UK FINANCE

A response to the PRA 's Consultation Paper CP5/21 on its

Implementation of Basel standards

April 2021

Introduction

We are pleased to respond to the PRA's CP5/21.

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

Our members, range from globally systemically important banks, both UK and international, mid-tier banks and building societies as well as newer banks, all of which will be impacted by the proposals in this CP. This UK Finance response has been informed by extensive discussions with all our members, both banks and building societies, large and small.

Key messages

Our members support harmonisation with international standards

We are supportive of the CRR2 regime to implement Basel 3 standards in the UK. We also welcome the decision taken by the UK authorities to defer the implementation of UK CRR2 by six months to 1 January 2022, given the opportunity this affords all stakeholders to provide feedback on the proposals.

Like the PRA our members believe it is important that Basel III is implemented in a way that is internationally consistent. The establishment of and adherence to international standards is key to ensuring a global level playing field and promoting the UK's competitiveness by avoiding gold-plating and the fragmentation of capital across different jurisdictions.

In addition, as previously set out in the UK Finance response to the HMT consultation on the implementation of the Investment Firms Prudential Regime and Basel 3 standards, we support the introduction of new activities-based principles to be taken into account in UK prudential rulemaking.[1]

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[1] Section 144C of the Financial Services Bill proposes: "When making CRR rules, the PRA must, among other things, have regard to "(a) relevant standards recommended by the Basel Committee on Banking Supervision from time to time, (b) the likely effect of the rules on the relative standing of the United Kingdom as a place for internationally active credit institutions and investment firms to be based or

We believe proposed approach under the UK Financial Services Bill will enable UK authorities to strike the right balance between prudent rulemaking, international regulatory alignment and also ensuring the continued attractiveness of the UK as a financial centre to domestic and international financial services firms. It is principally through the lens of the proposed principles we provide member firms' views on the PRA's CRR2 proposals below.

In our view, however, the PRA's proposals lean towards the most prudently conservative approach of either the CRR2 or Basel 3.1. For example, the PRA proposes applying the Basel 3.1 approach to CCF, a more conservative approach than CRR2. Similarly, it does not plan to implement the CRR2 quick fix approach to, the inclusion of some software assets in regulatory capital, or the CRR2 treatment, of client clearing activities for NSFR purposes, also permitted in the Basel framework. We would also encourage the UK to address the concerns raised, where applicable, at the Basel Committee to ensure the UK and Basel approaches remain aligned and minimise jurisdictional divergences in addressing these issues.

Instead the PRA should be confident that its judgement-based approach to supervision, amongst the most sophisticated in the world, can substitute for the automatically most conservative capital approach. In targeted areas, our view is also that adaptions to global standards are warranted, to improve the level playing field where other jurisdictions have made adjustments, to protect UK competitiveness, and to generally deliver risk sensitive improvements. The removal of the Alpha factor to groups of counterparties in SA-CCR stands out as a much-needed adaptation in this regard.

Software - the CRR2 quick fix

Our members continue to make significant investment in software to support customers, competition and operational resilience. They are disappointed that the PRA is ignoring its international competitiveness of the UK and Innovation in the financial services sector objectives and focussing narrowly on an overly conservative prudential soundness objective by concentrating only on the realisable or recoverable values of software in liquidation.

The strong view of member firms is that the PRA should consider alternative approaches to the full deduction approach for intangible software assets . We have proposed possible alternatives that we would be happy to discuss with the PRA in due course.

The Standardised Approach to Counterparty Credit Risk

The UK has held a leading position as an international hub for derivatives activity over a number of years. Around 43% of all OTC foreign exchange derivatives and 50% of all OTC interest rate

to carry on activities and (c) the likely effect of the rules on the ability of CRR firms to continue to provide finance to businesses and consumers in the United Kingdom on a sustainable basis in the medium and long term…".

derivatives (as measured by the average daily turnover) were transacted in the UK, as per the latest 2019 BIS triennial survey[2].

Given the significant size of the UK's derivatives market and its predominantly cross-border nature it is important that the impact from SA-CCR in the UK is fully understood and taken into account in the design of the final policies.

We strongly urge the PRA to set the alpha factor to 1.0 for certain groups of counterparties. Without this, capital requirements for derivatives activity is likely to increase significantly and the secondary effects of that, such as increase in cost of hedging for derivatives users and implications for the UK's, competitiveness should be considered.

We also suggest that the PRA pauses or delays the implementation of SA-CCR in other parts of the framework for example by maintaining the use of IMM in Large Exposure framework.

The implementation of SA-CCR in the UK is also an opportunity to take account of technical clarifications endorsed by the Basel Committee. These clarifications were issued after the finalisation of the EU CRR2 rules in May 2019 and were subsequently onshored by the UK. For instance we encourage the PRA to adopt, inter alia, the revised BCBS treatment of multiple margin agreements and its approach to multiple netting sets and liquidation period in the calculation of applicable haircut for un-margined transactions.

Collateral substitution in the Large Exposures regime

The Basel large exposure rules are relatively clear that the substitution approach applies in all situations where collateral is received. But in the PRA's proposed rules there is a lack of clarity as to how the substitution approach should be applied for different transaction types, especially with regard to funded credit risk mitigation, securities financing transactions and collateralised derivatives. They could be interpreted as to mean that substitution is only required where there has been a risk-weight substitution using the Financial Collateral Simple Method. This key differential is likely to lead to an inconsistent implementation by firms.

We suggest that a separate consultation would enable the PRA and industry to work together to clarify how the substitution approach should be applied and to identify where it could negatively impact risk management practices, for example the use of government bond collateral. This would support the smooth functioning of repo and securities borrowing/lending activities, which are important to the global standing of the UK's wholesale markets and avoid a potentially significantly and harmful reduction in their liquidity.

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[2] BIS Triennial Central Bank Survey, 16 September 2019, Tables showing global foreign exchange market turnover and interest rate derivatives market turnover, available at: https://www.bis.org/statistics/rpfx19_fx_annex.pdf (Table 19 on page 66) and https://www.bis.org/statistics/rpfx19_ir_annex.pdf (Table 9.1 on page 19)

Funding and liquidity

We would like to draw the PRA’s attention to a number of areas of concern:

- Level playing field implications of the conservative approach being taken on interdependent outflows when compared to equivalent European rules. This additional burden is exacerbated by existing Brexit headwinds and results in UK banks being at a competitive disadvantage to their EU peers. The removal of the presumption of interdependence for client clearing transactions being an area of particular concern.
- Proposal to diverge from Basel rules by applying unnecessary additional prudence without properly assessing the impact on the UK banking industry.
- Insufficient regard being given to cost of implementation vs prudential benefit. For example the imposition of funding requirements on a subsidiary at an individual level as a pre-requisite to waiving individual liquidity requirements under a Domestic Liquidity Subgroup Waiver
- The inappropriateness of cross-referencing prudential measures from the LCR into the NSFR leading to unintended consequences on the latter. For example the reliance on a 30-day price decline test to calibrate required stable funding (RSF) factors for equities.
- On the broader theme of liquidity and funding management, we strongly encourage the PRA to allow more flexibility in the conditions for creating Domestic Liquidity Sub-groups (DolSub), in particular for groups choosing to operate in the UK with a holding companies structure.

Reporting and disclosure

We welcome the PRA’s approach to updating reporting requirements and in particular its efforts to align reporting and disclosure. In this respect our members note that the year-end deadlines for submitting COREP, FINREP and other regulatory returns present a particular practical challenge. which is exacerbated by the routine need to resubmit said returns following the auditing of profits and the conclusion of dividend discussions. We request that the PRA extend the timeline for COREP and FINREP submissions at year ends to two months to streamline firms’ reporting and disclosure processes and to reduce the need for repeat submissions.

We also propose that the PRA revisits quarterly disclosure requirements and considers limiting these to consolidated and ring-fenced entities only. Members consider there to be little benefit to the market from publishing a small number of Pillar 3 disclosures where there is no corresponding financial information published.

Proportionality matters

We are supportive of a proportionate application of CRR2 which takes into account firms’ size, business model and risk appetite. So we welcome for instance the proposal which will allow firms to choose not to apply the current accounting categories for the profit and loss account, in the calculation of operational risk and the simplified SA-CCR approach.

We are looking forward to engaging with the PRA about opportunities for introducing a more proportionate approach to bank regulation and supervision, raised in its recent Discussion Paper.

Chapter 5 - Definition of Capital

Introduction

Software is essential for banks and building societies, supporting core operations, cyber security, regulatory and supervisory reporting. Its importance has continued to grow following the greater digitisation of UK firms operations, accelerated by the Covid pandemic and UK firms continue to make significant investment in software to support competition and enhance operational resilience for the benefit of customers. The capital treatment of software is therefore significant for UK firms' regulatory capital. We are disappointed that the PRA proposes to de-recognise the accounting value of software assets from regulatory capital, reversing the effect of the CRR2 quick fix.

Furthermore, we believe that the proposal to fully reverse the current treatment of software assets would be inconsistent with the UK government's economic policy in relation to international competitiveness of the UK and innovation in the financial services sector.
We believe that in establishing the capital treatment in the UK for software assets it is necessary to consider a broad range of issues, and not solely focus narrowly on the realisable or recoverable values in liquidation or a stress.

A broader approach was followed by the EBA in their work on developing the Draft Regulatory Technical Standards on the prudential treatment of Software Assets under Article 36 of the CRR. The EBA considered a range of aspects in their review of treatment, including valuation and amortisation of software assets, international differences in the regulatory treatment of investments in software, and the differences and impact of the different treatment applied by non-banking entities. The EBA proposals on the capital treatment of software assets - which are currently in force in the EU (and UK) - aimed to achieve an appropriate balance between conservatism / prudence and the recognition of the significance of software assets from a business and economic perspective in an increasingly digital environment.

We believe the PRA's concerns are at least partly mitigated by the resolution regime now in place in the UK which means that software in many firms can be considered to have value as it is essential to support continued operations under bail-in and sale scenarios. In addition, value from a sale of software would also likely be achieved for firms, particularly challenger firms, with business models dependent on technology platforms, although this has not yet been tested in practice.

We note the PRA's concern about the loss absorbency of the capital equal to the value of software assets. However these values represent assets, the valuation of which are subject to external audit, like those of any other assets on the balance sheet. Framing the question on how much loss certain assets absorb tests the answer to the wrong question. We would like to re-focus the question on the value and useful life of the assets, and the impact of such assets being used and amortised over time. This response explores this in stress, bail-in, wind down and resolution perspective.

The strong view of members is that the PRA should consider alternative approaches to the full deduction approach for intangible software assets. We believe that the current approach should

continue as it is the appropriate treatment for UK firms' software assets. However, if the PRA remains unconvinced that the current capital treatment is appropriate, we suggest that an adjustment is made to the risk weighting applied to software assets that are not deducted under this approach. Alternatively Pillar 2 approaches could be followed. We have outlined proposals on these capitalisation approaches below.

We outline below points relating to the impact of the PRA's proposals on international competitiveness and innovation, and considerations for the valuation of software assets.

Basel III, International level playing field & UK 'Attractiveness'

Although the Basel III standard requires the deduction of Intangible Assets, the capital treatment of software assets internationally depends on jurisdiction's accounting approach and whether software assets are classified as intangible assets. Hence there is no uniform capital treatment internationally for software Assets. In particular, in the US and Switzerland software assets are generally risk weighted rather than deducted. We recommend that the PRA take a leading role at Basel in tacking these inconsistencies rather than that diverging from major jurisdictions unilaterally and adversely impacting UK financial sector.

The Chancellor's letter Remit and recommendations for the Financial Policy Committee sent to the Governor of the Bank of England (March 2021) outlined that ultimately PRA rules and policies should support the government's overall strategy for financial services. Key aspects of the economic policy are International Competitiveness of the UK and Innovation in the financial services sector. As the EU is applying a more measured and hence less punitive approach to software assets than that proposed by the PRA for capital, and other key jurisdictions such as US and Switzerland also do not fully deduct software assets, if the UK adopts the full deduction approach it will be significantly out of line with key international jurisdictions. This will put UK firms at a competitive disadvantage, both those UK firms operating internationally and for UK domestic-focussed firms who have to meet higher capital minimum requirements vs. banks competing for UK business, and be inconsistent with UK government policy.

The PRA should consider retaining a form of limited divergence from the Basel standard (as the EU is doing) measured on capital outcomes for software assets to assist competitiveness of the UK banking sector internationally and align with other jurisdictions. This would be consistent with the recommendations outlined in the Chancellor's letter of March 2021.

Innovation, UK Investment and Non-Banks

UK banks and building societies make significant investments in software, and these can drive innovation (as well as support core operations) in the sector, which HMT is keen to encourage and is outlined in the Chancellor's March 2021 letter.

The PRA's proposed treatment as noted above will acts as a disincentive to UK banks and building societies making investments in software given the importance to the sector of optimising capital. The full CET1 deduction effectively forces banks to treat software expenditure as a cost rather than as an investment, as reflected in their accounts.

This disincentive would inappropriately conflict with the current UK fiscal measures put in place to encourage investment. There are currently research and development tax reliefs available for qualifying software investment and the 'super deduction' included in the Finance Bill 2021 adds to those by including a 130% first year allowance. This relief applies equally to software costs accounted for as intangible fixed assets as it does to physical assets.

Non-regulated entities outside of the banking / building sector, such as Fintech companies, do not have a similar barrier to investment in software through capital deductions and therefore will have an even greater competitive advantage in the development of Software if the PRA approach is adopted.

The proposed treatment will also penalise UK firms making acquisitions of Fintech companies to scale innovation and enhance service delivery. As a consequence, UK firms would be relatively disadvantaged from a pricing and valuation perspective compared with banks based in the US and EU potentially bidding for the same Fintech companies.

The cost benefit analysis shown in CP5/21 notes an uplift in CET1 capital being estimated at 30bps and 39bps for large and small firms respectively. Absent from this analysis is the impact of curtailment in lending to the real economy. It is plausible therefore the quantum of capital uplift for the 5 largest UK firms being equal to an estimated £3bn and that this could translate to £15bn to £25bn in restrictions in lending to, for example, SMEs and business who will be part of the private sector recovery in the twin headwinds of Brexit and the pandemic. Similarly for some challenger banks, being new entrant to the market and having no notable 'back book', they can be instrumental to the recovery yet at the same time, may disproportionately impacted by having to invest in new technologies, software forming a relatively higher proportion of their asset base. So it is disappointing that in the proposal this has not been a key consideration and that one objective of the PRA has so disproportionately overshadowed another equally important objective.

This policy is another area, in additional to MREL, where the PRA is taking a more risk adverse approach than the EU placing UK firms at a competitive disadvantage. This regime will impact significantly on challenger banks whose valuations are mainly based on the user experience they are providing based on the quality and recency of their software. There are many firms looking to enter into financial services or other incumbent firms, that may want to enhance their digital offerings that are likely to buy software from these challenger banks in the event of resolution, increasing income in a resolution scenario and reducing losses to depositors and other creditors.

Valuation of software

We understand that the PRA does not have a multitude of evidence supporting the valuation of software assets from failing or failed firms, in the form of value being associated separately for their software assets. We note that this forms the basis of concern driving the proposal in the CP.

Value in liquidation, without additional MREL, there are some firms, principally challenger banks, whose business models are dependent on technology platforms which are seen as a source of competitive advantage. We would expect that such firms' software would consequently have value (to other firms or acquiring entities) in the event of liquidation or stress, although there have to date been no examples which would illustrate this.

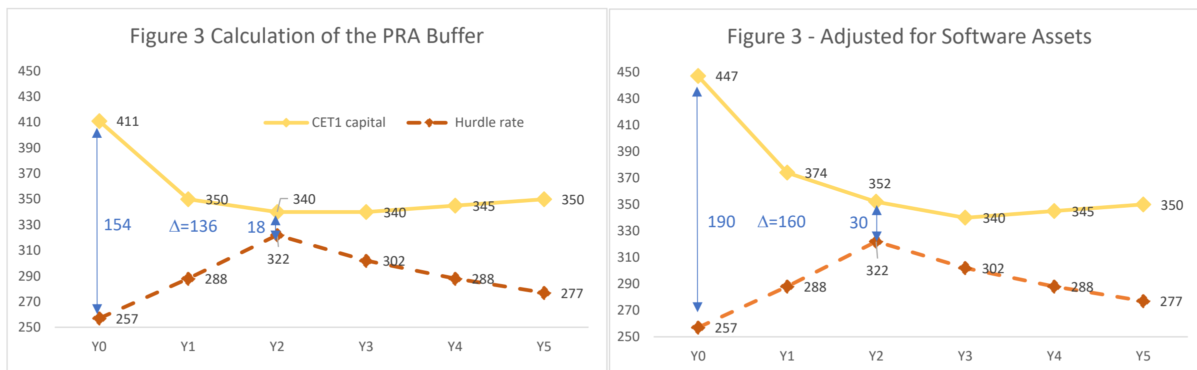
Value in bail-in: Furthermore, in the UK a resolution regime has been established whereby UK firms (particularly large firms) will not be taken through (modified) insolvency at the point of non-viability. The resolution approach to these firms is to ensure that they continue as an operating concern with recapitalisation, either through bail in of through a sale to another firm. In these scenarios, software becomes integral to the firm in resolution and essential to facilitate the resolution process – it can therefore be regarded as having value as part of the whole firm over time. From this vantage point, it seems wrong to disregard the value of the asset to the firm for Capital purposes through deduction. Such firms already bear the cost of providing for continuity through meeting their MREL requirement. Consequently, there is no basis to be seeking a 'market' for the software. An appropriate valuation would be based on the firms investments in the software (as is the case in accounting). Software assets reduce in value over time, due to obsolescence and in the case of a firm subject to acquisition (both in a point of non-viability scenario or less extreme scenario) there is generally a process whereby an acquired firm's software is decommissioned and replaced with software from the acquiring firm. This concept is recognised in the accounting framework, and would also be appropriate in the capital framework, as curtailed by the EBA's regulatory technical standards (RTS). We note that software in acquired entities in many cases is likely to continue in use for a significant (multi-year) period of time.

As such, the value of software assets in UK firms where integral to its business proposition or through its ability to support resolution should be recognised by the capital framework in the UK , noting that the accounting value is already prudently reduced by the overlay of the EBA RTS.

Pillar 2

By design, the Pillar 2b framework captures any software assets in two aspects:

For firms with PRA buffer based on the reduction in surplus capital resources in stress, the amortisation of such assets feeds into the capital profile, thus generating CET1 capital requirements, as illustrated in the stylised example modifying that in the PRA's methodology paper:



The chart shows that of an additional assumed £36m of software assets (£190m-£154m) increasing CET1 in the right hand chart, the excess over the hurdle rate falls by an additional £24m (£160m-£136m), increasing the stress-based requirements. Ignoring any CCyB, CCoB and other factors, this is to highlight potential in-built controls to limit the impact of the CRR Quick Fix benefit.

