

**Joint AFME- ISDA (“the Industry”)
Response to the PRA CP 16/22 –
Implementation of the Basel 3.1 standards**

March 2023

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PRA consultation- Implementation of the Basel 3.1 standards¹

1 Executive Summary

The Association for Financial Markets in Europe (AFME) and International Swaps and Derivatives Association (ISDA), collectively the 'Industry' welcomes this opportunity to respond to the Prudential Regulation Authority's (PRA) consultation paper CP16/22 – Implementation of the Basel 3.1 standards.

In evaluating the PRA's proposals, we have formulated recommendations that seek to:

- i) Maintain global connectedness in the financial system by supporting the role of the UK as an international financial hub;
- ii) Ensure the coherence and robustness of the prudential framework by removing duplicative, overlapping or overly conservative requirements that have acted as safeguards whilst the framework was being phased-in;
- iii) Reach an appropriate and risk-sensitive calibration that takes into account international standards, as well as implementation in major jurisdictions and proposes adaptations to reflect regional specificities; and
- iv) Ensure implementation timelines are coordinated internationally.

We note that, in a post-Brexit environment, the UK has the ability to write its own rules independently, taking into account the 'have regards' outlined in the Financial Services and Markets Act 2000² and the more recent Financial Services Act 2021³. This provides an opportunity for the capital rules to be reviewed holistically and we support the PRA's intention to review other elements of the framework, such as the treatment of securitizations when the appropriate powers are afforded to the PRA through the Financial Services and Markets Bill.

Overall, the Industry welcomes the proposals from the PRA including the targeted changes that would better capture risk and support the competitiveness of the UK. The Basel 3.1 capital framework is a necessary element of preserving financial stability. Equally, it is important that capital requirements are in line with the real economic risk incurred by banks. As such, we remain concerned by the significant impact on banks' capital requirements that will result without further changes, and urge to improve risk sensitivity in the framework. Disproportionate capital requirements have an impact on banks' ability to provide key financing, liquidity, hedging services and products to end-users.

The PRA's [Aggregated Cost Benefit Analysis](#) (Appendix 7 to CP16/22) shows the direct costs that it estimates will be placed on the Industry by its proposed rules. The PRA's analysis estimates that firms would raise on average around 3.1% additional Common Equity Tier 1 (CET1) capital, or £14.2 billion in total across all firms, compared with a baseline in which the proposals in CP 16/22 are not implemented

¹ <https://www.bankofengland.co.uk/prudential-regulation/publication/2022/november/implementation-of-the-basel-3-1-standards>

² <https://publications.parliament.uk/pa/bills/lbill/58-01/162/5801162.pdf>

³ <https://publications.parliament.uk/pa/bills/lbill/58-01/162/5801162.pdf>;
<https://www.legislation.gov.uk/ukpga/2021/22/contents/enacted>

in the UK.⁴ This impact estimate is based on the assumption that Pillar 2 adjustments will be made to release capital reserves as the revised framework incorporates more risk components under the Pillar 1 framework. Total capital, which includes CET1 capital, Additional Tier 1 capital, and Tier 2 capital, would also be expected to rise by 3.1%, or £19.7 billion in total across all firms. This analysis is based on banks maintaining the minimum required capital requirements and in the Industry's view underestimates the capital impact, as we do not expect that banks can operate at significantly lower capital ratios after the reforms have been implemented.

In contrast, the Industry Quantitative Impact Study (QIS) performed⁵ before the consultation was released shows that the implementation of the Basel 3.1 package in the UK will have a significant impact across the banks participating in the study and would require banks to raise significantly more in CET1 / T1 capital than estimated as part of the PRAs cost benefit analysis, to maintain their existing capital ratios.

Furthermore, the total operational compliance costs are estimated to be **£4.9 billion**.⁶ The largest share of these costs stem from the changes to the market risk framework, which accounts for £3.8 billion mainly incurred by large banks. The CVA framework accounts for a further £0.7 billion (or 14% of total costs for all firms), of which £0.6 billion (or 88% of total CVA costs) are incurred almost entirely by large banks.⁷

In its Cost Benefit Analysis, the PRA confirms that it has considered areas where Pillar 2 adjustments may offset some impacts of the proposed package. It is important that there is a comprehensive review of the Pillar 2 framework to mitigate overlap and duplication of capital charges with the Pillar 1 capital framework, and that this review is conducted as soon as possible to ensure significant day-1 impacts on banks resulting from duplicative unadjusted Pillar 2 requirements are avoided.

In our response to the HMT public consultation on the Implementation of the Basel 3.1 standards, submitted alongside this, we comment on revocations to facilitate the PRA's rulemaking and also include our position on equivalence. We highlight amendments that are required to operationalize the use of CVA intragroup exemptions as foreseen by the PRA, as well as on how to rationalize equivalence decisions more generally, particularly related to intragroup exposures. We believe the current system to be unduly complex in this area and this package provides an opportunity to improve this area of the framework materially.

We cover the following in this consultation response:

Chapter 3: Credit Risk – Standardised Approach (SA)

Changes in the treatment of credit risk under Basel III represent some of the widest ranging and most impactful measures on the role of banks in financing the real economy, due to the reduction on the scope of modelling directed at corporates and financial institutions.

⁴ <https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/consultation-paper/2022/november/cp1622app7.pdf>, p.19

⁵ The industry quantitative impact study was based on final Basel 3 standards and finalised before publication of the PRA's UK Basel 3.1 proposals.

⁶ Ibid.

⁷ <https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/consultation-paper/2022/november/cp1622app7.pdf>, p. 16

Consequently, while we support the PRA's proposal for a hybrid approach and the 65% RW for investment grade unrated corporates, we urge the PRA to closely monitor and keep under review the proposed treatment for non-investment grade unrated corporates, with regard it having a negative impact to financial stability and UK competitiveness and risk-sensitivity. Alongside this we propose several other policy options the PRA should also explore before finalising its approach.

Likewise, removing the SME and Infra supporting factors could further negatively impact upon competition and growth in a difficult economic climate.

With regard to currency mismatch the PRA should review its broad approach which captures asset based lending of HNWI, with a view to aligning scope to other jurisdictions and providing greater clarity on application for HNWI.

The change in performance guarantees from 20% to 50% will adversely impact trade finance in the UK. Consequently, we urge continuation of the existing 20% conversion factor (CF) which is supported by empirical data. This type of low-risk finance is also likely to be impacted by the changes to the scope of PSEs in third countries and recognition of Export Credit Agencies (ECAs).

Some aspects of real estate proposals need addressing to avoid adverse outcomes, as well as further guidance to support implementation.

Chapter 4: Credit Risk – Internal Rating Based (IRB) Approach

The PD input floor as an additional Basel 3.1 policy measure for residential real estate exposures does not appear meaningful, while the UK has introduced a number of very effective safeguards to balance the UK housing market. In the same token, policy making with more flexible measures than banking regulation is thought to be more efficient. Furthermore, with the introduction of the Output Floor (OF), a regulatory backstop has been created and additional conservatism could be seen as double counting.

Misalignment of currency denomination and definitions between Basel and UK text increases the exposure fluctuations unduly in particular for internationally operating banks. We recommend permitting banks to use a EUR threshold as an alternative.

Undue conservative treatment of treasury functions of corporates and funds should be avoided and hence those exposure types should be excluded from the asset value correlation (AVC) scope. As regards supporting factors, we would caution against any undue IRB treatment that would increase the cost of capital in areas fundamental for economic growth, e.g. SME and infrastructure finance. This holds in particular, as banks do undertake due care in assessing the riskiness of those exposure and allocate the relevant economic and regulatory capital.

The PRA should undertake a holistic review of the SA treatment for unrated Central Banks as part of the mandatory removal of the modelling option. This should clarify that ECAI sovereign ratings can be applied to both the central government and central banks when the rating methodology applied by the ECAI reflects the connection between the central government and central bank.

In terms of PD estimation and obligor grade adjustment we would highlight that parental support should be available as an input to the PD model where firms are able to demonstrate a reduction in default risk, recognised through the use of a parental support framework informed override.

Chapter 5: Credit Risk Mitigation (CRM)

The Industry welcomes the flow charts that have been included within the consultation by way of summaries of the new framework, which bring additional clarity to the framework.

We believe that the CRM framework can be further developed to closer align the recognition of credit risk mitigation to the economic form of the transaction, such as ensuring collateral that is an effective loss mitigant is not ineligible due to the way in which material positive correlation is defined. Also, the current rules for risk weight substitution when the underlying exposure is on a standardized approach forces the application of standardized risk weights to the guarantor, even when a direct exposure to the guarantor would be under IRB. Banks should be permitted to apply risk weight substitution using the risk weight applicable to the guarantor rather than a standardised risk weight. This will ensure a more risk sensitive approach and importantly enable firms to meet the overarching CRM requirement where the risk weight derived from application of CRM is not greater than that for a comparable direct exposure to CRM protection provider.

Furthermore, coherence can be brought to the framework by creating consistency in how credit protection is treated under different capital approaches. Whilst some of these differences prevail by design, we believe the consistency of eligibility should be reviewed. For instance, collateral subject to haircut is treated differently under SA-CCR versus under the supervisory haircut method, when logically they should be treated the same.

In some instances, we also believe that there are unintended consequences from the proposed rules and have sought to protect against these adverse consequences, whilst addressing the concern we believe the PRA is intending to mitigate. An example in this regard is the treatment of trading book instruments used as collateral for securities financing transactions, where PRA's proposals would inadvertently render a large pool of assets ineligible which we do not understand to be the intent. We propose in this instance, that the concerns would be better addressed by an accompanying supervisory statement that sets out the expectations around the properties of the collateral and related risk management.

Chapter 6: Market Risk

We continue to support balanced, risk-sensitive and robust regulatory standards that enhance financial stability, but also preserve banks' capacity to support wholesale markets. The Industry appreciates the PRA's primary objective to promote safety and soundness of the firms it regulates and the pragmatic steps to improve the measurement of risk.

We welcome many of the PRA's proposals such as:

- The one-year transitional period for Profit and Loss Attribution Test (PLAT);
- The recognition of Risks Not In Models (RNIMs) in PLAT;
- The increased flexibility on the treatment of Collective Investment Undertakings (CIUs) within the Internal Model Approach (IMA) and Standardised Approach (SA);
- The ability to include in back-testing risk factors that are considered non-modellable; and the

- Introduction of a risk bucket for carbon trading.

To further improve the market risk framework in the UK, we have provided recommendations across a number of areas such as the capital treatment of CIUs (where alternative methods to capitalise should be permitted) and on the Residual Risk Add On (RRAO) where exactly matching back-to-back transactions should be excluded from the RRAO charge. We also believe that the 3 basis-point floor in the IMA Default Risk Charge (DRC) should be removed for the exposures subject to 0% risk weight in the SA DRC (see also Industry analysis on this area)⁸ and we believe a risk weight of 40% for carbon trading under the FRTB SA should be assigned alongside a higher tenor correlation parameter of 0.996 based on empirical data and analysis⁹.

Further to these enhancements to risk sensitivity proposed in this response, clarification and guidance should be provided in other areas of the rules such as the SA authorisations as well as the re-assignment of positions between the Trading book and the Banking Book.

Finally, we have provided details of an Industry survey focusing on FRTB that shows a significant decrease in IMA adoption after the implementation of FRTB, especially when the scope of trading desks under internal models is considered, mainly due to firms' concerns regarding the Risk Factor Eligibility Test (RFET) and NMRF frameworks, which appear to act as barriers for firms. Thus, the Industry would welcome further engagement to find an appropriate solution, bearing in mind the regulatory objectives and practicality considerations.

Chapter 7: Credit valuation adjustment and counterparty credit risk

The Industry welcomes proposals from the PRA in the Credit valuation adjustment (CVA) and Counterparty Credit Risk (CCR) section of the CP 16/22. We particularly support some of the proposals such as the introduction of an additional sub-sector for pension funds leading to an increased granularity of risk weights for CVA and the application of reduced alpha factor of one for pension funds and non-financial counterparties for the standardized approach for counterparty credit risk (SA-CCR).

Nonetheless, the Industry believes that further amendments are required to the CVA and CCR framework to ensure that the rules are commensurate with underlying risk, especially given that advanced approaches are not allowed for CVA calculation. This is further supported by an Industry QIS¹⁰ which shows that under the UK CP 16/22 rules, both CVA and CCR frameworks will result in an increase in RWA for the banks.

We strongly encourage the PRA to extend the definition of the proposed Pension Scheme Arrangements (PSA) sub-sector bucket to include regulated financial entities, and UCITS or equivalent funds, and assign risk weights of 3.5% and 8.5% for Investment Grade (IG), and High Yield (HY) entities respectively.

⁸ [ISDA White Paper: FRTB IMA DRC and the 3 Basis Point Floor](#)

⁹ ISDA White Papers: [Implications of the FRTB for Carbon Certificates and Implications of the FRTB for Carbon Certificates A Global Perspective](#)

¹⁰ QIS exercise for COB December 2021 conducted for 7 banks and for COB June 2022 conducted for 5 banks (both UK and international) with significant operations in the UK market

It is crucial that the revised framework meets its intended objectives to capture all CVA risks by recognizing the full potential of CVA hedges and aligning regulatory CVA risk with treatment of CVA risk from an accounting perspective under IFRS rules. We also propose a simplification of the CVA intragroup framework to allow UK institutions that are subsidiaries of non-UK banking groups to maintain their ability to exempt transactions with group companies outside a UK consolidated group and we have proposed an additional option for firms to choose a simpler approach to the PRA's proposed CVA and SA-CCR transitional arrangement.

For the CCR framework, the Industry encourages the PRA to recalibrate the alpha factor to one for the SA-CCR exposure calculation for all counterparties and more broadly for all applications of SA-CCR. We furthermore continue to call for a broader review at the Basel Committee to ensure global consistency, especially given some of the developments in major jurisdictions outside the UK.

Chapter 8: Operational Risk

The Industry supports the PRA's proposals of setting the Internal Loss Multiplier (ILM) to 1, complemented by a risk sensitive Pillar 2 framework. Further to this, operational risk is the only area of the prudential framework that does not recognize hedging; it is important to have appropriate recognition of risk mitigation, particularly in terms of insurance cover for certain types of operational risks. This is even more important given the removal of the advanced modelling approach (AMA) and should be reflected in the updated Pillar 2 framework.

To facilitate implementation, we also ask for improvements in the read-across and mapping between FINREP and the Business Indicator sub-components.

Chapter 9: Output Floor

The Industry supports the application of the output floor at the highest level of consolidated level. Without adjusting the requirement for RFBs which are subject to ring-fencing rules that are not applied in other jurisdictions, they will potentially be subject to higher costs from the output floor versus banks with otherwise identical risk profiles, creating a systematic competitive disadvantage in the ability to service the real economy.

In addition, we support a review of the basis upon which the capital stack for calculating the output floor is defined, aligning it to the capital stack in Basel. In the absence of this, we believe the manner in which the Pillar 2 framework is re-calibrated to take account of increases in Pillar 1 and interaction with other areas of the framework, namely the Output floor and buffers, will be even more important.

Finally, the impact of the output floor on securitizations has not formed part of this consultation. This is an important aspect of the framework and action should be taken to complete a review as soon as practicable, with an interim solution introduced to avoid any cliff effects prior to completion of the review.

Chapter 10: Interaction with the PRA's Pillar 2 framework

We strongly support the PRA's intention to review the Pillar 2 framework, covering credit, market and operational risk, as well as the interaction with buffers. We ask that the review is complemented by an

Industry consultation and suggest additional areas to those included in Chapter 10 of the PRA's consultation that should feature in the review, such as CVA. We urge the PRA to commence the review as soon as possible to allow any adjustments to be made and the impacts understood prior to the go-live of the Basel 3.1 standards. In conjunction with this, the intended work to avoid gaps or duplications in the Pillar 1 and Pillar 2 capital frameworks on day 1 of implementation of the proposals is critical, as the impact of unadjusted Pillar 2 requirements is likely to be significant.

