UK FINANCE

A response to the

# FPC's consultation on amendments to its framework for the O-SII buffer

February 2022

## Introduction

UK Finance is the collective voice for the banking and finance industry. Representing more than 300 firms, we act to enhance competitiveness, support customers, and facilitate innovation.

We are pleased to respond to The Financial Policy Committee's (FPC) Consultation Paper (CP) reviewing its approach to the other systemically important institutions (O-SII) buffer.

The proposals chiefly impact our larger UK member banks but all of our members have had the opportunity to contribute to the formation of this response.

## Key messages

*Support for review and its key proposals*

We support the FPC's earlier than required review of the O-SII framework as we agree is important to examine the impacts of the Covid shock on how the framework has operated during this period of stress. So we support the FPC's proposals to replace the total assets metric with the Leverage Exposure Measure (LEM), thus excluding central bank reserves, but including undrawn credit facilities, to determine O-SII buffer rates.

We also welcome the FPC's confirmation that it will not re-assess individual firms' O-SII buffers using this new metric until 2023, with a view to them taking effect in January 2025, and that in the meantime these buffers will remain fixed at 2019 levels.

Like the FPC we currently see the O-SII buffer as a structural, not cyclical, buffer but note the debate about the useability of buffers and will monitor developments in this area.

We believe the methodology chosen for calculation of the O-SII buffer should be transparent and easily communicated, which we believe the FPC's approach to be.

*Exclusion of Central Bank Reserves from the Leverage Exposure Measure*

We welcome the FPC's proposal to change the metric used to determine other systemically important institutions (O-SII) buffer rates from total assets to the UK LEM. This will helpfully avoid central bank reserve increases interacting with the O-SII buffer and possibly disrupting credit supply as a result. We however note that the exclusion of central bank reserves from the LEM as outlined in PS21/21 is not permanent, and the FPC's direction to the PRA on this exclusion is subject to an annual review. We are therefore concerned that there could be unintended consequences if the FPC decides at a future point to reverse the exclusion for the LEM, increasing bank LEM values and potentially resulting in higher O-SII buffer levels being assigned to some firms.

We therefore suggest that for the O-SII buffer a '*UK Leverage exposure measure excluding central bank claims*' is applied so that the intended comparison against the recalibrated thresholds for the purposes of O-SII buffer determination is performed, avoiding any unwarranted impacts due to central bank claim levels.

*Gilt carve out for O-SII buffer*

We welcome the exclusion of the central bank reserves from the threshold. The Bank of England will remember that on a number of occasions UK Finance and its predecessor associations have argued for the exclusion of gilt holdings from prudential regulatory metrics without success, despite their very low risk profile.

Our member banks' holding of gilts is important to the UK economy, and that importance will increase now that the Bank of England is starting to reduce its own gilt holdings through passive quantitative tightening. Setting a measure that will likely incentivise banks to reduce their direct and indirect holdings of Gilts will therefore be counterproductive.

Holding liquid assets in the form of gilts, instead of reserves, at the Bank of England does not mean that a firm is of greater systemic importance or has greater capacity to disrupt the UK economy if it were to fail. So in our view the arguments for excluding central bank reserves from the measure apply equally to holdings of gilts.

So we propose that, for O-SII Buffer threshold calculation purposes only, holdings of gilts should be excluded from the calculation. This suggestion reflects our expectation that as time goes on the Bank of England will seek to dispose of the nominal £875 billion of gilts it now owns as a result of the Asset Purchase Facility. Commercial banks may be disinclined to invest in them in size, recognising the capital penalty that may result. We see this as an emerging risk to the normalisation of monetary policy as the economy recovers.

*Indexation*

We recall that the FPC's May 2016 Framework for the systemic risk buffer, now known as the O-SII buffer following the introduction of CRD V, raised the possibility of adjusting the £175 billion nominal threshold, which could be re-set perhaps in line with nominal GDP or inflation.

We urge the FPC to consider indexing the nominal thresholds corresponding to different SRB rates to avoid downward creep in what is considered to be a systemically important firm. This is particularly relevant in an (albeit transitory) higher inflation environment.

*A graduated approach*

We note that The Capital Requirements (Capital Buffers and Macro-prudential Measures) Regulations 2014 establishes six different rates ranging from 0 to 3%. Our members however do note that this approach does lead to cliff edge effects which may result in their constraining balance sheet growth.

Whilst we recognise the merits of a simple and transparent approach that is aligned with that of other jurisdictions, (including the framework used for the setting of the G-SIB buffer), but as currently structured the step-function mapping may choke lending. The UK's recovery from the Covid shock will rely on banks increasing their supply of credit to households and businesses, now the range of Covid emergency support schemes has been removed.

We suggest that the average of a firm's quarter-end LEM be used, rather than its 31 December year end figure. This average exposure better represents a firm's systemic importance through time and is less subject to unexpected volatility at year end. If such a measure is not adopted, we would suggest that the FPC framework and PRA implementation permit some flexibility when setting O-SII buffers in the instances where a bank's UK LEM only slightly exceeds one of the defined threshold levels at the assessment date, but its UK LEM has been below the threshold in preceding periods.

Of course UK Finance and our members would be delighted to discuss the contents of this brief response to the FPC's consultation if appropriate.

*Responsible Executive*

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