For firms where the PRA buffer is set using the Wind Down Cost (WDC): firms' Solvent Wind Down (SWD) plan should consider the costs of wind down and the value of all assets to be liquidated, including its software assets using prudent valuation. Should this cost based valuation exceed the PRA buffer, set using the methodology in SS3/21 (paragraphs 4.7-4.9), the firm's internal risk measures are expected to consider such higher value. (see 4.11 of the SS).

Proposals

We do support the pragmatic and considered approach taken the EBA and EU in revising the capital treatment of software assets. We however recognise that the PRA remains concerned with the potential impact on safety and soundness of firms of this approach but feel that the reversion to full deduction of Software Intangible Assets would be excessively prudent and inconsistent with the government's economic policy considerations.

Potential suitable approaches would be:

Treatment within Pillar 2

Our members do not favour a Pillar 2 approach that adds back the value of software deducted, where a firm can demonstrate its value in resolution, by providing a Pillar 2a offset. If the PRA is minded to adopt a Pillar 2 approach, which we would not support (in part because of transparency issues and the difficulty of demonstrating value in resolution without actually going through resolution!) it could adopt the EU approach and provide a Pillar 2a add-on for firms that are unable to satisfy them that their software could have value in resolution. Any such add-on should either be linked to software assets rather than total RWA or be fixed in nature. Such P2A should consider any offset from P2b such that Pillar 2 charges do not exceed the Pillar 1 benefit.

Revised Risk Weighting of software assets

An alternative proposal would be to adopt the current EU approach to identify non-deducted software assets. But, to address concerns about the valuation of software assets, the risk weighting of the non-deducted assets would be increased to 250% from the current 100%.

The selection of 250% is consistent with the risk weighting that is applied to other assets in the Basel Framework that are generally fully deducted under the Basel framework but are subject to a threshold exemption level – under this level the assets are risk weighted at 250%. In UK CRR this is applied to Significant Investments in Financial Sector entities and Deferred Tax Assets dependent on future profitability and arise from temporary differences.

We would also propose for consistency with the Basel and CRR treatments that the maximum amount of Software Assets that are non-deducted is capped at 10% of CET1 capital.

This treatment has the advantage of simplicity in implementation and consistency with the general framework applied in the Basel standards and CRR.

Summary

Software is essential to the banking sector especially in a post pandemic and post Brexit environment. The proposed capital treatment will have a significant impact on innovation, investment for banks' own as well as their customers' benefit and to enhance operation resilience. We therefore urge the PRA to consider a proportionate capital treatment of software in light of its policy objective of international competitiveness of the UK and innovation in the financial sector as well as prudential soundness. Key considerations are:

1. **Basel III level playing field and jurisdictional inconsistencies**
2. **Innovation, UK investment (including lack of benefit from 130% first year allowance from 2021 Budget) and disparity and competitive disadvantage compared with non-banks**
3. **Value in software assets – in liquidation; in bail-in; in solvent wind-down; and in business as usual**
4. **Alternative proposals of options under Pillar 2 and 250% risk weighting**

Chapter 6 - Market Risk

We have no substantive comments on Chapter 6 and agree that the proposed approach will improve the proportionality of the derogation from market risk requirements for firms with limited trading activity.
We support the daily evaluation requirement for trading book treatment.

We however cross refer to UK Finance's response to HMT's recent consultation on *the Implementation of the Investment Firms Prudential Regime and Basel 3 standards*. In particular we:

- encouraged the UK authorities to consider whether there is significant utility in having an earlier reporting requirement for the Standardised Approach (SA), rather than focus on reporting implementation to be aligned with the binding capital requirement of FRTB.
- requested that firms be given sufficient time to make any required implementation changes. Therefore, the regulations should be finalised at least 6 months before the first reporting date. Based on the PRA's proposal in CP5/21 to re-use the EU template, which we support, we ask that they should be available by September 2021 to enable the first reporting date as of March 2022.

Chapter 7 - Collective Investment Undertakings

As noted in our response to HM Treasury's consultation, we believe strongly that the PRA should implement the capital requirements for funds on the basis set out in the Basel standards. So we have urged HM Treasury to remove the need for equivalence assessment in this area.

Nevertheless, if the need for equivalence assessment is retained, we would urge HM Treasury and PRA to expedite equivalence assessments so as to reduce any unintended cliff edge effects where banks try to alleviate significantly higher RWAs by offloading investments. Notable jurisdictions where equivalence assessments should be prioritised as a matter of urgency, are US, Canada, Mexico, China Hong Kong, Malaysia, Singapore, Switzerland and Australia.

We believe that such equivalence determinations could be expedited, by the PRA considering a smaller number of key factors relevant to funds specifically including:

- The general compliance of jurisdictions with the standards recommended by the Basel Committee, as evidenced by periodic independent assessments;
- The scale of investments by UK-domiciled banks in these jurisdictions and the resulting individual and collective risk to the UK financial system (which we believe, in many cases, will be de minimis to the capital base) – to be monitored on a periodic basis.
- The extent to which funds located within the jurisdiction are subject to conduct regulations locally

A possible alternative approach to equivalence assessments would be for the PRA to allow banks to make proposals for a ‘case-by-case’ equivalence assessment using external consultants. The bank would incur the cost of doing the assessment. This an approach that has been previously used with the PRA for other exposures.

There should be a specific treatment for investments which are made either (a) to satisfy Government investment requirements (such as investments under the Community Reinvestment Act in the US) or (b) support Government endorsed investment programmes (such as the Business Growth Funds in the UK, Canada and Australia). It is possible that these investments may not qualify as legislative programmes within the meaning of the Basel standards and so would not benefit from a lower risk-weight, but if they are specifically intended to support government objectives, for example, in providing longer term investments for smaller businesses, we do not believe they should not be penalised by an additional UK equivalence test.

In the aftermath of the Covid-19 crisis, there is particular demand in various jurisdictions to develop Business Growth Funds to support SMEs with equity products. Similarly, we are also now seeing funds being promoted by governments to fund green finance initiatives, with banks being asked to co-invest. In both cases, the ability to invest would be affected by the proposals.

In relation to the proposed PRA rules for exposures to CIUs, we note that it proposes adjustments for derivatives even where under the mandate-based approach (MBA) approach. Many fund mandates do not specify what percentage of their exposures could be in derivatives, preventing application of the provisions and related CVA calculations. This would mean for some banks use of the Fallback approach (FBA or the majority of their portfolios. We consider that this should be revisited at the Basel level. Additionally, clarification is also sought on whether this is intended to apply to CIU exposures used as collateral as well as direct exposures.

In terms of using the look-through approach (LTA) and MBA, we also wish to clarity on the frequency of information disclosed by the fund. Specifically, we would ask that this is no more frequent than on a quarterly basis. Specifically, funds are likely to disclose or report information on a semi-annual or quarterly basis at most, whereas most banks under PRA reporting requirements, provide regulatory information on a monthly basis.

We would also note, that in Rule 7 in section 5 of the new large exposures CRR part of the rulebook provides conditions where the structure of a transaction shall not constitute an additional exposure (i.e. look through is not required). One of these conditions covers measures designed to prevent the redirection of cash flows away from the transaction to persons who are not entitled to receive them, and sets out that a UK UCITS’s and similar structures in an equivalent third country are automatically assumed to meet this condition. We assume that the equivalence provisions for CIU’s in Art 132 are relevant but would request that the PRA to make the minor amendments to their wording (page 131, PRA Rulebook (CRR) Instrument 2021) to make clarify which equivalence decisions are relevant.

It would also be helpful to understand whether the PRA concurs with the recent EBA view (EBA/RTS/2021/04 see page 59) which sets out that in principle CIUs are not financial institutions and therefore not subject to prudential consolidation. In respect of significant holdings in CIUs, the

interaction between the look-through rules and the consolidation rules is unclear, and if CIUs are subject to consolidation then potentially small changes in the size of a shareholding can produce a significant change in RWAs.

Summary

1. **The UK authorities should implement the capital requirements for CIUs on the basis set out in the Basel standards, removing the need for an equivalence assessment.**

2. **Should the UK authorities not agree with our suggestion that there should not be an equivalence assessment we urge them to accelerate equivalence assessments to avoid banks' sell-down of CIU positions to ahead of sudden and material RWA increases.**

3. **Equivalence assessments could be undertaken by the authorities, based on a small number of key factors or by firms themselves.**

4. **Legislative programmes supporting government initiatives should benefit from the lower Basel risk weight and not be subject to further equivalence tests.**

5. **Disclosure by funds is usually no more frequent that quarterly. This should be recognised as the PRA sets firms' reporting requirements.**

Chapter 8 Counterparty credit risk

Industry appreciates and supports international and UK efforts to improve the regulatory capital treatment of derivatives. These efforts have made SA-CCR one of the most significant capital drivers for derivatives activity.

As the PRA considers implementation of Basel 3[3], Industry also supports the PRA's commitment to international standards and favours continued alignment with the Basel prudential framework as a starting position.

Nevertheless, we believe that the increase in capital requirements expected as a result of the implementation of SA-CCR warrants further attention by UK authorities, in particular given its potential impact on commercial end-users (CEUs) [4]. Industry views an adjustment in the application of the Alpha factor as a necessary adaptation, to prevent negative implications to end users and to avoid damaging the UK's standing in the global derivatives markets. It is particularly crucial that the UK application of SA-CCR takes account of adaptations made to the treatment of derivatives in other regions to protect the UK eco-system.

Given the UK's leading position in the OTC derivatives market, its considerable size and predominantly cross-border nature, it is important that the impact from SA-CCR in the UK is fully understood, acknowledged and factored into the final rule making.

We encourage the PRA to consider a range of design improvements to the SA-CCR methodology in a way that would enhance its risk sensitivity and strengthen the capital framework. In this context, as already envisaged in the UK Financial Services Bill[5], it is essential that the UK application of SA-CCR protects the UK financial ecosystem and its relative standing as a global financial centre, including for derivatives markets, and in doing so takes account of adaptations made in other regions and at the Basel level. We outline improvements which we recommend the PRA makes immediately and therefore would not impact PRA implementation timelines, as well as those improvements that we believe should be reviewed at the Basel level before UK implementation.

Finally, we urge PRA to consider the implications of the introduction of SA-CCR in a more holistic way given its mandatory use across many parts of the prudential capital requirements, including for

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[3] 'Basel 3' refers to the prudential capital standards for banks finalised by the Basel Committee on Banking Supervision (BCBS) in December 2017 with subsequent updates and revisions.

[4] The term CEU in this response is used to refer to any market participant other than a bank, an investment firm or a hedge fund. As noted in Section 2.1, we recommend that the PRA reconsiders the impact of Alpha for different groups of counterparties, including but not limited to corporates and pension funds

[5] Section 144C of the UK Financial Services Bill, expected to be finalised in the nearest future, sets out the considerations which the PRA should "have regard to" as part of their prudential rule-making process: "When making CRR rules, the PRA must, among other things, have regard to … (b) the likely effect of the rules on the relative standing of the United Kingdom as a place for internationally active credit institutions and investment firms to be based or to carry on activities …". The Bill is available at: https://publications.parliament.uk/pa/bills/lbill/58-01/162/5801162.pdf

counterparty credit risk, large exposures, leverage in the near term from January 2022 and for the output floor from January 2023.

To illustrate and support these views, this response provides a number of recommendations described in more detail in the sections that follow:

1. **Realignment with Basel:** this section includes specific items where Industry recommends realignment with the Basel framework (including the latest BCBS FAQ responses) as the starting position for UK implementation;
2. **Adjustment in the application of the Alpha factor**: this section sets out why Industry is urging the PRA to set the Alpha factor to 1 for all derivatives transactions with CEUs, as a simple and effective way to mitigate negative implications to UK banks and CEUs, and to bring the effect of UK implementation more in line with other regions;
3. **Other design improvements:** this section sets out targeted but important areas in the methodology where immediate adaptations by the PRA and in some cases longer term review at Basel level would be helpful and would strengthen the framework;
4. **Simplified SA-CCR (sSA-CCR) and Original Exposure Method (OEM):** this section provides our response and recommendation to the introduction of the new simplified approach.
5. **Implementation in other parts of the framework**: This final section considers the implications and uncertainties surrounding the introduction of SA-CCR in other parts of the framework.

1. Realignment with Basel

This section sets out items where Industry recommends a technical change or clarification to align the UK's implementation with the current treatment under the Basel framework.

The implementation of SA-CCR in the UK is an opportunity to take account of technical clarifications endorsed by the Basel Committee subsequent to the adoption of the EU CRR2 rules which included SA-CCR in May 2019 and later onshored by the UK. Those clarifications are reflected in the combined Basel Framework. To ensure consistency with the internationally applicable standard the Industry encourages the PRA to incorporate those clarifications where progress has been made at international level in the proposed UK SA-CCR rules, rather than replicating the EU CRR2 text.

We note that a mechanism for making technical amendments in the UK prudential regulations is already envisaged under the UK CRR (as onshored via Statutory Instruments (SIs) adopted in 2018, 2019 and 2020) Article 457 Technical adjustments and corrections. Moreover, the UK Financial Services Bill also introduces powers for Her Majesty's Treasury and the UK relevant regulators to make changes to the CRR rules when that is warranted having regard to "relevant standards

recommended by the Basel Committee on Banking Supervision…(Section 144C (a) and other parts of the Bill) [6].

Industry views these as natural changes to establish the starting position for UK rules.

In the Annex, Industry provides suggestions on changes to the corresponding SA-CCR articles of the PRA Rulebook that incorporate the latest BCBS guidance.

1.1 Treatment of multiple margin agreements within a netting set

The original publication of the SA-CCR rule took place in 2014 at the Basel level and was introduced in the EU as part of the second iteration of the Capital Requirements Regulation ("CRR2") as adopted in 2019 and subsequently onshored by the UK. Therefore the proposed SA-CCR rules as currently drafted in the PRA Rulebook do not reflect certain changes made by the Basel Committee[7] for the treatment of multiple margin agreements and multiple netting sets and its calibration is outdated.

The original Basel SA-CCR calculation methodology described in BCBS 279 required banks to divide a netting set (defined on the basis of a master netting agreement) into sub-netting sets where multiple margin agreements exist. We note that SA-CCR as a methodology for exposure calculation was developed before the uncleared margin requirements (UMR) for derivatives came into force. The latter led to banks having to put in place multiple Credit Support Annexes (CSAs) under the existing netting agreements. Hence, in practice, it has become common to have one netting agreement and multiple CSAs with one counterparty, and the requirement to split the netting set into separate sub netting sets each corresponding to a separate CSA does not reflect the economics of netting that would apply in the event of default of the counterparty.

In December 2019, the BCBS provided further clarifications with regard to the treatment of netting sets with multiple margin agreements through the FAQ to rule CRE52.74 that specified that grouping of derivative transactions in one netting set when calculating the exposure value is allowed subject to certain conditions. Given that this BCBS clarification is available to all jurisdictions that are currently adopting SA-CCR (via the consolidated Basel 3 Framework), Industry strongly recommend that the UK SA-CCR rules to be aligned with the Basel framework in this regard, as it strikes a better balance in the recognition of legal agreements and of the benefit of having multiple margin agreements.

Given that the implementation of SA-CCR by UK banks is at full speed, we believe that making this targeted technical amendment to the relevant articles in the PRA proposed rulebook (274(4), 275 (Replacement cost) and 278 (Potential Future Exposure)) to reflect the BCBS's FAQ is well

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[6] https://publications.parliament.uk/pa/bills/lbill/58-01/162/5801162.pdf

[7] In particular section CRE 52.74 of the consolidated Basel III framework on the treatment of multiple margin agreements and multiple netting sets

warranted and should not be delayed. Otherwise, the current text is likely to create an uneven playing field for the UK banks in comparison to other jurisdictions.

1.2 Mandatory liquidation period for un-margined netting sets

As currently drafted in the PRA rulebook, Article 276(3)(a) requires firms to apply a one-year liquidation period to all un-margined netting sets for the calculation of collateral haircut under SA-CCR, irrespective of the remaining maturity of transactions within the netting set. The EU treatment was in line with the general guidance provided in Basel CRE 52.5. However, according to further clarification provided by the BCBS in response to FAQ1 under CRE 52.10, the liquidation period in the calculation of applicable haircut for un-margined transactions shall be the maturity of the longest transaction in the netting set, capped at 250 days. This is particularly relevant for un-margined transactions maturing within one year.

Under current proposed PRA rules, the value of cash and securities collateral received for these transactions is reduced by a factor of 5 times (i.e., the one year liquidation period as per PRA rules always equals $\sqrt{250/10}$), which is more than would be required under the global standards for transactions maturing within one year. It also has an adverse to the impact on regulatory capital requirements from market developments in Settle-To-Market (STM), under which the variation margin is treated as cash settlement rather than collateralization and leads to a shorter, i.e., one day, trade maturity.

The proposed rules could not only unduly penalise short dated netting sets but also undermine the risk mitigation effect received from eligible collateral and therefore potentially demotivate the market participants to provide collateral for relevant netting sets.

Industry recommends that the UK implementation is aligned to the Basel treatment in relation to the determination of the liquidation period for un-margined netting sets.

1.3 Treatment of one-way margin agreements

Clarification is sought in the proposed PRA rules on the treatment of netting sets covered by 'one-way margin agreements', where the institution is required to post variation margin to a counterparty but is not entitled to receive variation margin from that counterparty.

While BCBS indicates in CRE52.2 those netting sets should be treated as un-margined for the purpose of SA-CCR and clarifies in a footnote of CRE52.10 that variation margin posted to the counterparty should be included as an exposure in the Replacement Cost, the PRA is currently silent on the treatment of those arrangements.

Industry recommends that the PRA rules clarify the treatment of one-way margin agreements in alignment with the Basel framework.

2. Adjustment in the application of the Alpha factor

Industry notes that the Alpha factor was introduced so that SA-CCR would not produce a lower exposure amount than a modelled CCR approach. However, according to consistent feedback from members, SA-CRR produces an exposure measure that is materially greater than exposures calculated under the Internal Model Method (IMM). In Industry's view this warrants a readjustment by the PRA.

The uplift in requirements could have significant negative implications to commercial end users (CEUs) and to UK banks, and risks damaging the UK standing as a global financial centre for derivatives markets activity.

We note that a combination of conservative assumptions are built into the SA-CCR design, such as limited diversification benefit across hedging sets, conservative add-ons calibrated into a stress period and the application of Alpha factor of 1.4 on top, to name a few. These have a significant negative impact on directional portfolios that banks generally have with CEUs, when these clients are looking to hedge typical financial risks (FX, interest rate) they incur as part of their ordinary business activities.