In addition, as the review will entail revisions to the PRA's Pillar 2 methodologies, we believe this provides an opportunity to provide additional detail in policy statements and related documents regarding the methodologies, and for the PRA to give greater insight and transparency into the drivers behind the differences in firms' ICAAP versus the final assessment of Pillar 2 requirements communicated as part of the SREP review.

Chapter 11 & 12: Disclosure (Pillar 3) and Reporting

In addition to specific feedback relating to reporting and disclosure templates and clarifications, Industry highlights the need for sufficient time (at least 18 months) for banks to be able to implement the PRAs final reporting guidelines, as well as a mapping tool to map reporting to disclosures.

More generally, disclosures should apply at the highest level of consolidation, and we ask that the PRA guard against imposing subsidiary level requirements, particularly where the subsidiary is incorporated into Group disclosures in its home country. We recognize that in some instances local disclosure is important, but these requirements should be proportionate.

Chapter 13: Currency redenomination

We support the PRA's approach, though this may create a mismatch for cross-border banks that are managing against Basel requirements denominated in other currencies. There should be some flexibility in managing against thresholds in a currency other than GBP.

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Further to the feedback provided to the individual chapters, and as noted in the Industry response to DP4/22 – 'The PRAs future approach to policy', we would like to emphasize here that the Industry supports the open dialogue that is currently maintained between the PRA and the Industry and is encouraged by the intent to increase the level of engagement in this regard. The Industry supports the continuation of structured policy development built on ongoing dialogue and consultation between policymakers and Industry that delivers the clarity, certainty and predictability that international businesses and investors seek.

2 Trade Association Contacts

Key Contacts

ISDA: Gregg Jones

Senior Director, Risk and Capital

gjones@isda.org

+44 20 3808 9746

AFME: Sahir Akbar

Managing Director, Deputy Head of Prudential Regulation

sahir.akbar@afme.eu

+44 20 3828 2732

Credit Risk Contacts

Constance Usherwood

Director, Prudential Regulation

Constance.usherwood@afme.eu

+44 20 3828 2719

Caroline Liesegang

Managing Director, Head of Prudential

caroline.liesegange@afme.eu

+44 20 3828 2676

Credit Risk Mitigation Contact

Sahir Akbar

Managing Director, Deputy Head of Prudential Regulation

sahir.akbar@afme.eu

+44 20 3828 2732

Market Risk Contacts

ISDA: Gregg Jones

Senior Director, Risk and Capital

gjones@isda.org

+44 20 3808 9746

ISDA: Stelios Antouera

Assistant Director

santouera@isda.org

+44 20 3808 9749

AFME: Jouni Aaltonen

Managing Director, Prudential Regulation

jouni.aaltonen@afme.eu

+44 20 3828 2671

Counterparty Credit Risk and Credit Valuation Adjustment Contacts

International Swaps and Derivatives Association (ISDA)

Gregg Jones

Senior Director, Risk and Capital

gjones@isda.org

+44 20 3808 9746

Stelios Antouera

Assistant Director, Risk and Capital

santouera@isda.org

+44 20 3808 9749

Toby Coaker

Assistant Director, Public Policy

tcoaker@isda.org

+44 7720 683 490

Association for Financial Markets in Europe (AFME)

Sahir Akbar

Managing Director, Deputy Head of Prudential Regulation

sahir.akbar@afme.eu

+44 20 3828 2732

Operational Risk Contact

Jouni Aaltonen

Managing Director, Prudential Regulation

jouni.aaltonen@afme.eu

+44 20 3828 2671

Output floor Contact

Sahir Akbar

Managing Director, Deputy Head of Prudential Regulation

sahir.akbar@afme.eu

+44 20 3828 2732

Pillar 2 Contacts

Sahir Akbar

Managing Director, Deputy Head of Prudential Regulation

sahir.akbar@afme.eu

+44 20 3828 2732

Jouni Aaltonen

Managing Director, Prudential Regulation

jouni.aaltonen@afme.eu

+44 20 3828 2671

Disclosure and Reporting Contact

Mark Bearman

Director, Prudential Regulation

mark.bearman@afme.eu

+44 20 3828 2675

3 Chapter 3. Credit Risk - SA

3.1 Question 3

Do you have any comments on the PRA's proposed approach to the use of external credit ratings and the proposed due diligence requirements?

Recommendation(s)

As set out below in our answer to Question 8 below, there is a low level of ratings coverage for corporate counterparties to warrant the exclusion of ratings for such counterparties. While we welcome HMT's consultation on broadening ratings coverage in the UK, we are unconvinced that it will result in a clear route to ratings compliant with Basel's rules. Similarly, while it is understood that other jurisdictions, such as the EU, are also exploring this option, this is not globally consistent and will not address the issue for UK headquartered banks in the long run.

As per our response to Q8 we therefore think the PRA should assess the impact of removing the use of external ratings for risk weighting exposures just to corporates, (as the US has done for all ratings). This could also allow the UK to remain compliant with the Basel approach (65% risk-weight for investment-grade, 100% for other corporate exposures and 85% for SMEs) and ensure UK banks remain competitive with international banks.

We agree with the principle that firms should not mechanistically rely on ECAs and we support undertaking due diligence, which is in line with current practice. Nonetheless, this provision should be regularly reviewed in terms of process so it does not become unduly bureaucratic. The CP recognises that IRB firms will already carry out this due diligence in accordance with their IRB approval and so would not have to perform separate due diligence for the assignment of risk weights under the output floor. It would be helpful for the PRA to clarify that this applies to all exposures for an IRB firm, as long as they apply consistent due diligence across their entire portfolio. For example: where a firm has an internal model and credit process used across a portfolio but only part of that portfolio has permission to use the IRB approach for external reporting. It would introduce undue complication to implement an additional due diligence process for a part of the portfolio, where the split is applied in reporting systems rather than through front-end processes.

3.2 Question 4

Do you have any comments on the PRA's proposed definition of commitment and proposed *conversion factors (CF) for commitments*?

Recommendation(s)

We welcome the application by Basel of a consistent definition of commitment across both the standardised and internal ratings based ('IRB') approaches. This is important in ensuring that actual RWAs and the output floor are measured on a consistent basis. We note however, that the PRA is proposing to deviate in relation to the recognition of exposure for the IRB approach, where the PRA is proposing an 'unrecognised exposure adjustment'. Further details in our response to this proposal will be provided in our response to the IRB section; however it is important to stress that consistency is key between the two approaches.

The PRA has decided not to exercise the positive national discretion to exempt certain arrangements for corporates and SMEs which meet specific criteria (in line with Basel CRE 20.94, footnote 53) from the definition of commitment. Under the proposals, facilities that remain wholly within the control of the banks for each drawing will generate a regulatory exposure, which is subject to the relevant credit conversion factors ('CCFs'). We do not support the PRA's decision not to exercise the discretion as it will lead to higher RWA and leverage requirements, where the risk remains wholly at the discretion of the firm, and will unnecessarily inflate the bank's true risk position, leading to a competitive disadvantage for UK banks. We would note that the EU, HKMA and south Korea have so far all indicated they will apply this national discretion. For products such as trade finance, receivables finance and equipment finance, banks have significant control over drawings with authority to prevent them regardless of the client's fulfilment of conditions precedent, thereby meeting the conditions outlined in the national discretion. Given the level of banks' control, the PRA should exercise the national discretion which is in alignment with Basel.

In addition, the PRA should allow banks the ability to delay the recognition of exposure where it is subject to mandatory regulatory approvals, such as competition clearance. In such circumstances, offer and acceptance will have been met, but the borrower is unable to draw down on a facility until approval has been given. Since this approval is not within the control of either the lender or the borrower and it is possible that consent may not be given, it is inappropriate for RWAs to be recorded until regulatory consent is given.

A further consideration we would urge the PRA to review is the exact scope of "other commitments with certain drawdowns" which are in scope for a 100% conversion factor per Table A1 in Article 111. The concept of "certain drawdowns" is not defined in the rules and is also not envisaged with respect to commitments in the Basel standards which include all commitments in CRE 20.98 and subject to a 40% CCF. The application of a 100% CCF in CRE 20.95 is broadly understood to encapsulate direct credit substitutes which expose a firm to the same risk of loss as a direct exposure to the underlying default risk would.

Commitments on the other hand are broadly not in this same class of risk prior to any drawdown/funding as at this point in time any risk of loss would be mitigated to the firm as long as the loan documentation includes provisions which prevent any funding occurring if the borrower

were to become insolvent/default prior to drawdown. This breaks the concept of certain drawdown as there is some conditionality to that drawdown. Further, other conditional events e.g. regulatory approvals for acquisitions etc. or internal credit approvals would also reduce certainty of drawdown and should be scoped out of 100% CCF application.

We would propose that the term “certain drawdowns” be clarified to only encapsulate commitments which would be available to be drawn down on a fully unconditional basis without any conditionality. Conditions which would result in a commitment not having certain drawdown could include, amongst others, the following conditions:

- Insolvency/default of the client such that the risk of loss on default is the same as a direct credit exposure; Other conditionality included in the documentation e.g. external regulatory approvals for acquisitions or internal credit approvals.

Finally we think the PRA could provide additional clarity on the treatment of CFs for syndicated commitments which, once drawn economically, only expose firms to settlement risk in the period between funding and settlement of the syndication and as such are lower risk commitments than those for which the firm will retain a long term hold in an on-balance sheet loan post drawdown.

3.3 Question 5

Do you have any comments on the PRA’s proposed CFs for issued off-balance items? Do you have any additional data that the PRA could access? In particular, do you have any data relating to the appropriate CF for ‘transaction-related contingent items’ in downturn conditions?

Recommendation(s)

As is noted in the consultation paper, the PRA’s approach of applying a 50% to CCFs for ‘other commitments’ is super-equivalent to Basel 3.1, which applies 40%. The PRA considers that this is justified on safety and soundness grounds; however, if the PRA’s approach is adopted, the higher cost of these facilities would put UK banks at a competitive disadvantage, which will have a direct effect on the real economy e.g. global trade, including UK import finance and loan offers. Furthermore, these conversion factors will be used for commitments to counterparties capitalised under the F-IRB approach, which will be expanding due to the removal of the ability to use A-IRB on exposures such as to large corporates. Therefore, a conservative non-risk sensitive approach will impact exposures capitalised under the modelled approach too. We would note that no evidence has been published to support this policy decision. It is important that this evidence is published and publicly assessed

before any proposals can be finalised. In the absence of published evidence, the CCF of 40% should be applied in line with Basel and/ or differentiated as set out below.

3.3.1 Wholesale

If the data shows that the PRA's approach is derived from aggregate data across a set of products, it should consider disaggregating the data and apply CCFs with a greater level of granularity. For example, our experience shows that a 50% CCF is not justified in relation transactions related contingent items that facilitate Trade Finance (e.g. performance bonds, bid bonds, retention bonds, advance payment, warranties, and standby letters of credit related to particular transactions). Empirical data already provided to the PRA indicates that a 50% CCF is not appropriate, this is further supplemented by the additional more recent data provided by Global Credit Data and the International Chamber of Commerce ('ICC') in Appendix 14.1.1 of this paper. In relation to performance guarantees, the data shows that values lower than 20% are appropriate. Further, the ICC assessed the impact of a 50% CCF would increase the cost of performance guarantees by 150% which would heavily impact on corporate business and reduce market capacity for this type of product due to increased RWAs. Similarly the data for documentary credits suggests that a 20% CCF for all documentary credits (not just one year or less) would be more appropriate.

Aside from this, we note that the EU has proposed to adopt a phasing in of CCFs for unconditionally cancellable items over 3 years from 1 January 2030. Again, this will mean that the UK is placed at a competitive disadvantage to European peers, since the uplift will be borne in actual RWAs from the outset. We recommend that a similar transitional provision is adopted.

3.3.2 Definitional issue:

There appears to be contradiction between proposed definition of commitment and the current definition of conversion factor ("CF"). The PRA has chosen to adopt the Basel's text definition of commitment which in summary states there needs to be an offer of credit made by the bank to the client which is accepted by the client. Therefore commitment = offer + acceptance. In the CP the PRA mentions that this is the point at which RWA should be assigned.

The [PRA-proposed definition of 'commitment' states in CP16/22, Appendix 4, Annex Y \(page 433\):](#)

*means any off-balance sheet **contractual arrangement** that has been **offered** by the institution and **accepted** by the obligor, including to extend credit, purchase assets or issue off-balance sheet items (but which is not itself an issued off-balance sheet item). This includes but is not limited to any such arrangement that may be:*

- (1) unconditionally cancelled by the institution at any time without prior notice to the obligor; or*
- (2) cancelled by the institution if the obligor fails to meet conditions set out in the relevant agreement, including conditions that must be met by the obligor prior to any initial or subsequent drawdown under the arrangement.*

Given the proposed definition of commitment it's not unreasonable to conclude that unadvised limits would not meet the definition, as a client cannot accept what they are not aware of. However the current definition of CF (Article 4(1) point 56) states that a conversion factor will be applied to the higher of the advised or the unadvised limit.

'conversion factor' means the ratio of the currently undrawn amount of a commitment that could be drawn and that would therefore be outstanding at default to the currently undrawn amount of the commitment, the extent of the commitment being determined by the advised limit, unless the unadvised limit is higher;

HMT^[1] is proposing to update the Article 4(1)(56) definition for conversion factor as these definitions will remain in the UK CRR. This is presumably as these definitions are not technically part of Basel 3.1 (and the PRA is only mandated to make rules for those elements of the onshored CRR relating to Basel 3.1 under the FS Act 2021). We understand that these will be moved to the PRA rulebook in a later exercise once the FSM Bill is enacted and the PRA rule-making powers are formalised. However, this is unclear.

Proposed update [new text in bold]: "conversion factor" means the **expected** ratio of the currently undrawn amount of a commitment **from a single facility** that could be drawn **from a single facility before default** and that would therefore be outstanding at default to the currently undrawn amount of the commitment **from that facility**, the extent of the commitment being determined by the advised limit, unless the unadvised limit is higher;

HMT notes (CP 3.20, page 18) that the aim of the update is to clarify that the conversion factor is an expected ratio (in line with the proposed updated definition of PD), and to clarify that conversion factors can also be measured at facility level.

We, therefore, welcome clarity from the PRA as there have been minor changes made by HMT, but we consider that this definition needs revisiting given Basel 3.1 and are also unclear why this is not being moved into the PRA rulebook.

3.4 Question 6

Do you have any comments on the PRA's proposed approach to exposures to central governments and central banks, regional governments and local authorities, public sector entities (PSEs), and multilateral development banks (MDMs)?

Recommendation(s)

Article 114 should be clarified to confirm that sovereign ECAI ratings apply equally to central governments and central banks except in the case of broader monetary unions e.g. ECB.

3.4.1 Central banks

Under the proposed rules, if a central bank is unrated and is not in an equivalent country and denominated/funded in a domestic currency, then it is subject to a 100% risk weight under the standardised approach. While sovereigns are generally rated, often the central bank in a jurisdiction is not rated. The sovereign rating methodologies of the major rating agencies are undertaken in such a

^[1]. [HMT Basel 3.1 consultation document.pdf \(publishing.service.gov.uk\)](#)

manner that the risk of such entities is consistent with the central government. We support clarification that ECAI sovereign ratings can be applied to both the central government and central banks when the rating methodology applied by the ECAI reflects the connection between the central government and central bank specifically when the central bank is not that of a monetary union e.g. ECB where they are managing the monetary policy of several nations. (see also our response to Q19 for more detail).

