would avoid firms undertaking consequent intra group transactions to manage such short-term temporary LE excesses in the trading book.

We believe the objective of this helpful soft limit exemption is to cater for market price volatility leading to temporary LE excesses which cannot be directly controlled by the firm, but which it can subsequently respond to, by for instance, re-margining, selling down positions and

executing hedges. Without such a pragmatic approach firms would need to hold excessive large exposures stress buffers to avoid breaching the 25% limit. This proposed limit may not be fully effective in periods of stress anyway and the extra buffers that firms would consequently hold may detract from market liquidity.

#### **4. Approach to intragroup trading book exposures**

We fully support the retention of a trading book soft limit for intragroup exposures which helpfully avoids complicating intragroup risk management approaches. But we find *the increased NCLEG cap of 250% is too low* considering the proposed removal of the IM method for SFTs. This 250% cap should be raised or left unlimited and negotiated as part of the permission application process to avoid impacts on firms' booking models.

Countries in the EU, with which the UK competes to attract and retain trading business, have used the national discretions in CRR to apply their own approaches to affiliate exposures and may fully, or partially exempt them from their large exposure framework. For instance, France permits a full exemption whilst Germany offers a more generous 400% partial exemption, making the UK requirements unnecessarily super-equivalent to those applied by our near neighbours. These may not be aligned with PRA's growth and competitiveness secondary objective as they create an uneven playing field.

Given this, drawing on experience over the previous years and considering the existence of a new hard cap (85% in the proposals), we do not believe a maximum percentage cap is either beneficial or necessary. To the extent the PRA requires a set limit however, firms' analysis shows it should be set to at no less than 350% to avoid repercussions on BAU operating models.

#### **5. NCLEG waivers/permissions**

There are *timing considerations* associated with the renewal of existing NCLEG waivers which expire before the proposed implementation dates. A more straightforward alternative would be for the PRA to temporarily extend all NCLEG permissions expiring before the new amended rules come into force. This would allow firms to plan in advance and apply as needed under the new rules only once, rather than submitting two different waivers in a short period of time. This would be more efficient for firms and the PRA, particularly as it is unclear if NCLEG permissions granted under the current rules would be granted with the normal practice of a 3-year expiry and be retained as legacy NCLEG permissions under the new rules for this long period of time. We are particularly anxious to ensure that no firms are penalised through having an inflight application in progress at the time the new rules are introduced.

We are unclear about the *purpose of the 25% notification requirement* for Core UK (CUKG) exposures to NCLEG, given CoRep reporting requirements. It is likely that firms will frequently be reporting that they have exceeded the 25% excess. In the absence of more detail on why the PRA needs this information, and the frequency of notifications required, members suggest this notification be removed.

We welcome the proposal to allow all firms to apply for *Higher NCLEG limit*. However, according to Article 400 (6A), a firm may only use the NCLEG exemption or Higher NCLEG exemption where the total amount of non-trading book exposures from the firm to its NCLEG does not exceed 100% of the firm's Tier 1 capital. Capping the non-trading book exposure at 100% of firm's Tier 1 capital within NCLEG would hinder the operational flexibility of international banks.

The flexibility of trading book and non-trading book composition within the overall NCLEG limit is in line with existing rules should be retained.

## **6. Mandatory Substitution Approach**

*The Mandatory Substitution Approach unnecessarily duplicates other regulatory mechanisms*

Philosophically we question the intent behind the Large Exposures framework in the context of the MSA, as the purpose of the large exposures framework, as stated in LEX10, is to ensure a bank can withstand the losses generated by a single idiosyncratic default event.

However, the introduction of the mandatory substitution approach (MSA) appears to be protecting against the risk of losses generated by multiple default events of unconnected clients. For instance, a firm has transactions with 10 counterparties each of which is individually collateralised by an instrument issued by A – oftentimes a sovereign bond. The firm would only be exposed to a default related loss in the situation where all 10 counterparties and the issuer were to default simultaneously. The default of any individual issuer A would not, in and of itself, create a loss for the firm, absent any direct holdings of A by the firm.

