24 August 2021

Capital Standards Team
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Submitted electronically to: CP14_21@bankofengland.co.uk

Re: Consultations by the FPC and PRA on changes to the UK leverage ratio framework

Dear recipient,

The Association for Financial Markets in Europe (AFME) and International Swaps and Derivatives Association (ISDA), collectively 'the industry', welcome the opportunity to comment on the FPC and PRA consultations on changes to the UK leverage ratio (LR) framework.

The industry broadly supports the FPC and PRA's positions on implementing a leverage ratio that is better aligned with the BCBS standards for a broader set of institutions in the UK. This will enhance regulatory coherence as well as address some level-playing field considerations.

The industry's main comments relate to the definition of the scope, foreign asset threshold and how the central bank claim exemption is applied:

- There should be an opt out of the CB claim exemption for certain firms (such as investment firms, broker-dealers or other subsidiaries that cannot deposit funds with the central bank) that are not essential to monetary policy transmission. These firms should comply with the 3% threshold without the CB claim exemption as they naturally do not hold large customer deposits. The UK LR was initially scoped only for the largest UK banks with significant deposit taking activities and access to Bank of England facilities. However, with the expansion in scope, banks with certain other business models will also become subject to the UK LR.

- With regards to the scope, we believe that clarity is required for calculation of foreign assets. There are multiple considerations in terms of treatment of trading book assets, group structures, guarantees and derivatives or insurance policies. Furthermore, we recommend that an averaging methodology is applied to adjust for seasonal volatility of foreign asset holdings and to stabilise the measure. Such an averaging methodology should be based on the quarterly FINREP submissions to avoid additional operational burden.

- There are also issues with sub-consolidations, as we explain later in this comment letter. The UK LR framework as proposed has LR set at sub-consolidations for certain entity

structures, and one can assume therefore that the intention is to also set the LR MREL requirement at a sub-group level. However, MREL is still set at an entity level within the risk-based requirements, creating potential ambiguity. A clarification is required how these contrasting requirements would work in practice. Our recommendation is to align the risk based MREL with the LR framework at sub-consolidated level.

- Another consideration for UK bank subgroups is to address some legal entity structure related issues pertinent to ring-fenced subgroups. The ambiguity arises when a ring-fenced sub-group is headed by a holding company. In this situation, the LR would apply both at the sub-consolidated level and at the level of any subsidiary firm in the subgroup that individually meets the thresholds. Our proposal is for the PRA to extend the permission process to disapply the individual requirement where a firm that meets the threshold is contained within a ring-fenced sub-group.

In addition, we highlight in this comment letter a few points that relate to level-playing field with other European banks regarding export finance guaranteed by Export Credit Agencies, central bank practices in emerging markets and treatment of foreign COVID guarantees.

Finally, we would like to highlight that there are areas of ambiguity and potential double-counting of exposures in the BCBS exposure measure (EM). It would be helpful to establish an overarching principle in a form of recital or by other means to allow banks to eliminate demonstrable double-counts from the EM, unless a specific treatment is explicitly asked for (e.g. treatment of SFTs). Such a principle would eradicate the need to address each potential scenario individually and to make the framework overly prescriptive.

We thank you in advance for your consideration and please do not hesitate to contact us with questions or if you would like to discuss our recommendations further. We remain committed to assisting policymakers in achieving the objectives of the UK Leverage Ratio.

Kind regards,

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Scope of application

The industry participants feel the scope of application is not very clear and that there are inconsistencies between the scope to whom the binding LR applies and the COREP reporting requirements. Ideally, the reporting requirement should be aligned with binding capital requirement to avoid unnecessary operational burden for firms that do not need to comply with the LR capital requirement. In this context, we recommend aligning the scope definitions in chapter 9 and chapter 13 supervisory expectations so that firms not subject to the UK LR do not need to effectively comply with the LR requirements.

In addition, further clarification and justification is required on why £10 bn of foreign assets contrary to $50 bn of UK retail deposits is an appropriate threshold to subject institutions to comply with the UK LR. The CP doesn't contain any information on the rationale or the assessment of risk that would justify this particular lower threshold.

Further clarification is also needed on how the £10 bn foreign asset threshold will be implemented in practice. The definition of the £10bn foreign asset threshold should be clarified with respect to both banking book and trading book exposures. This ambiguity can be best demonstrated using the following examples:

- Where an institution issues banking book loans to non-UK counterparties and the loans are guaranteed by UK based guarantors e.g., UK based parent companies of foreign subsidiaries, would such exposures be in scope of the foreign asset thresholds?
- Where a number of foreign subsidiaries of a UK parent institution have consolidated total non-UK assets of over £10bn, will the UK parent institution be in scope of the leverage ratio requirement at a consolidated level?
- Where an institution holds long and short positions in foreign assets in the trading book, is the £10bn threshold calculated based on the net open asset position? Conversely, it will also need to be determined if a net short position of a foreign asset in the trading book results in any contribution towards this threshold.
- If a UK institution enters into a Total Return Swap (TRS) with a UK counterparty, where the TRS references a long position in a third-country debt instrument, will this contribute to a foreign asset threshold?