3.4.2 Export Credit Agencies (ECAs)

We request that the PRA avails itself of the Basel discretion under CRE 20.1211 to allow certain quasi-sovereigns (i.e. those ECAs classed as PSEs) to be treated as sovereigns under the proposed mandatory standardised approach (SA). This would enable direct access for this non-significant class of quasi-sovereigns to be treated as sovereigns as per Basel, which also provides for similar treatment to be applied to non-UK exposures where other jurisdictions are also using this Basel discretion.

The UK proposed mandatory standardised approach for sovereigns under CP16/22 allows direct access to a zero risk weight for ECAs classed as sovereigns. However, those classed as quasi-sovereigns (ie PSE-ECAs) will not be able to directly access the same treatment under the proposals (CP16/22, 3.7412).

The request to the PRA relates to considerations around equivalence, and the PRA removal of UK CRR 116(4). While UK CRR Article 116(4) currently reflects, in part, the discretion set out in Basel 20.12 for the UK, it does not include the ability also set out in the Basel for firms to treat non-UK PSE exposures as sovereign where these third countries also allow the PSEs in that jurisdiction to be risk-weighted in the same manner.

We would welcome a UK designated list for eligible global PSE-ECAs via a PSE-specific equivalence framework under HMT remit, or a standalone-assessment and framework devolved to the PRA. Alternatively, given this is small and less material subset of exposures, a preferred operational fix may be achieved via a new clause in Article 116 to cover this subset to potentially access 0% RW treatment under the CRR 114 standardised routes, and rely on the 'supervisory and regulatory arrangements' equivalence requirements for non-UK exposures under 114(7) conditions.

Potential drafting to address and enable application of the same consistent treatment for sovereign ECAs and quasi-sovereign ECAs (given no difference in risk and national discretion under Basel) would be as follows:

[Article 116 insert:] *Exposures to public-sector entities may be treated under Article 114 as exposures to the central government and central bank in whose jurisdiction they are established*

¹¹ **Basel CRE20.12:** *Subject to national discretion, exposures to certain domestic PSEs¹² may also be treated as exposures to the sovereigns in whose jurisdictions the PSEs are established. Where this discretion is exercised, other national supervisors may allow their banks to risk-weight exposures to such PSEs in the same manner.*

¹² **CP16/22, 3.66:** *For PSEs, the PRA proposes not to treat any exposures to UK PSEs as exposures to the UK central government, a regional government, or a local authority in the UK. This aligns with the Basel 3.1 standards, as the PRA proposes to not implement the Basel 3.1 [ie Final Basel 3] national discretion to treat PSEs as exposures to the sovereign in certain circumstances.*

where there is no difference in risk between such exposures because of the existence of specific public arrangements.

[Article 147A(1)(a) insert:] In addition, for point (b)(i) of Article 147(2), exposures of a quasi-sovereign institutions classed as a public sector entity under Article 116 where there is the existence of specific public arrangements and no difference in risk between such exposures and those by the central government and central bank.

Operational consideration around indirect access:

- The PRA confirmed in AFME Industry discussions the expectation that banks can indirectly apply a 0% risk weight using the credit risk mitigation framework given the allowance for indirect counter-guarantees by sovereign entities (CP6/22, 5.101; Appendix 4, Article 214).
- This means that instead of applying unfunded credit protection (UFCP) conditions to a PSE-ECA issued guarantee in respect of the transaction, the bank will look through to the public arrangements/guarantee for the PSE-ECA. While in theory, we agree that this may achieve the same treatment indirectly for many export finance exposures in the form of cover/guarantees, it adds some complexity, uncertainty and potential compliance, operational and legal costs. In addition, in the separate potential business scenario, for example, where a bank is lending to a PSE-ECA and UFCP is not in use then there remains no direct or indirect access.
- Given ECA exposures – due to an organizational /institutional structural difference – can be designated in either the sovereigns or quasi sovereigns classes, we believe this access should be direct and automatic for PSE-ECA given the proposed application of a mandatory standardised approach for government ECAs with the same risks.

International competitiveness analysis

- It is important to maintain an equivalence with EU and other jurisdictions where the financial institutions (banks) can treat exposures to PSE as central government when such PSE benefits from the central government financial support. For example, where the central government will assume the entire liability of the PSE-ECA in the event of insolvency and such arrangement is confirmed in their relevant national legislation.
- Some official ECAs from certain jurisdictions (Denmark, Switzerland, Belgium, US, Korea, Japan etc) take an organisational or institutional form of a PSE as opposed to being an integral part of central government itself. EEA banks may treat the PSE-type of ECA exposures (typically an ‘unfunded guarantee’) as a central government exposure as these PSEs have financial support from the central government under the specific legislative arrangement as per CRR 116(4) and/or CRR 150(1)(d)(i).
- It is important to point out that, in the ECA business, UK banks globally compete with non-UK banks in pricing the non-UK PSE’s exposures, not on the pricing of UK-PSE exposure.
- The PRA proposed Article 116(3A), corresponding to the UK CRR 116(5) equivalence regime, leads to a 20% RW at best (Credit Quality Step 1) for non-UK PSEs. As such, UK banks will not be able to compete with, for instance, EEA banks which may apply 0% RW for exposures to PSE ECAs who are treated as central government. This as, in most EU member states, the competent authorities chose

to allow the direct use of the SA. UK banks will be disadvantaged compared to banks in the EU or other jurisdictions in running a global ECA business. UK banks will be uncompetitive in this segment (PSE type) of ECA exposure.

- Pre-Brexit: IRB banks were able to access SA and the zero RW via the EU CRR Article 150(1) for, at least, EEA ECA exposures under Article 114(4) and 116(4). However, this access was removed post Brexit given restriction of Article 114(4) and 116(4) to the UK.
- UK Basel 3.1 proposal on PPU: The PRA proposes to remove Article 150(1)(d)¹³ given the introduction of a new PPU framework for application of the SA for IRB banks for certain asset classes (ex quasi sovereigns), and mandatory standardised for sovereigns.

3.4.3 Multilateral Development Banks ('MDBs')

On MDBs, the current rules (CRR Article 117) contain a power for HMT to amend the list of 0% risk weighted MDBs. While we understand the PRA now has a discretion to amend the MDB list at any time, we think it would be appropriate that the criteria it will use for determining additional 0% MDBs are set out in its supervisory statement on the standardised approach. A firm should be entitled to apply to the PRA to have the list amended, where it can demonstrate that the MDB meets the criteria. We have also observed some typos which should be addressed:

- 117(1A) where it incorrectly refers to paragraph 3 instead of paragraph 2; and
- In the definition of unrated multilateral development banks in the Application & Definition section 1.2 a 'not' has been omitted.

3.5 Question 7

Do you have any comments on the PRA's proposed changes to the external credit rating approach (ECRA), the proposed introduction of the standardised credit risk assessment approach (SCRA), for exposures to unrated institutions, and the proposed treatment of covered bonds?

Recommendation(s)

The PRA should consider reducing the burden of the due diligence requirements associated with the SCRA approach by allowing for 3rd party data or publishing a list of financial sector counterparties which meet the due diligence requirements. The PRA could also consider maintaining the "minimum financial regulatory requirements and buffers as implemented in the relevant jurisdiction" more centrally for consistency, as part of the equivalence assessments under Art 107(4), given that only

¹³ CP 16/22 4.106: The PRA has also considered whether to retain other existing CRR permanent partial use exemptions. The PRA considers that the majority of the existing exemptions are either no longer relevant, due to other changes in the framework such as restrictions on the scope of modelling; or no longer necessary, due to the proposed introduction of a more general exemption for immateriality as set out in (b) above. The PRA therefore proposes to remove these exemptions. The PRA proposes; however, to retain the exemptions currently in the CRR relating to intragroup exposures and exposures in the form of minimum reserves required by the Bank of England.

institutions in those jurisdictions are to be treated within exposures to institutions, In turn this would drive consistency of approach.

In terms of the ECRA we note the PRA intends to address ‘cherry picking’ of their use of ECAI exposures by “preventing firms using different ECAIs for risk-weighting than they do for risk management purposes and business decisions”. This could present a problem for subsidiaries of third-country groups which have IRB models which are used for overall group risk management and decision making but which don’t have local IRB models. The PRA should therefore make clear that the external ratings of the same agencies should be considered as part of internal rating assessments.

3.5.1 Covered bonds

Regarding covered bonds, the requirements for eligible assets in Article 129(1)(c) are more restrictive than the corresponding Basel requirements (CRE 20.34 (4)). The PRA requires the institution underlying the covered bonds to have a CQS of step 1 unless the maturity of the exposure is less than 100 days, in which case a CQS of step 2 is acceptable. Basel’s rules simply require the CQS to be of step 2 or lower. The requirement that such assets cannot exceed 15% of total covered bond issuances of the institution is common across both the PRA and Basel’s texts. We would recommend the PRA to remove the “maturity” based distinction in the eligibility requirement for covered bonds issued by institutions and instead adopt the simplified approach specified in Basel.

Secondly, although not a direct change from CP 16/22, we would like the PRA to revisit the ‘CRR Covered Bond’ definition which was introduced as part of the Withdrawal Act. The definition in CRR Article 4 (1) (128A), restricts the ability to use the preferential risk weights in Article 129 to only covered bonds which are issued by a credit institution which has its registered office in the UK. This is more restrictive than the Basel requirement in CRE 20.33, which only states that covered bonds must be subject by law to special public supervision designed to protect bond holders.

Covered bonds are used in liquidity portfolio management. Holding of covered bond positions issued by non-UK institutions is now economically unviable, thereby restricting positions to UK issuers, removing the ability to hold a diversified portfolio, especially for banks which already have significant risk to UK residential exposures, which are generally the exposure class underlying UK covered bond issuances.

The removal of the ability to use A-IRB on covered bond exposures in the new framework, increases the issues with the ‘CRR Covered Bond’ definition, as the F-IRB LGDs cross refer to Article 129.

We would like the PRA to work with HMT to consider an equivalence regime so that covered bonds issued by non-UK institutions, but which meet the Basel requirements, can also benefit from the preferential risk weights. Alternatively, we would like the PRA to align to Basel so that covered bonds issued by non-UK institutions, but which meet the Basel requirements, can also benefit from the preferential risk weights.

3.5.2 Institutions

The PRA proposes to allow exposures to institutions (rated or unrated) to receive lower risk weights for short-term exposures, where the original maturity of the exposure is six months or less and the exposure arises from the movement of goods across national borders.

Limiting this rule set to ‘movement of goods’ means that services which are an important portion of trade finance globally will be excluded even though they form an increasing share of global trade. Additionally, limiting it to ‘across national borders’ will exclude in-country trade finance.

We recommend the inclusion of services-based trade and in-country trade for exposures to institutions (short-term) under the standardised approach.

3.6 Question 8

Do you have any comments on the PRA’s proposed approach for exposures to unrated corporates? Do you have any evidence – quantitative or qualitative – to support your comments, particularly in respect of the proposed 135% risk-weight for non-investment grade exposures?

Recommendation(s)

The PRA proposes to adjust the Basel 3.1 standards by introducing the option to risk-weight investment grade unrated corporates as a lower weight than prescribed in the Basel 3.1 standards at 65%, and non-investment grade unrated corporates at a higher rate of 135%. We welcome the PRA’s proposal, in particular we support the proposal to introduce an option for banks to apply a lower 65% RW for investment grade corporates and remove the listing requirement as one of the criteria for an unrated corporate to be classified as “investment grade”.

Nonetheless, while the decision to apply a hybrid approach has served to ameliorate some of the concerns with the application of the output floor, we consider that the PRA’s decision to set the risk weight for non-investment grade corporates to 135% should be closely monitored and reviewed. In the process of the PRA consultation we understand the rationale behind the higher RW for non-investment grade corporates is to achieve an overall average RW of 100% in line with the general Basel SA RW for unrated corporates. Members are concerned, however, that the higher RW of 135% could have a negative impact with respect to financial stability, risk sensitivity and UK bank competitiveness.

With respect to financial stability, this measure could lead to cliff edge effects for those exposures close to or just over threshold for banks to apply 65% and therefore achieve a lower cost of funding.

In terms of competitiveness, exposures that become subject to the 135% RW may become concentrated in SA banks or international branches (which only apply a 100% RW), thus reducing the

diversity of UK bank balance sheets. Hence, the 135% RW would be punitive versus non-UK banks, such that counterparty migration could be expected and remaining customers would absorb the higher costs of finance in the balance of the portfolio. We are also concerned about the inconsistent approaches being adopted in relation to unrated corporates from an international perspective. We recognise that the EU's solution is a transitional provision whereas the UK's is a more permanent one; however, during the output floor transitional period, it will leave UK banks at a competitive disadvantage.

The detrimental impact will not just be when UK banks are operating in the EU. This could result in a negative competitive impact for UK banks lending in the UK, since the PRA has proposed that UK subsidiaries and branches of EU banks will not be subject to a floor requirement in the UK. While this is only expected to have an effect during the latter years of the output floor transitional, this could be on a more long-term basis, if the EU choose to extend their transitional arrangements for unrated corporates. As well as monitoring the 135% RW for competitive distortion, the UK should consider transparency regarding the criteria for such equivalence decisions and introduce a mechanism to review the status of these decisions on a regular basis.

If the PRA significantly changes its approach to the option to apply differentiated RW for unrated corporates then we would request further Industry consultation on this before the rules are finalized. We also propose some further policy options which warrant further consideration and dialogue with Industry post-consultation:

1. **Potential to align with the SCRA approach:** While we welcome HM Treasury's ('HMT') consultation on broadening ratings coverage in the UK, we are unconvinced that it will result in a clear route to ratings compliant with Basel's rules. Similarly, while it is understood that other jurisdictions, such as the EU, are also exploring this option, this is not globally consistent and will not address the issue for UK headquartered international banks in the long run, especially given the challenge of ratings take up (and therefore UK banks' international exposures) is also significant in other jurisdictions such as Asia.

Consequently, if there is no route to mass coverage of compliant ratings available, one solution that could be considered is to align with the SCRA just for corporates (as per the US approach albeit it applies for all ratings). In doing so, the analysis should consider the impact of the removal of the ECRA on rated corporate exposures, although – as acknowledged by the PRA in the consultation paper itself – we do not think the listings requirement would be relevant. This option should analyse whether it enables the UK to remain compliant with the Basel approach (65% risk-weight for investment-grade, 100% for other corporate exposures and 85% for SMEs) and ensure UK banks remain competitive with international banks.

2. **Refining the scope of the corporate exposure class:** The wide scope of application of the corporate classification will mean that the negative effects will not just apply for traditional corporates but will also have negative effects for NBFIs, such as funds, pension funds and insurance companies. All of these institutions service traditional corporates and use securities

financing transactions ('SFTs') and derivatives to access funding and at the same time, give banks the ability to cover short positions, which is important for liquidity in markets. As such, not only will this have direct costs for those corporates subject to the 135% RW, but may also result in increased cost of business through costs being passed on from these institutions. Furthermore, as CVA exemptions previously applicable to SMEs have been removed, whilst offset partially by recalibrating the alpha factor to 1 for non-financial counterparties, there may also be reduced access to and/or cost of hedging products available. Therefore, regulatory costs are an additional headwind that corporates will need to face in an already difficult macro-environment.

Consequently, we suggest the PRA explore developing a separate exposure class that is more appropriate to the characteristics of funds and other financial corporates and assess what could be an appropriate risk weight to apply to this exposure class.

In so doing, we suggest the following definition of a Fund be considered:

"An entity established to hold only financial instruments as defined in International Accounting Standards (IAS 32.11) including financial assets such as quoted and unquoted equity and debt securities, and other instruments such as derivatives, as well as associated financial exposures such as stock borrowing and lending. A fund is either managed by a third party (such as an asset manager) or by the entity itself. It does not control any of the entities in which it holds financial assets, unless these entities are themselves funds. The fund may take a range of legal forms including open-ended funds, closed-ended funds, mutual funds, investment trusts and investment companies."