2.1. Preventing negative implications to CEUs

Increased capital requirements from SA-CCR are expected to constrain UK banks' capacity to support demand for derivative products at an acceptable cost and to limit CEUs' ability to hedge risks. The term CEU in this response is used to refer to any market participant other than a bank, an investment firm or a hedge fund. Under the proposed application of the Alpha factor, different groups of counterparties including but not limited to UK corporates and pension funds would be left with fewer affordable alternatives to hedge their structural commercial risks, which would further affect their financial strengths and competitiveness. Hence Industry recommends that the PRA considers the impact of applying the Alpha factor to these groups of counterparties.

In the context of Covid recovery, it is particularly critical that CEUs can continue to hedge normal course business risks, secure financing at reasonable rates and continue to act as agents of economic growth.

Industry therefore urges the PRA to consider as a priority a simple and effective approach to mitigating the impact on CEUs to apply an Alpha factor of 1 (one) in the calculation of exposures to CEUs.

This approach of removing the Alpha uplift could be implemented swiftly. In addition, it would be better aligned with the exemptions for non-financial counterparties under UK EMIR[8], supporting the objective of these exemptions.

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[8] UK EMIR for non-financial counterparties

2.2. Avoiding damage to the attractiveness of the UK

It is fitting to acknowledge that the UK has held a leading position as an international hub for derivatives activity over a number of years. Around 43% of all OTC foreign exchange derivatives and 50% of all OTC interest rate derivatives (as measured by the average daily turnover) were transacted in the UK, as per the latest 2019 BIS triennial survey[9]. In comparison, in the OTC derivatives space for these types of derivatives, the US occupies the second place with around 16% and 32% respectively[10].

Other jurisdictions have made adaptations to the Basel standards to adjust requirements to their local markets, counterparties, products and risks. In particular, the US have allowed for exemption from applying the Alpha factor to exposures with end users. The EU has also granted exemptions from CVA requirements for derivative transactions with a range of counterparties.

In this context, the Industry's view is that the application of Basel standards without adaptations in the UK could damage the UK's attractiveness for global derivatives market activity. Other regions could stand as increasingly more efficient trading locations in a post Brexit environment, where global banks have had to enhance their ability to trade based on client preferences and jurisdictional factors. The frictional costs to booking transactions in the EU especially have reduced.

In this regard, Industry notes section 144C of the forthcoming Financial Services Bill[11], which states that "When making CRR rules, the PRA must, among other things, have regard to … (b) the likely effect of the rules on the relative standing of the United Kingdom as a place for internationally active credit institutions and investment firms to be based or to carry on activities …", and urges the PRA to ensure a level playing field in the regulatory treatment of derivatives activity for the UK-based banks in comparison to other jurisdictions.

Given the significant size of the UK's derivatives market and its predominantly cross-border nature it is important that the impact from SA-CCR in the UK is fully understood and taken into account in the design of the final policies.

We also note that the impact from SA-CCR is not an isolated CCR RWAs impact; its effects will spill over into other areas of the prudential framework where SA-CCR will be relied upon for measuring counterparty exposure. Please refer to section 5 for a further discussion of this point.

[9] BIS Triennial Central Bank Survey, 16 September 2019, Tables showing global foreign exchange market turnover and interest rate derivatives market turnover, available at: https://www.bis.org/statistics/rpfx19_fx_annex.pdf (Table 19 on page 66) and https://www.bis.org/statistics/rpfx19_ir_annex.pdf (Table 9.1 on page 19)

[10] See footnote 8

[11] https://publications.parliament.uk/pa/bills/lbill/58-01/162/5801162.pdf

3. <u>Other design improvements</u>

This section highlights targeted but important areas in the proposed methodology where Industry believes that improvements would be helpful and would strengthen the capital framework.

Industry has considered these areas of improvement and has distinguished between items that can be addressed by PRA rules immediately, and implemented in the near term, and items that would require further engagement with Industry and coordination with other jurisdictions ahead of implementation.

Industry reiterates that across all items and recommendations, including where Industry views immediate PRA adaptations to the Basel framework as necessary, engagement with other jurisdictions to improve alignment and achieve the level playing field is strongly encouraged. However, Industry acknowledges that items set out in 3.2 would require review at Basel level before January 2023 as well as further Industry engagement ahead of UK implementation.

3.1. Immediate improvements

In Industry's view the items below should be addressed by PRA rules immediately. Industry's view is that these items could be implemented without impacting PRA timelines.

Allow Index decomposition

The PRA's proposal to depart from the prescriptive EU approach and increasing flexibility on the allocation of complex positions to more than one asset class (PRA CP paragraph 8.10) is considered by Industry to be a positive step. It is a good illustration of where the PRA can achieve the desired policy outcome by enabling firms to better reflect the risk associated with transactions and by obtaining sufficient assurance via implementation reviews.

Industry encourages the PRA to take a similar proportionate approach in allowing the decomposition of indices (equity, credit, commodity indices) to improve risk sensitivity by more accurately reflecting the exposure of highly correlated long and short positions. The hedging set amount for equity and credit derivative contracts requires a bank to differentiate between index and single name underliers for the purposes of different supervisory factors, option volatilities and correlation parameters. With respect to commodity indices, a bank would have to select a single supervisory factor to the index and treat it as a single commodity sub-class as opposed to a diversified index. As a result, banks are unable to decompose an index into its underlying components as they do in other areas of the prudential framework (e.g., FRTB). If index decomposition were permitted it would allow firms to more appropriately represent the risk, which the PRA can also obtain sufficient assurance on via implementation reviews in due course.

Improve the calculation of the Supervisory Delta for interest rate options via a transaction-level shift (λ)

As currently formulated in the PRA Rulebook, Article 279a (1) states that institutions should use the same lambda (λ) parameter across all interest rate options in the same currency and that lambda should be set as the lowest possible value across all interest rate options in the same currency within the portfolio of an institution.

This approach has two disadvantages. Firstly, it may lead to a misstatement of the sensitivities to rates. Changes in the value of the lambda parameter should be matched by a change of the volatility of the same currency. However, the SA-CCR supervisory rates volatility is constant for every currency and maturity. Also, shifts vary significantly across maturities of the underlying swap, with larger shifts applied to shorter maturities.

Secondly, the calibration of the lambda parameter based on an institution's portfolio will result in different estimates of the supervisory delta across institutions for the same trade.

We recommend setting the lambda parameter at trade level as the absolute value of the minimum between the forward price (P) and strike price (K), floored to a minimum threshold. This approach guarantees that the treatment for a given trade is consistent and comparable across institutions regardless of the composition of their portfolios.

Allow more flexibility in the calculation of Supervisory Delta for certain non-linear derivatives

The SA-CCR framework is welcome in that it provides a much more economic representation of non-linear derivatives by allowing, as part of the risk position calculation, the recognition of the supervisory delta to reflect the directionality and the sensitivity to the underlying risk factor. The calculation for this however is based on a simplified Black-Scholes formula for options and is not suitable for all types of derivatives. This has been partially addressed by allowing transactions such as collars, that are a finite linear combination of derivatives to be represented as positions in each of these individual options, however this decomposition does not provide a suitable economic representation for all non-linear derivatives, particularly those that display time-dependency (or path dependency) such as barrier options.

In such transactions, the ultimate pay-out is not only dependent upon a single price point but on the path taken between inception and expiration. For barrier options this is represented by a knock-in or knock-out condition (such as the underlying price reaching a certain threshold) which, if not met, in the case of a knock-in, or met, in the case of a knock-out, renders the option worthless, irrespective of the final position.

The danger of allowing these to be calculated as plain vanilla options, using only the spot price vs. a strike price in the calculation of the supervisory delta is a misstatement of the resulting delta, risk position and ultimately the add-on.

While barrier options have been used to illustrate the problem of time-dependency, this issue also applies to transactions with lookback features (e.g. a payoff based on a maximum or minimum price within a time period, cliquets, rachets and auto-callables) or range accruals (e.g. where the payoff is based on a number of observed points that fall within a defined range).

While it might be possible to replicate these time-dependent positions as a combination of options for which the Black-Scholes is able to calculate a supervisory delta, this would not be a straightforward linear combination, and different institutions may replicate these positions in different ways leading to different results across the industry.

It would therefore be preferable to allow institutions to use their own internal methodologies to determine Supervisory Delta for this specific set of non-linear derivatives transactions.

3.2. Longer term improvements

The items below are recommended for review at the Basel level before January 2023. Further coordination with other jurisdictions and further engagement with Industry would be necessary ahead of implementation in the UK.

The Industry would welcome further engagement with the UK regulators as well as at the international level in a continued effort to improve the risk-sensitiveness of SA-CCR whilst avoiding unintended consequences. The Industry acknowledges that this requires coordinated effort at the international level rather than only at a local UK level. Industry would be fully supportive to contribute to further discussions with the view of achieving a more strategic and coordinated approach at the international level. This, in turn, will contribute to a more consistent and coherent treatment for derivatives under the SA-CCR and help resolve some of the known implementation issues.

Improve the recognition of initial margin in the calculation of total exposure

The benefit that initial margin (IM) provides in reducing derivatives exposure is not sufficiently recognised in the SA-CCR calculation of exposures. SA-CCR does recognise IM through the PFE multiplier formula, but this formula results in a conservative recognition of IM. It leads to a disproportionate amount of IM needed to be posted to reduce the exposure, and without further modifications, leads to an overstatement of the exposure amounts and to unduly conservative capital requirements. In the context of increasing clearing and margining across the sector, the disproportionate impact of this conservatism in the methodology is only expected to grow. It is paramount that it is addressed. In practice, there are no impediments to IM amounts being able to cover losses in the event of a default that would justify the current approach.

To calculate the PFE component of the exposure value of a derivative in SA-CCR, banks are permitted to take into account collateral that the counterparty has posted to cover losses in the event of a default. This can be made up of IM, representing the minimum amount of collateral that needs to be posted to enter a trade, and the variation margin, which is intended to cover losses from movements in the market value of the trade.

SA-CCR does recognise IM through the PFE multiplier formula, but this formula results in a far more conservative recognition of IM, than the corresponding treatment under the Current Exposure Method (CEM). This means that a disproportionate amount of IM needs to be posted to reduce the exposure value in SA-CCR. The lack of adequate recognition of IM results in overstated exposures and therefore unduly conservative capital requirements. Given the expected future increase in IM requirements with the phase-in of more counterparties under the UMR for derivatives and the replacement of legacy trades with new trades, this impact is only expected to grow. The conservative calibration of the SA-CCR aggregated amount ("Add-on") should thus be adjusted significantly to improve recognition of IM in the PFE multiplier.

Recognise diversification benefit across hedging sets within an asset class

SA-CCR calculates the overall exposure of a portfolio of derivative on a net basis. This means that where there is a netting agreement in place, a group of transactions are viewed together, such that losses arising from one position are offset by gains in another, subject to certain limitations. One of these limitations is that the derivatives be within the same hedging set. A hedging set subdivides the transactions within an asset class into sub-groups of derivatives that share similar risk factors, e.g. interest rate derivatives are sub-divided by reference currency, and foreign exchange derivatives are sub-divided by currency pair.

SA-CCR does not reflect any diversification benefit across hedging sets within an asset class, i.e. the positive exposure value of one hedging set cannot be offset with a negative exposure value of another hedging set. This is overly conservative and risk insensitive, and significantly overstates the exposure value compared to internal modelled approaches, where some degree of diversification is assumed.

Net Cash Flows to Single Amount per Currency

In terms of FX transactions, SA-CCR calculates RWAs linked to distinct currency pairs (e.g. EUR/USD), which means that multiple exposure values could be calculated across multiple pairs separately. Nonetheless, if considered together, the exposure value would have been zero. For example, if, as part of a netting set there are different currency pairs of equal volume (e.g. EUR/USD, USD/GBP, GBP/EUR), the SA-CCR methodology would require banks to calculate the capital requirements for each and then add them together. This would be despite the fact that the net exposure by currency would be zero.

4. Simplified SA-CCR and OEM

Comments made above regarding the impact of the Alpha factor uplift also apply to firms under the sSA-CCR and OEM approaches. These simplified approaches being less granular and risk adjusted than SA-CCR, smaller and less complex firms would be proportionally more affected. Hence firms applying a simplified approach also support the adjustment to Alpha described in previous section of this paper.

In addition, we highlight an operational challenge with the PRA's proposed approach and a recommendation to provide firms with longer transitions periods between methods, of 6 months or more (as opposed to the current "within three months" which suggests a transition period of under 3 months). Finally, we would welcome a clarification on the thresholds for sSA-CCR.

Operational challenges preventing the application of the proportionate approaches

The proposed rule is that unless the PRA is otherwise notified, the SA-CCR approach is applied. This requires a decision by firms to assess which CCR method applies, overlaid by an operational decision on the process to implement, noting that firms may move up and down the CCR thresholds as to which CCR method applies.

For firms on the cusp between OEM to sSA-CCR and between sSA-CCR and SA-CCR, the decision to choose SA-CCR over the sSA-CRR or sSA-CCR over the OEM methods may be based on the operational implementation difficulty if the firm were to move from one threshold to the next and vice versa, as opposed to increase/decrease in business volumes, sustained increments or decreases in market values or changes in business model due to a combination, acquisition or divestment.

The data requirements and complexity in calculation between OEM, to sSA-CCR and to SA-CCR become exponentially heavier and may mean some firms run shadow versions of more complex CCR methods in anticipation of these changes. This may mean smaller or non-complex institutions choose SA-CCR to implement to avoid the need to buy or implement new processes, which has a time and cost for regulatory reporting and risk functions including governance and oversight thereof.

The implication is that firms choose the higher methodology although qualifying for a lower methodology, thereby nullifying the concession of proportionality.

As proposed by the PRA, Article 273b allows firms less than 3 months post exceeding the conditions listed to notify the PRA and to make the change in their process. Smaller and less complex firms recommend to allow for a longer transition period between methods, of a minimum of 6 months. This would support more effective proportionality in practice, given the operational challenges in changing methods.

Finally, for consistency and clarification, firms are seeking to confirm the GBP threshold for moving from sSA-CCR to SA-CCR in the proposed rules, as para 8.19 and para 8.24 of CP 5/21 set the threshold at £263 million and Table 1 in para 15.6 of CP 5/21 sets the GBP threshold at £260 million. We would be grateful for confirmation on which threshold will be used.

5. Implementation in other parts of the capital framework

The application of SA-CCR will be mandatory across important and/or untested parts of the prudential capital requirements including Large Exposures, Leverage in the near term from January 2022 and the Output Floor from January 2023. Hence it will materially affect all banks and users of derivatives, and the impact will not be restricted to those that apply standardised methodologies. It

is industry's view that this warrants a holistic review of the specific implications of introducing SA-CCR in the Large Exposure, Leverage and Output Floor parts of the capital framework.

Industry urges the PRA to consider a review of the impact and the appropriateness of SA-CCR before it is implemented in other parts of the capital framework. In this review, the PRA should consider adjustments and design improvements to SA-CCR that take account of its impact beyond capital requirements for counterparty credit risk.

With regards to the Large Exposure framework specifically, firms using the modelled approach would urge the PRA to pause or delay the implementation of SA-CCR and to continue to allow these firms to use IMM until its impact is known and can be better anticipated. This would align with the approach taken by the US. Industry notes that no impact assessment has been undertaken regarding this part of the framework in the UK despite its significance, hence more time is required.

In addition, industry notes that SA-CCR could significantly impact Leverage requirements, but that the UK's Leverage framework was not included in this consultation. Industry would therefore request the opportunity to provide further feedback on SA-CCR once the proposed amendments to the Leverage framework are also known.

Summary

Industry expects that SA-CCR will have a significant impact on derivatives markets participants, both banks and end users, and could have significant implications for the standing of the UK as an attractive location for global derivatives activity. To mitigate these impacts, Industry recommends that the PRA considers:

1. **Setting the Alpha factor to 1 for CEUs**
2. **Realigning with Basel on the treatment of multiple margin agreements within a netting set and on the mandatory liquidation period for un-margined netting sets;**
3. **Making immediate design improvements to the SA-CCR methodology including by allowing index decomposition and improving the calculation of Supervisory Delta**
4. **Raising additional design improvements to the Basel Committee for review on the longer term**
5. **Pausing or delaying the implementation of SA-CCR in other parts of the framework (maintaining the use of IMM in Large Exposure framework) and carrying out a holistic review of its specific impact; and**
6. **Extending the transition period for firms moving from the simplified approaches to SA-CCR to more than 6 months and confirms the threshold amount for doing so.**

Annex

Alignment of UK PRA SA-CCR rules with the consolidated Basel capital framework (inclusive of BCBS responses to FAQs)

BSBC CRE52 – Counterparty Credit Risk	PRA proposed rulebook – Annex D Counterparty Credit Risk (CRR)

1.1 Treatment of netting sets with multiple margin agreements

In December 2019, the BCBS provided a clarification to rule CRE 52.74 (Treatment of multiple margin agreements and multiple netting sets) through FAQ1 on the calculation of the exposure value (both the replacement cost (RC) and the potential future exposure (PFE) for netting sets (NS) which have multiple margin agreements (MAs). Although the rule CRE 52.74 states that single netting sets with multiple MAs should be subdivided into sub-netting sets aligned with their respective MAs for both the calculation of the RC and PFE, the Dec 2019 clarification from the BCBS adds further detail which, as currently drafted, is not captured in the SA-CCR articles. In particular, the BCBS acknowledges that the RC for the purpose of rule CRE 52.74 should be calculated at the level of the entire original netting set (not at the level of the sub-netting sets) with a number of modifications to the RC formula applicable to margined netting sets as follows:

- Original formula for margined netting sets (BCBS CRE 52.18 and PRA Rulebook Art. 275(2))

$$RC = \max\{CMV - VM - NICA, TH + MTA - NICA, 0\}$$

- BCBS proposed application for netting sets with multiple MAs (BCBS CRE 52.72 FAQ1; no equivalent in the PRA Rulebook)

$$RC = \max\{CMV - VM - NICA, \sum TH_i + \sum MTA_i - NICA, 0\}, \text{ where}$$

CMV is the value of all derivative transactions (both margined and unmargined) in the netting set;
VM, NICA are the haircut value of net variation margin (VM) and NICA held by the bank for all derivative transactions within the netting set;
$\sum TH_i$ is the sum of the counterparty thresholds across all variation margin agreements within the netting set;
$\sum MTA_i$ is the sum of the minimum transfer amounts across all variation margin agreements within the netting set;

We would like to stress that the BCBS's answer to the FAQ1 explicitly mentioned that "the inputs to the RC formula should be interpreted" as described above.