This list of examples is not exhaustive but demonstrates the difficulty in determining the assets to calculate the exposure. It is clear that further clarifications are required, bearing in mind the objectives of the UK LR.

Separately on implementation of the threshold methodology and determination of the £10 bn threshold, we believe that a form of averaging methodology would be beneficial in order to stabilise the determination, as some firms can have significant seasonal variation in holdings of non-UK assets. We recommend that the averaging methodology, as well as the calculation of foreign assets is further defined based on quantitative assessment and the methodology is defined with the objectives of the UK LR in mind. As noted in the executive summary, the methodology and frequency should be based on existing quarterly FINREP reporting requirements.

Derogation from individual requirement for entities within ring-fenced subgroup

As set out in paragraph 10.7 of the PRA consultation *an RFB which is the ultimate parent entity within a sub-consolidation group will not be subject to an individual requirement, if it meets the threshold on an individual basis*. This is implemented by amendments to Paragraph 2.1 on the basis of application in the Leverage Ratio – Capital Requirements and Buffers Part and is consistent with the FPC's proposed direction. However, this does not address the situation where a ring-fenced sub-group is headed by a holding company, in this situation the leverage ratio would apply both at the sub-consolidated level and at the level of any subsidiary firm in subgroup that individually meets the thresholds. This rule appears to give rise to an incremental requirement for these firms purely on the basis of their corporate structure.

The PRA also proposes to allow application on a sub-consolidated basis as an alternative to an individual requirement on a case-by-case basis and subject to PRA permission. However, the conditions placed around the granting of any application are such that they would not enable the individual application of the requirement to be replaced by the sub-consolidated requirement at the ring-fenced sub-group level. The nature of the oversight and governance of a ring-fenced subgroup means that leverage ratio risks and capital are managed at the level of the subgroup including any subsidiaries; there is a governance structure in place at the level of the ring-fenced holding company which covers the subgroup; the entities included within the subgroup are generally UK and EU based so there is effective supervisory cooperation. Unfortunately, it is not clear that this derogation would be applicable for sub-consolidations headed up by a holding company and the requirement that it would only be applicable for subsidiaries (rather than also including participations) means it would not in all situations be able to be applied at the level of ring-fenced sub-group.

Our proposal would therefore be that the PRA extend the permission process to disapply the individual requirement where a firm that meets the threshold is contained within a ring-fenced sub-group. In this situation the firm would still be subject to the Pillar 1 requirement at the sub-consolidated level and the PRA would receive detailed reporting on leverage at the firm level for relevant entities within the subgroup.

Central bank (CB) claims and minimum LR

The industry believes that there should be an opt out of the CB claim exemption, which would allow certain firms that are not essential to monetary policy transmission to comply with the 3% threshold without the CB claim exemption. In this context, we note that initially the UK LR was scoped only for the largest UK banks with significant deposit taking activities and access to Bank of England facilities. However, with the expansion in scope of the UK LR requirements, banks with certain other business models (investment firms, broker-dealers or other subsidiaries that cannot deposit funds with the central bank) will also become subject to the UK LR. The CB claim exemption and consequent increase in the LR measure do not seem to be justified for these entities, as they naturally do not hold large customer deposits. Therefore, they do not contribute as directly to the transmission of monetary policy as deposit taking banks. Such firms should be able to opt out from the CB exemption and comply with the 3% LR measure instead.

Central Bank claim maturity mismatches

The industry in concerned about the proposed direction suggested in the CP (paragraph 3.6, and hence PRA consultation Art. 429a) that central bank claims (including reserves) can be excluded from the Leverage Exposure Measure (LEM) only if their contractual maturity is less than the contractual maturity of the supporting deposits.

The capacity of emerging markets central banks to raise long-term liquidity is supported by their issuance of bonds. Holding of these bonds are allowed to satisfy central bank reserve requirements. However, the bonds generally have longer term tenors than client deposits and so would not qualify for exclusion from the LEM. This would lead banks to shift their required reserves from bonds to deposits, hence hindering the capacity of emerging markets central banks to raise long term liquidity and undermine the stability of the financial system.

We therefore propose that the maturity matching requirement should not be required for central bank bonds that meet reserve requirements.

Covid guarantee schemes

Loans under UK's Bounce Back Loans Scheme (BBLS) or to SMEs on the back of EEA government 100% backed Covid-19 guarantee schemes can be deducted from LEM. We believe this should be expanded to include jurisdictions outside of the EEA.