In terms of the risk weight, an approach like the Standardised Credit Risk Assessment (SCRA) for Institutions could be applied. For instance, the Fund SCRA approach could include three grades:

- Grade A would include any fund: (i) that is subject to the UK's regulations for Collective Investment Schemes or Pension Schemes, or any similar regulatory regime that limits a fund's permitted borrowing; and (ii) which has adequate capacity to meet financial commitments in a timely manner. We would expect this grade to include most regulated funds, such as pension funds, UCITS and US mutual funds.
- Grade B would include all other funds that have adequate capacity to meet financial commitments in a timely manner. We would expect this grade to include unregulated funds, such as private equity and hedge funds.
- Grade C would be any fund subject to material default risk. This would include circumstances where adverse business, financial or economic conditions are very likely to lead, or have led, to an inability of the counterparty to meet its financial

commitments. We would expect this grade to include only a small proportion of funds that are under financial stress.

Similar to the SCRA for institutions, we also propose that separate risk weights are applied to exposures with an original maturity of three months or less, to reflect the reduced risk of these transactions, typically collateralised securities financing transactions.

Credit quality step	Grade A	Grade B	Grade C
Risk weight (>3 months)	40%	100%	150%
Risk weight (<3 months)	20%	55%	150%

These proposed grades reflect the key risk drivers of IRB models such as type of regulation and permitted borrowing. Other drivers of the IRB model would include investment concentration, net asset value and length of time active. We would welcome further discussion with the PRA about credit risk drivers for funds.

We note the PRA has raised concerns regarding maintaining the simplicity of the SA approach. If such an option were to be developed, it could potentially be limited to those banks that have the capacity to apply the differentiated RWs for unrated corporates or on an opt-in basis (subject to regulatory approval), while simpler SA banks could maintain the broad corporate exposure class.

We would also note that this proposal will require further development in dialogue with banks and there are open aspects which need to be considered – for instance treatment of underlying corporate collateral. Members would welcome the opportunity to engage further beyond the scope of this consultation.

3. **Treatment of SPVs:** A further consideration we would urge the PRA to take, is a review of the treatment of certain types of SPVs whose risk characteristics are very different to that of other corporates (we consider such a review would also compliment the aforementioned point on funds). For those types of SPVs specifically these could warrant a further differentiated approach to reflect their structural nature and the risks inherent in exposures to these types of entity. We understand the PRA's desire to keep the corporate treatment simple, but we would be pleased to provide further details as to why we view that a different treatment is justified for these on prudential grounds.

For SPV repack structures where a firm will utilise an SPV to repackage non-corporate debt securities to provide a more customised return to investors but with still a direct credit linkage to the underlying non-corporate debt collateral placed within the vehicle these have no independent default risk as they have been specifically structured to be bankruptcy remote and

therefore any exposures to the SPV are ultimately only as default credit risky as a direct exposure to the underlying collateral would be. Particularly the exposures assumed by firms to the SPV in order to provide the return on the notes are structured to be super senior and have priority recourse to any assets of the SPV before any claims of the investors are paid out.

It is often highly conservative to treat exposures to these SPVs as unrated corporate exposures when the credit risk is backed by sovereign or financial bonds.

Therefore we would suggest that for SPVs, which would otherwise fall into the standardised approach to credit risk category of unrated corporates, a specific carve out is considered which would allow for the risk weight to be determined by direct reference to the CQS which would apply to a direct exposure to the SPV collateral assets. This will often relate to HQLA government debt securities eligible for a 0% risk weight which is significantly lower than the currently proposed 65% which could apply to investment grade unrated corporates.

The lack of a differentiated treatment for these types of SPVs has always been of competitive disadvantage for non-IRB firms vs IRB firms but will now present a further challenge for IRB firms as well, due to the wide difference between the RWA computed under IRB vs the standardised approach impacting on the output floor.

Overall there is a strong economic rationale for end investors for these structures which we would like to continue to be able to support. In particular, SPV repacks structures allow institutional investors (e.g. insurers, asset managers, etc.) who can't do derivatives for practical reasons but have a need to manage their duration and other risks on their liabilities to invest in notes which provide the appropriate hedging for these risks but still with the minimal credit risk that could be obtained from a direct investment in government bonds. The need for this mainly arises as the depth of liquidity in floating rate HQLA long term government debt (or availability in currency of investment) is minimal due to limited issuance of these types of securities. However, the repack structure allows for conversion of the fixed interest rate into a more customised floating rate which manages the risks of these companies without exposing them to significant credit risks providing overall benefit to the functioning of the economy by facilitating management of the risks of these institutional investors. For instance, Norwegian / Japanese investors who want exposure in NOK or JPY can't rely only on domestic market or on corporates / sovereigns issuing in NOK/JPY.

If the PRA does undertake a review of the treatment of SPVs in the context of unrated corporates. then a potential new rule to analyse/consider the impact of could be as follows:

Exposures to SPVs

1. Exposures to SPVs which meet the conditions in paragraph 5 shall be assigned a risk weight in accordance with the credit quality step to which direct exposures to the collateral assets

would be assigned if a credit assessment by a nominated ECAI is available in accordance with the following table:

Credit quality step	1	2	3	4	5	6
Risk weight	20%	50%	75%	100%	150%	150%

2. For the purposes of paragraph 1 where the SPV has more than one collateral asset the assessment shall be performed based upon the CQS applicable to the worst quality asset.
3. With exception to paragraph 1 for exposures to SPVs for which a direct exposure to the collateral assets would be eligible for a 0% risk weight under Articles 114-118 shall be eligible for a 20% risk weight.
4. Exposures to SPVs for which a credit assessment for direct exposures to the collateral assets is not available or which are backed by corporate bonds shall be treated in accordance with [the approach for risk weighting of exposures to unrated corporates].
5. The approach in paragraph 1 shall be applied when the following conditions are met with respect to the SPV:
 - a. The purpose of the SPV is solely to repackage debt securities
 - b. The SPV is bankruptcy remote
 - c. The recourse is limited to the SPV assets
 - d. The claims on the SPV are senior or super senior to other claims on the SPV assets
 - e. The assets of the SPV are debt securities which would be allocated to an exposure class in Article 112(a-f)

3.7 Question 9

Do you have any comments on the PRA's proposed approach for specialised lending exposures, or data that is relevant to this analysis?

Recommendation(s)

We welcome the PRA's decision to adopt the Basel's approach of applying a preferential 80% risk weight where a project finance exposure is in the operational phase and is considered high quality. However, restricting the preferential treatment to only "high quality" project finance exposures would put UK banks at a competitive disadvantage to our peers in the EU as under the proposed EU CRR3 text, the preferential treatment is extended to "high quality" object finance exposures as well.

Object finance exposures benefit from recourse to physical collateral rather than the entity behind the exposure. Historical data shows that losses in the specialised lending area are less than half that of

those for unsecured corporate exposures¹⁴. For example, Global Credit Data (GCD) reported the recovery rate at 90% for aircraft finance in May 2022¹⁵, and at 86% for shipping finance in a report in August 2022¹⁶. Therefore, we recommend re-considering a RW of 100% for object finance (aviation and shipping) exposures, as there is a collateral in place with a high recovery rate.

Similar to the reasoning provided in the EU CRR3 proposed text, we also consider that unrated object finance exposures benefitting from a prudent and conservative management of the associated financial risks by complying with a set of criteria capable to lower their risk profile should benefit from a favourable capital treatment in the form of a lower risk weight as opposed to the general treatment of all unrated object finance exposures under the Basel 3.1 standards.

We would recommend that the PRA introduces more granularity in the risk weighting of specialised lending category by distinguishing “high quality” exposures from rest of the “object finance” exposures. The PRA can provide additional guidance on the criteria for an object finance exposure to be considered as high quality.

3.8 Question 10

Do you have any comments on the PRA’s proposed removal of the infrastructure support factor? Do you have any evidence – quantitative or qualitative – to support your comments?

Recommendation(s):

We would support maintaining the infrastructure supporting factor (ISF), or at a minimum allowing for exposures that are subject to the ISF RW to be grandfathered appropriately.

We believe that removing the Infrastructure Supporting Factor (ISF) will put UK banks at a disadvantage compared to European competitors given there is no intention to remove the ISF in the EU CRR (CRR3). This would limit our ability to efficiently target important infrastructure lending business supporting the key environmental objectives specified in the ISF criteria including climate change mitigation, sustainability and energy transition.

We propose that the PRA re-considers the removal of ISF in order to stimulate investment in this important market and ensure UK banks are not disadvantaged compared to international competitors. A level playing field with European banks is a key consideration in this regard.

We note that one of the primary purposes of the ISF when first announced by the European Parliament was to encourage investment in well-structured infrastructure financing given infrastructure

¹⁴ [EBF summary on Basel IV1 in Europe, 11 June 2021](#)

¹⁵ <https://globalcreditdata.org/wp-content/uploads/2022/05/GCD-Aircraft-RR-Dashboard-2022.pdf>

¹⁶ <https://globalcreditdata.org/wp-content/uploads/2022/08/GCD-Ship-RR-Dashboard-2022-v1.1-1.pdf>

development's key role in economic growth, international competitiveness and job creation. While the implementation date was brought forward to facilitate additional support during COVID-19, the underlying fundamentals have not changed and we would support the continued availability of ISF under both the standardised and IRB approaches.

Retaining the ISF framework would facilitate the ongoing prioritisation of assets meeting the prescribed environmental objectives and structural risk mitigation measures. In this context we would propose that consideration is given to more closely aligning the proposed "high-quality project finance" definition to the existing ISF criteria to ensure consistency.

Lower pricing requirements by market participants on robustly structured infrastructure finance facilities further demonstrate the lower inherent risk of these exposures compared to a like-for-like corporate benchmark. It can be considered that the market views recovery prospects more positively than can be differentiated by ratings.

3.9 Question 11

Do you have any comments on the PRA's proposed removal of the small and mediumsized enterprise (SME) support factor? Do you have any evidence – quantitative or qualitative – to support your comments?

Recommendation(s)

It is regrettable that the SME supporting factor is being revoked under the PRA's proposed rules. While Basel includes concessionary risk weights for SME exposures under the new regime, these are not as preferential as those currently applied. It should also be noted that while there some compensating factors in the standardised approach from the reduced risk weight, there will be no such beneficial treatment for the IRB approach as the firm size adjustment applies under current rules.

Given the UK is now heading in a recessionary environment, the removal or reduction of any beneficial treatments for exposure to SMEs could have a negative impact on the pace of economic recovery, where SMEs have been disproportionately affected. It is also expected that the removal of the SME supporting factor will increase UK banks' RWAs and create a competitive disadvantage with European peers. In the absence of data to suggest the current application of the SME supporting factor has led to an insufficient recognition of the risk of SME exposures, we suggest that some form of support is maintained to this sector of the economy at a similar level to the EU (which in effect results in a 75% RW when the SME coefficient is applied).

Furthermore, we believe the definition of SME as currently drafted is too complex and onerous on firms, especially due to its reference to the EC recommendation. Under these rules, firms are required to identify all a counterparty's linked and partner enterprises to determine the annual turnover. This is a complex, highly manual process which leads to a high degree of compliance risk. For the definition

of SME, we would recommend alignment to Basel by using the accounting definition of Group Consolidated Turnover, which would also make it consistent with other parts of the rules such as firm size adjustment under the IRB approach.

3.10 Question 12

Do you have any comments on the PRA's proposals for retail exposures?

Recommendation(s)

In relation to the PRA's proposals for retail exposures, we have comments falling under two categories:

3.10.1 Transactors

While we generally support the PRA's approach to the implementation of the transactor rules, the rules are unduly onerous for counterparties that generally behave as transactors but have an inadvertent or temporary breach e.g. overdrawn for 24 hours before pay day. In such cases, the counterparty will have to wait a full 12 months before moving back to transactor status. To limit any cliff effects, it would be beneficial if the rules contained a materiality threshold below which a counterparty's status may be retained. We note that other regulators have proposed this in their implementation of Basel 3.1, albeit these require further development.

3.10.2 Currency Mismatch

We note that the PRA has followed Basel in applying the currency mismatch rules to both retail and residential mortgage exposures. We consider that the scope of application of these rules should be limited:

- We have observed that the HKMA has limited the scope of application of the mismatch rules to regulatory residential real estate exposures or retail exposures in the form of instalment loans or non-revolving loans with pre-specified schedules of repayment of principal and interest (instead of regulatory residential real estate exposures and all retail exposures). We would request that the PRA follow suit to avoid any competitive disadvantages.
- The PRA's approach captures asset-based lending to high net worth individuals qualifying as retail. For such transactions, the underwriting criteria are based upon the assets rather than the customer's income. Given the collateral is the key driver of risk management and the rules require haircuts for the mismatches between the currency of collateral and the exposure, we consider that the application of an additional haircut is inappropriate.

We note that in the consultation paper (paragraph 3.189) it states that the currency mismatch multiplier should be applied where there is a mismatch between the currency of the loan and the

obligor's main source of income; however in the rules there is no reference to the obligor's main source of income. The inclusion of the term would limit the requirement to assess whether a currency mismatch is required for a significant proportion of the portfolio where the main income matches and would therefore serve to reduce operational complexity. Firms will only be required to assess whether multiplier is required where the exposure is not in the main source of income and whether the hedge criteria are met.

We welcome the PRA's proposal for the use of country of residence where data is not available for loans booked before 1 January 2025. In markets where there are large numbers of ex-pats this may not be the best alternative. We recommend the scope of alternative data is broadened to include country of residence or country of employer.

We acknowledge that it is insufficient to assess the borrower's income currency at origination only. We recommend that guidance is given on the assessment approach required post-origination. We propose that be able to regard itself as compliant on an ongoing basis, where it makes clear at origination that it is the customer's responsibility to advise of any change in circumstances, including change of address/income etc. in their annual statement.

Further guidance is required on the items qualifying as a financial hedge. For example, a customer having deposits with a bank covering minimum 12 months of loan instalments could be a financial hedge to avoid the application of the multiplier.

3.10.3 Criteria of Identifying Regulatory Retail Exposures

The CP sets out criteria that must be met for an exposure to be classified as regulatory retail. This introduces a product criterion which is broadly in line with the BCBS standards but in the draft rule text (Article 123A) seems to limit the application to certain Corporate SME facilities. In particular, commitments are allowed but not all instruments that may be issued under a facility are included. The proposed definition for commitment includes off-balance sheet items to issue off-balance sheet items, but not the off-balance sheet items themselves. To follow the proposed rules as written would mean, for example, that a facility to issue guarantees on behalf of a corporate SME may be categorised as a regulatory retail exposure, but any guarantees issued under the facility would not. We consider this may be an unintended consequence of drafting and would appreciate clarification on this point.

3.10.4 Other retail

As per our comments for the SME supporting factor we also support a reconsideration of the SME definition. As currently drafted the SME definition is too complex and onerous on firms, especially due to its reference to the EC recommendation. Under these rules, firms are required to identify all a counterparty's linked and partner enterprises to determine the annual turnover. This is a complex, highly manual process which leads to a high degree of compliance risk. For the definition of SME, we

would recommend alignment to Basel by using the accounting definition of Group Consolidated Turnover, which would also make it consistent with other parts of the rules such as firm size adjustment under the IRB approach.

3.11 Question 13

Do you have any comments on the PRA's proposal that the value of the property shall be measured at origination and on the proposed approach to determining origination value? Do you have any comments on the proposed prudent valuation criteria?

Recommendation(s)

The PRA decided to retain the requirement to use valuation at origination in the assessment of LTVs. We consider that this is not risk sensitive and unsuitable for longer-dated mortgages. We recommend that the retention of the marked-to-market approach to property revaluation since this is the approach currently used in risk management practices, including IRB models.

