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## AFME consultation response

### CP12/22 – Risks from contingent leverage

Date 03/02/2023

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#### Executive Summary

AFME and its members appreciate the opportunity to provide feedback on the proposed PRA contingent leverage framework being consulted upon. The PRA has been asking for the contingent leverage data from some banks as envisaged for the framework for a while. We also understand that other authorities are applying this template and that for example the ECB's Single Supervisory Mechanism (SSM) included 14 banks in its contingent leverage exercise in 2022. We appreciate the efforts of regulators to continue working on identifying the right scope and sources of material contingent leverage that this framework should capture.

The responses to the consultation within this comment letter are split between issues that relate to the proposed changes to the ICAAP supervisory expectations and the proposed changes to the reporting requirements.

Firstly, we believe that there will likely be a difference between the actual contingent risk that should be considered within the ICAAP and what may be reported on the templates, unless the scope and expectations are further clarified. In this context, the sub paragraph 2.48 in SS31/15, which states that firms should set out contingent leverage risks by each relevant trade structure that optimises leverage exposure, seems to point towards a limited number of business lines and structures that should be in scope for the regime. Therefore and in order to make the assessment informative and useful for the PRA, the focus should be on those businesses and structures which are considered to have a material and plausible risk of contingent leverage. We note that for example under the SSM, only a limited number of institutions with relevant business lines are generally in scope for the additional contingent leverage framework.

Secondly, the industry suggests that while the bi-annual reporting (i.e. every six months) would be appropriate, the reporting should be effective from 1 January 2024, with first a first reference reporting date of 30th June 2024. This will provide firms with sufficient time to build and test the new reports following the finalisation of the contingent leverage rules. Also, the industry questions the supervisory benefit and value added from daily averaging in the new templates, as opposed to say, month-end averages. Month-end averaging would align with the frequency of LV49-LV52, given collateral swap data is required on a monthly average basis.

Finally, we note that there is a significant overlap between the liquidity templates for LCR and NSFR as well as broader liquidity terminology and the contingent leverage proposal. We suggest that some of the data could be captured from the existing templates (such as LV49 vs LCR 75.1) to avoid unnecessary burden and to reduce duplication, in the spirit of PRA PP 4/22.

AFME and its members remain at the PRA's disposal should you have any questions regarding the feedback.

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## **Proposed changes to ICAAP supervisory expectations**

AFME and its members welcome clarification on the PRA's supervisory expectation and intentions regarding certain aspects of the ICAAP proposal.

Firstly, and based on the objectives of the contingent leverage framework, we would welcome a clarification on the scenario in which targeted action would be undertaken by the PRA under the Pillar 2 framework. In our view, such targeted action is an extension of the already existing considerations of risks that need to be identified for the risk-weighted asset regime and liquidity requirements. In terms of the ICAAP and potential evolution of a leverage Pillar 2 requirement, we note that there is a significant risk of duplication with capital and liquidity requirements which have already captured these risks. Firms already hold substantial liquidity buffers against funding risk for the same positions considered within this consultation and the reporting. Therefore, any capital considerations should relate to material and plausible risks of contingent leverage only when this identifies economic risks which have not been capitalised under the existing capital and liquidity frameworks. This is of particular importance as the objective of the Leverage Ratio (LR) is to be a non-risk based simple indicator of solvency rather than a risk or liquidity measure. In this regard, the concept of "contingent leverage" is not sufficiently defined in the consultation paper. The methodology for measuring contingent leverage and calibrating corresponding additional own funds needs to be further clarified to ensure transparency and a level playing field. The guidelines should be more explicit that additional capital requirements in respect of contingent leverage are only expected to be imposed in special situations where the risk of contingent leverage is assessed and quantified as material by reference to the institution's profile, capital and funding base.

In this context, the sub paragraph 2.48 in SS31/15, which states that firms should set out contingent leverage risks by each relevant trade structure that optimises leverage exposure seems to point towards a limited number of business lines and structures that should be in scope for the regime. To align this with the templates, we recommend that the disclosures should focus only on the more bespoke products subject to contingent leverage, where there is a risk of increased leverage exposure under a stress scenario. Typically, under stress circumstances, the big LR exposure measure risk for banks stems more from the flight to safety and increased deposits flows, as evidenced during the previous crises.

Secondly, all firms have internal limit frameworks in addition to the regulatory minimum leverage ratio. Such limits serve as a buffer for contingent leverage risks, given businesses will operate within prescribed limits. In addition, a number of businesses such as flow repo trading which commonly benefit from regulatory LR netting do not create material contingent leverage concerns due to the short-term nature of the business and high quality of collateral used (largely HQLA) in the transactions. Therefore, only businesses that the firm and PRA have identified as sources of material contingent leverage should be subject to contingent leverage ICAAP considerations. To ensure a targeted and focussed approach, the preference may be for firms to focus on those businesses and structures which are considered to have a material and plausible risk of contingent leverage in order to make the assessment informative and useful for the PRA.