Furthermore, the BCBS provides clarification on the calculation of the PFE in those cases. As a general rule, banks would follow the same formulae for the PFE as outlined in the respective rules (CRE52.20 – PFE, CRE52.23 – PFE multiplier; CRE52.25 – Aggregate Add-on and CRR2 Art. 278 – PFE, Aggregate Add-odd and PFE multiplier), but taking into account that the Aggregate Add-on amount for the netting set (as input into the PFE multiplier formula and the final PFE amount) should be calculated as the sum of the aggregated add-ons calculated for each sub-netting set, where sub-netting sets are constructed separately for:

- all trades without variation margin (grouped into one sub-netting set)
- all margined trades with the same margin period of risk (MPOR) (grouped into one sub-netting set)

We believe that BCBS's latest formulation of RC and PFE under SA-CCR for netting sets with multiple margin agreements strikes a better balance and recognises that for a given netting set only one net amount is determined in the event of a close out.

A draft of proposed amendments to the PRA Rulebook is provided below in comparison to the relevant rules from the Basel framework which include the latest technical interpretations (FAQs).

Basel framework	PRA Rulebook
Treatment of multiple margin agreements and multiple netting sets CRE52.74 If multiple margin agreements apply to a single netting set, the netting set must be divided into sub-netting sets that align with their respective margin agreement. This treatment applies to both RC and PFE components.	**Article 274 Exposure value** 4.Where multiple margin agreements apply to the same netting set, institutions shall allocate each margin agreement to the group of transactions in the netting set to which that margin agreement contractually applies to and calculate an exposure value separately for each of those grouped transactions. **Suggested modification:** **Additional subparagraph 2 to be added as follows:** "For netting sets covered by multiple margin agreements the replacement cost (RC) shall be calculated as set out in subparagraph 2 of paragraph 2 of Article 275 and the potential future exposure (PFE) shall be calculated as set out in subparagraph three of paragraph 1 of Article 278."
FAQ1 (Answered Dec 2019): How should multiple margin agreements be treated in a single netting agreement? The SA-CCR standard provides two distinct methods of calculating exposure at default: one for "margined transactions" and one for "unmargined transactions." A "margined transaction" should be understood as a derivative transaction covered by a margin agreement such that the bank's counterparty must post variation margin to the bank. All derivative transactions that are not "margined" in this sense should be treated as "unmargined transactions." This distinction of "margined" or "unmargined" for the purposes of SA-CCR is unrelated to initial margin requirements of the transaction. The SA-CCR standard implicitly assumes the following generic variation margin set-up: either (i) the entire netting set consists exclusively of unmargined trades, or (ii) the entire netting set consists exclusively of margined trades covered by	**Article 275 Replacement cost** 2.Institutions shall calculate the replacement cost for single netting sets that are subject to a margin agreement in accordance with the following formula: RC = max {CMV – VM – NICA, TH + MTA – NICA, 0} where: RC = the replacement cost; VM = the volatility-adjusted value of the net variation margin received or posted, as applicable, to the netting set on a regular basis to mitigate changes in the netting set's CMV; TH = the margin threshold applicable to the netting set under the margin agreement below which the institution cannot call for collateral; and MTA = the minimum transfer amount applicable to the netting set under the margin agreement.

the same variation margin agreement. CRE52.74 should be applied in either of the following cases: (i) the netting set consist of both margined and unmargined trades; (ii) the netting set consists of margined trades covered by different variation margin agreements.

Under CRE52.74, the replacement cost (RC) is calculated for the entire netting set via the formula for margined trades in CRE52.18. The inputs to the formula should be interpreted as follows:

- V is the value of all derivative transactions (both margined and unmargined) in the netting set;
- C is the haircut value of net collateral held by the bank for all derivative transactions within the netting set;
- TH is the sum of the counterparty thresholds across all variation margin agreements within the netting set;
- MTA is the sum of the minimum transfer amounts across all variation margin agreements within the netting set;

Under CRE52.74, the potential future exposure (PFE) for the netting set is calculated as the product of the aggregate add-on and the multiplier (per CRE52.20). The multiplier of the netting set is calculated via the formula in CRE52.23, with the inputs V and C interpreted as described above. The aggregate add-on for the netting set (also to be used as an input to the multiplier) is calculated as the sum of the aggregated add-ons calculated for each sub-netting set. The sub-netting sets are constructed as follows:

- all unmargined transactions within the netting set form a single sub-netting set;
- all margined transactions within the netting set that share the same margin period of risk (MPOR) form a single sub-netting set.

Suggested modification:
Additional subparagraph to be added under notations as follows:
"For netting sets covered by multiple margin agreements the RC shall be calculated using the formula set out in the first subparagraph of paragraph 2, with TH and MTA replaced by the sum of margin thresholds and the sum of minimum transfer amounts respectively of all margin agreements covered by the same netting set."

Article 278 Potential future exposure
1.Institutions shall calculate the potential future exposure of a netting set as follows:
PFE = multiplier * $\sum_a AddOn(a)$
where:
PFE = the potential future exposure; a =the index that denotes the risk categories included in the calculation of the potential future exposure of the netting set;
AddOn(a) = the add-on for risk category a calculated in accordance with Articles 280a to 280f, as applicable; and
multiplier = the multiplication factor calculated in accordance with the formula referred to in paragraph 3.

For the purpose of this calculation, institutions shall include the add-on of a given risk category in the calculation of the potential future exposure of a netting set where at least one transaction of the netting set has been mapped to that risk category.

Suggested modification:
Additional subparagraph three to be added under the second subparagraph under paragraph 1:
"For netting sets covered by multiple margin agreements the Aggregate Add-on $\sum_a AddOn(a)$ for the purpose of calculating the PFE and as an input into the multiplier formula in paragraph 3 shall be calculated at sub-netting set level defined as follows:

- all unmargined transactions within the netting set form a single sub-netting set;
- all margined transactions within the netting set that share the same margin period of risk (MPOR) form a single sub-netting set."

1.2 Mandatory liquidation period for un-margined netting sets

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CRE 52.5
In both cases, the haircut applicable to noncash collateral in the replacement cost formulation represents the potential change in value of the collateral during the appropriate time period (one year for unmargined trades and the margin period of risk for margined trades).

CRE 52.10 FAQ1: How must banks calculate the haircut applicable in the replacement cost calculation for unmargined trades?

The haircut applicable in the replacement cost calculation for unmargined trades should follow the formula in CRE22.59. In applying the formula, banks must use the maturity of the longest transaction in the netting set as the value for NR, capped at 250 days, in order to scale haircuts for unmargined trades, which is capped at 100%.

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Article 276 Recognition and treatment of collateral

(3) For the purposes of point (d) of paragraph 1, institutions shall set the liquidation period relevant for the calculation of the volatility-adjusted value of any collateral received or posted in accordance with one of the following time horizons:
(a) one year for the netting sets referred to in Article 275(1);

(b) the margin period of risk determined in accordance with point (b) of Article 279c(1) for the netting sets referred to in Article 275(2) and (3).

Suggested modification:
Amend point (a) under paragraph 3 as the following:
“The remaining maturity, M, as referred to in Article 279c of the longest transaction in the netting set, capped at one business year and floored at 10 business days, for the netting set referred to in Article 275(1).”

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1.3 Treatment of one-way margin agreements

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CRE 52.2

The replacement cost (RC) and the potential future exposure (PFE) components are calculated differently for margined and unmargined netting sets. Margined netting sets are netting sets covered by a margin agreement under which the bank’s counterparty has to post variation margin; all other netting sets, including those covered by a one-way margin agreement where only the bank posts variation margin, are treated as unmargined for the purposes of the SA-CCR. The EAD for a margined netting set is capped at the EAD of the same netting set calculated on an unmargined basis.

CRE 52.10 Footnote 2

As set out in CRE52.2, netting sets that include a one-way margin agreement in favour of the bank’s counterparty (i.e. the bank posts, but does not receive

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Article 275 Replacement cost

1. Institutions shall calculate the replacement cost RC for netting sets that are not subject to a margin agreement, in accordance with the following formula:

$RC = \max\{CMV - NICA, 0\}$

Suggested modification:
Additional subparagraph to be added under the first subparagraph under paragraph 1:

“For the purpose of this paragraph, the netting sets that are subject to a one-way margin agreement under which the institution is required to post variation margin but is not entitled to receive variation margin from the counterparty shall be treated the same as the netting sets that are not subject to a margin agreement. The volatility-adjusted value

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</table>

variation margin) are treated as unmargined for the purposes of SA-CCR. For such netting sets, C also includes, with a negative sign, the variation margin amount posted by the bank to the counterparty.	of the variation margin posted by the institution to the counterparty should be included in the calculation of RC and treated in the same manner as *NICA*. “
1.4 Definition of MPOR in the calculation of maturity factor	
CRE 52.50 For margined transactions, the maturity factor is calculated using the margin period of risk (MPOR), subject to specified floors. That is, banks must first estimate the margin period of risk (as defined in CRE50.18) for each of their netting sets. They must then use the higher of their estimated margin period of risk and the relevant floor in the calculation of the maturity factor (CRE52.52). The floors for the margin period of risk are as follows: (1) Ten business days for non-centrally cleared transactions subject to daily margin agreements. (2) The sum of nine business days plus the re-margining period for non-centrally cleared transactions that are not subject daily margin agreements. (3) The relevant floors for centrally cleared transactions are prescribed in the capital requirements for bank exposures to central counterparties (see CRE54). **CRE 52.51** The following are exceptions to the floors on the minimum margin period of risk set out in CRE52.50 above: (1) For netting sets consisting of more than 5000 transactions that are not with a central counterparty the floor on the margin period of risk is 20 business days. (2) For netting sets containing one or more trades involving either illiquid collateral, or an OTC derivative that cannot be easily replaced, the floor on the margin period of risk is 20 business days. For these purposes, "Illiquid collateral" and "OTC derivatives that cannot be easily replaced" must be determined in the context of stressed market conditions and will be characterised by the absence of continuously active markets where a counterparty would, within two or fewer	**Article 279c Maturity Factor** 1. Institutions shall calculate the maturity factor as follows: (b) for transactions included in the netting sets referred to in Article 275(2) and (3), the maturity factor is defined as: $$MF = \frac{3}{2}\sqrt{\frac{MPOR}{OneBusinessYear}}$$ **Suggested modification:** **Additional definition to be added under the subparagraph (b) under paragraph 1:** MPOR = the margin period of risk of the netting set determined in accordance with Article 285(2) to (5).

days, obtain multiple price quotations that would not move the market or represent a price reflecting a market discount (in the case of collateral) or premium (in the case of an OTC derivative). Examples of situations where trades are deemed illiquid for this purpose include, but are not limited to, trades that are not marked daily and trades that are subject to specific accounting treatment for valuation purposes (e.g. OTC derivatives transactions referencing securities whose fair value is determined by models with inputs that are not observed in the market). (3) If a bank has experienced more than two margin call disputes on a particular netting set over the previous two quarters that have lasted longer than the applicable margin period of risk (before consideration of this provision), then the bank must reflect this history appropriately by doubling the applicable supervisory floor on the margin period of risk for that netting set for the subsequent two quarters.	

Chapter 9 - Operational risk

We have no comments to make on Chapter 9

Chapter 10 - Large exposures

Industry appreciates and supports international and UK efforts to improve the large exposure framework and the desire to enhance the identification, management and control of exposures to single counterparties. As the PRA considers implementation of Basel 3, industry also supports the PRA's commitment to international standards and favours continued alignment with Basel as a starting position.

However, we have serious concerns that the scope of the proposal as regards mandatory substitution contains significant ambiguities and is likely to lead to inconsistent implementation. We also question the economic rationale for the substitution approach outlined and are concerned as it stands that this could lead to a reduction in liquidity in the repo market. The repo market is generally dominated by government debt in particular from the G7 countries. Many of the G7 countries are exempt from LE limits under the existing rules however liquidity for countries that are not exempt is likely to be impacted.

To illustrate and support these views, this response has been structured in 5 sections as follows:

1. **Clarification of scope of substitution approach,** outlining concerns that the changes implemented to the framework mirroring CRR2 lack clarity and risk inconsistent implementation;
2. **Alignment with Basel,** if the intent is to align with the Basel large exposure rules then additional clarity should be provided particularly as regards securities financing transaction and derivatives.
3. **Design improvements – substitutions approach,** urging the PRA to consider a change to the framework regarding substitution;
4. **Other design improvements**
5. **Drafting issues,** setting out targeted but important areas in the methodology where changes or increased flexibility would be helpful and strengthen the framework;

1 <u>Clarification of scope of substitution approach and operational difficulties</u>

As noted in the consultation the current CRR allows firms to choose whether to assign an exposure to the underlying borrower or to a provider of credit protection or collateral – i.e. to use a 'substitution approach'. The Basel framework mandates the substitution approach, and this has been implemented in Europe under the changes set out in CRR2.

The PRA also proposes that the substitution approach must be applied and has done this by reflecting the CRR2 changes in the new Large Exposures (CRR) Part of the PRA rulebook. These changes are included in articles 401(4) and 403(1), however the interaction between these articles is unclear and therefore there is a lack of clarity as to how the substitution approach should be

applied for different transaction types, especially with regard to funded credit risk mitigation, securities financing transactions and collateralised derivatives.

We understand that the intent of the PRA is to apply full substitution however as the rules are currently written there is even uncertainty over the fundamental issue as to whether the substitution approach applies to all situations where collateral is received and recognised in the capital framework either by risk-weight substitution or by exposure reduction or whether it should only be used where there has been a risk-weight substitution using the Financial Collateral Simple Method. This second approach is consistent with the substitution approach under the risk-based capital framework and the new reporting forms for large exposures under taxonomy 3.0 which recognise CRM using substitution and funded credit protection other than substitution.

The Basel large exposure rules are relatively clear that the substitution approach applies in all situations where collateral is received and if this is the PRA's intention then this should be made clear by amending articles 401 and 403. As it stands the rules are likely to lead to divergent implementation as to how broadly the substitution approach is applied.

Industry therefore urgently requests clarity as to the scope of the 'substitution approach' and under what circumstances it should be used. If the expectation is of a broad application, then further guidance would be required as to how this should be done for various products and situations. Under article 399(4) firms are required to monitor concentrations of collateral issuers and providers of unfunded credit protection. Firms will have their own methodologies and processes to fulfil this requirement and these processes would not necessarily be executed through RWA reporting systems. The operational challenges of implementing the (clarified) substitution rules and of implementing the necessary controls will be significant and firms are likely to require additional time beyond 1 Jan 2022 to make the necessary adjustments to systems and processes. More details of areas of uncertainty and where further clarity is needed is covered in the next section.

1.1 Implications of the substitution approach

The industry would like to highlight further implications of the substitution approach on other parts of the large exposure framework and the resulting issues if the intension is to align with Basel, where the substitution approach is applicable under all CRM approaches.

1.1.1 Reporting

According to Article 394, firms are required to report all information about large exposures to the competent authority. The reporting framework on large exposures consists of four templates, which are provided in Appendix 13 of the PRA CP 5/21[12] with respective reporting instructions[13]

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[12] *Annex VIII: Reporting on large exposures and concentration risk*, UK COREP and FINREP data items, Appendix 13, PRA CP5/21.

[13] *Annex VIII: Instructions for reporting on large exposures and concentration risk*, UK COREP and FINREP instructions, Appendix 13, PRA CP5/21.

In the instructions for reporting on large exposures and concentration risk, ‘indirect exposure’ is defined in the reporting instructions as the “*exposures allocated to the guarantor or the issuer of the collateral rather than to the immediate borrower in accordance with substitution approach under Article 403*”. However, in COREP template C 28.00 and C29.00, ‘indirect exposures’ are reported in column 120 – 170 when and only when the guarantor or collateral issuer would be assigned an equal or lower risk weight than that would be applied to the original counterparty under standardised approach for credit risk. The criteria of populating column 120 – 170 are the preliminary conditions to apply FCSM, but not under other CRM approaches such as FCCM or MNA.

If the instructions were to be followed, firms will not report any information on exposures substituted under approaches other than FCSM. It raises further questions from the industry on the actual scope of substitution approach as outlined in previous sections.

It is critical that the PRA provides the Industry with further clarification and appropriate amendments to these respective COREP templates and the reporting instructions to address this issue, well in advance of the first reporting date of 31 March 2022 to ensure firms have sufficient implementation time.

1.1.2 Calculation of concentration risk RWA

Articles 395 and 397 set out the methodology for calculating additional own funds requirements for large exposures in the trading book that exceed the large exposure limits, also known as the ‘concentration risk RWA’.

The mandatory substitution approach will lead to an increase of total exposures to a client that is a trade counterparty, as well as a CRM provider for firms’ exposures with other clients. As such, firms may have to calculate concentration risk RWA when the substituted exposures are in the trading book, which may not be the case under the current CRR where substitution is only required for collateral applied under FCSM and guarantees.

As clarified in Article 397, concentration risk RWA is calculated based on risk weights used in the market risk RWA, counterparty credit risk RWA or settlement risk RWA. For an exposure that is assigned to a collateral provider or guarantor, it is unclear from the proposed rules which risk weight should be applied and firms may take very different implementation approaches in absence of regulatory guidance. Potential approaches include but are not limited to:

- Apply the respective risk weight that would be assigned to the original counterparty if the exposure is not substituted;
- Apply the risk weight as per Article 299 as if it is direct trade exposure with the guarantor or collateral issuer under internal rating based approach or standardised approach, where applicable.

Therefore, the Industry would encourage the PRA to provide additional guidance on the calculation of concentration risk RWA for exposures under substitution approach.

1.1.3 *Application of exemptions*

Article 400 allows exposures to be exempted from the application of large exposure limits if they meet certain conditions. A typical example are exposures to a multilateral development bank (MDB) that, if unsecured, are assigned a 0% risk weight under the standardised approach for credit risk.

In addition to the existing guidance on large exposure exemptions, the mandatory substitution approach raises further considerations in applying exemptions, especially when exposures with the original counterparty can be exempted.

Consider the following hypothetical example, where a firm has a direct trade exposure of £1 m with a MDB that is 0% risk weighted under Article 117 and received collateral in form of AAA rated corporate bonds. If uncollateralised, the firm will be able to exempt the entire exposure amount under the large exposure framework. However, as it receives and recognises the corporate bonds as collateral, it now has to report an additional ‘indirect’ exposure to the bond issuer. The total exposure arising from the trade is higher with the recognition of eligible CRM than without, which is controversial to the fundamental principle under the CRM framework where the use of eligible CRM shall not lead to higher exposures. In addition, it leads to an asymmetric and inconsistent treatment when the example is reversed with the corporate becoming the trade counterparty and the MDB becoming the CRM provider. Post exposure substitution, it is reasonable to exempt the exposure assigned to the MDB as it is meeting the condition under Article 400(1)(b).

A few commenters have suggested that firms may choose to de-recognise the CRM in calculating exposure with the original client in the first scenario to avoid the mandatory substitution to non-exempted CRM provider. However, Article 399 sets out the requirement to apply CRM techniques consistently in capital requirements for both credit risk and the large exposure framework. As such, firms that choose to de-recognise the CRM for large exposure purpose will also have to de-recognise the CRM in credit risk RWA calculation. Although it may result in a minimal quantitative impact given the exempted counterparty would be subject to a 0% risk weight, it potentially encourages “cherry picking” of the application of CRM and does not necessarily enhance firms’ safety and soundness. More importantly, it compromises the transparency and adequacy of the regulatory framework.