Should the PRA decides to retain the valuation at origination approach, we propose that the recommendations as set out below are considered.

We welcome the flexibility of being able to use more recent valuations (subject to meeting specific conditions) but, unlike the Basel rules (CRE 20.74), the PRA's rules do not specify that if there is a decrease in the property valuation, it can be subsequently increased upwards up to the value at origination. This should be allowed under the PRA's rules.

Basel 3.1 standards (CRE 20.75(2)) specify that "National supervisors should provide guidance setting out prudent valuation criteria where such guidance does not already exist under national law". However, apart from specifying that Ijara mortgages should be treated as residential real estate exposures and should meet all property revaluation requirements, the supervisory statement does not provide any additional guidance on prudent valuation criteria. The PRA should provide additional guidance on the prudent valuation requirements, especially in its supervisory guidance.

Rather than specifying only valuations done by a valuer could be considered for updating the origination LTV, we propose this is linked to how valuations are conducted for new mortgage loans, which should include AVMs, i.e. any valuations conducted in the same manner as at origination should be considered eligible. Mandating valuations by valuers would ultimately see the cost passed on to the customer.

If a customer pays for a revaluation (i.e. not one driven by the Bank) it should be accepted as an update valuation for the purposes of LTV calculation. It would be difficult to justify to a customer why we can't reflect the new valuation (in their pricing for example) if they have paid for a proper valuation to be carried out.

3.12 Question 14

Do you have any comments on the PRA's proposed approach to risk-weighting real estate exposures?

Recommendation(s)

3.12.1 Commercial Real Estate

We have significant concerns regarding the implementation of a standardised risk weight floor of 100% for commercial mortgages that are not materially dependent upon the cashflows generated by the property. This is negative deviation from Basel which allows:

- risk weights of 60% for part of the exposure up to 55% of the property value and the risk weight of the counterparty for the residual exposure, where the exposure meets the criteria to be deemed 'regulatory real estate'; and
- the risk weight of the counterparty for other commercial mortgages.

While we note that the PRA's proposal is consistent with its current approach to commercial mortgages, this issue requires reconsideration because of its material impact upon the output floor. The PRA's approach will result in secured exposures attracting a higher risk weight than unsecured exposures to the same counterparty. Given that these are not buy-to-let type exposures, because of their lack of material dependency on cashflows, such an approach is illogical. Furthermore, it will place UK banks at a commercial disadvantage to banks in other jurisdictions.

3.12.2 Residential Real Estate

The PRA has chosen to apply just the loan splitting approach for regulatory residential real estate exposures that are not materially dependent upon the cashflows generated by the property; whereas Basel allows both a loan splitting and whole loan approach.

While we welcome the PRA's decision to exclude social housing exposures from the material dependence check, we have noted that for social housing, under the loan splitting approach, the PRA has decided to apply a risk weight floor of 75% for the part of the exposure that is more than 55% of the property value. The PRA's approach may result in secured exposures attracting a higher risk weight than unsecured exposures to the same counterparty. Given that these are not buy-to-let type exposures, because of their lack of material dependency on cashflows, such an approach is illogical.

We would ask that the PRA include the examples provided in Basel in relation to the loan splitting approach as this is a helpful guidance for an otherwise complicated calculation. This should be included in the supervisory statement.

3.12.3 Regulatory Real Estate Criteria

There are several areas of the PRA's proposed implementation of the regulatory real estate criteria which warrant further consideration:

- The PRA has proposed that the regulatory real estate category only include those properties where the development is complete. Basel allows a concession that "under construction" properties meeting certain requirements to qualify for the "finished property" criteria as set out in CRE 20.74 (1). The PRA should exercise this discretion.
- In addition, we consider that the PRA should recognise monoline-insured loans as regulatory residential real estate where the requirements specified in the Basel text are met (CRE 20.71(3), footnote 29).
- In the Basel text, the risk weight of the junior lien after multiplying by 1.25 is capped at the risk weight that would apply if the exposure were risk weighted as "other real estate". In the PRA's proposed text, no such risk weight cap is applied. We would request the PRA to re-instate the risk weight cap in line with the Basel text for the risk weight of junior liens where the base risk weight is multiplied by 1.25. In addition, we would request the PRA include the additional clarification provided in the Basel text (CRE 20.71(3), Footnote 28) in relation to the recognition of junior liens where an intermediate lien is held by a different bank.
- The PRA should also consider providing guidance on the definition and level of metrics to determine good underwriting practices in its supervisory statement. This is a national discretion allowed under the Basel text.

3.12.4 Definition of 'Materially Dependent on Cash Flows'

- We propose that the requirement for materially dependent on cash flows (MDoCF) for residential mortgages is only applied for new mortgage loans booked from 1 January 2025. Applying this rule to mortgage loans booked before this date would result in an increase in RWA for loans that were not assessed and priced based on this rule. Applying a higher risk weight to an existing portfolio reduces the financial resources available to support new business. This would be at the detriment of the housing Industry and wider economy.
- We have concerns that it will be difficult to obtain data required to assess materially dependent on cash flows ("MDoCF") over a representative mix of good/bad years.
- Our interpretation is that for determining material dependence for residential real estate exposures to individuals, the number of properties is the only relevant criteria, i.e. if the number of properties is three or fewer, none of the properties are considered MdoCF, if more than three all properties except the customer's main residence are considered MdoCF. However, in the supervisory statement there is also mention of such a check to be carried out

for individual borrowers in the supervisory statement (Appendix 11). We would like the PRA to clarify the treatment for exposures to individuals.

- In addition we note the '3 property rule' must be applied across all lenders which will be difficult to monitor, especially internationally. The rule also comes with the requirement for ongoing monitoring and re-classification of lending, should the 3 property rule be subsequently breached. This impacts on returns and pricing as loans may initially be priced assuming they are not materially dependent but the capital treatment may change without any reference to the initial lender e.g. a new lender provides funds for a fourth property. For this reason it would be more appropriate to allow the initial 3 properties to retain the capital treatment at inception, with the fourth and subsequent properties being treated as materially dependent on cashflows generated by the property. Alternatively the PRA should consider taking a supervisory statement approach to support smooth implementation and operationalization of this rule.
- Our understanding is that to be considered in the assessment the properties need to be mortgaged (so the customer could have 4+ but only those that are mortgaged would be considered). Where properties are mortgaged, if affordability is based on personal income only we do not think these should be considered as MDoCF. A more appropriate assessment could be that to be included in the assessment, they should be mortgaged based on rental income.
- Our interpretation is that any property in Multiple Occupancy is automatically treated as MDoCF. If our interpretation is correct, we do not agree this is necessary. When assessing mortgage applications, we would not consider income from other occupants. Therefore, we do not believe they possess an incremental risk. We recommend this specific requirement is either dropped or modified to only cover scenarios where income of other occupants is considered in the mortgage application.

We also have certain additional suggestions as per below:

- The PRA should allow exposures secured by residential real estate property to associations or cooperatives of individuals that are regulated under national law and exist with the only purpose of granting its members the use of a primary residence in the property securing the loans to be excluded from the material dependence check. This is consistent with the Basel text and can be relevant for mortgage exposures originating from non-UK jurisdictions as well.
- As allowed under the national discretions provided in the Basel 3.1 standard, the PRA could provide additional guidance setting out criteria on how material dependence should be assessed for specific exposure types. This can be included in the PRA's supervisory statement.

3.12.5 Land acquisition, Development and Construction ('ADC') Exposures

Basel expects national supervisors to give guidance on the levels of pre-sale or pre-lease contracts/or equity at risk from the borrower to pass the threshold to achieve the preferential risk weight of 100% for residential real estate exposure classified as ADC. The PRA should provide guidance in the rules on the levels, so that a 100% RW may be applied.

3.13 Question 15

Do you have any comments on the PRA's proposals on capital instruments, defaulted exposures and high-risk items?

Recommendation(s)

We recommend that the PRA removes the "High Risk" exposure classification and corresponding risk weight of 150% to align with the Basel 3.1 standards. The guidelines for identifying such exposures are unclear and represent considerable operational complexity for banks.

3.14 Additional comments on Credit Risk SA Framework

Area of the consultation	Additional Comments
3.14. 1 Defaulted exposures	We recommend that the PRA adopts Basel's national discretion of applying a 50% risk weight where the specific provision is no less than 50% of the outstanding loan amount as this is more risk sensitive
3.14.2 Equity holdings made pursuant to NLPs	Basel provides the national supervisors the discretion to allow banks to assign a risk weight of 100% to equity holdings made pursuant to national legislated programmes that provide significant subsidies for the investment to the bank and involve government oversight and restrictions on the equity investments. The PRA text does not have any mention of such programmes. We would suggest that the PRA may include the preferential risk weight of 100% for national legislated programs. Even if it is not applicable for the UK, such programs may exist in other jurisdictions.
3.14.3 Equity definition	The PRA should apply the national discretion provided in the Basel text (CRE 20.56, Footnote 23) to clarify that <i>"equity investments that are structured with the intent of conveying the economic substance of debt holdings or securitisation exposures would not be considered an equity holding"</i> .
3.14.4 Equity exposures	Under Article 133 the PRA allows institutions to apply 150% risk weight to equity investments that are not equity exposures in paragraph 5. Would shares purchased from an exchange for trading purpose qualify for this treatment? This complication arises from shares held as part of CIUs/hedge fund. Under the PRA draft text for TB/BB boundary, equity components under a CIU or hedge fund could be classified as banking book. It is not clear to us whether such shares should be categorised as an equity exposure as defined in Article 133 paragraph 1. Could PRA provide a list of examples for such kind of equity investments?
3.14.5 Exposures to an institution in the form of minimum reserves required by the Bank of England.	The criteria in Article 119(4)(a) is still written from a ECB's perspective, and references ECB requirements. We suggest wording in point (a) needs to be updated. <i>"4. Exposures to an institution in the form of minimum reserves required by the Bank of England to be held by an institution may be risk-weighted as exposures to the Bank of England provided:</i>

	<i>(a) the reserves are held in accordance with national requirements which are, in all material respects, equivalent to those in Regulation (EC) No 1745/2003 of the European Central Bank of 12 September 2003; “</i>
3.14.6 Implicit governments support in ECAI assessments	Under the PRA text in Article 138 (g) an institution shall not use an ECAI credit assessment that incorporates assumptions of implicit government support for the purposes of applying a risk weight to an institution. We suggest the PRA applies the national discretion of a 5 years transitional arrangement (Basel 20.18 footnote 13). This would support banks with identification of which ratings have implicit support, which could otherwise be challenging.

4 Chapter 4. Credit Risk - IRB

4.1 Question 16

Do you have any comments on the PRA's proposed implementation timelines?

Recommendation(s)

The PRA takes a different approach to the implementation of changes which require updates to internal models and anticipates that not every model will be fully compliant by 1st January 2025. In this situation firms will need to submit remediation plans and assess whether post-model adjustments are required. We recommend that this can be catered for by a simple update to the existing Article 146 for Roadmap for IRB repair in place since the beginning of 2022. Coordination of adopting new models under Basel 3.1 is important e.g. where models are being submitted to multiple regulators for approval. In addition, if overseas models are being updated to align to other regulators' Basel 3.1 implementation timelines, recommend Overseas Models Approach ('OMA') applications be submitted before 1 July 2024 and approved in a reasonable timeframe.

4.2 Question 17

Do you have any comments on the PRA's proposals for permission to use the internal ratings based (IRB) approach?

Recommendation(s)

4.2.1 Materiality of non-compliance

The Industry welcomes the proposed developments in standards for IRB application approval for new models and material model changes. However, further clarity and guidance is sought on the supervisory expectation over the materiality of non-compliance. We note the proposal to align documentation requirements across all types of model change is unduly burdensome for non-material model changes e.g. simple recalibrations of parameter estimates undertaken on a regular basis. It is therefore recommended that a more proportionate approach is taken and firms are allowed to set internal thresholds to assess such materiality.

4.2.2 Senior Management Function (SMF) attestation

Under the current process, new model and material change applications are submitted through a routine process with an appropriate senior manager, who may not sit in a SMF but give sign-off to attest compliance with regulations. The current approach is considered to be sufficient and effective. Therefore, it is recommended to follow the existing approach and allow the compliance attestation to be provided by appropriate senior management.

4.3 Question 18

Do you have any comments on the PRA's proposed IRB exposure classes and subclasses?

Recommendation(s)

4.3.1 Central Govt/Central Banks

It is unclear why the PRA has sought to completely remove IRB for Central Government and Central Bank exposures yet retain the ability to apply the IRB in relation to multilateral development banks, public sector entities and regional governments and local authorities. The PRA rationale for low default portfolios and difficulties in modelling would apply to all sovereign and quasi sovereign especially where PSE/RGLAs benefit from Government support/guarantees.

4.3.2 Quasi sovereign – Public Sector Entity Export Credit Agencies (PSE-ECAs)

We are requesting that the PRA avails itself of the Basel discretion under CRE 20.12¹⁷ to allow certain quasi sovereigns (i.e. those ECAs classed as PSEs) to be treated as sovereigns under the proposed mandatory standardised approach (SA). This would enable direct access for this non-significant class of quasi sovereigns to be treated as sovereigns as per Basel, which also provides for similar treatment to be applied to non-UK exposures where other jurisdictions are also using this Basel discretion.

The UK proposed mandatory standardised approach for central governments under CP16/22 allows direct access to a zero risk weight for ECAs classed as central governments. However, those classed as quasi-sovereigns (i.e. PSE-ECAs) will not be able to directly access the same treatment under the proposals (CP16/22, 3.66¹⁸).

The request to the PRA relates to considerations around equivalence, and the PRA removal of UK CRR 116(4). While UK CRR Article 116(4) currently reflects, in part, the discretion set out in Basel 20.12 for the UK, it does not include the ability also set out in the Basel for firms to treat non-UK PSE exposures as sovereign where these third countries also allow the PSEs in that jurisdiction to be risk-weighted in the same manner.

We would welcome a UK designated list for eligible global PSE-ECAs via a PSE-specific equivalence framework under HMT remit, or a standalone-assessment and framework devolved to the PRA. Alternatively, given this is small and less material subset of exposures, a preferred operational fix may be achieved via a new clause in Article 116 to cover this subset to potentially access zero RW treatment under the CRR 114 standardised routes, and rely on the 'supervisory and regulatory arrangements' equivalence requirements for non-UK exposures under 114(7) conditions.

¹⁷ **Basel CRE20.12:** Subject to national discretion, exposures to certain domestic PSEs⁷ may also be treated as exposures to the sovereigns in whose jurisdictions the PSEs are established. Where this discretion is exercised, other national supervisors may allow their banks to risk-weight exposures to such PSEs in the same manner.

¹⁸ **CP16/22, 3.74:** For PSEs, the PRA proposes not to treat any exposures to UK PSEs as exposures to the UK central government, a regional government, or a local authority in the UK. This aligns with the Basel 3.1 standards, as the PRA proposes to not implement the Basel 3.1 [ie Final Basel 3] national discretion to treat PSEs as exposures to the sovereign in certain circumstances.

Potential drafting to address enable application of the same consistent treatment for sovereign ECAs and quasi-sovereign ECAs given no difference in risk and national discretion under Basel:

[Article 116 insert:] Exposures to public-sector entities may be treated under Article 114 as exposures to the central government and central bank in whose jurisdiction they are established where there is no difference in risk between such exposures because of the existence of specific public arrangements.

[Article 147A(1)(a) insert:] In addition, for point (b)(i) of Article 147(2), exposures of a quasi-sovereign institutions classed as a public sector entity under Article 116 where there is the existence of specific public arrangements and no difference in risk between such exposures and those by the central government and central bank.