We believe these sorts of risks are already covered by stress testing expectations and concentration risk requirements under the Pillar 2 framework making the MSA superfluous. We recognise however that this is a debate to be had at the Basel Committee level and would be happy to support the PRA in raising this issue at an internationally. We believe this should be raised with Basel before the introduction of the MSA approach in the UK to prevent the potential adverse impacts on SFT and bond market liquidity and hence the competitiveness of the UK regulated banking sector in performing SFT intermediation activities between key market borrowers and lenders of collateral.

*Impact on smaller wholesale firms*

Furthermore, to the extent the MSA would be more binding on *smaller wholesale banks* due to lower LE limits, or activity pushed to unregulated and opaque non-banks effective competition, price depth and discovery available to end users would be reduced. Reliance on unregulated entities who may not consistently allocate resources to the UK economy through the cycle may be exacerbated.

That smaller and less-sophisticated banks typically use triparty custodian's services to manage reverse repos, which include automated collateral substitutions, compounds this problem. The custodian's system automatically replaces a security pledged as collateral with another if it falls below agreed eligibility criteria. This protects the firm from risk of losses in the

event of single idiosyncratic default. However, this automatic replacement will further complicate their large exposure calculation, which goes against the PRA's stated position in the CP favouring simplification.

Clearing reverse repos through a Central Clearing Counterparty (CCP) - exempt under current proposals – is not, in our view, feasible for smaller firms due to the costs involved in becoming a member and the restrictions (in terms of haircuts and limited range of collateral accepted) put in place by the CCPs.

### *Sovereigns should be exempt from the mandatory substitution approach*

Regardless of whether or not the PRA decides to retain the MSA it should refrain from imposing it on sovereign exposures.

The Basel LEX did not include sovereigns in the Large Exposures framework. The PRA can therefore readily achieve compliance with the Basel large exposure framework without imposing the mandatory substitution on sovereign exposures. Article 400(1) (a) continues to provide that only *exposures to sovereigns that are risk-weighted at 0% are excluded exempt from large exposure limits*. To achieve a 0% risk-weight under standardised credit risk rules several alternative conditions must be met. The credit rating must be AA- or above to qualify CQS1 but in the case of lower rated third country sovereigns, the requirement is for:

1. an equivalence decision over the credit institution regulations applied by the third country;
2. the application of a 0% risk weight by the third country regulator; and;
3. the condition for exposures to be 'denominated and funded in the domestic currency' of the sovereign.

We continue to question the rationale for aligning the conditions in the large exposure rules to the credit risk rules, in particular, the connection to the credit risk regime and scope restriction of the exemption compared to Basel, particularly with respect to the "funded" condition which is not compatible with the concept of indirect exposures.

The 'funded' condition set out in Article 114(7) to obtain a 0% risk-weight specifically for indirect exposures taken under the mandatory substitution approach is problematic. On the basis that collateral received is off-balance sheet, it is not possible to ascertain how the collateral issuer or counterparty is funding the collateral posted and there is no need for it to be internally funded by the institution.

Furthermore, having respective liabilities funded in the relevant currency would have no impact of the firm's ability to liquidate that same collateral in the event of a default of the underlying counterparty and therefore has no bearing on the actual default risk of the collateral issuer. Even in the context of repos/reverse repos with a cash leg it is likely that on-balance sheet netting will occur and result in insufficient corresponding liabilities versus a gross exposure only on received collateral.

In its 2017 discussion paper on [The regulatory treatment of sovereign exposures](#) the BCBS noted that “funding sources are somewhat fungible and not necessarily linked to specific assets”. The context of this requirement originally was to mitigate foreign exchange risk and as discussed by the committee, these risks would be captured under the market risk framework even when arising from banking book exposures.

So, in our view there should be no need to differentiate between local and foreign currency issuance in terms of application of a 0% risk weight for credit risk, the purpose of which is to cater for the default risk of the issuer. The credit risk arising is clearly somewhat differentiated according to the currency denomination of the sovereign bond as the issuer has more latitude to avoid domestic currency defaults through currency devaluation. But, even for foreign currency issuance, sovereign exposures are the most liquid global assets which perform a key role in financial markets as the most commonly utilised collateral.