In a post-Brexit world, expanding this deduction to relevant Covid-19 support schemes to all countries would provide better support to PRA's standing as a global banking regulator. Government backing to Covid-19 schemes has a wide range and limiting the allowed deduction only to small sized loans to SMEs understates the impact that scheme lending has had on banks' balance sheets. Hence, we believe this deduction should be broadened for all Covid-19 government schemes regardless of loan size, borrower type and country, but only up to the percentage of government backing.

Double counts on exposure measure

The industry believes that there are areas of ambiguity in the BCBS LEM. It would be helpful to establish an overarching principle in a form of recital or by other means to allow banks to eliminate demonstrable double-counts from the EM, unless a specific treatment is explicitly asked for (e.g. SFT E-C add-on).

Examples of such double counts include:

- MREL holdings which are deducted from MREL are not currently removed from the LEM. The comparable CRR2 provision points to the Tier 1 capital stack, and therefore Tier 2 and MREL double counts are not removed.
- EAD reductions for provisions and overlapping securities positions.

Treatment of open-ended SFTs

Open-ended repos present standard market practice in many jurisdictions, where this practise has been developed in order to reduce operational burden between counterparties that often rollover their overnight transactions if funding requirements do not change materially. In these cases, the transactions can be unwound unconditionally at any time, by either counterparty, which makes them substantially similar to overnight repos rolled over every day. We believe that these transactions should be treated as if they had a one-day maturity and that the requirement of "same explicit final settlement date" should be deemed to be met, in order to allow the netting of cash payables to, and cash receivables from, the same counterparty. The leverage framework otherwise results in different exposures depending on market practice, for instruments which are economically equivalent (i.e. open repos and overnight repos).

We believe that treating open-ended repos as overnight repos is appropriate when the following characteristics are met:

- Open repo is used to invest cash or finance assets where the parties are not sure how long they will need to do so. Until an open repo is terminated, it automatically rolls over each day. An open repo can have a fixed or a variable rate. Interest accrues daily but is not compounded (i.e. interest is not earned each day on interest accrued over previous days). Outstanding interest is typically paid off monthly. The repo rate on an open transaction will be close to the overnight repo rate, but it will not change until the parties agree to re-set the rate.
- Collateral is marked to market daily in order to maintain the level of the haircut and a change in the market value of the securities portfolio triggers variation margins (with an appropriate and predefined threshold). Generally, only very small portions of securities are moved every day (depending on the change in the mark to market value of the existing securities portfolio and possible change in the nature of the securities).
- Open-ended SFT transactions that can be terminated at any day subject to an agreed recall notice period should be considered equivalent to having an explicit maturity equal to the recall notice period. This is to ensure that such transactions are eligible for the netting of cash receivables and payables of repurchase transactions and reverse repurchase transactions with the same counterparty.

Leverage ratio and MREL

The Bank of England's (BoE) Statement of Policy on Minimum Requirements for Own Funds and Eligible Liabilities (MREL) defines its approach to the distribution of MREL resources within groups ("Internal MREL"). In cases where BoE is a host authority of an overseas banking group, BoE sets Internal MREL requirements for material subsidiaries in the UK. The calibration of the requirements is based on the higher of: two times its Pillar 1 capital requirements and one times its Pillar 2A add-ons or two times the applicable leverage ratio requirement. The on-shored version of CRR II (article 92b) also requires subsidiaries to maintain Internal MREL calibrated at 90% of the higher of 16% of RWAs or 6% of leverage exposure (and 18% of RWAs or 6.75% of leverage exposure from 1 January 2022).

The industry supports the implementation of the LR; however, firms will benefit from a better interaction between the two regimes. The industry requests that the Internal MREL is calibrated based on the leverage ratio only when the latter is a binding minimum requirement to a firm.

Separately, the UK LR framework as proposed has LR set at sub-consolidations for certain entity structures, and one can assume therefore that the intention is to also be set the LR MREL requirement at a sub-group level. However, MREL is still set at an entity level for RWAs, creating some potential ambiguity for banks and investors. A clarification is required how these contrasting requirements would work in practice. The industry recommends aligning the risk-based MREL with the LR framework also at sub-consolidated level.

Export Credit Agency (ECA) guarantees

Under EU rules, guaranteed parts of exposures arising from export credits can be deducted from LEM. Guarantees from ECAs are an important means for countries to help their exporters by supporting commercial contracts. They enable other countries (mainly developing countries) to purchase goods and services from the exporters' home country. Not allowing this deduction in LEM would have an adverse impact both on global trade flows and also on developing economies' access to vital goods and capital investment. It would also put UK banks at a competitive disadvantage compared to EU banks.

Counterparty credit risk

The exposure measure for SA-CCR remains an issue. For leverage purposes, the exposure measure is meant to be reflective of the balance sheet value and not a risk value. As such, increasing the mark-to-market value by the alpha factor of 1.4 does not seem appropriate. We propose that the alpha factor be removed from the leverage exposure calculation.