- Operational consideration around indirect access:
- The PRA confirmed in AFME Industry discussions the expectation that banks can indirectly apply a zero risk weight using the credit risk mitigation framework given the allowance for indirect counter-guarantees by sovereign entities (CP6/22, 5.101; Appendix 4, Article 214).
- This means that instead of applying unfunded credit protection (UFCP) conditions to a PSE-ECA issued guarantee in respect of the transaction, the bank will look through to the public arrangements/guarantee for the PSE-ECA. While in theory, we agree that this may achieve the same treatment indirectly for many export finance exposures in the form of cover/guarantees, it adds some complexity, uncertainty and potential compliance, operational and legal costs. In addition, in the separate potential business scenario, for example, where a bank is lending to a PSE-ECA and UFCP is not in use then there remains no direct or indirect access.
- Given ECA exposures – due to an organisational/institutional structural difference – can be designated in either the sovereigns or quasi sovereign classes, we believe this access should be direct and automatic for PSE-ECAs given the proposed application of a mandatory standardised approach for government ECAs with the same risks.

International competitiveness analysis

- It is important to maintain an equivalence with EU and other jurisdictions where the financial institutions (banks) can treat exposures to PSE as central government when such PSE benefits from the central government financial support. For example, where the central government will assume the entire liability of the PSE-ECA in the event of insolvency and such arrangement is confirmed in their relevant national legislation.
- Some official ECAs from certain jurisdictions (Denmark, Switzerland, Belgium, US, Korea, Japan etc) take an organisational or institutional form of a PSE as opposed to being an integral part of central government itself. EEA banks may treat the PSE-type of ECA exposures (typically an ‘unfunded guarantee’) as a central government exposure as these PSEs have financial support from the central government under the specific legislative arrangement as per CRR 116(4) and/or CRR 150(1)(d)(i).
- It is important to point out that, in the ECA business, UK banks globally compete with non-UK banks in pricing the non-UK PSE’s exposures, not on the pricing of UK-PSE exposure.
- The PRA proposed Article 116(3A), corresponding to the UK CRR 116(5) equivalence regime, leads to a 20% RW at best (Credit Quality Step 1) for non-UK PSEs. As such, UK banks will not be able to compete with, for instance, EEA banks which may apply 0% RW for exposures to PSE ECAs who are

treated as central government. This has, in most EU member states, the competent authorities chose to allow the direct use of the SA. UK banks will be disadvantaged compared to banks in the EU or other jurisdictions in running a global ECA business. UK banks will be uncompetitive in this segment (PSE type) of ECA exposure.

- **Pre-Brexit:** IRB banks were able to access SA and the zero RW via the EU CRR Article 150(1) for, at least, EEA ECA exposures under Article 114(4) and 116(4). However, this access was removed post Brexit given restriction of Article 114(4) and 116(4) to the UK.

UK Basel 3.1 proposal on PPU: The PRA proposes to remove Article 150(1)(d)¹⁹ given the introduction of a new PPU framework for application of the SA for IRB banks for certain asset classes (ex quasi sovereigns), and mandatory standardised for sovereigns.

4.3.3 Financial Corporates

Currently as drafted, financial corporates are defined as financial sector entities. The term FSE which is used elsewhere in the CRR is not aligned with the Basel approach for a financial corporate. In particular it includes entities such as ancillary services entities and doesn't include funds. We therefore recommend alignment with Basel and a definition which does not cross refer to FSE. This will help to ensure consistency of scope of AIRB models on a global basis for international banks.

4.3.4 Large Corporates

The proposed currency redenomination from Euros to Sterling will cause consistency issues within an international bank when there are currency fluctuations. For example, the large corporate €500 million threshold for 'total consolidated annual revenues' being redenominated to greater than £440 million could result in a different population scopes for AIRB modelling and regulatory reporting for different regulators. We recommend that the Euro threshold should be permitted as an alternative in the UK to be consistent with Basel.

The PRA proposes to adopt only the 'three year rolling average turnover' measure but not the most recent turnover amount every three years, as allowed under the Basel framework. Both should be permitted to ensure consistency with Basel.

The PRA introduces a consolidated asset test into the definition which is not specified in Basel. We recommend it is removed to align with Basel. If the PRA feels it has no option but to retain this test we recommend that it can be measured the same way as the turnover test, being either the latest amount every 3 years or a 3-year average.

¹⁹ CP 16/22 4.106: The PRA has also considered whether to retain other existing CRR permanent partial use exemptions. The PRA considers that the majority of the existing exemptions are either no longer relevant, due to other changes in the framework such as restrictions on the scope of modelling; or no longer necessary, due to the proposed introduction of a more general exemption for immateriality as set out in (b) above. The PRA therefore proposes to remove these exemptions. The PRA proposes; however, to retain the exemptions currently in the CRR relating to intragroup exposures and exposures in the form of minimum reserves required by the Bank of England.

4.3.5 Retail

We anticipate a substantial reduction in the size of the Retail SME population due to: (i) The retail SME limit being retained by Basel, which is now outdated and does not reflect the reality of SME exposures; (ii) Consideration of undrawn limits (which are intended to serve the customer) in the assessment against the Retail SME threshold. As a result, SME customers will be pushed out of the retail exposure class and therefore subject to higher capital charges and costs, which will ultimately put pressure on this segment. We recommend that the PRA reconsider the inclusion of undrawn commitments in the assessment against the Retail SME limit and also consider raising the Retail SME limit from the proposed GBP 0.88 million to be more reflective of changes in economies since the original threshold was set.

Currency redenomination for the 'retail' exposure class should permit the use of €1 million threshold rather than £0.88 million, again to avoid consistency issues within an international group if there are currency fluctuations.

Currently standardised exposures are not assessed against the QRRE definition. In some cases, Retail portfolios are a mix of QRRE and Other Retail (e.g. a HK credit card customer with multiple credit cards and limits exceed €100k). Even though there is no distinction for Standardised RWA calculation (current or future) the IRB definition of QRRE would need to be applied for all Standardised exposures to calculate the ratio with the two non-mortgage sub-classes.

4.3.6 Equity

The Industry agrees with proposed treatment that RWA for equity exposures to be calculated using the SA. Consequently, it is suggested to amend the proposed Equity exposure class under IRB approaches. The Industry recommends to introduce a new IRB exposure class for Units or shares in CIUs instead of creating sub classes under the Equity exposure class, given all Equity exposures should be calculated under SA. This would also align with the SA where CIU and Equity exposures are two separate exposure classes.

4.4 Question 19

Do you have any comments on the PRA's proposed restrictions on the use of the IRB approach?

Recommendation(s)

4.4.1 Removal of IRB for central government and central bank exposures

We would support the PRA undertaking a holistic review of the SA treatment for unrated Central Banks. This should clarify that ECAI sovereign ratings can be applied to both the central government and central banks when the rating methodology applied by the ECAI reflects the connection between the central government and central bank specifically when the central bank is not that of a monetary union, e.g. ECB, where they are managing the monetary policy of several nations.

ECAs only publish a rating for the entity or entities actually issuing the government debt and as such central banks can often appear technically unrated which would result in an unfavourable risk weight other types of exposures to the central banks than holdings of the debt instruments e.g. SFTs.

The potential issue arises because Article 114 of the CRR states that exposures to central banks and central governments should be risk weighted at 100%, unless a series of exceptions apply (paragraphs 2-7 or Article 114). For countries without equivalent supervision, the only potential deviation from a RW of 100% lies in external ratings. It is implicit in paragraph 2 that the existence of an external rating for the central bank or for the central government would change the risk weight of associated exposures, but not of exposures to both entities. In other words, we would like to confirm that the existence of an external credit rating for a central government would not by itself be sufficient to change the risk weight of exposures to an unrated central bank (and vice-versa).

The sovereign rating methodologies of S&P, Moody's and Fitch are broadly clear that they consider central banks to be of a consistent risk with the central government and we have seen no observable instances where a central bank is rated differently to the central government (albeit there are limited practical examples of central banks being explicitly rated as they broadly do not issue the government debt in their name): e.g.

S&P Sovereign Rating Methodology extract: "138. The ratings on monetary authorities outside of monetary and currency unions are at the same level as their respective sovereign because we consider that they are **analytically inseparable from one another.**"

Fitch Rating Methodology extract: "Central banks, like other public-policy institutions, are agents of the sovereign, but as part of the macroeconomic policy framework are considered to be very closely linked to the sovereign. As such, **Fitch typically treats rated securities issued by the central bank as equivalent to securities issued by the sovereign from a rating perspective,**"

Moody's Rating Methodology extract: "Because a **central bank's credit profile is typically inextricably intertwined with that of the government and therefore influenced by the same credit fundamentals, issuer-level and instrument-level ratings assigned to a central bank typically correspond to those of the central government.** In assigning a central bank rating, we consider the central bank's institutional setup, as well as relationship between the sovereign and the central bank and their overall alignment."

Our proposal is in line with the Basel principles established for sovereign risk weighting as per point 18 of the 2001 supporting document to the New Basel Capital Accord 2001 ("Given the similarity in risk profiles, claims on central banks are assigned the same risk weight as that applicable to their sovereign governments"). Further, we see no conflict with the possible future direction for Basel standards set out in the 2017 discussion paper on the regulatory treatment of sovereign exposures, where Table 6 indicates a differentiation in risk weight treatment being considered between central governments and central banks in the future but with the central banks being considered higher quality than the central government - i.e. blanket 0% proposal for all central bank exposures where denominated and funded in domestic currency and alignment to the central government otherwise. In most cases in practice, we indeed observe that a) in a stress, the central bank is the stronger entity providing

support to the Ministry of Finance-Treasury, and b) in most events of defaults, it is the central government entities that default and the central bank does not.

Therefore, we consider a scenario where there is a possible 100% risk weight applied to central banks to be very drastic and an overly conservative approach compared to the economic risk of exposures to these entities.

4.5 Question 20

Do you have any comments on the PRA's proposed approach to roll-out, permanent partial use, and reversion?

Recommendation(s)

See also our response in Q18 with suggested drafting for the PRA-proposed Article 147A(1)(a) in respect of the national discretion to treat certain quasi sovereigns as sovereigns where the risk is the same.

4.5.1 PPU within roll-out class for large Global banks

CRR Article 150B (4) sets the expectation that no more than 50% of RWA for each roll-out class is calculated using the Standardised approach and 150B (2)(b) states that only 5% of RWA for each roll-out class may be calculated using the Standardised approach on the grounds that the type of exposure is immaterial. This suggests that any additional exposures could only be exempted on the grounds that the institution cannot reasonably model them as assessed using the criteria given in 150B (2)(a). For Global banks with a large geographical footprint, the 5% threshold would only capture a relatively small proportion of portfolios, which could result in institutions being forced to develop IRB models for portfolios, considered immaterial within the institution but exceed the 5% for their sub-class, for no purpose other than to meet an arbitrary target, on the grounds that they did not meet the 3 criteria set out in 150B (2)(a). We recommend that the PRA reconsider the criteria and thresholds for determining PPU.

4.5.2 Roll-out of the IRB approach

Article 147c describes the methodology for the roll-out of the IRB approach. It is unclear what the intention is of the requirements contained in paragraphs 1 and 2 of the article. They are almost identically worded so it is difficult to simply understand what it required by each. We recommend the PRA re-word the text to avoid any ambiguity.

4.6 Question 21

Do you have any comments on the PRA's proposals relating to the 1.06 scaling factor and to the 1.25 asset value co-efficient of correlation multiplier?

Recommendation(s)

4.6.1 1.25 asset value co-efficient of correlation (AVC) multiplier

Industry welcomes additional clarity provided by the PRA for the application of AVC multiplier but would also suggest the PRA to consider the following suggestions.

Firstly, the Industry suggested to align with Basel in determining the asset size for large financial sector entities (FSEs) definition. Current PRA proposal of asset size determination is based on total individual or consolidated assets. But Basel CRE 31.7 states that the most recent audited financial statement of the parent company and consolidated subsidiaries should be used. We recommend alignment with Basel, especially to ensure consistency of scope of AIRB models on a global basis for international banks.

Additional suggested changes to AVC definition of Large FSE and Unregulated FSE

Industry recommends that treasury entities of non-financial groups should be explicitly removed from FSE definition, when such entities are solely to perform financial services to its wider non-financial group.

Within the current guidance provided by the EBA (as set out in 2015_2383)²⁰, funds are not considered to be FSEs. Traditional funds such as pensions funds do not carry out the activities listed in the CRD Annex. This should be explicitly defined within the PRA rules for the scope of AVC to avoid any confusion.

4.7 Question 22

Do you have any comments on the PRA's proposal to remove the SME support factor under the IRB approach? Do you have evidence – quantitative or qualitative – regarding the appropriateness of the IRB approach for SME exposures in the absence of the support factor?

Recommendation(s)

As per comments in SA section.

4.8 Question 23

Do you have any comments on the PRA's proposal to move the infrastructure support factor under the IRB approach? Do you have evidence – quantitative or qualitative – regarding the appropriateness of the IRB approach for infrastructure exposures in the absence of the support factor?

²⁰ [2015_2383 Scope of asset value correlation adjustment for regulated entities | European Banking Authority \(europa.eu\)](https://www.eba.europa.eu/en/press/2015/2383-scope-of-asset-value-correlation-adjustment-for-regulated-entities)

Recommendation(s)

We would support maintaining the ISF under the IRB or at the very least appropriate grandfathering of existing exposures that fall under this treatment.

The ISF has been and continues to be a key lever for banks to utilise to grow their sustainable finance asset base, support decarbonisation in the real economy through financing climate mitigation and adaptation activities, and maintain competitiveness, particularly with European banks.

In the absence of the ISF, we expect that the capital requirements on UK banks' infrastructure funding businesses would be higher than the EEA counterparts for eligible transactions, which would put UK banks at a competitive disadvantage and limit participation and growth in this area.

4.9 Question 24

Do you have any comments on the PRA's proposed approach to calculation of risk weighted assets and expected loss, not covered by the questions above?

Recommendation(s)

4.9.1 Definition of Commitment

The definition of commitment should be consistent across all approaches. It's unclear why there is 'unrecognised exposure adjustment' which introduces inconsistencies. This will mean scope of population of exposures is different between SA and IRB and therefore output floor. In practice that cannot be easily corrected as a top-down adjustment on portfolio level would be needed but the commitment assessment is carried out on relationship/obligor level.

Further deviations under AIRB in SS (para 17.11) also introduce unnecessary deviations – instead national discretion for Footnote 53 should be introduced which will provide the same outcome as intended by this para i.e. exposures where a full credit assessment is needed do not need to be included in EAD and attract CF.

4.9.2 Treatment of Expected Loss amounts

The rule to restrict using excess specific provisions for defaulted exposures to cover EL of other exposures is overly conservative and should be removed. The fact that provisions haven't been used up is inherently positive and makes resources effectively available. Restricting that availability is artificially underestimating the firms provisioning capacity.

4.10 Question 25

Do you have any comments on the PRA's proposed general requirements for use of the IRB approach?

Recommendation(s)

The Industry welcomes a more standardised monitoring reporting framework.

4.10.1 IRB model governance and validation:

It is unclear how “material differences between established procedures and actual practice” would be defined (Para 4.175). It is an existing requirement for senior management to provide notice to the management body of exceptions to established policies (UK CRR Article 189(2)(a)) and further clarity is requested over the differences between the requirements to support banks to comply with the PRA expectations for each one.

CRR Article 174 (c) indicates that the data used to build models should be representative of the population of the institution’s actual obligors or exposures. Paragraphs 28-34 of EBA GL 2017/16 provide additional clarity on representativeness of data for calibration of risk parameters. This is largely adopted in Appendix 13, paragraphs 8.10 to 8.14, however paragraph 34, which allows for adjustments to be made and MoC to be applied in cases where limitations in representativeness have been identified, has not been included. This implies that firms would need to have perfectly representative data at the outset (due to the expectation of Article 174(c)). We do not believe this is a realistic expectation for all portfolios and recommend that paragraph 34 of EBA GL 2017/16 is included in Appendix 13 to allow adjustments to be made to correct for biases/non-representativeness in the data.