In particular the impact on [exposures to counterparties in emerging markets](#) will be problematic. Many of our members’ counterparties in emerging markets may only have their local sovereign bonds to offer as collateral. This could have deleterious impacts on the pricing of sovereign debt as the lack of robust repo markets will reduce the ability to re-use and fund sovereign debt, depriving developing economies of access to the broadest range of international capital markets.

It is clear that the BCBS has recognised the importance and extensive use of sovereign bonds as collateral so has granted them broad exemption from its LEX framework. Given this, and the potential negative impacts on London’s preeminent position as a trading venue for sovereign bonds the PRA should too.

As we note above, in our view there are strong arguments that sovereign exposures should be fully exempted from the large exposures regime. But if this is not accepted by the PRA then, at a minimum, we would recommend that it ideally exempts all sovereigns from the MSA approach or at least simplifies the sovereign exemption by removing the ‘funded’ condition required as part of Art. 114(7) or deem this condition to always be met for the purposes of mandatory substitution. Otherwise, it should provide further rationale for the condition and clarify how firms are expected to implement this in practice.

## Technical Questions

- a) It would be helpful if the PRA clarifies that the additional capital requirement in relation to [trading book exposures exceeding 25% of Tier 1](#) is that “Risk Weighted Assets”, rather than “Own funds”, is calculated simply as the amount of the excess. This is our understanding from discussion with the PRA during the UK Finance meeting.

The alternative interpretation, which we do not think is correct, were it to be a 100% own funds requirement, would result in an effective hard limit, as the amount of capital required would be greater than fully writing off the exposure to Tier 1 capital.

- b) For firms wishing to apply for a **higher NCLEG permission**, it is not possible to determine from the guidance provided in CP14/24 how the PRA will set the limit in the range between 100% and 250%.

There is general guidance that a firm must demonstrate it meets the Trading Activity Wind-down expectations in SS1/22 and booking arrangement expectations in SS5/21. However, a view as to what the principles that the PRA will apply in calibrating the NCLEG limit in that range would be helpful to allow firms to gauge the level of NCLEG they could achieve and better assess the impact of the rule changes in CP14/24 on their capital position. This could be published as an update to the CRR Non-core large exposures group template which firms are required to complete in order to apply for the current NCLEG permission.

- c) As per article 400(7)(a), a firm with a Higher NCLEG permission or an NCLEG permission must make a **Single Borrower Limit Notification** whenever the total amount of exposures from the Core UK group (including the firm) to a particular member of the firm's NCLEG is likely to exceed, or has exceeded 25% of the Tier 1 capital of the PRA-authorized firm with the largest Tier 1 capital base in the core UK group. We would recommend increasing the written notification requirement to 75% in proportion to proposed Higher NCLEG permission up to 250% or alternatively removing the requirement in light of regular quarterly CoRep reporting of the relevant exposures.

If this proposed requirement is retained could the PRA clarify the frequency of such notifications, particularly is this only upon the initial occurrence of an excess or an ongoing requirement thereafter?

- d) Could the PRA confirm the correct interpretation in para 4.5 of the CP in respect of bond **collateral posted as margin** under a derivatives master agreement (where, for CCR purposes, alpha is not equal to 1).

The text in the body of 4.5 (*"The recognised amount assigned to the collateral issuer or protection provider will be (a) the exposure value before taking into account the effect of CRM, where applicable, minus (b) the exposure value, after taking into account the effect of the CRM"*) appears to indicate that the amount assigned to the collateral issuer is the market value of collateral multiplied by alpha (since exposure value includes the alpha term).

In contrast, the text that follows at bullet 3 (*"[The] recognised amount will be ... the value of the collateral as recognised in the calculation of the counterparty credit risk exposure value for any instruments with counterparty credit risk"*) appears to indicate that the amount assigned to the collateral issuer is the market value of collateral without adjustment for volatility adjustments or alpha.

Should the amount assigned to the collateral issuer be multiplied by alpha or not?

- e) Could the PRA confirm that when calculating the effect of collateral under SA-CCR or IMM firms should continue to **consider the transaction to be margined**?

In order to calculate the exposure to CRM providers under SA-CCR firms typically have to run two calculations. One calculation assumes that there is no collateral, typically resulting in a higher EAD, and another calculation including the collateral received typically, resulting in a lower EAD. The EAD delta is the amount allocated against the CRM provider. For margined transactions it seems appropriate to assume that margining effects apply for both calculations. It would also be helpful to clarify whether cash collateral should be included in both calculations and does not require any consideration in the MSA approach.