Averaging Requirements (para 14.13-14.17)

In the section the PRA proposes that from 1 January 2023 firms will report daily on-balance assets and SFT exposures averaged over a quarter, with monthly averaging for off-balance sheet items and the capital measure. The PRA acknowledges the SFT exposures component as new and expects firms to retain their existing averaging calculation in reporting in a transition period from 1 January 2022 to 1 January 2023. During this period a daily average for on-balance sheet assets will be required, with monthly averaging for off-balance sheet items and the capital measure.

However, for firms that were previously not subject to UK framework there is currently no averaging methodology/reporting implemented, all reporting is on quarter-end spot basis in line with the European requirements. Based on the above, such firms will be required to report daily averages for on-balance sheet for the first time during the transitional period from 1 January 2022.

We don't believe this is proportionate for these firms, nor can be realistically be implemented in such a short period of time. We would also like to note that the proposed implementation

of averaging reporting appears to go further than the Basel requirements where the focus is specifically securities financing transactions (refer to Footnote 49 on p.42). Please refer to Appendix for reference.

We would therefore propose that firms not currently required to report under the daily averaging methodology will stay on existing spot methodology during the transitional period until 1 January 2023. An alternative to this may be to allow such firms to operate under monthly averaging in the transitional period.

Key Metrics (UK KM1) – Additional leverage ratio disclosure requirements

The industry agrees with the inclusion of the iterations of the leverage ratio, with and without central bank claims and under the averaging methodology, within the leverage disclosure templates such as UK LR2. However, we do not believe that the inclusion of this information in the Key Metrics disclosure (UK KM1) is necessary and would only increase operational burden and complicate this template. We propose that the LR information in the key metrics are limited to core information on satisfying the requirements. This would also be broadly in line with the Basel direction regarding disclosures.

Other minor points

- Appendix 2 (1.A.2.i), in the footnote, the reference to LV40 looks incorrect, it should be LV44.
- Template LV47, Row 0130 description "Exempted CCP leg of client-cleared trade exposures (original exposure method)" seems incorrect and looks like a copy paste from Row 0120. We believe it should be "Capped notional amount of written credit derivatives".
- Template LV47, Row 0490 states to report based paragraph 1 of Article 468 of the CRR. Article 468 transitional arrangement expired at the end of 2017 and therefore the relevance of Row 0490 is unclear.
- Template LV40, the excel template circulated as appendix 6a includes column 0040, Add-on for SFTs, which has all cells greyed out. We assume that this column is not for input and will be deleted.
- Template LV40, please confirm that row 0090 should exclude central bank exposures and that central bank exposures are then reported separately in row 0380.
- Template UK LR1 – LRSum: It is not clear where certain deductions from or adjustments to capital should be reflected in the return. These include items such as intangible assets, thresholds deductions, pensions etc.
- Row 11 has a title of "(Adjustment for prudent valuation adjustments and specific and general provisions which have reduced tier 1 capital (leverage))" and references points (a) and (b) of Article 429a(1).

- 429a(1)(b) “any items, other than liabilities, deducted in the calculation of the capital measure referred to in Article 429(3);” would seem to include these types of deduction / adjustment, although this is unclear from the row title.

Appendix

Reference: BCBS - Revisions to leverage ratio disclosure requirements June 2019

The Committee reviewed the comments received on the consultative document and conducted a quantitative impact study of the range of proposed treatments. Based on these inputs, the Committee has agreed that internationally-active banks must disclose the amounts of adjusted gross securities financing transaction (SFT) assets (as defined in paragraph 51(i) of the leverage ratio standard)3 based on quarter-end values and on an average of daily values over the quarter as part of their Pillar 3 requirements, in addition to disclosure of the total leverage exposure and the leverage ratio as calculated using the averaged value of SFTs. Given the heightened volatility in SFT markets around quarter-end dates, the disclosure of banks' average SFT exposures during the quarter will provide stakeholders with additional information related to banks' actual leverage.

This revision will apply to the Pillar 3 disclosure requirements associated with the version of the leverage ratio standard that will serve as the Pillar 1 minimum capital requirement as of 1 January 2022. Revisions to the Pillar 3 disclosure templates and instructions that will serve to implement these revised disclosure requirements are set out in the Annex to this document.

The Committee will continue to monitor trends in banks' leverage ratio exposures and may consider extending the scope of disclosure requirements based on averages if warranted to address potential window-dressing behaviours identified for other types of exposures, including derivative replacement cost and central bank reserve exposures as had been proposed in the December 2018 consultative document. The Committee also will continue to consider whether amendments to leverage ratio Pillar 1 calculation requirements would be appropriate to mitigate any persisting window-dressing behaviour.