4.10.2 Seasoning assessment and adjustment

Paras. 10.6 and 12.24 of Appendix 13 for PD and LGD respectively set the expectation that firms adjust their estimates with an adequate MoC to account for any lack of representativeness caused by seasoning. Clarification is requested that a MoC would not be required if firms can demonstrate that seasoning effects are already captured by the model, i.e. the model does not underestimate risk through time. In addition, for LGD specifically, Para 12.24 initially refers to “time from the date of default” when discussing seasoning, but subsequently refers to default rates peaking several years after origination i.e. referring to “time since origination”. Aging of defaults and time on books are not directly connected, therefore clarification is requested that the LGD seasoning assessment is related to aging of defaults only and not time on books.

4.11 Question 26

Do you have any comments on the PRA's proposed approach to the definition of default?

Recommendation(s)

There is a typo Article 178 in the new PRA rulebook – 178(2) (da). Using this threshold we will unlikely have any defaults - misquoted the materiality threshold for DoD as £440 million when it should be £440.

Distressed Restructuring

The consultation paper creates some uncertainty on the linkages between the definition of 'distressed restructuring defaults' and 'forborne non-performing exposures'. The linkage between the two has been removed in paragraphs in paragraphs 3.15 to 3.19 of Appendix 14, which came from the current paragraphs 49 to 55 in EBA/GL/2017/16). We support this amendment which was an overly burdensome requirement to meet. However, we note that references to 'forbearance' and 'forborne non-performing exposures' still occurs in paragraph 8.2 of Appendix 14 and recommend it is removed to avoid ambiguity.

4.12 Question 27

Do you have any comments on the PRA's proposed PD, LGD, and CF or EAD input floors?

Recommendation(s)

4.12.1 PD Input floors for retail portfolios

- The proposed 0.1% PD input floor for UK residential mortgages seems unnecessary given the other safeguards that have been put in place to address PRA's concerns around uncertainty in risk weights, such as the 10% exposure weighted risk weight floor, Hybrid PD modelling requirements and Output floor. Given these other safeguards we believe the PRA should align the floor with the Basel value for international consistency. We suggest it might be better not to hard-wire this policy proposal into the rules but address on a case by case basis or via supervisory statements, to allow for future flexibility with model development.
- The consultation paper states that 0.1% and 0.05% PD floors are applicable to QRRE transactor exposures and other QRRE exposures respectively, whilst Article 163(1) of the updated CRR states that all QRRE exposures will be subject to a 0.1% PD floor. We assume that both references are incorrect and recommend that the Basel 3.1 provisions are followed where 0.05% and 0.1% PD floors are applied to QRRE transactor exposures and all other QRRE exposures respectively.

- The reference to a higher PD input floor for Transactors (0.1% compared to 0,05% per Basel 3.1) accords with that for Revolvers, in Basel 3.1. This proposal appears to be punitive for exposures to Transactors. We recommend that PRA align with the Basel value.

4.13 Question 28

Do you have any comments on the PRA's proposals on PD estimation?

Recommendation(s)

4.13.1 PD estimation: obligor grade adjustment, i.e. parental support

The PRA proposes to introduce new requirements for the recognition of support arrangements in PD models (4.226-8). This includes the expectation that undocumented support arrangements are to be excluded.

The ability to take account of parental support is an integral part of banks' client management framework for global banking business. It is important for global clients that we are able to provide banking facilities to their global subsidiaries in a way that reflects the credit quality of the client group.

Banks' parental support frameworks have been in place prior to the introduction of the IRB regulations in 2008 and uses the parent's Credit Grade as the key input (with the exposure receiving a level of notch downgrade from the parent's grade that is dependent on the level of support). This is consistent with the approach taken by the Rating Agencies and reflects our experience that the key determinant of risk for global subsidiaries is the credit quality of the parent.

A key requirement of banks' framework is that for any support to be taken into account, the parent must be highly rate (i.e., a maximum of one notch below investment grade). This ensures that the parent is of a standing that they would have both the ability and willingness to support their subsidiaries.

Banks' historic long-run default rates by the type of support illustrates that the internal governance banks' apply when taking account of parental support leads to lower default rates. AFME members will be supplying supporting data separately on a bilateral basis.

In 4.226²¹ the PRA has said that its preference is for parental support to be used as an input to the PD model. In 4.227²² the PRA then says that it considers that undocumented support arrangements are often unclear and not robust. In addition, the PRA considers that it is difficult for firms to demonstrate a reduction in default risk from these arrangements, and it is difficult for supervisors to challenge whether these arrangements are appropriately reflected in IRB models.

Providing banking facilities to subsidiaries is an integral part of global business for banks. Therefore, we believe that we can demonstrate that the application of our parental support framework for the different types of support (including undocumented support) is robust. The reduction in default risk from these different types of support can be seen in banks' historic data. Firms should be given the opportunity to demonstrate to the PRA that their parental support arrangements are adequately reflected in their IRB models. This would be consistent with the IRB approach of firms using their own data to select and support the key risk drivers used in their models, to derive capital requirements that are aligned to the historic risk of their portfolios. Curtailing the benefit that can be given for certain types of support will unnecessarily hinder our ability to support the global expansion of UK companies. Thereby, increasing the cost and limiting the types of banking facilities that the subsidiaries of UK businesses would have access to.

Furthermore, it is our understanding that the EU approach will remain the same, and we expect HK and Singapore's approach to also remain unchanged, to allow the obligor rating adjustment to be recognised in PD modelling without a specific requirement for documented parental support. Where other local jurisdictions do not have this requirement, this will also increase capital and/or costs – both compliance and operational – for banks required to do so by their home regulator and potentially impact competition in other markets.

In addition, the proposed CRR text does not explicitly reference the use of pooled data across institutions being recognised, and that if used the bank must demonstrate that the internal rating systems and criteria of other banks in the pool are comparable with its own. We would ask for clarification around the use of pooled data for PD estimation.

4.13.2 Discrete vs continuous rating scales

The PRA proposes to disallow continuous rating scales due to the perceived risk that they could reduce RWA without increasing the overall risk capture of the model. We consider the scope of this

1. ²¹ **CP6/22 4.226:** *The PRA considers that it would be desirable for firms to reflect support arrangements in PD models where they are able to demonstrate a reduction in default risk, as the PRA considers that linking RWAs to risks advances the PRA's primary objective. As such, the PRA proposes to continue to permit firms to reflect certain support arrangements in IRB obligor rating grade assignments.*

²² **Section 4.227:** *However, the PRA considers that undocumented support arrangements are often unclear and not robust. In addition, the PRA considers that it is difficult for firms to demonstrate a reduction in default risk from these arrangements, and it is difficult for supervisors to challenge whether these arrangements are appropriately reflected in IRB models. The PRA therefore proposes that adjustments to obligor grades would only be permitted where the support arrangements are in writing.*

proposal (covering all PD models) to be excessive, given that firms have in practice been able to achieve and demonstrate robust risk differentiation for very low PD exposures across a wide range of existing portfolios. Moreover, we consider that the perceived risk outlined by the PRA is mitigated by other proposed measures including the revised, higher input floors. If the PRA maintains this provision, we recommend that the expectation is limited to Retail Mortgages only – this is because other portfolios, such as Retail Unsecured, typically have wider and richer sources of available data to provide robust risk differentiation across the rating scale.

4.13.3 Minimum data requirements for PD estimation

In the updated CRR Article 180(1)(h) and (2)(e) the PRA sets the expectation that "The data shall include a representative mix of good and bad years from the economic cycle relevant for the type of exposures". We note that it may not be possible to meet this requirement for portfolios/geographies where the available internal/external/pooled default/loss data history does not cover a representative downturn period and economic cycle. We recommend the PRA clarifies the proposed requirement to include the use of macroeconomic information or other external factors (when available and representative) to estimate default data covering a representative mix of good and bad years; or, the ability to adjust internal datasets (e.g. through reweighting or some other techniques) to allow a representative mix of good and bad years

4.13.4 Point in Time plus Buffer methodology

Currently the Point in Time plus Buffer approach is commonly used by firms to model PD for Retail Unsecured exposures. This approach is typically based on a continuous rating scale. Clarification is requested that the Point in Time plus Buffer approach would still be allowed under the new proposals (in association with discrete rating scales, should the PRA disallow use of continuous rating scales).

4.13.5 Long-run Average default rate calculation

In the updated CRR Article 180(1)(aa) and (2)(aa) the PRA sets the expectation that long-run average PDs should be estimated based on the observed historical average one-year default rate that is a simple average based on the number of obligors (count-weighted). We believe the proposed rule is conflating the calculation of the one-year observed default rate (which should be count-weighted, as specified in Paragraph 11.4 of Appendix 13), and the long run average default rate (which should be time-weighted, as specified in Paragraph 11.11 of Appendix 13). Our recommendation is to align CRR Article 180(1)(aa) and Article 180(2)(aa) to the calculations described in Paragraph 11.4 and 11.11 of Appendix 13, thereby achieving consistency with Basel.

4.14 Question 29

Do you have any comments on the PRA's proposals to LGD estimation?

Recommendation(s)

4.14.1 Proposed introduction of an alternative methodology for collateral in LGD estimation

- The alternative methodology for accounting for non-financial collateral in LGD estimates using Foundation LGD values is required to be adopted where firms have fewer than 20 relevant data points for any non-financial collateral. The threshold of 20 relevant data points is given in the consultation paper but not included in Article 169B(1)(b), which refers only to having sufficient data to model. We request the threshold is included along with a clarification of what “relevant data points” means in the context of a Mortgage LGD model.

4.14.2 Ineligible collateral treatment

- The PRA requires that cashflows associated with disregarded and ineligible collateral are not included in LGD estimates. This is a change to the existing requirements which permit their inclusion in the model calibration, but not as a risk driver, subject to making any adjustments to avoid bias to the LGD for unsecured exposures (paragraph 127 EBA/GL/2017/16). The exclusion of these cash flows will bias the real recovery amount and hence bias the LGD incurred by the firm. While we support PRA’s approach on not including disregarded and ineligible collaterals as risk drivers, we recommend the PRA should allow them to be included in the model calibration, especially when the recoveries have a material effect on losses during a downturn period.

4.14.3 Incomplete workouts

- The PRA provides an option for the LGD calibration to assume zero future costs and recoveries for incomplete workouts. Based on the current wording, it is unclear whether the draft provision applies to all parts of the LGD model, including the Best Estimate of Expected Loss (BEEL) parameter. We would recommend that the PRA clarify that where a firm decides to assume zero future costs and recoveries for incomplete workouts, this assumption should be applied consistently across all parts of the LGD model including the BEEL parameter. We believe that this will lead to a more consistent and coherent quantification approach between BEEL and Downturn LGD parameters
- Paragraph 14.12(b) of the draft supervisory statement in Appendix 13, states that costs and recoveries for ‘incomplete workouts’ (defaulted facilities that have not completed the ‘maximum period of the recovery process’) can be estimated only up to the maximum period of the recovery process, whilst paragraphs 14.6, 14.10(b) and 14.11 state that costs and recoveries for unresolved workouts (defaulted facilities that have completed the ‘maximum period of the recovery process’) can be included up to the moment of estimation.

These restrictions on the recognition of recovery cash flows do not reflect the guidance recently provided at the PRA Mortgage Roundtable in October 2022, where it was noted that “the most conservative approach consists of classing all these exposures as a repossession event”, i.e.,

unresolved exposures at the maximum period of the recovery process can be assumed to be repossessed, thus allowing the recognition of appropriate collateral recoveries. We believe excluding such collateral recoveries means that model estimates would not be reflective of actual risk management practices and could lead to illogical LGD estimates. We recommend aligning to the expectation set out in the October 2022 Mortgage Roundtable, by allowing appropriate recognition of collateral recoveries post the maximum period of the recovery process for the purpose of LGD estimation.

4.14.4 Additional drawings after default

We support PRA proposal to permit additional drawings after default to be recognised in LGD estimates for non-retail exposures, as an alternative to the existing UK CRR requirement to only recognise them in EAD estimates.

First-to-default derivatives should count as CRM in the LGD calculation.

4.15 Question 30

Do you have any comments on the PRA's proposals to EAD estimation?

Recommendation(s)

4.15.1 Scope of EAD modelling under the AIRB approach

- Article 166D provides the conditions for modelling conversion factors or exposure at default (EAD) and this includes the prohibition of modelling for on-balance sheet items, only off balance sheet items may be modelled and combined with the on balance sheet value defined in Article 166A(2). Article 166A(2) defines the exposure value of on-balance sheet items as 'the accounting value measured without taking into account any credit risk adjustments made'.

Currently, it is common practice to estimate EAD for on-balance sheet items on non-revolving retail facilities (e.g. mortgages, unsecured loans) as the on-balance sheet amount plus an expected amount of future accrued interest over the months of non-payment prior to default. We request that you provide confirmation that this approach remains acceptable.

We do not have any concerns with the proposal to adopt the fixed-horizon approach for Retail exposures.

4.16 Question 31

Do you have any comments on the PRA's proposals for maturity?

Recommendation(s)

The Industry supports the PRA proposal to maintain the substance of its existing approach, being to apply the effective maturity approach for the FIRB.

4.16.1 Regarding the PRA proposes that for purchased receivables, the effective maturity would be a minimum of one year.

The PRA proposes to align treatment of effective maturity for purchased receivables with the Basel 3.1 standards of a minimum of one year in lieu of the existing 90-day minimum. However, Basel 3.1 standards do not explicitly specify a maturity floor applicable to purchased receivables.

In such a scenario (i.e. where Basel does not set out a specific maturity floor for purchased receivables), purchased receivables exposures that can be classified as self-liquidating trade finance transactions, satisfying the definition for 'trade finance' set out in clause (80) of Article 4 (1) of CRR, should be eligible to get the maturity floor of one day. For other purchased receivables exposures which do not fall within the ambit of the 'trade finance' definition a default maturity floor of one year would be applicable. Letters of credit should have the same maturity treatment as other exposures classified as self-liquidating trade finance transactions (BCBS text makes explicit reference to letters of credit having the same maturity characteristics).

The case for purchased receivables falling within the ambit of the 'trade finance' definition is based on their underlying link to movement of goods and services, short-term (less than one year) and non-revolving nature of the transactions. Hence it is recommended that these products get a treatment similar to 'trade finance' and get a maturity floor of one day.

We recommend that when purchased receivables fall under 'trade finance' definition, then apply a maturity floor of one day; and when purchased receivables do not fall under the 'trade finance' definition, then the default maturity floor of one year will apply.

We note that the liquidity regulations (PRA CP 17/21) have already incorporated this aspect. Purchased receivables (under the items on-balance sheet factoring and off-balance sheet factoring) is already being treated as trade finance and are subject to the same funding factors.

4.16.2 Regarding the Maturity for trade products that may have an indeterminate tenor

Trade products like guarantees may have an indeterminate tenor dictated to by business practices related to government and public sector contracts, where these guarantees remain outstanding for a considerable length of time well after the commercial contract is completed. Given the indeterminate nature of these guarantees, banks currently apply a maturity cap of 5 years under AIRB and 2.5 years under FIRB approaches in calculating risk weighted assets (RWA) for the life cycle of these instruments.

We seek clarification if banks following the FIRB approach for corporate portfolios can use the ‘effective maturity’ approach in combination with the 2.5 year cap for trade-related guarantee instruments when the tenor is indeterminate.

4.17 Question 32

Do you have any comments on the PRA’s proposals for specialised lending?

Recommendation(s)

4.17.1 Definitions

We support PRA proposal to align the definition of specialised lending to the Basel definition CRE30.07.