Consequently, the preference may be, as above, for firms to be able to set their own materiality standards to define any relevant product sets, and to be able to consider at a macro level, rather than being required to consider each trade structure independently as stated in Annex I of PRA SS31/15.

This approach would be preferable compared to the current proposal which suggests consideration of each "capital efficient" trade structure independently as stated in Annex I of PRA SS31/15. AFME and its members feel that this approach would be onerous relative to the informational benefit that can be derived, particularly for immaterial structures or portfolios. Additionally, guidance on whether intercompany exposures are in scope should be clarified.

Finally, additional guidance is required on the definition of "franchise client" and scope of contingent leverage risk to ensure consistency and comparability across different firms. As currently defined, significant work

would be required to identify such clients across all of the firms' trading activities, when it appears from the draft amendments to SS 31/15 that the primary focus here is Prime Brokerage. We are therefore concerned that the current definition will require considerably more effort for a limited benefit by extending this concept to all business lines.

### **Proposed changes to reporting requirements**

AFME and its members also highlight that there is a significant overlap with the liquidity templates for LCR and NSFR as well as broader liquidity terminology. Therefore, some of the data could be captured from the existing templates (such as LV49 vs LCR 75.1) to avoid unnecessary burden and to reduce duplication, in the spirit of PRA PP 4/22. Furthermore, we recommend introduction of validation rules to ensure data provided across the various templates are consistent.

- The consultation paper adds new terminology that firms are required to incorporate in their reporting capabilities but not explicitly defined. These include “franchise client” and “internalisation”, which in many business lines mean different things and are subjective by nature. Investment is required to develop consistent approach across business lines.
- The strategic implementation of the incremental reporting requirements set out in the consultation paper does not only include data collection, which by itself does not raise major concern, but the infrastructure, procedures and controls required to process and categorize the data.
- Although there have been a number of iterations of ad-hoc collection exercises on contingent leverage, developing the data, procedure and controls for both enrichment to the (liquidity) feeds and new information for “franchise client” and “internalisation”, will be challenging for the proposed first submission in 2024, particularly as certain information is required on a daily basis from 1<sup>st</sup> July 2023 for the calculation of averages, which was not part of the previous ad-hoc exercises.

Therefore, while we agree that bi-annual reporting (i.e. every six months) would be appropriate, the reporting should be effective from 1 January 2024, with first a first reference reporting date of 30th June 2024. This will provide firms with sufficient time to build and test the new reports following the finalisation of the rules.

Also, the industry questions the supervisory benefit and value added from daily averaging in the new templates, as opposed to say, month-end averages which would align the frequency of LV49-LV52 given collateral swap data is required on a monthly average basis. The existing daily averaging requirements for SFT and on-balance sheet exposures were introduced in the international disclosure standards and designed to capture the short-dated nature of relevant transactions. However, the international standards do not require incremental reporting requirements on contingent leverage risk. Given the contingent nature of such risks, it can be argued that a more proportionate approach of month-end average is sufficient, given the additional categorisation (e.g. for franchise clients, internalisation, etc.) that has been requested. Although the PRA has suggested the average data can be provided on a ‘best estimates’ basis, we note that this is based on the valuation of assets and not the additional data that this reporting would require (namely data required to disaggregate portfolios by; franchise clients, internalisation, liquidity categorisation of assets). The operational burden of performing daily averaging on additional data sets in a controlled manner should not be underestimated.

Separately, we note that the averaging methodology in the UK Leverage Ratio (LR) framework ensures that some of the “window dressing” behaviour that the contingent leverage framework is trying to address in other jurisdictions is not relevant to firms in the UK. Therefore, we recommend that the averaged period is based on a six month-end average consistently across on-balance sheet assets, securities financing transactions and off-balance sheet items.

Finally, it is fundamentally important that the definitions are clear and can be interpreted consistently across different business lines and legal entities, as well as across the industry. We therefore welcome additional PRA

guidance in this area (e.g. qualitative criteria, any quantitative metrics, etc.), as without this clarity, the data can be meaningless in supporting the PRAs objective to capture systemwide risk of contingent leverage.

#### LV52.00 Treatment of internalised trades

We noted that for written credit derivatives (row 0090) the reporting template requires reporting activity in which the underlying asset is level 1 HQLA (row 0110). As these are credit derivatives, HQLA is not relevant and therefore we propose that this row is deleted from the reporting template and associated instructions.