CP 6/19 – Pillar 2 liquidity: Updates to the framework

Date: 24 April 2019

UK Finance and ALMA are pleased to respond to the PRA's consultation paper CP6/19 on Pillar 2 liquidity[1].

UK Finance is the collective voice for the banking and finance industry. Representing more than 250 firms across the industry, we act to enhance competitiveness, support customers and facilitate innovation.

ALMA is the UK Asset & Liability Management Association whose mission is to provide and promote the highest standard of education and professional excellence, share best practice and be a leading advocate within asset and liability management.

Overview

UK Finance and ALMA have previously highlighted concerns around the introduction of PRA110, such as through our response to the consultation paper CP13/17 on *Pillar 2 Liquidity*[2] and CP22/18 on *Liquidity reporting: FSA047 and FSA048.* In these responses we highlighted the significance of the additional reporting requirements of PRA110 and requested a longer implementation timeframe, and also concerns about the requirement to submit PRA110 on a T+1 basis and requested a remittance period of two business days. We were grateful that both of these were taken on board, with the original 1 January 2019 proposed start date moved and the PRA110 allowed to be submitted on a T+2 basis. We hope that the concerns raised in this response will be similarly taken on board.

Redefinition of Pillar 1 standards and potential double count of intraday liquidity risk capture

The PRA Consultation Paper proposes to redefine the LCR standards in Basel III and the Delegated Act to disqualify from eligible High-Quality Liquid Asset ("Eligible HQLA") securities that are pledged to generate intraday liquidity, even if these securities are otherwise unencumbered at the close of each business day when the LCR calculations are performed. Effectively, this update broadens the scope of the Pillar 1 LCR requirement to include intraday evaluations.

We would like to emphasise that the LCR is not intended to capture intraday liquidity risk and this is explicitly acknowledged in the Basel LCR Standard (paragraph 41): "Banks and regulators should be aware that the LCR stress scenario does not cover expected or unexpected intraday liquidity needs"[3]. As such, the PRA captures intra-day risk as part of its Pillar 2 framework, where firms are required to consider 'double duty'. The Statement of Policy (SoP) published in February 2018[4] provides certain details on the PRA's approach to capturing intra-day risks and to sizing of the Pillar 2 add-ons. While the full details of the PRA methodology are not transparent to the industry, it is

[1] https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/consultation-paper/2019/cp619.pdf

[2] https://www.ukfinance.org.uk/system/files/UK%20Finance%20response%20to%20PRA%20CP%2013%2017.pdf

[3] https://www.bis.org/publ/bcbs238.pdf

[4] https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/statement-of-policy/2018/pillar-2-liquidity-sop.pdf

sufficient to say that firms are already required to account for intraday risk through a Pillar 2 add-on requirement.

Any additional requirement to reduce the balances from Eligible HQLA reporting, either from auto-collateralised repurchase agreements (ACR) or intraday credit lines, may lead to capturing the same risk in Pillar 1 as well as in Pillar 2 leading to a double count.

It is also worth noting that ACR merely change the composition of highly liquid assets since the collateral (subject to haircuts) is used to finance the purchase of securities. This is explicitly recognised in the Basel Intraday Standards (page 4): "liquidity usage [in ACR] are only those related to the haircut applied by the central bank."[5] If the PRA's intention is to fully capture a firm's liquidity position post auto-collateralisation, the corresponding newly unencumbered purchased assets should also be taken into account.

Cost benefit analysis

We note that the PRA considered that a "period of one month is justified in light of the relatively minor impact of the proposed changes" in the consultation. However, the proposed addition of the paragraph 2.29AA is likely to have a material impact on the provision of intra-day liquidity, which according to a 2017 Bank of England paper equated to £48.4bn sourced daily on average through CHAPS and CREST[6]. Out of this £48.8bn, an average of £29.7bn was provided exclusively through the ACR facility in CREST. The average daily maximum amount, as suggested in the CP, will be much higher.

Accordingly, we believe that the PRA should conduct a detailed Cost Benefit Analysis to clarify the impact of this change to direct and indirect participants in securities settlement systems, as required by section 138J(2)(a) of the Financial Services and Markets Act 2000 (FSMA), using data held through firms' submissions. As part of this exercise, it would be useful for the PRA to consult with the Bank of England in order to understand and consider any potential unintended consequences in CREST of the proposed approach.

Competitive disadvantage and market pricing

The proposal as drafted would only be applicable to PRA regulated firms creating a comparative disadvantage compared to their European peers. Existing Pillar 2 add-ons increase the required HQLA holdings attributed to firms, but we are unaware of any assessment and interpretation, whether in the UK or elsewhere, that disqualifies Eligible HQLA from the numerator of the LCR (Pillar 1) based on intraday usage. Introducing an intraday filter to Eligible HQLA would represent a fundamental change to the design of the UK application of the LCR Delegated Act that could result in material inconsistencies with European regulatory standards and market practices.

The requirement to hold incremental liquidity for securities settlement activity would make market making in government bonds more expensive and may impact the pricing and liquidity in the government bond repo market. We therefore question its compatibility with the PRA's secondary objective to facilitate effective competition in the markets for services provided by PRA-authorised persons in carrying on regulated activities under section 2H of FSMA.

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[5] https://www.bis.org/publ/bcbs248.pdf

[6] https://www.bankofengland.co.uk/-/media/boe/files/payments/rtgs-and-chaps-service-description-december-2018.pdf

Thus, we recommend that the PRA removes the Eligible HQLA reporting guidance set out in the section 2.29AA of the CP.

Net debit calculation

We understand that there may be some inconsistency in how some firms are performing their net debit calculation, which has caused the desire to make proposed additions to supervisory statements in this consultation to mitigate this. We would suggest that the PRA clarifies bilaterally with those institutions, or their third-party solution provider, where there might be misunderstanding in how the instructions to perform this calculation should be followed. The proper application of the current requirements and expectations is a more appropriate route to mitigating these risks than the amendments proposed in this consultation.

Publication of the liquidity calculation tool and granular LCR

We would be grateful if the PRA would provide clearer timelines on when the equivalent Liquidity Metric Monitor (the "LMM") for the PRA110 will be released and whether it would be included as part of 1 July submission requirements, so that our members can better understand how the PRA intends to use the PRA110.

For example, it is not apparent how the addition of the memo lines on derivatives collateral will feed into the granular LCR calculation and, if the LMM is to be used in the calculation of granular LCR, the industry should be given sufficient time (ideally 12 months) between the introduction of the LMM and the application of the granular LCR requirement.

The early release of the LMM would allow for review and testing of this tool during the transitional period as well as establishing the right governance and controls, and, which should reduce the concerns around retiring the FSA047 and FSA048.

Third consultation on Pillar 2 Liquidity

The PRA has not published its third CP on the Pillar 2 framework and this could impact PRA110 reporting (Section 2.11). We would be keen to know when this third CP on Pillar 2 liquidity implementation is expected. There is also a question as to whether firms will be able to offset Pillar 2 risks with assets pre-positioned at the Bank of England and the impact of the removal of the glide path as mentioned on the Bank of England website in October.

Workshops on liquidity reporting

We suggest that the PRA engages with our members on the detailed concerns that transitioning to the PRA110 may pose through workshops, which UK Finance and ALMA would be pleased to facilitate.

Nicholas Edge
✉ nicholas.edge@ukfinance.org.uk
☎ 020 3934 1023

Colin Johnson
✉ info@ukalma.org.uk
☎ 07507 910619