The industry encourages PRA to consider the concerns raised above and welcome clarification on the exemption application for exposures under substitution approach and corresponding reporting instructions.

2. Alignment with Basel

We understand that the PRA wishes to align with the Basel rules. The Basel large exposures rules were designed “so that the maximum possible loss a bank could incur if a single counterparty or group of connected counterparties were to suddenly fail would not endanger the bank’s survival as a going concern”. Under the proposed rules direct exposures and exposures through collateral are treated identically. Exposures through collateral only result in a loss if there is a double default and where the collateral is received from multiple obligors there would have to be multiple double defaults in order for the loss implied by the proposed rules to materialise. The industry continues to believe

that is a gross oversimplification and is unnecessarily punitive. The industry is supportive of the need for banks to be able to aggregate exposures across direct exposures and exposures through collateral and guarantees. We would propose that rules are first clarified, followed by a period of reporting and time for calibration/adaptation of business models before subjecting collateral and received guarantees to the large exposure limits.

Even within the Basel rules there are a number of areas which lack clarity and likely to lead to differing interpretation and implementation by firms without further guidance. A non-exhaustive list of these issues is discussed below:

- Where collateral is received under a securities financing transaction can this be netted with collateral given in the same netting set where they are both issued by the same client in accordance with the same methodology as specified for direct exposures in Article 390(3)?
- We would assume that for netting sets, the first step would be to net down the various trades against each other. There will then be a net amount owed and multiple sets of collateral. It is unclear what allocation rules should be followed in this situation (pro-rata, based on credit quality, etc) particularly when the netting set is over-collateralised
- Where collateral received is a trading book eligible instrument can this be netted with short positions issued by the same client?
- The interaction of SA-CCR with the substitution approach could give rise to a substitution greater than the total value of collateral actually received due to the alpha factor.

Particularly, in relation to *Sovereign Exposures* members would like to request that the PRA updates the UK framework to follow the design of the Basel standards (LEX10.7) with respect to the treatment of sovereign exposures. Basel alignment should be preferred over the EU approach in order to i) improve clarity in the Industry and ensure consistent application across firms; and ii) prevent a disproportionate and punitive impact in the Industry's use of government bonds as collateral via the application of mandatory risk substitution.

In PRA rules as proposed, the combination of replicating the EU's approach without further guidance and the lack of flexibility in applying mandatory risk substitution is problematic.

Under the Large Exposure framework currently, per CRR Article 400, sovereign exposures may be exempted where they receive a 0% risk weight. Furthermore, under Article 114(4) and (7), where these exposures are "denominated and funded in the domestic currency", they may receive a 0% risk weight if the jurisdiction is deemed equivalent and a 0% risk weight is applied under domestic laws. The wording in Article 114 is ambiguous however and has not been clarified to date including in the EBA Q&A process[14]. This ambiguity is being replicated in PRA proposed rules without the necessary guidance on what is meant by "funded" in relation to exposures "denominated and funded in the domestic currency"; specifically, that the term can be interpreted irrespective of the bank's liability structure.

In addition, consistent with the design of the Basel framework, sovereign exposures should not fall within the scope of mandatory substitution requirements. For instance, the default risk associated with an indirect concentration to sovereigns that attract a 0% risk weight is negligible and should not result in constraining exposures. The simplistic framework was not designed to and therefore should not constrain the use of government bond collateral, which is an essential and well-established risk management tool. This would be overly burdensome and would risk impacting Industry's capacity to support the real economy.

Based on these considerations, Industry urges the PRA to consider an exemption of sovereign exposures from the framework in line with Basel standards and to provide greater clarity as to how the substitution approach is intended to work in these and other situations and would be happy to work with the PRA to develop a working framework.

Other jurisdictions have given relief in respect on SFTs with *highly liquid collateral* and for the use of the SACCR within large exposures. The PRA should consider equivalent measures in order to ensure that the UK remains a competitive jurisdiction.

3. **<u>Design improvements – substitution approach</u>**

In addition to the lack of clarity discussed above the substitution approach is very punitive for what is a contingent risk and would only give rise to an exposure upon the default of the obligor. This is clearly unlikely to happen for multiple counterparties simultaneously so the requirement to take an exposure to collateral assets from the same counterparty where they are held in different netting sets seems unnecessary.

3.1. Alternative substitution approach

The methodology is very punitive as it is a gross basis with no available mitigants which is not aligned to the actual risk assumed on the collateral. A more risk aligned but still effective methodology would:

1. Set the exposure to the issuer of collateral at an amount equal to the largest total market value of the net collateral received (less any collateral provided with equal or junior seniority – i.e. in line with Article 390(3)) from any one single group of connected clients (i.e. if a group of clients were to default and we were to enforce our collateral this is the largest exposure that would then arise to the collateral issuer).
2. This could then be supported by an additional large exposures limit on the maximum amount of net collateral related to a single issuer group which can be received by a single group of connected clients which should be set equal to 25% of Tier 1 capital – the net exposure to the group of connect clients (i.e. for a single group of counterparties the firm should not be able to take collateral relating to a single issuer group that would cause a breach of the large exposures limits if that issuer group were to default and cause an increase in exposure to the client).

This can be illustrated with the following simple example:

25% of Tier 1 Capital	**50**	
Proposed Collateral Limit (25% of Tier 1 - Net Exposure)	**30**	
Example	**Example 1**	**Example 2**
Gross Exposure to Client	**100**	**100**
Collateral A	-80	-30
Collateral B		-30
Collateral C		-20
Net Exposure to Client	**20**	**20**
Net Exposure following default of largest collateral item	**100**	**50**
LE Breach following collateral default (Y/N)	**Y**	**N**

This would adequately address and control the risks to collateral issuer defaults such that no limits would be breached on occurrence of a default within the scope of those exposures which should be assumed to be at risk of a simultaneous default due to control/interconnected relationships. This would also be in a manner which is commensurate with the approach for direct exposures to the same clients.

3.2. <u>Market impediment</u>

It should be noted that this rule will provide a significant market impediment to the smooth functioning of repo and securities borrowing/lending markets and significantly reduce liquidity in these markets as firms will be required to take a gross exposure to the issuer of collateral regardless of whether or not this has been on lent to another client or not.

3.3. <u>Use of SA-CCR</u>

[The concerns set out in our response to the implementation of SA-CCR will also apply to the exposure measurement for large exposures purposes]

Specific issue related to substitution approach set out above would be resolved by setting alpha to 1.0 for the large exposure purposes.

4. <u>Other design improvements</u>

4.1. Use of SA-CCR

[The concerns set out in our response to the implementation of SA-CCR will also apply to the exposure measurement for large exposures purposes]

4.2 Use of Credit Conversion Factors

Recent clarifications around the meaning of "committed" under regulatory rules means that there is the likelihood of increased reporting of committed but unconditionally cancellable exposures. Without the use of Credit Conversion Factors (CCF)s these and other trade related products will be reflected at 100% which is unnecessarily punitive and may result in reduced lending to the real economy.

4.2 Covered Bond exemptions

Depending upon the outcome to the collateral substitution requirements discussed above, firms will have more exposures to covered bonds where these have been received as collateral under SFTs. This has therefore increased the scope of covered bonds to which firms will have exposures. However covered bonds are secured on an underlying pool of assets which can cover the claims on the bonds in the event of a default of the issuer and as a result covered bonds under the Basel framework are allowed to be included at an exposure value of no less than 20% of the nominal value to reflect this additional security. This approach is a national discretion available under the existing CRR and we ask that the PRA consider adopting this discretion in line with the Basel requirements.

4.3. Intragroup treatment

Several key jurisdictions, including the US and Switzerland, do not cap intragroup large exposures between regulated entities, and within the European Union there are several possible waivers across borders depending on certain criteria. As the UK moves ahead to create close partnerships built on strong supervisory coordination and mutual recognition with highly regulated key partner countries post-Brexit, we would argue that the presumption in UK regulation is for a large exposure waiver. Concretely, we advocate that concerning large exposures between UK banks and regulated affiliates located in countries with which the UK has a mutual regulatory recognition agreement, intragroup LE waivers are granted, and that they are only withheld in exceptional circumstances.

4.4 Reciprocation for French measure

In the PRA's policy statement PS24/19[1], in accordance with the European Systemic Risk Board (ESRB) recommendation (ESRB/2018/8) the PRA reciprocated the measure imposed by the Haut Conseil de stabilité financière (HCSF) in France in July 2018, which tightened the large exposure limit in CRR Article 395(1) to 5% of eligible capital in respect of the exposures of UK G-SIIs and O-SIIs to French non-financial corporations meeting the definition of 'highly indebted'.

This measure requires the monitoring of two different large exposures limits, requiring a methodology that is more operationally complex to manage than other large exposure limits. In the context of the UK's departure from the EU, we believe the reciprocity is no longer required and ask that it be discontinued particularly as the ESRB recommendation was founded on the requirement to apply

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[1] Large exposures: Reciprocation of French measure | Bank of England

consistent macroprudential policy within the EU and contribute to a level playing field across the single market. As this was neither an EU or Basel requirement we do not believe this would give rise to any international equivalence considerations and can therefore be removed from the PRA Rulebook whilst other updates to the large exposures section are also being made as part of CP5/21.

4.5 Reporting

1. Exposure reporting inconsistencies

There is an inconsistency between reporting requirements in Art 394 of the proposed Large Exposures part of the rulebook and Art 14 of Chapter 5 of the Reporting (CRR) Part of the PRA Rulebook.

- Art 394(2) requires that "institutions shall report the following information to their competent authority in relation to their 10 largest exposures to shadow banking entities which carry out banking activities outside the regulated framework on a consolidated basis". This is a deviation from EU CRR2 which suggest it was deliberate.

- Art 14(4) of Chapter 5 of the Reporting (CRR) Part of the PRA Rulebook however makes reference to reporting information on the 10 largest exposures to institutions as well as the 10 largest exposures to shadow banking entities. This is also replicated in the instructions in Annex 9.

2. Definition of an Institution.

Paragraph 12 of Annex 9 cross refers the definition of an institution to point 3 of CRR Art 4(1). However, Art 391 provides a separate definition of an institution for large exposures purposes. We would like the PRA to clarify if this is deliberate, and if so, also clarify for what purpose each definition would be used in the large exposures framework and reporting.

3. Shadow Banking

The EBA's guidelines on 'limits on exposures to shadow banking entities…' (EBA/GL/2015/20) defines shadow banking entities as entities that carry out credit intermediation activities, and specifically carves out from this definition entities that are subject to an appropriate and sufficiently robust prudential framework. The definition of an institution for large exposures purposes in Art 391 is restricted to those established in the UK or an equivalent third country. HMT's latest set of equivalence decisions restricts this to the EEA only, resulting in institutions outside of this geographic area to be out of scope of the definition of an institution.

We assume that a "robust prudential framework" would be granted equivalent status, and therefore ask that the PRA clarify whether they intend for firms to treat these "non-institutions" as shadow banks. Alternatively, should firms use the definition of an institution as provided in Art 4(1) and disregard Art 391.

If firms are required to use the Art 391 definition for the purposes of reporting information in relation to the Top 10 exposures to shadow banks, the list is likely to be satisfied by the reporting of large institutions in countries within a regulated framework which is treated as an institution for credit risk purposes, but not for large exposures. We do not believe this is the intention of the shadow banking governance framework and there is a risk that other, smaller but more risky, shadow banking entities may be omitted from the PRA's internal assessments of this sector.
Furthermore, the Bank of England's Statement of Policy on the interpretation of EU guidelines and recommendations after the UK's withdrawal from the EU states that the BoE and PRA expect firms to continue to comply with the guidelines. The EBA's guidelines on 'limits on exposures to shadow banking entities…' require that firms set both an aggregate limit and individual limit on exposures to shadow banking entities with various control and governance mechanisms in place. This could become burdensome and unnecessarily punitive if the scope of institutions is narrow, and other global institutions become eligible for assessment as a shadow bank.

CRR contained a mandate for the EBA to develop RTS to specify the criteria for the identification of shadow banking entities. This has been removed from the PRA's drafting of the rulebook. We ask that the PRA provide technical standards and guidance on this subject.

Reporting burden – the existing reporting rules require exposures to be reported which are greater than Eur300 million but lower than 10% of eligible capital. We would encourage the PRA to reduce the reporting burden on firms and only require large exposures to be reported.

5. <u>Drafting issues</u>

A) The construct of Article 390(5) is not clear that indirect exposures from derivatives may be subjected to the netting provisions of Article 390(3). This is not in line with Basel. The wording of this article would benefit from the following wording changes to improve clarity:
   1) add the following at the start of the sentence: "for the purposes of Article 390(3)"; and
   2) change the word "add" to "include"

B) Article 390(4) first subparagraph only refers to derivatives contracts. It should also refer to SFTs as otherwise the derogation in the last subparagraph technically does not make sense

C) Article 390(9) has been left blank – why? What does this mean for calculation of indirect exposures under Article 390(5)? e.g. can members now just use JTD per FRTB now or is a separately specify methodology contemplated?

D) Article 395(5) and 397 – can the PRA replace the reference to Article 299 with Title II of Part Three (i.e. make it explicitly clear that counterparty credit risk can be TB)

E) Regulation 1187/2014 still refers to eligible capital. This should be updated to Tier 1 capital in line with the overall change.

Summary

1. **The scope of the application of the substitution approach when collateral is received should be clarified**
2. **The identical approach to the treatment of direct exposures to counterparties and exposure through collateral should be revisited.**

Chapters 11 and 12 Liquidity Coverage Ratio & NSFR

Introduction

This section focuses on industry comments and concerns around the UK's proposed implementation of the remaining aspects of Basel's liquidity framework, principally the Net Stable Funding Ratio (NSFR) as well as aspects of the Liquidity Coverage Ratio (LCR).

We would like to draw the PRA's attention to a number of areas of concern which can be broadly grouped under the following categories:

- Insufficient regard being given to cost of implementation compared to prudential benefit. For example the imposition of funding requirements on a subsidiary at an individual level as a pre-requisite to waiving individual liquidity requirements under a Domestic Liquidity Sub Group Waiver (DolSub).
- The inappropriateness of cross-referencing prudential measures from the LCR into the NSFR leading to unintended consequences on the latter. For example the reliance on a 30-day price decline test to calibrate required stable funding (RSF) factors for equities.
- Level playing field implications of the conservative approach being taken on interdependent assets and liabilities when compared to equivalent European NSFR rules. This additional burden is exacerbated by existing Brexit headwinds and results in UK banks being at a competitive disadvantage to their EU peers. The removal of the presumption of interdependence for client clearing transactions is an area of particular concern.
- Proposals to diverge from Basel rules by applying additional prudence without properly assessing the impact on the UK banking sector.

Before addressing the LCR and NSFR specifically we will highlight a number of general issues impacting both metrics. This will be followed by specific items on the LCR, NSFR, a summary of key points and then finally an Appendix listing a number of additional issues around the proposed NSFR rules.

General points

Domestic Liquidity sub-group

Section 4 of appendix 8 (Draft Statement of Policy ‘Liquidity and funding permissions’) sets out the requirements for liquidity sub-groups to meet the requirements of the LCR, NSFR and supporting funding risk management standards. While industry welcomes the inclusion of the NSFR as a metric which can be managed at the sub-group level, we would like to highlight the need for greater flexibility in allowing for the creation of a DolSub.

First, we have noted the requirement that prior to applying for a waiver, each in scope entity would need to meet LCR and NSFR requirements on a standalone basis. We would note that this could lead to increased liquidity requirement that would at best be inefficient for stable management of liquidity and funding risks, and at worse could require higher levels of liquidity held by banking groups resulting in higher overall costs of securing funding.

In addition, Industry recommends that the PRA retains flexibility to waive the application of individual liquidity and funding requirements where they are met by the parent holding company. At a minimum, given CDR5 requirements to authorise financial holding companies (FHC) which result in FHCs being responsible for the application of prudential requirements at a consolidated level, PRA rules should allow the authorised FHC to be eligible to form part of the DolSub. PRA rules should not exclude groups choosing to operate in the UK under a holding company structure from being eligible to manage their liquidity and funding at subgroup level.

Industry notes that financial holding companies (FHC) s were permitted to form part of a DolSub under BIPRU 12.8 and that this is not a requirement that originates from Basel. Industry also notes that in retaining flexibility to grant a CRR Art.8 waiver to holding companies, the PRA would continue to be able to consider DolSub applications on a cases by case basis in line with CRR conditions; for example, the condition that the PRA has no material concerns about the management of liquidity risk at the sub-group level, including its processes and procedures.

We see these changes to the PRA’s proposed rules as essential to support the prudent and effective management of liquidity and funding risk in the UK without undue costs and barriers.

Retirement of LIBOR and transition to SONIA

Within the Draft Annex XIX ‘Instructions for Reporting on Additional Liquidity Monitoring Metrics’, under heading ‘C69 Pricing for various lengths of funding’, Point 3 (b) has been amended from ‘three month EURIBOR for EUR or LIBOR for GBP and USD’ to ‘three month EURIBOR for EUR or a similar index for other currencies’.

With the retirement of LIBOR at the end of 2021 and the transition to SONIA rates, further clarification is requested as to what would be deemed as a similar index for GBP. Unlike EURIBOR, SONIA is an overnight risk-free rate and does not include any credit adjustment spreads. Therefore, we do not deem utilising SONIA for GBP as being a similar index as utilising three-month EURIBOR for EUR.

Definition of SMEs

Within Annex 1 Liquidity Coverage Ratio (CRR), Article 3 'Definitions' of the Draft PRA Rulebook, the reference to EC legislation 2003/361/EC utilised to define SMEs has been removed. With no specific definition stated in the rulebook, should banks now revert to this same definition contained within the HM Treasury 'Capital Requirements (Amendment) (EU Exit) Regulations 2018' to define SME for liquidity purposes?

Chapter 11: Liquidity Coverage Ratio

Market stress period for determining Level 2B assets

The industry would welcome further guidance in terms of the approach to identifying stress periods for the purpose of establishing the price resilience of equities. At its most expansive, the definition could currently be read as measuring the effects of multiple stress periods which, depending on the equities in question could date back over 50 years. A clearer definition and regulatory text would support a consistent approach adopted across the industry.

More prescription and guidance on stress period will ensure that this rule is applied consistently across the industry ensuring those banks that take a more prudent approach are not unfairly disadvantaged.