- f) How should a firm treat collateral which is *itself collateralised by a pool of underlying assets*, for instance RMBS or covered bonds which are by design, over collateralised? We understand that in the case of SFTs Article 6 allows firms the option to look through to identify multiple underlying providers of collateral. In the case of covered bonds and RMBS the mortgages are essentially the ultimate recourse a firm has in default. Could a firm look through to the underlying mortgage collateral rather than issuer of the security? Could the PRA clarify that Article 390(7) is applicable in the context of indirect exposures as well as direct?
- g) How should firms calculate the *over-collateralised amount on derivatives* under the mandatory substitution method? Given the 5% floor embedded in the multiplier calculation under the Standardised Approach for Counterparty Credit Risk (SA-CCR) methodology, in theory exposures can never be over-collateralised if the Potential Future Exposure (PFE) component is also included. Therefore, we think it is appropriate to calculate the over-collateralised amount on derivatives as the difference between collateral received post regulatory haircut and the market value of the derivatives.
- h) Should the *exposure value for SFTs and derivatives be on a gross basis* where the collateral is not recognised but the netting set is retained?

The Large Exposure framework does not explicitly state if the benefit from credit risk mitigation (CRM) should be recognised when determining if the large exposure threshold is met or not. Members have generally excluded the benefit of CRM for the identification of the Large Exposure (i.e. for reporting purposes) but have permitted it for the assessment of exposures against the Large Exposure limits.

Members have told us there is less consensus on the approach for SFTs and derivatives – where the adjusted exposure value could be used (i.e. with the benefit of collateral) or the gross value could be used (i.e. removing collateral/margin) from the netting set calculation. This ambiguity exists in the Reporting Instructions, where firms are instructed to continue to recognise the ‘netting arrangements’ but without specifying whether that is with or without collateral in the netting set calculation.

- i) How should the *indirect exposures to CRM providers* for SFTs under a master netting agreement or in a security-for-security trade be calculated?

For a single reverse repo, it is clear how the exposure to CRM provider should be calculated. But when several reverse repos and repos are transacted with a single counterparty, under a master netting agreement, the calculation is significantly more complex and there is a lack of clarity as to how this should be done. In this situation the entity would have received and posted securities across multiple issuers. Recognising exposure to CRM only for received securities would be extremely conservative and would ignore that in practise in case of default of a counterparty the received and posted securities would all be netted down. Taking a simple security-for-security trade where no cash has been exchanged is another example where recognising CRM against the received security does not reflect the economic reality of the risks the entity is actually facing. Could the PRA clarify how the exposure to CRM providers should be calculated in these situations?

- j) The BCBS's LEX Guidelines allows for *exposure measurement of covered bonds* to be a lower exposure value (but no less than 20% of nominal bond holding) if the bonds satisfy certain conditions. Is there scope to review the PRA's approach to this?

For smaller UK banks, the current approach may restrict access to low-risk investment opportunities. With continued consolidation of UK banking sector, the issue is compounding and may require action to provide capacity to support unsecured BaU banking relationships.

- k) We would recommend that the PRA align the *definition of institution* in point 1.3 to that in the credit risk framework under Article 107 to ensure consistency of the definition of institution across the two frameworks. At present there is arguably an inconsistency created by the lack of equivalence decisions by HMT for Article 391 besides EEA and it is unclear what benefit having a specific equivalence requirement and different scope of institution under the large exposures framework provides.
- l) We would recommend that the PRA take the opportunity *to restructure the C28 and C29 returns*, particularly with respect to how indirect exposures and credit risk mitigation are reported. These templates were designed at such a time where credit risk mitigation with substitution effects was limited to unfunded credit risk mitigation and the financial collateral simple method and therefore in the context of a broader MSA requirement these templates are no longer aligned to the structure of the large exposures rules.

Of course, UK Finance would be pleased to facilitate any further discussion with members on the issues we have raised in this response. We are content that the fact that UK Finance has responded to this consultation be published by the PRA on its website.

### *Responsible Executive*

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