Historic Look Back Approach

By basing the Historic Look Back Approach (HLBA) calculation on the largest absolute net 30-day outflows realised during the last 24 months introduces pro-cyclicality to the LCR ratio. Pro-cyclicality can be mitigated by introducing more flexibility depending on the point in the economic cycle. This will prevent pressures on the banks' liquidity being amplified during times of stress. We note that the HLBA does not specify adjustments to reflect changes in the composition and characteristics of institutions' derivatives portfolios that may have occurred over the last 24 months and that it does not provide guidance for events that are not related to an adverse market scenario, e.g. idiosyncratic derivative counterparty events.

We would welcome a PRA review of the calculation and would propose a change in the requirement to maintain a 100% outflow for the full 2-year period if subsequent peaks are materially below an acute stress period.

Eliminating potential asymmetries for conditional cash flows

The LCR standard is currently not clear on how conditional cash flows should be treated where these are contractual pass-throughs.

An example of this where a firm deposits cash with agent banks as part of client money protection guidance. In this instance there is no liquidity risk, however, a firm is required to gross-up the cash flows and therefore could be subject to reduced inflows as a result of the inflow cap.

Another example is on-balance sheet mortgages that pass-through cash flows to securitisation vehicles. The mortgage inflows are subject to a 50% haircut, but the outflow to the securitisation is weighted at 100%. This does not reflect the economic substance or actual cash flow mechanics of such a transaction and creates a fictitious net outflow.

Article 26 ("Outflows with inter-dependent inflows") allows for firms to apply on a case-by-case basis to net down interdependent in- and outflows, however this is a highly onerous process for items that are contractually guaranteed pass-throughs.

Given the onerous nature of applying for permissions to apply Article 26 on a case-by-case basis, the industry would welcome the PRA to include provisions in their final policy to allow the automatic netting of pass-through cashflows where certain conditions are met (such as these cashflows being contractually guaranteed).

Chapter 12: Net Stable Funding Ratio

Interdependent assets and liabilities: Applicability of NSFR to client clearing activity

As part of firms' futures and listed derivatives business, they act as intermediary and execute trade on exchanges / clearing houses on behalf of clients. In the course of this activity, firms receive margins from clients and onward pledge margin to clearinghouses. Assets (margin required from exchanges / clients) and liabilities (margin received from clients / exchanges) from the derivatives clearing activities are inter-dependent. The PRA has removed the specific reference to 'derivative clearing activities' from the scope of inter-dependent assets and liabilities.

The PRA have also stated that in "practice [they have] not identified circumstances in which this treatment would be warranted".

Firms facilitate client transactions on exchanges and clearing houses to provide them access to listed derivatives and OTC cleared products. Clients use derivatives as one of their risk management tools to manage their exposures to various asset classes. This activity is self-funded in that margin received from clients is sufficient to cover any margin posting to the exchanges.

As industry practice, firms do not offer any guarantee for the performance of the exchanges to their clients. There is no need to fund this business activity with long term funding as would be required by the NSFR if interdependence was not recognised for client clearing transactions.

Any term funding requirement would increase the funding costs which will ultimately be passed on to the clients. This is a very competitive business and clients will have to take this into account while making their decisions. At a time when UK banks are facing various headwinds, including Brexit and

the relocation of activity from the UK to the Eurozone, high NSFR requirements for such activities will have the unintended consequence of reducing UK firms' market share in them.

We recommend that the PRA should specify that derivatives client clearing activities qualify for treatment as interdependent assets and liabilities and no prior approval from the PRA is required. Therefore, ensuring the associated assets and liabilities qualify for 0% RSF and 0% ASF respectively.

Treatment of Equity Securities

Equity price test[15]

We ask the PRA to revisit the funding requirement for equities. At its core, the NSFR is intended as a ratio to measure funding stability over the long term. It was neither intended nor designed as a stress metric. On the other hand, the Liquidity Coverage Ratio is designed to be a stress metric and firms are required to meet a 30- day stress.

Consequently, the reliance on parameters set out in the Liquidity Coverage Ratio to calibrate stable funding requirement under NSFR is conceptually incongruent and introduces pro-cyclicality to the NSFR.

The price decline test used in determining eligibility of equity shares from a HQLA perspectives look at price drop over a 30-day horizon. We think using the 30-day price decline test to determine stable funding requirement for equity shares in the NSFR is not appropriate. This increases pro-cyclicality in the NSFR during stress periods; as markets decline and more equity shares prices suffer declines of more than 40% the required stable funding requirement would increase from 50% to 85%.

The industry would welcome the removal of this price test from the NSFR to support the overall objective of the NSFR as a ratio to measure long term funding stability.

Main index and recognised equities

Incentivising reliance on equities that are good at withstanding short term price shocks may be at the expense of equities that represent a better source of funding over a longer time horizon.

50% RSF is an appropriately prudent RSF factor and we would recommend that this is applied to all Main Index and Recognised Exchange equities irrespective of their price decline and financial/non-financial status. Additionally, we would propose a centralised list be used, e.g. the ESMA list used for the eligibility of collateral[16] under the capital framework. Or alternatively, can the PRA clarify that where a major index has not been identified by the local competent authority then the ESMA (or

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[15] LCR delegated act, Article 12(1)(c)(iii) "… level of decline in the share's stock price or increase in its haircut during a 30-day calendar day market stress period did not exceed 40% or 40 percentage points, respectively;"

[16] CRR Article 197 *Eligibility of collateral under all approaches and methods*

some other central list) should be used as an appropriate substitute. Both proposals ensure a consistent and harmonized approach across UK banks.

Treatment of own issuance securitisations

The read across between LCR and NSFR results in a highly punitive NSFR Required Stable Funding (RSF) factor of 85% for high quality securitisations which do not qualify as HQLA under the LCR. This applies specifically to retained notes of own issuance securitisations.

This creates an unintended disincentive for banks wanting to convert mortgage assets into a more readily liquid and marketable format to reduce the risk in banks' mortgage books. Furthermore, these securities can readily be used to generate funding in central bank operations and market repo transactions. This highlights that applying the principles of the LCR, which looks at a short-term idiosyncratic shock, is not applicable to a stable funding measure such as the NSFR.

The following RSF factors are applied to particular categories and highlight the vast discrepancies in treatments:

- 85%: RSF factor for senior AAA rated securitisations which are not eligible as LCR HQLA (e.g. own issuance AAA RMBS notes).
- 65%: RSF factor for residential mortgages qualifying for a 35% risk weight under the standardised approach to credit risk. Despite not being readily marketable or benefiting from credit enhancement, underlying mortgages can attract a lower RSF than some senior AAA rated securitisation notes. We note of course that if packaged as a pool and lodged at the central bank these mortgages have liquidity benefit, but unless already pre-positioned, this may take time to achieve.
- 25%: RSF factor for otherwise identical senior AAA rated securitisations which are not own issuance (qualifying as level 2B liquid assets under the LCR).

The current treatment does not reflect the ability to raise funding against such securitisations. Own issued high-quality securitisations are eligible for central bank operations and attract a standard haircut of 22-27% in BoE SMF operations. As such a bank could readily raise 70%+ funding against such collateral.

The industry feels that the PRA should align the RSF factor for such securitisations to their underlying funding risk by removing the exclusion for own issued securities. Recognising the liquid nature of these positions, the RSF should be closer to the 25% RSF applicable to comparable Level 2B securitisations.

Trade Finance Exposures

A required stable funding factor ('RSF') of 50% is proposed to apply to on-balance sheet Trade Finance exposures that are maturing in less than six months. Trade Finance facilities are not revolving in nature and typically require clients to present transaction documentation for each

drawdown request, which the bank assesses prior to drawing. As such, the bank retains significant control over future drawings and can choose not to fund if there are risk factors of concern. In the post-Brexit recovery period, it is critical that UK enterprises retain access to affordable Trade Finance in order to weather the increasingly complex international trade barriers. As such, and in order to maintain a level playing field with the EU, the UK's largest trade partner, our preference is for on-balance sheet Trade Finance exposures that are maturing in less than six months to attract an RSF of 10%.

It is also proposed that RSF factors will depend on the residual maturity of the off-balance sheet trade finance-related product (5%, 7.5% and 10% where the residual maturity of an asset is less than 6 months; between 6 and 12 months; and greater than 12 months, respectively). Empirical data from across the industry, as reported in the International Chamber of Finance (ICC) Trade Register demonstrate that the actual claims paid rate is 0.25% for non-financial guarantees and 1.41% for financial guarantees. The off-balance sheet RSF factors are therefore disproportionate, and we request that the RSF factor is set at 0 – 5.0%. We recommend 2.5% as the applicable RSF which is still conservative and is a stressed requirement for what is a non-stressed metric.

We note that the consultation paper does not recognise the funding neutral nature of acceptances and propose that acceptances are treated as interdependent assets and liabilities. An acceptance is an on-balance sheet unfunded exposure arising in the course of documentary trade finance. In the absence of a regulatory classification, an acceptance would default to treatment as a funded asset with punitive RSF. Under an acceptance, a bank takes on two exposures: a liability that the bank must pay to the beneficiary (another financial institution), concurrently with a receivable asset which the bank will collect from the acceptance provider (a corporate). The liability will generally have no ASF due to the short tenor of these transactions, however without recognising the interdependency the unfunded asset would attract required stable funding.

PRA approach to the treatment of SFTs

Netting

The PRA propose to introduce additional netting criteria for SFTs. Specifically, SFT transactions which use Level 1 HQLA will not be allowed to be netted off against SFT transactions that do not use Level 1 HQLA.

The potential consequence of such a requirement will be to result in the grossing up of exposures in a manner which is not consistent with Basel or accounting treatment and would place firms operating in the UK at a competitive disadvantage relative to peers operating in competing jurisdictions.

Non-cash Collateral received as part of a Collateral Swap

The industry would like the PRA to consider the ASF treatment of off-balance sheet non-cash collateral received as part of a collateral swap transaction. Currently, in a transaction whereby non-cash asset is lent against non-cash collateral, the lent asset is considered as encumbered and may attract a higher RSF factor. However, the non-cash collateral received is typically off-balance sheet

and therefore would receive no ASF value, despite the fact that the firm has the right to reuse the asset and raise funding.

For example, a Level 2A asset (15% LCR haircut) is lent against a Level 1 asset (0% LCR haircut) collateral for 10 months. The Level 2A asset's RSF would increase from 15% to 50%. However, as the Level 1 asset is off balance sheet, it is not recognised to have any ASF value. The current treatment is the same as lending the Level 2A asset on an unsecured basis, which is not reflective of the risk characteristic of the transaction. This also ignores the fact that the Level 1 asset could be used for funding purposes.

The industry asks the PRA to consider recognising the ASF value of the off balance-sheet non-cash HQLA received (unencumbered and free to be reused) as part of a collateral swap.

Treatment of Securities held as hedge for derivatives

Firms provide equity market exposures to clients via short term transactions such as equity swaps. These derivatives transactions are important to institutional investors as they provide an efficient way for them to gain exposures to assets without holding the underlying cash securities. To hedge the market risk exposures, firms hold cash securities against such equity swaps. Securities are partly or fully funded through Initial Margin received by firms from their clients. Typically, firms have the right to re-use the collateral received and the securities held for the duration of the underlying swap. However, the link between the hedge and swap is not recognised in the NSFR, and therefore the shares held as hedges attract either 50% or 85% RSF, whereas the ASF for the Initial Margin received from clients is zero.

We recommend that the PRA should set 0% required stable funding for securities held as hedges and funded via initial margin received from clients where the firm has a right to re-use the collateral received.

Summary

In summary, and for the reasons articulated above, the industry would request the PRA to amend a number of areas of the proposed liquidity provisions contained within CP 5/21. This includes, but is not limited to, the following areas:

5. **To remove the requirement that each in scope entity of a DolSub waiver meet LCR and NSFR requirements on a standalone basis.**
2. **To provide more guidance on what constitutes a "stress period" in the context of the LCR Level 2B equity price decline test.**
3. **To review the Historic Look Back Approach calculation methodology in order to mitigate pro-cyclicality.**
4. **To be categoric in specifying that derivatives client clearing activities automatically qualify for treatment as interdependent assets and liabilities requiring no prior approval from the PRA.**
5. **To remove reliance on the short-term equity price decline test in order to calibrate RSFs in the NSFR and instead applying the already prudent RSF of 50% to all Major Index/Recognised Exchange equities.**
6. **Aligning the treatment of own issuance securitisations to underlying funding risks by removing the exclusion for own issued securities.**
6. **Short term Trade finance exposures should attract an RSF of 10%.**
7. **To refrain from divergence from Basel standards by implementing additional netting criteria for SFTs**

Appendix: Additional NSFR issues

Please note that the table below lists additional NSFR concerns member banks would like to bring to the attention of the PRA and do not represent a summary of the issues raised above.

Suggested Amendments to Proposed PRA NSFR Rules (APPENDIX H – CP5/21)

No	PRA Rulebook Article Reference	Proposal	Rationale
TRADE FINANCE EXPOSURES			
1	**Article 428(f) Para 2** [Provision left blank]	**Treatment of payables and receivables arising from trade finance acceptances as interdependent assets and liabilities** **[insert]** Payables and receivables arising from trade finance acceptances shall be considered to meet the conditions set out in paragraph 1.	An acceptance is an on-balance sheet unfunded exposure arising in the course of documentary trade finance. In the absence of a regulatory classification, an acceptance would default to treatment as a funded asset with punitive RSF. Under an acceptance, a bank takes on two exposures: a liability that the bank must pay to the beneficiary (another financial institution), concurrently with a receivable asset which the bank will collect from the acceptance provider (a corporate). The liability will generally have no ASF due to the short tenor of these transactions, however without recognising the interdependency the unfunded asset would attract required stable funding
2		**Reduced RSF Factor for trade finance off-balance-sheet related products** **New provision following 428(r)** 2.5% Required Stable Funding Factor Trade finance off-balance-sheet related products as referred to in Annex I of the *CRR* with a residual maturity of less than one year.	The consultation outlines RSF factors that depend on the residual maturity of the off-balance sheet trade finance-related product (5%, 7.5% and 10% where the residual maturity of an asset is less than 6 months; between 6 and 12 months; and greater than 12 months, respectively). However, empirical data from across the industry, as reported in the International Chamber of Finance (ICC) Trade Register, demonstrates that the actual claims paid rate is only 0.25% for non-financial guarantees and 1.41% for financial guarantees. On this basis, setting a requirement of 5% or higher is disproportionate to the expected pay rate. The proposed 2.5% is still conservative and is a stressed requirement for what is a non-stressed metric.

No	PRA Rulebook Article Reference	Proposal	Rationale
3	**Article 428s (1) d** Trade finance off-balance-sheet related products as referred to in Annex I of the *CRR* with a residual maturity of less than six months	**Reduced RSF Factor for trade finance off-balance-sheet related products** Trade finance off-balance-sheet related products as referred to in Annex I of the *CRR* with a residual maturity of ~~less than six months~~ one year or more.	Please see above rationale provided for trade finance off-balance sheet related products with residual maturity of less than one year.
4	**428(u)** Trade finance off-balance-sheet related products as referred to in Annex I of the *CRR* with a residual maturity of at least six months but less than one year shall be subject to a 7,5 % required stable funding factor.	**Reduced RSF Factor for trade finance off-balance-sheet related products** [deleted]	Please see above rationale provided for trade finance off-balance sheet related products with residual maturity of less than one year.
5	**Article 428v (b)** [CRR2 provision deleted]	**Reduced RSF Factor for trade finance on-balance sheet products** **New provision:** (b) trade finance on-balance-sheet related products with a residual maturity of less than six months;	Trade Finance facilities are not revolving in nature and typically require clients to present transaction documentation for each drawdown request which the bank assesses prior to drawing. As such, the bank retains significant control over future drawings and can choose not to fund if there are risk factors of concern. In post-Brexit recovery period, it is critical that UK enterprises retain access to affordable Trade Finance in order to weather increasingly complex international trade barriers. As such, and in order to maintain a level playing field with the UK's largest trade partner, it is appropriate for on-balance sheet trade finance exposures which are maturing in less than six months to attract an RSF factor of 10%.

No	PRA Rulebook Article Reference	Proposal	Rationale
6	**428(v)(c)** Trade finance off-balance-sheet related products as referred to in Annex I of the *CRR* with a residual maturity of one year or more	**Reduced RSF Factor for trade finance off-balance-sheet related products** [deleted]	Please see above rationale provided for trade finance off-balance sheet related products with residual maturity of less than one year.
7	**Article 411 (16)** 'factoring' means a contractual agreement between a business (the 'assignor') and a financial entity (the 'factor') in which the assignor assigns or sells its receivables to the factor in exchange for the factor providing the assignor with one or more of the following services with regard to the receivables assigned: (a) an advance of a percentage of the amount of the assigned receivables, generally short term, uncommitted and without automatic roll-over; (b) receivables management, collection and credit protection, whereby, in general, the factor administers the assignor's sales ledger and collects the receivables in the factor's own name; for the purposes of Title IV (The net stable funding ratio), off-balance sheet factoring shall be treated as trade finance;	**Recognition of on-balance-sheet factoring as trade finance** 'factoring' means a contractual agreement between a business (the 'assignor') and a financial entity (the 'factor') in which the assignor assigns or sells its receivables to the factor in exchange for the factor providing the assignor with one or more of the following services with regard to the receivables assigned: (a) an advance of a percentage of the amount of the assigned receivables, generally short term, uncommitted and without automatic roll-over; (b) receivables management, collection and credit protection, whereby, in general, the factor administers the assignor's sales ledger and collects the receivables in the factor's own name; for the purposes of Title IV (The net stable funding ratio), on and off-balance sheet factoring shall be treated as trade finance;	On balance sheet factoring works similarly to off-balance sheet factoring, linked to the working capital cycle of the client. The only difference between them is that the client has chosen to not pass the risk of the buyer default onto the factor (which means that the factor also has recourse to the seller client in case of non-payment of an invoice). Defining on balance sheet factoring as non-trade finance would be contrary to the industry practice.
8	**Article 428s 1c**	**Removing stable funding requirement from commitments to issue guarantees and letters of credit**	In absence of this exemption, the undrawn committed facilities to issue off balance sheet products (like guarantees and letters of credit) would attract 5% RSF.

No	PRA Rulebook Article Reference	Proposal	Rationale
	The following assets and off-balance-sheet items shall be subject to a 5 % required stable funding factor: … (c) The undrawn portion of committed credit and liquidity facilities pursuant to Chapter 2 of the Liquidity Coverage Ratio (CRR) Part of the *PRA* Rulebook; (d) Trade finance off-balance-sheet related products as referred to in Annex I of the *CRR* with a residual maturity of less than six months. …	The following assets and off-balance sheet items shall be subject to a 5% required stable funding factor: … The undrawn portion of committed credit and liquidity facilities pursuant to Chapter 2 of the Liquidity Coverage Ratio (CRR) Part of the PRA Rulebook excluding commitments to issue guarantees and letters of credit…	For products where the drawn RSF itself is between 5% – 10% (or 2.5% for <1yr as proposed herein) and the probability of a fund outflow for a committed undrawn facility requires 2 events (facility utilisation as well a contingent event), RSF of 5% undrawn facility value is overly punitive.
TREATMENT OF MARKETS TRANSACTIONS			
9	**Article 428r**	**Treatment of short covering securities financing transactions** **New provision:** 1 (h) monies due from securities financing transactions with financial customers, where those transactions have a residual maturity of less than six months, and where those monies due are collateralised by assets that are used to cover short transactions. 1(i) commitments to issue guarantees and letters of credit	**Short covering securities financing transactions** Securities financing transactions where the collateral borrowed is used to cover shorts are liquidity and funding neutral, i.e. they are financed by the proceeds of the short sale transaction. The LCR recognises this, by setting the inflow from such transactions to 0%, matching the outflow rate of cash received from the sale. There is no equivalent recognition of this in the NSFR, which is therefore overly conservative. Incorporating a similar treatment into the NSFR would avoid unnecessary costs on the provision of market-making services, and would not lead to a shortfall of stable funding against this activity (which as we note is self-funding). **See rationale provided against Article 428s 1c. The proposal is reducing the stable funding requirement from 5% to 0%.**

No	PRA Rulebook Article Reference	Proposal	Rationale
10	**Article 428ad** (a) unencumbered assets that are eligible as level 2B assets pursuant to Chapter 2 of the Liquidity Coverage Ratio (CRR) Part of the PRA Rulebook, excluding level 2B securitisations and high quality covered bonds pursuant to that delegated act, regardless of whether they comply with the operational requirements and with the requirements on the composition of the liquidity buffer as set out in that delegated act;	**Qualifying Criteria for Level 2B Equities** **New Provision** (a) unencumbered assets that are eligible as level 2B assets pursuant to Chapter 2 of the Liquidity Coverage Ratio (CRR) Part of the PRA Rulebook, excluding level 2B securitisations and high quality covered bonds pursuant to that delegated act, regardless of whether they comply with the operational requirements, the requirements set out in Articles 7(4), 12(c)(ii) and (iii), and with the requirements on the composition of the liquidity buffer, as set out in that delegated act;	The PRA correctly identifies that incorporating the 40% price drop test used in part to determine which equities are Level 2B could be pro-cyclical and have unintended consequences. However, the issue is broader than this single provision. In practice, by incorporating all criteria from the LCR into the NSFR, the PRA has de facto incorporated into it much of the severity of the LCR stress. This contradicts the claim that the NSFR is a less stressed metric. We are not aware of any empirical evidence, and the PRA has provided none, that over the one-year time horizon and milder stress scenario of the NSFR equities that are: (i) not denominated in GBP, or only denominated into other currencies up to the amount of the LCR stressed outflows, (ii) have dropped in price by more than 40% in a 30-day period of severe stress and/or (iii) are issued by a financial institution require more stable funding than those equities which are not. The PRA recognises the difference with the LCR by not requiring assets to meet the operational requirements, but does not extend that logic to other requirements designed to serve the same purpose. To ensure coherence with the NSFR scenario, these restrictions should be removed. Even following this change an RSF factor of 50% is still conservative relative to the liquidity and funding value of these securities. We would note similar restrictions apply to Level 1 assets, in respect of caps on net stressed outflows. It seems strange that a 1-year funding requirement for an asset would vary according to the institution’s outflows in that currency in the next 30 days.

No	PRA Rulebook Article Reference	Proposal	Rationale
11	**428(f)2** [Corresponding CRR2 provision deleted]	**Derivative client clearing and interdependent assets and liabilities** 2. Assets and liabilities shall be considered to meet the conditions set out in paragraph 1 and be considered as interdependent where they are directly linked to the following products or services: (a) [Provision left blank] (b) promotional loans and credit and liquidity facilities that fulfil the criteria set out in the delegated act referred to in Article 460(1) for institutions acting as simple intermediaries that do not incur any funding risk; (c) covered bonds that meet all the following conditions: (i) they are covered bonds as referred to in provisions implementing Article 52(4) of Directive 2009/65/EC or they meet the eligibility requirements for the treatment set out in Article 129(4) or (5) of this Regulation; (ii) the underlying loans are fully match funded with the covered bonds that were issued or the covered bonds have non-discretionary extendable maturity triggers of one year or more until the term of the underlying loans in the event of refinancing failure at the maturity date of the covered bond;	The PRA has removed a number of CRR2 provisions that correctly identify interdependent assets and liabilities, and fulfil the conditions laid out in paragraph 1. The PRA has provided no justification for so doing, and this approach will overestimate the funding needs of these activities, and the stable funding requirements of subsidiaries of UK headquartered banks in Europe. The industry is particularly surprised the PRA has not granted this treatment for derivative client clearing where an overly penal treatment could result in firms seeking to relocate this activity to the EU (where outside the UK consolidation), or being uncompetitive when compared to EU banks which may see activity migrate of its own accord. The industry sees no benefit in the PRA soliciting waiver applications from the numerous client clearing banks operating in London when many other regulators recognise the interdependent nature of this activity. For avoidance of doubt, UK-headquartered banks may also have subsidiaries that offer promotional loans pursuant to sub-paragraph (a) and issue covered bonds pursuant to paragraph (b)

No	PRA Rulebook Article Reference	Proposal	Rationale
		(d) derivative client clearing activities, provided that the institution does not provide to its clients guarantees of the performance of the CCP and, as a result, does not incur any funding risk.	
12	**Article 428ag(a)** **85 % required stable funding factor** The following assets and off-balance-sheet items shall be subject to an 85 % required stable funding factor: (a) any assets and off-balance-sheet items, including cash, posted as initial margin for derivative contracts, unless those assets would be assigned a higher required stable funding factor in accordance with Article 428ah if held unencumbered, in which case the higher required stable funding factor that would apply to those assets if they were held unencumbered shall apply;	**Crediting initial margin received with stable funding value** **<u>Alternative 1:</u>** (a) any assets and off-balance-sheet items, including cash, posted as initial margin for derivative contracts, <u>net of any assets including cash received as initial margin for derivative contracts that can be rehypothecated</u>, unless those assets <u>posted</u> would be assigned a higher required stable funding factor in accordance with Article 428ah if held unencumbered, in which case the higher required stable funding factor that would apply to those assets if they were held unencumbered shall apply; **<u>Alternative 2 (new text, all underlined):</u>** **<u>Article 428l2</u>** **<u>85 % available stable funding factor</u>**	The NSFR treats initial margin asymmetrically, and inconsistently with variation margin. In reality, initial margin received that can be re-hypothecated is a funding source equivalent to variation margin and should be treated symmetrically with initial margin placed.

No	PRA Rulebook Article Reference	Proposal	Rationale
		Any assets and off-balance-sheet items, including cash received as initial margin for derivative contracts that can be rehypothecated,	
13	**Article 428ah(2)(a)** Institutions shall apply a 100 % required stable funding factor to the difference, if positive, between the sum of fair values across all netting sets with positive fair value and the sum of fair values across all netting sets with negative fair value calculated in accordance with Article 428d. The following rules shall apply to the calculation referred to in the first subparagraph: (a) variation margin received by institutions from their counterparties shall be deducted from the fair value of a netting set with positive fair value where the collateral received as variation margin qualifies as a level 1 asset pursuant to Chapter 2 of the Liquidity Coverage Ratio (CRR) Part of the PRA Rulebook, excluding extremely high quality covered bonds specified in that delegated act, and where institutions are legally entitled and operationally able to reuse that collateral;	**Deduction of non-Level 1 variation margin received from the fair value of a netting set with positive fair value** (a) variation margin received by institutions from their counterparties shall be deducted from the fair value of a netting set with positive fair value where the collateral received as variation margin qualifies as a high quality liquid assets pursuant to Chapter 2 of the Liquidity Coverage Ratio (CRR) Part of the PRA Rulebook, having been adjusted for applicable haircuts, and where institutions are legally entitled and operationally able to reuse that collateral;	The PRA rightly departs from the Basel standard and permits the recognition of re-hypothecatable collateral received as a funding source. However, the proposed treatment does not reflect the funding value of non-Level 1 collateral received. This treatment does not reflect the fact that such collateral does have funding value and is incoherent with the rest of the NSFR where such funding value is recognised with beneficial RSF factors.
14	**428(e)1** Assets and liabilities resulting from securities financing transactions and long settlement transactions with a single counterparty and with	**Removal of additional netting condition** Assets and liabilities resulting from securities financing transactions and	The PRA has introduced a provision that is not included in either the Basel standard, CRR2 rules or the NSFR standard as implemented in any other jurisdiction.

No	PRA Rulebook Article Reference	Proposal	Rationale
	underlying collateral that comprises either level 1 assets only or non-level 1 assets only shall be calculated on a net basis, provided that those assets and liabilities meet the following netting conditions: (a) the transactions have the same explicit final settlement date; (b) the right to set off the amount owed to the counterparty with the amount owed by the counterparty is legally enforceable in the normal course of business and in the event of default, insolvency and bankruptcy; (c) the counterparties intend to settle on a net basis or to settle simultaneously, or the transactions are subject to a settlement mechanism that results in the functional equivalent of net settlement.	long settlement transactions with a single counterparty ~~and with underlying collateral that comprises either level 1 assets only or non-level 1 assets only~~ shall be calculated on a net basis, provided that those assets and liabilities meet the following netting conditions: (a) the transactions have the same explicit final settlement date; (b) the right to set off the amount owed to the counterparty with the amount owed by the counterparty is legally enforceable in the normal course of business and in the event of default, insolvency and bankruptcy; (c) the counterparties intend to settle on a net basis or to settle simultaneously, or the transactions are subject to a settlement mechanism that results in the functional equivalent of net settlement.	The PRA has provided no justification for this treatment other than it "considers this approach to be prudent". However, that is not the applicable test (clearly any increase in the severity of the NSFR is arguably "prudent"). As this treatment goes beyond the minimum requirement of the Basel standards the industry is concerned it could impact the competitiveness of the UK.
OTHER PRA NSFR RULES			
15	**428a** Where the net stable funding ratio set out in this Title IV (The net stable funding ratio) applies on a consolidated basis in accordance with rule 2.4 of this Part, the following provisions shall apply: (a) the assets and off-balance-sheet items of a subsidiary having its head office in a third country which are subject to required stable funding factors under the net stable funding requirement set out in the national law of that third country that are higher than those specified in Chapter 4 of Title IV (The net	**Removal of 'worst of' rule** [Deleted]	Taking the 'worst of' local rules and consolidated rules on an item-by-item basis is overly prudent and was not included in the Basel standard. This treatment fails to recognise that, for many jurisdictions, some parts of the NSFR may be more conservative, and others less so. By only taking into account parts of the standard which are more conservative it will lead to overly prudent results, which overestimate the funding risk in overseas subsidiaries, both when compared to the Basel standard, the PRA's rules and the local regulatory implementation.

No	PRA Rulebook Article Reference	Proposal	Rationale
	stable funding ratio) shall be subject to consolidation in accordance with the higher factors specified in the national law of that third country; (b) the liabilities and own funds of a subsidiary having its head office in a third country which are subject to available stable funding factors under the net stable funding requirement set out in the national law of that third country that are lower than those specified in Chapter 3 of Title IV (The net stable funding ratio) shall be subject to consolidation in accordance with the lower factors specified in the national law of that third country; (c) third-country assets which meet the requirements laid down in Chapter 2 of the Liquidity Coverage Ratio (CRR) Part of the PRA Rulebook and which are held by a subsidiary having its head office in a third country shall not be recognised as liquid assets for consolidation purposes where they do not qualify as liquid assets under the national law of that third country which sets out the liquidity coverage requirement; (d) [Note: Provision left blank]		The provision should be deleted, or if thought necessary to "overrule" the local regulatory calibration, this assessment should be conducted at the overall requirement of the subsidiary, i.e. less severe factors should be permitted to offset more severe factors. We would also note part (c) refers to the LCR treatment of HQLA, not the NSFR treatment which would be covered in part (a), so is superfluous.
16	**428(b)5** Institutions shall ensure that the distribution of their funding profile by currency denomination is generally consistent with the distribution of their assets by currency.	**Removal of restrictions on currency mismatches** [Deleted]	This provision is copied across from the LCR which is a cashflow metric, where it is intended to address over-reliance on transacting FX swaps during the 30-day stress period. However, the NSFR is a balance sheet metric, and currency mismatches in funding are typically hedged using off balance sheet derivatives, e.g., through the use of FX swaps, which are not treated in the same manner as on balance sheet assets and liabilities.

No	PRA Rulebook Article Reference	Proposal	Rationale
			It is therefore, perfectly possible for an institution to be fully hedged on a currency basis, and yet the distribution of their funding profile by currency denomination to not be generally consistent with the distribution of their assets. Equally the NSFR scenario is entirely consistent with FX swap markets remaining open. In summary: whilst this provision makes sense for the LCR, it does not for the NSFR.
17	**428(c)3** Unless otherwise specified in this Title IV (The net stable funding ratio), where an item can be allocated to more than one required stable funding category, it shall be allocated to the required stable funding category that produces the greatest contractual required stable funding for that item.	**Removal of the requirement to apply most penal funding requirement** [Deleted]	The PRA has deleted the corresponding provision from the LCR (see Article 4(6) of the LCR Delegated Act). It's not clear why the PRA has not made the corresponding change in the NSFR. Generally, in prudential regulation, there is not a requirement for firms to take the most penal regulatory treatment of an activity when an alternative exists (see e.g. encumbrance of collateral pools in the LCR)
18	**428(d)6** [CRR2 Provision deleted]	**Derivative transactions with central banks** 6. Competent authorities may decide, with the approval of the relevant central bank, to waive the impact of derivative contracts on the calculation of the net stable funding ratio, including through the determination of the required stable funding factors and of provisions and losses, provided that all the following conditions are met: (a) those contracts have a residual maturity of less than six months;	The PRA notes in the CP that a Basel discretion permits the exemption of derivative contracts with central banks, and states: "the PRA would consider granting rule modifications to exempt such transactions from the NSFR should that be necessary". However, it has deleted the relevant provision in the final rules and not included it as a permitted waiver (as it has, for example, with the intragroup treatment in Article 428h amongst others). It is not clear why the PRA has taken this approach, and if anything regarding the PRA's willingness to grant such waivers should be read into it. For consistency, the provision should be reinstated with the appropriate language regarding available waivers.

No	PRA Rulebook Article Reference	Proposal	Rationale
		(b) the counterparty is the Bank of England or the central bank of third country; (c) the derivative contracts serve the monetary policy of the Bank of England or the central bank of a third country. Where a subsidiary having its head office in a third country benefits from the waiver referred to in the first subparagraph under the national law of that third country which sets out the net stable funding requirement, that waiver as specified in the national law of the third country shall be taken into account for consolidation purposes.	
19	**428(f)1** 1. An institution may apply to the competent authority for permission to treat an asset and a liability as interdependent. For the purpose of this article, an asset and a liability are interdependent where: … (c) the asset and interdependent liability have matched maturities; …	**Maturity condition for interdependent assets and liabilities** (c) the asset and interdependent liability have substantially matched maturities, with a maximum delay of 20 days between the maturity of the asset and the maturity of the liability;	The PRA has amended, without comment, the maturity condition in the CRR2. Given the NSFR measures the stability of funding over a one-year time horizon, it is not necessary for the maturities to be precisely matched for there to be no funding risk on such a time horizon.
20	**428(l)(b)(iv)** multilateral development banks referred to in Article 117(2) and international organisations referred to in Article 118;	**Broader definition of multilateral development banks**	It is unnecessarily restrictive to limit the MDB's in this article to those in Article 117(2) of the CRR. This excludes a number of MDBs who can provide stable deposits and doesn't recognise that many MDBs have been incorporated since the original CRR and are not included.

No	PRA Rulebook Article Reference	Proposal	Rationale
		multilateral development banks referred to in Article 117~~(2)~~ and international organisations referred to in Article 118;	The PRA has the opportunity to carefully consider the definition of MDBs, noting the list currently used has remained broadly unchanged since 2013. Finally, we would note this issue is applicable in many places throughout the LCR and NSFR
21	**428p (7)** [CRR2 provision deleted]	**Temporary Central Bank Operations** In the case of non-standard, temporary operations conducted by the Bank of England or the central bank of a third country in order to fulfil its mandate in a period of market-wide financial stress or in exceptional macroeconomic circumstances, the following assets may receive a reduced required stable funding factor: …	In the CP, the PRA notes this provision is in the Basel standard (it is also in CRR2) but states that rather than following the Basel and European approach of explicitly including it in the standard, were it to be thought necessary they would agree this approach with the Bank of England and offer, we presume, a modification by consent, at the time. However, this significantly narrows the scope of the CRR2 provision which was not limited to the operations of the domestic central bank. As such if the central banks of third countries were to use this provision, UK headquartered banks would be unable to take advantage of it. The PRA should reinstate this provision as it is applicable to third parties, and permit firms to use it if it has been incorporated in the national rules of the stable funding requirement of a third country.
22	428 p(9)	Art. 428p(9) *Institutions shall include financial instruments, foreign currencies and commodities for which a purchase order has been executed in the calculation of the amount of required stable funding ~~financial instruments~~*	Drafting error

Suggested Amendment to proposed PRA LCR Rule (APPENDIX I – CP5/21)

23	**Article 2** **…** **…** **3.** Where a *CRR consolidation entity* is required to comply with Chapter 2 of the Liquidity Coverage Ratio (CRR) Part of the *PRA* Rulebook on the basis of its consolidated situation all the following provisions shall apply: (a) … (b) liquidity outflows in a subsidiary undertaking in a third country which are subject under the national law of that third country setting out the liquidity coverage requirement to higher percentages than those specified in Title III (Liquidity outflows and inflows) shall be subject to consolidation in accordance with the higher rates specified in the national law of the third country; (c) liquidity inflows in a subsidiary undertaking in a third country which are subject under the national law of that third country setting out the liquidity coverage requirement to lower percentages than those specified in Title III (Liquidity outflows and inflows) shall be subject to consolidation in accordance with the lower rates specified in the national law of the third country; **…**	**(b)** [Deleted] **(c)** [Deleted]	Refer to Item 16 above. Refer to Item 16 above.
24	**Article 24**	**…**	We note that the provision in the DA, that flows directly from the Basel standard, which permits the use of a 3% outflow rate for

	1. Unless the criteria for a higher outflow rate under Article 25(2), (3) or (5) are fulfilled, the amount of retail deposits covered by the UK deposit guarantee scheme or an equivalent deposit guarantee scheme in a third country shall be considered as stable and multiplied by 5 % where the deposit is either: (a) part of an established relationship making withdrawal highly unlikely; or (b) held in a transactional account. … **6. [Note: Provision left blank]**	**Insert** 6. Credit institutions shall multiply by 3 % the amount of the retail deposits covered by a deposit guarantee scheme in a third country equivalent to the scheme referred to in paragraph 1 if the third country allows this treatment.	insured deposits, in certain limited circumstances, has been deleted. No analysis to support this deletion has been provided. In contrast, the Basel Committee standard, the EU rules, rules in a number of third country jurisdictions, and the Basel Committee RCAP of these jurisdictions have all endorsed this approach. We would also note this is an example of the unfair treatment in Article 2, where more lenient treatments are ignored, and more severe treatments incorporated. As in Article 2, there is no justification for making this a permission. It should simply be applied in the consolidated ratio. Therefore an outflow rate of 3% should be applied, where this treatment is authorised by third countries.
25	**Article 30** The credit institution shall add an additional outflow corresponding to collateral needs that would result from the impact of an adverse market scenario on the credit institution's derivatives transactions if material. This calculation shall be made in accordance with technical standards made under 2017/208.	The credit institution shall add an additional outflow corresponding to collateral needs that would result from the impact of an adverse market scenario on the credit institution's derivatives transactions if material. This calculation shall be made in accordance with technical standards made under 2017/208. Institutions shall include any increase in this requirement no later than 30 days following the calculation.	The Historical Look Back Approach introduces significant pro-cyclicality to the LCR measure as it is calculated as the largest absolute net 30-day collateral flow realised during the last 24 months. A possible way to reduce the procyclicality in this provision would be to delay increases impacting the LCR calculation for a period of up to 30 days. This is aligned with the provision that provides a 30-day ‘cooling off’ period for changes in HQLA eligibility.

Chapters 13 & 14 Reporting and Disclosure

1. <u>Alignment between reporting and disclosures (Mapping Tool)</u>

Para 14.4 of CP 5/21 states that "The ITS on public disclosures include templates and instructions that implement the first two phases of the Basel disclosure framework and directly reflect the updates to prudential requirements proposed elsewhere in this CP. "

The EBA produced a Mapping Tool to show how Pillar 3 should "directly reflect" COREP/FINREP. The PRA has not included this Mapping Tool in CP5/21.

Can the PRA confirm whether it expects firms to follow the Mapping Tool to produce Pillar 3 disclosures?

Firms have identified a small number of cases where the COREP/FINREP data points mapped to per Mapping Tool have definitions which are not consistent with the Pillar 3 definitions. Examples identified to date include some datapoints for CR7A, CR3 and CCR3.

Can the PRA advise preferred approach in these circumstances? (Details of potential inconsistencies identified to date are provided in Addendum)

2. <u>Year-end and half year COREP and FINREP submission deadlines</u>

Firms face significant challenges at both half year and year ends producing a high volume of financial disclosures, Pillar 3 disclosures, COREP, FINREP and other regulatory reports, often for multiple entities, to tight timelines. Firms also submit PRA 101-103 returns during this period.

The increased alignment between regulatory reporting and disclosures is a welcome development which will help to mitigate some of the production challenges which members face.

Notwithstanding this, the year-end deadlines for submitting key regulatory returns presents a particular challenge. Profits are not necessarily audited by this date, and Boards may not have concluded on dividends, meaning that COREP returns must be prepared and submitted on a non-final basis. They must then be updated and resubmitted some weeks later following results finalisation and audit completion. Preparation and governance of key regulatory returns typically involves personnel who are also heavily involved in ARA and Pillar 3 preparation: the demands on their time are exceptionally high during this period.

Both firms and the PRA want regulatory reporting to be of the highest quality; for resubmissions to be the exception rather than the norm; and for there to be consistency between regulatory reporting and disclosures. To this end we propose that the COREP and FINREP submission deadline at year-end should be extended to at least 2 months or 45 business days. This would allow for submission once only on a 'final' basis; would allow firms to focus attention on external disclosures in the first instance; and by doing so would make a very substantive difference to firms year end reporting challenges

We propose the PRA should extend the timeline for COREP and FINREP submissions at year end to at least 2 months or 45 business days.

3. PRA approach to EBA Q&As

CP 5/21 para 13.6 states:

"*The PRA considers that the most efficient way to implement the proposed updates to UK COREP and UK FINREP by the time the proposed new prudential requirements could come into effect is to use version 3.0 of the EBAs reporting taxonomy".*

As there are a relatively large number of changes to reporting included in taxonomy 3.0, it is likely that a substantial number of queries will arise which will be addressed via the EBA's Single Rulebook Q&A tool.

Can the PRA confirm its approach to EBA Q&As?

4. Annex XXVI - SUPPLEMENTARY REPORTING FOR THE PURPOSE OF IDENTIFYING AND ASSIGNING G-SII BUFFER RATES

This template G01:00 "G-SII indicators and EBU items" introduces, as a quarterly reporting requirement, the G-SII indicator data which is currently collected and published annually. It also contains four additional items (not part of the annual G-SII exercise) which "consider the European Banking Union as a single jurisdiction".

The purpose of this new quarterly reporting requirement was set out in the EBA ITS 2020/04 and was explicitly linked to European Banking Union development. Notably, the ITS stated that:

"81. *……, the inclusion of these data requirements is a key contribution to fostering the worldwide recognition of the Banking Union, the achievement of which is an objective of the established European Commission for the period 2019–2024."*

The fact that this was the EBA's principal reason for introducing the reporting is not referenced in CP5/21. The PRA's own rationale for introducing this into their quarterly reporting regime, having exited the EU, is unclear. We can see no obvious supervisory benefit for increasing the frequency of collection of G-SII indicators, or for requiring the additional EBU data items.

There will be an additional operational burden associated with quarterly preparation of this reporting for those firms affected. The summary return proposed does not reduce data collection or preparation timeframes compared to the current annual exercise, as all of the underlying details/data points must be collated in order to calculate the final indicators. Meanwhile the introduction of the "EBU as a single jurisdiction" section will add to the overall reporting burden.

We strongly urge the PRA to remove this requirement from the UK's quarterly supervisory reporting regime.

5. ANNEX II: INSTRUCTIONS FOR REPORTING ON OWN FUNDS AND OWN FUNDS REQUIREMENTS

C 08.07 - Credit risk and free deliveries: IRB approach to Capital Requirements (Scope of use of IRB and SA approaches (CR IRB 7))

The reporting instructions for C08:07 requires institutions to report all Standardised and IRB positions with the exception of securitisation positions and deducted positions in the C 08.07 template. However, certain Standardised exposure classes such as exposures in default, exposures associated with particularly high risk, exposures in the form of units or shares in collective investment undertakings ("CIUs") and "other items" are not included in the exposure class breakdown of the C 08.07 template.

Members request clarification on whether these exposures are to be reported in the template and, if these positions are in scope, how the PRA expects them to be classified.

6. ANNEX VII: INSTRUCTIONS FOR REPORTING ON LOSSES STEMMING FROM LENDING COLLATERALISED BY IMMOVABLE PROPERTY

Paragraph 10(b) of Annex VII states that Institutions shall report a) one total template; b) one template for each national market in the Union the institution is exposed to, and; c) one template aggregating the data for all national markets outside the Union the institution is exposed to.

Post Brexit, as the UK is no longer a part of the European Union, should the reference to "the Union" in Paragraph 10(b) of Annex VII be replaced with a reference to "the UK"?.

If this is the case, could the PRA confirm that firms should report:

a) one total template;
b) one template for the UK; and
c) one template aggregating the data for all national markets outside the UK the institution is exposed to.

Chapter 14 - Disclosure

1. Narrative Pillar 3 tables

The suite of Pillar 3 Annexes includes narrative tables (e.g. CRA, CRB). Adopting these will represent a significant departure from the current style of Pillar 3 disclosures; which in turn may create some practical challenges.

Can the PRA confirm that it wants firms to adopt the narrative tables in their Pillar 3 documents from 2022?

2. Art 434 Location/medium of disclosures

Art 434 CRR2 requires:

"Institutions shall disclose all the information required under Titles II and III in electronic format and in a single medium or location. The single medium or location shall be a standalone document".

For certain disclosures (notably Remuneration) many firms' practice has been to include all the required disclosures together as part of the ARA or separate Remuneration report, and not to separately disclose component parts in the Pillar 3 document. Firms consider this is a more efficient and useful way for end users to be provided with all the relevant subject information.

Will the PRA allow firms to continue to 'signpost' a (select) number of Pillar 3 disclosures as permitted by BCBS ?

3. Quarterly disclosure requirements for large institutions

Article 433a1(c) sets out quarterly disclosure requirements for large institutions. This will comprise templates OV1; KM1; LIQ1 and only if applicable certain Flow statements (CR8, MR2-B , CCR7). Many groups publish summary financial information for their large institutions on a semi-annual basis only and restrict publication of quarterly financial information to consolidated group only. Members question how useful the Pillar 3 disclosures for large institutions will be in the absence of accompanying financial information.

Will the PRA revisit this quarterly disclosure requirement and limit quarterly disclosure requirements to consolidated (and ring-fenced) entities only?

4. G-SII Disclosure

Article 441 requires G-SIIs to disclose annually, as part of their Pillar 3 disclosures, their G-SII indicators. Members advise that timing of Pillar 3 disclosures means it is very likely said indicators will not be finalised by time of publication. This raises the prospect of draft/ indicative data having to be included in Pillar 3, with final indicators published later. We do not believe this will be of benefit to users of Pillar 3, nor consistent with PRA's stated aim of strengthening but simplifying reporting and disclosure.

We propose that the PRA instead amend Article 434 which deals with the means of disclosure of Pillar 3, to make a clear exception for publication of G-SII indicator data by G-SIIs. Such amendment could for example state:

"*Institutions shall disclose all the information required in Articles 435 to 440 and Articles 442 to 451a of Title II and Title III in electronic format……"*
and then add a sub-paragraph which states:
"*G-SIIs shall disclose the information referred to in Article 441 no later than four months after each financial year-end."*

5. Net Stable Funding Ratio Disclosure

Article 451a (3) requires firms to disclose information in relation to their net stable funding ratio at quarter ends. The PRA seeks views from firms on whether spot disclosure of the NSFR and its components could lead to adverse market signalling during a stress.

We propose the NSFR disclosure should be on average basis, for example over the 4 quarter-ends preceding the disclosure. This would be in line with the current disclosure regime for LCR and would avoid adverse market signalling at times of stress.

6. ANNEX XXXVIII IRRBB

Non-maturity deposits

In respect of the IRRBB Pillar 3 qualitative disclosures on template UK IRRBBA, members highlight that a number of the disclosure requirements are proprietary in nature, namely (i) and (j). below. ***We recommend removing the requirement to disclose these metrics.***

(i) Average repricing maturity assigned to non-maturity deposits (NMDs).
(j) Longest repricing maturity assigned to NMDs.

We consider the average and max maturity information of NMDs to be commercially sensitive and potentially misleading to investors. NMD repricing maturity assumptions in isolation give an incomplete picture of overall interest rate risk. In absence of other component quantitative disclosures, this information could be misinterpreted as having a direct causal relationship to the overall ΔEVE & ΔNII quantitative disclosures

As a potential alternative approach in case removing the requirement is not possible, we would suggest aligning the approach for NMDs to the qualitative information requirements as a starting point. I Firms would have the flexibility to provide adequate narrative around this information, and they will be able to consider, if appropriate, the disclosure of a duration range or indicative duration to give a sufficient indication of the NMD duration. This alternative would be proportionate, to achieve objectives without requiring sensitive specific metrics to be disclosed.

The prescribed qualitative requirements on NMD should make it clear that the disclosure must give an indication of the governance, risk appetite, risk management applied to NMDs that make the strategy clear to the market.

More widely, members also question whether the information required in the qualitative disclosures is essential for external parties and the market to assess the nature and practices for measuring and controlling IRRBB and would highlight information requested may be easily misinterpreted. Members would note that the quantitative disclosures in UK IRRBB1 must be submitted on a consistent basis across industry (including the prescribed shocks per PRA Rulebook ICAA, 9.7) and consider this will provide a suitable means for the market to compare banks sensitivity to IRRBBB.

However, this misinterpretation can also apply to quantitative disclosures e.g. for a given disclosure date, firms may demonstrate varying levels of EVE exposure against Tier 1 capital that may be misinterpreted by the market as a perceived higher level of firm riskiness.

The PRA should consider the risk of this potential misinterpretation in the final IRRBB disclosure requirements.

Behavioural and strategic assumptions

Based on the BCBS d368 principles for supervisors (10 and 11), the evaluation of banks IRRBB exposures requires supervisors to compare the key behavioural and strategic assumptions made by banks. However, the mechanism by which this is sourced is not specified and accordingly members recommend that the PRA obtain these details only bi-laterally, rather than requiring their public disclosure.

ΔEVE & ΔNII assumptions within ANNEX XXXVIII.

We noted that the current drafting is highly ambiguous with regards to negative rate assumptions in the IRRBB disclosures. This could lead to vastly different approaches, and result in firms having to disclose potentially commercial sensitive information to explain their approaches.

We recommend that the PRA confirms:

- ***that the principles set out in paragraph 2.9B of the future SS31/15, which becomes effective from 31 December 2021 (as included in PS26/20), should be applied for the calculation of ΔEVE quantitative disclosures***
- ***including the -100 basis points rate floor in the calculation of the disclosable ΔNII measure.***

Timing of implementation

Further clarity would be welcomed from the PRA on initial reporting dates and frequency. Based on the consultation text, UK Finance members are working towards implementing and disclosing the quantitative NII and EVE metrics for the first regular disclosure date in 2022 (e.g. half year 2022

reporting for banks with a 31 December year-end). Qualitative information will follow for year end 2022 disclosures. In addition, we recommend that the first report is not comparative. The current template compares current vs. prior period however this would require disclosure for periods prior to the binding requirement; UK Finance members will therefore not be planning to include comparatives in their 2022 reporting

7. Annex XXII – Template CR6 IRB approach – Credit risk exposures by exposure class and PD range

The template requires a breakdown of exposures by PD range. The instructions have excluded certain exposure classes where this would not be appropriate, for example equity and securitisation, as the exposures cannot be split by PD. However, non-credit obligation assets (NCOAs) have not been excluded which would appear to be an oversight. The equivalent reporting template C08.03 does specifically exclude NCOAs in the instructions, part 3.3.1.

Members request that the disclosure template instructions are amended to exclude NCOAs.

8. Annex XXI & XXII – Template CR7-A IRB approach – Disclosure of the extent of the use of CRM techniques

Template CR7A asks for information on RWEAs before and after substitution effects, in columns 'm' and 'n'. The guidance for column 'm', which is described as "RWEA without substitution effects (only reduction)" states:

"The risk-weighted exposure amounts calculated in accordance with points (a) and (f) of Article 92(3) CRR, including any reduction of RWEA due to the existence of funded or unfunded credit protection, including where the PD and LGD or the risk weight is substituted due to the existence of unfunded credit protection. Nevertheless, in all cases, including where substitution approach is used, exposures are disclosed in the original exposure classes applicable to the obligor."

We believe this column is intended to capture:

- Where an exposure has been substituted from one exposure class to another, column m will report the RWA associated with that exposure in the row of the original obligor. Column n by contrast will report that same RWA in the row of the ultimate obligor.
- We do not believe this will result in meaningful information for the reader for the following reasons:
- Where the exposure is substituted to Central Governments by virtue of a government guarantee, and attracts a 0% risk weight, there is no RWA to 'move ' and report in the original obligor asset class in column m.
- Equally where substitution is from one obligor to another in the same exposure class , this presentation will not register any 'movement' in RWAs between columns m and n
- As CR7A does not include information on Standardised asset classes, any substitution that results in transfer of exposure between IRB and STA will also be incompletely represented in columns m and n.

So we propose that column m should not be reported. Instead, firms should provide narrative to supplement the table, describing the nature of material CRM with substitution effects including which obligor classes are most impacted.

ADDENDUM (example of potential misalignments between EBA Mapping Tool and definitions for respective reporting and Pillar 3 templates)

1 CR7A (IRB approach – disclosure of the extent of use of CRM techniques) and related reporting template C08:01 (IRB approach to capital requirements)

The EBA mapping tool maps collateral values reported in the COREP template "C 08.01 IRB approach to Capital Requirements" (columns 180 to 210) to CR7A columns b to e.

UK Pillar 3 disclosure instructions for the CR7-A template requires that the collateral value reported in columns b to e should be limited to the value of the exposure at the level of an individual exposure. Meanwhile UK COREP instructions for the C8.01 template do not specify such limits for collateral values reported in columns 180 to 210. Market values are reported, which can be in excess of exposure values.

In light of the above, we assume that columns b to e of the Pillar 3 Disclosure template CR7-A should not be linked to columns 180 to 210 of the COREP C8.01 template under the PRA rules; instead collateral value reported in these columns of CR7A should be limited to the value of the exposure.

2 CCR3 (Standardised approach – CCR exposures)/ related reporting template C07:00

The definitions for CCR3 state:

*Institutions using the credit risk standardised approach to compute risk weighted exposure amounts (excluding those derived from own funds requirements for CVA risk **and for exposures cleared through a CCP**) for all or part of their CCR exposures ………. shall disclose the following information.*

The EBA Mapping Tool maps all disclosures for CCR3 to COREP C07:00 (Standardised approach for credit and counterparty credit risk). Specifically, it maps to column 0210 "Exposure value of which arising from Counterparty Credit Risk". This column includes exposures cleared through a CCP; but the definition for CCR3 above explicitly excludes exposures cleared through a CCP.

Meanwhile column 0211 of C07:00 is "of which arising from CCR excluding exposures cleared through a CCP".

Can the PRA confirm whether it expects CCR3 to include or exclude exposures cleared through a CCP?

If PRA expects them to be excluded can it confirm the EBA Mapping Tool reference to Column 0210 of C07:00 could be replaced by reference to column 0211?

3 CR3 (CRM techniques overview) / related reporting templates F18 / F13

The EBA Mapping Tool for CR3 points to " maximum amount of guarantee or collateral that can be considered" , in templates F13 and F18, to populate the "Secured" values in template CR3. These FINREP datapoints are collateral values which are capped at the value of the exposure.

The definitions for CR3 state that where an exposure is partially secured, the full value of that exposure should be reported as secured:

In case the carrying amount of an exposure exceeds the value of collateral, financial guarantees and credit derivatives securing that exposure, the full carrying amount of that exposure should be included [as secured]

But by referencing FINREP datapoints which are collateral values, per the EBA Mapping Tool, in the case of partially secured exposures only the value of the security will be reported as secured in CR3. The remaining element of that exposure will be reported as unsecured.

Can the PRA confirm whether it expects CR3 to be prepared following EBA Mapping Tool, with partially secured exposures therefore being split between secured and unsecured?

UK Finance and its members look forward to discussing with the PRA the thoughts, observations and suggestions made in this response to the CP.

Responsible Executive

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