The UK CRR 147(8) can lead to inconsistent classifications as specialised lending or corporate exposures across banks depending on this interpretation and/or the different financing structures.

For example, some financing structures for aircraft and shipping will not meet all four characteristics that must be met in legal form or economic substance. We recommend that PRA adopt the full definition in the Basel text, and additionally provide guidance on aspects of the definition that are open to different interpretation by banks.

However, we note that the definition of HVCRE proposed by the PRA differs to Basel And we recommend the PRA aligns its definition to Basel CRE 30.15. Including part 1 which permits national supervisors to define the types of commercial real estate exposures sharing higher volatilities in portfolio default rates. In doing so, the PRA should recognize such classifications by other regulators.

4.17.2 Slotting risk weights

The PRA has revised the rules for applying preferential risk weights to slotting exposures within the ‘strong’ and ‘good’ slot categories. This replaces the existing rule whereby exposures with a remaining maturity of 2.5 years receive a lower risk weight. We have the following concerns with the new requirements:

- CRR article 153(4)(d)(i) contains the requirement that ‘the obligor could refinance the exposure in a severe but plausible stress in the refinancing market’ seems to be judgmental, and the supervisory factors already covered the dimensions of ‘financial strength’ and ‘cash-flow predictability’ slotting criteria. We recommend that this is deleted and the 2.5 year remaining maturity criterion is maintained. CRR Article 153(4)(d)(ii) enables ‘substantially stronger’ IPRE exposures in the strong slotting category to receive the preferential risk weight. The PRA definition of ‘substantially stronger’ for IPRE exposures is stricter than Basel and could mean

few exposures can benefit from it. We recommend that exposures that meet any of the criteria in Article 153(4)(e) can be considered 'substantially stronger'.

4.18 Additional comments on the proposed IRB framework

Area of the consultation	Additional Comments

4.18.1 The PRA CP section on “Short-term self-liquidating trade letters of credit (maturity less than one year/maturity greater than or equal to one year)”	Conversion factors (CF) to be applied under the Standardised and FIRB approach should be in separate tables. The PRA has proposed separate CFs for letters of credit when maturity is less than one year (20%) and when maturity is greater than or equal to one year (50%). We recommend that all documentary credits (DCs) be treated (irrespective of maturity) at 20% CF under both the standardised and foundation IRB approach. The case for 20% CF for DCs is based on data collated by the International Chambers of Commerce (ICC) sponsored Trade Register (TR) which establishes that the average CF for Import DCs which have defaulted is 18% and the average loss-given-default (LGD) of these crystallised exposures is a low 17%. If the PRA still wishes to maintain the distinction of 20% CF for DCs with a maturity less than a year and a 50% CF for DCs with a maturity greater than one year, then we recommend that this bifurcation is applied only to the standardised approach as maturity is already an explicit risk parameter in the calculation of RWAs within the FIRB approach. Not doing so, will effectively double count maturity-based risk in the risk weight calculation under the FIRB approach.
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4.18.2 Change in CFs for commitments to issue contingent liabilities

Conversion factors (CF) aim to account for two events:

1. CF for commitments define the probability that an unutilised facility converts to an issued exposure (which maybe on or off-balance sheet from an accounting perspective).

2. CF for issued transaction-related contingent liabilities (for e.g. issued letters of credit or issued guarantees) define the probability that such issued contingent liability exposures (which are off-balance sheet) convert to an on-balance sheet exposure.

For an unutilised contingent liability facility, both of the above events (which are independent of each other) need to happen before it becomes an on-balance sheet exposure (i.e. unutilised contingent liability facility -> issued contingent liability exposure -> obligor default -> trigger event leading to a conversion to an on-balance sheet exposure).

However, the regulations do not treat such scenarios appropriately. PRA has proposed that the lower of the two applicable CFs be applied – which is conceptually or mathematically not the correct probability.

For e.g., issued letters of credit get a 20% CF. 'Commitment to issue' letters of credit (which are not unconditionally cancellable in nature) will also get 20% CF. This means the risk is expected to be the same whether or not the product in question (letters of credit) is actually issued or not. This is not correct.

Below table highlights the way effective CFs will work as currently proposed

Effective Conversion Factors (CF)		Unissued / commitment to issue – Not unconditionally cancellable	Unissued / commitment to issue – Unconditionally cancellable	Remarks
Loans	100%	50% (C)	10% (D)	
Performance guarantees	50% (A)	50%* (lower of A & C)	10%* (lower of A & D)	Noting that the CFs associated with unissued are not proportionally altered to mimic the change in issued risk (compared to loans), leading to some unissued items being equal in risk to issued items (and others
Letters of credit	20% (B)	20%* (lower of B & C)	10%* (lower of B & D)	

				being proportionately very high)
(*assuming lower of the two CFs per PRA)				
However, based on correct mathematical multiplicative factors, the CFs should be:				
Effective Conversion Factors (CF)	Issued	Unissued / commitment to provide – Not unconditionally cancellable	Unissued / commitment to provide – Unconditionally cancellable	Remarks
Loans	100%	50% (C)	10% (D)	
Performance guarantees	50% (A)	25% (= 50% * 50%) (multiply A & C)	5% (= 50% * 10%) (multiply A & D)	Using multiplication to combine two CFs used for independent events to calculate risk of unissued moving to issued and then further moving to on balance sheet
Letters of credit	20% (B)	10% (= 20% * 50%) (multiply B & C)	2% (= 20% * 10%) (multiply B & D)	
Note that the above numbers use current PRA proposed CFs i.e. 50% for NUC commitments and 50% for performance guarantees. If the proposed CFs for these items are changed in the final PRA regulations, then these effective CF numbers will change accordingly as well				
We recommend that the regulations be amended to state that when there are commitments pertaining to off-balance sheet items, then the two conversion factors should be multiplied.				

4.18.3 Treatment of Fair Value /Held for Sale instruments in Expected Losses	▪ Banks must deduct expected credit loss from own funds (less provisions and valuation adjustments) (CRR Articles 36(d), 158 &159) ▪ However, for fair valued positions this represents a double count because the expected loss is already reflected in the accounts with gains and losses flowing through earnings. ▪ In other jurisdictions expected credit loss for fair valued positions is set to zero Recommendation ▪ We recommend that Expected Credit Loss for fair valued positions should be set to zero, in line with the US version of the rule: <i>ECFR, Title 12, Chapter II, Subchapter A, Part 217, §217.2 Definitions.</i> <i>Expected credit loss (ECL) means:</i> <i>(1) For a wholesale exposure to a non-defaulted obligor or segment of non-defaulted retail exposures that is carried at fair value with gains and losses flowing through earnings or that is classified as held-for-sale and is carried at the lower of cost or fair value with losses flowing through earnings, zero.</i>
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5 Chapter 5. Credit Risk Mitigation

Industry welcomes the flow charts that have been included within the consultation by way of summaries of the new framework. To enhance this further, we ask that article references are included within each box of the flow chart for ease of referencing the relevant section of the PRA rulebook.

In addition to this additional clarity, we include specific comments and recommendations in relation to the PRA's questions below:

5.1 Question 33

Do you have any comments on the PRA's proposals for recognising funded credit protection (FCP) for exposures that give rise to counterparty credit risk?

5.1.1 Clarity regarding conflicting references to IMM

Relevant Article

Article 191A(4) – “Articles 192 to 239 do not apply to an institution using the IMM, the LGD Modelling Collateral Method or the LGD Adjustment Method or to an institution taking into account funded credit protection covering an exposure arising from a derivative instrument”

Issue

Articles 192 to 239 do not apply to an institution using the LGD Modelling Collateral Method or the LGD Adjustment Method or to an institution taking into account funded credit protection covering an exposure arising from a derivative instrument. In addition, IMM refers to articles in this section.

Recommendation

The application of Articles 192 to 239 should be clarified / further specified to ensure coherence across the prudential rulebook.

5.1.2 Improve recognition of initial margin in calculation of total exposure

The benefit that initial margin provides to reduce derivatives exposure is not sufficiently recognised in the SA-CCR calculation of exposures. The methodology is very conservative and it leads to a disproportionate amount of initial margin needed to be posted to reduce the exposure. The lack of adequate recognition of IM results in overstated exposures and therefore unduly conservative capital requirements.

Given the significant increase of IM in the financial system over the last years it is economically important that it appropriately recognises the reduction in counterparty credit risk.

Recommendation(s)

The Industry recommends that the PRA should allow for better recognition of initial margin (IM), to reflect its risk-reducing properties.

5.1.3 Supervisory Discretion

Issue

Prudential rules do not always adequately capture the economic exposure a firm is subject to in a transaction (e.g. when modelled under IMM or SA-CCR), and this may lead to uneconomic results and incorrect trading incentives. Particularly in the case of new or exotic products, the application of existing requirements may not always be logical or appropriate.

Recommendation(s)

We view that the PRA should in select cases have the ability to apply supervisory discretion (subject to discussion with firms) to allow for flexibility in the treatment of such transactions.

5.1.4 Recognition of FCCM eligible collateral

Under the current capital rules, the following assets are eligible as potential credit risk mitigants for derivatives exposures calculated under the Standardised Credit Risk approach (SA-CCR):

- Assets listed in CRR Article 197 (Eligibility of collateral under all approaches and methods);
- Assets eligible under CRR Article 299, if the derivative is in the prudential Trading Book (Article 276 (1) (a)).

The Industry proposes to enlarge the eligible collateral assets to CRR Article 198 (additional eligibility of collateral under the Financial Collateral Comprehensive Method (FCCM)).

- The standardised approach SA-CCR applies a haircut method when valuing financial collateral. Those haircuts are the same as the ones that apply under the supervisory haircut method (Article 220) and the FCCM (Article 223) i.e. those of Article 224 for collateral of Article 196, i.e. those listed in Articles 197 and 198 (Basel at CRE52.11 states that the applicable haircuts are identical to that applicable to repo-style transactions which, in CRR, would be those applicable under either Article 220 or 223, i.e. all collateral listed at Articles 197 and 198).
- Logically, the perimeter of eligible financial collateral under SA-CCR should be the same than the perimeter under the supervisory haircut method (Article 220) or the FCCM (Article 223) listed in CRR Article 196 ("Without prejudice to Article 299, the collateral taken, and securities or commodities borrowed within such agreements or transactions shall comply with the eligibility requirements for collateral set out in Articles 197 and 198")
- In addition, Article 284 in describing the exposure value calculation of derivatives under IMM provides in paragraph 2 the recognition of collateral as referred in Articles 197 and 198 and points (c) and (d) of Article 299(2). Therefore, it would be inconsistent to allow article 198 to be eligible collateral under IMM and not under the SA-CCR method for the same type of transactions. Moreover, for a firm that uses both approaches (IMM and SA-CCR) for the

calculation of derivatives exposures against the same counterparty, the allocation methodology of collateral received would be determining if the collateral is eligible or not, which would result in partially recognizing the collateral received for the portion of it allocated to the IMM netting set, which we don't believe to be the intention.

Recommendation(s)

Consider amending SA-CCR Article 276 (1) (a) (b) to read: '1. For the purposes of this Section, institutions shall calculate the collateral amounts of VM, VMMA, NICA and NICAMA, by applying all the following requirements:

- (a) where all the transactions included in a netting set belong to the trading book, only collateral that is eligible under Articles 197, 198 and 299 shall be recognized;
- (b) where a netting set contains at least one transaction that belongs to the non-trading book, only collateral that is eligible under Article 197 and 198 shall be recognized;'

5.1.5 Margin in Transit

Under the current capital rules, firms are only allowed to reduce their credit risk exposures for derivatives by the amount of any eligible variation margin (VM) received by the firm. This frequently results in increased exposures to counterparties because of timing differences between a margin call and the receipt of variation margin, which is generally on a T+1 basis. Under the capital rules, VM received on T+1 cannot be used to offset derivatives exposures calculated on day T+0 even though firms fully expect the collateral to be received on T+1. This timing issue can result in significant increases in capital charges for firms in periods of stress and high volatility when trade values can move sharply. Most recently, this has been observed last year as a result of increased market volatility in response to the COVID-19 pandemic.

This timing issue can result in procyclicality whereby capital increases cause client facilitation to become more expensive precisely when liquidity is required. Under both the IMM and the SA-CCR, the calculated exposure at default (EAD) represents an expected exposure measure. In this regard, it should be noted that over time the non-zero current exposures resulting from timing differences should be on average zero. Therefore, removing these timing differences by allowing firms to reflect collateral that has been called but not yet settled should be allowed as it is consistent with an expected exposure measure as long as there is no underlying margin dispute.

In order to prevent increased capital charges for the firms due to these timing differences and to align more closely with an expected exposure measure, the Industry proposes that firms should be allowed to reflect the VM that is received and posted on a T+1 basis under both SA-CCR and IMM. This change will reduce unwarranted volatility in exposures and RWA, because of collateral shortfalls as a result of ordinary settlement cycle.

Supervisory Statement 12/13 under point 4B "treatment of unsettled margin" allows the recognition of collateral that has not settled yet in the calculation of the Expected Exposure under the Internal Model

Method where for example the delay in settlement of collateral arises as a result of the ordinary collateral call and settlement cycle as long as this settlement delay is not due to a dispute.

We believe the same approach should be allowed to be adopted under SA-CCR.

Collateral is called once for the entire portfolio irrespective if some of it is measured under IMM and some under SA-CCR. For a firm that uses both approaches (IMM and SA-CCR) for the calculation of derivatives exposures against the same counterparty, the allocation methodology of collateral received would be determining if the collateral is eligible or not, which would result in partially recognizing the collateral in transit for the portion of it allocated to the IMM netting set.

Recommendation(s)

Margin in transit rules already allowed under IMM should be extended for their use under SA-CCR as well as to ensure consistent treatment of collateral under both approaches. That is, firms should be allowed to reflect the VM that is received and posted on a T+1 basis under both SA-CCR and IMM.

5.1.6 Multiple netting sets subject to one margin agreement

Under the CRR capital rules, when multiple netting sets are jointly margined then Article 278(2) requires firms to calculate the Potential Future Exposure (PFE) by using the unmargined methodology.

According to CRR Art. 272 (4), individual transactions not subject to a bilateral netting under section 7 are treated “as its own netting set”. An example of such transactions can occur when entered into one with a branch of a counterparty in a non-netting jurisdiction or when all the transactions in the netting set are with a branch of a counterparty in a non-netting jurisdiction hence each trade forming its own netting set. As a result, the rule for unmargined PFE methodology could be interpreted such that it also captures cases where an individual non-nettable transaction (not qualifying under section 7) is jointly margined with a large regulatory netting set (qualifying under section 7) or when all transactions under an agreement are non-nettable and thus not qualifying under section 7.

The Industry’s proposal to amendment Article 278(2) ensures that the unmargined PFE methodology is applied only in case multiple netting sets (each of which qualify as per section 7) are jointly margined. The margined PFE methodology can however still be applied if there is only one netting set qualifying as per section 7 and some trades facing e.g. a branch in specific non-netting jurisdictions which do not qualify as per section 7. The margined PFE methodology should also be applied if all trades in the agreement are its own netting set as they do not qualify as per section 7.

Recommendation(s)

The Industry recommends that the PRA should consider amending Article 278(2) to read: ‘The potential future exposure of multiple netting sets as per section 7 that are subject to one margin agreement, as referred in Article 275(3), shall be calculated as the sum of the potential future

exposures of all the individual netting sets as if they were not subject to any form of a margin agreement’.

5.2 Question 35

Do you have any comments on the PRA’s proposals for recognising unfunded credit protection (UFCP)?

5.2.1 Risk Weight Substitution - Cross Recognition of guarantee provided under IRB approach

As set out in both the Appendix 1 and in Article 235 and 235A, a standardised risk weight substitution is proposed to be used when the exposure to the obligor is on standardised approach, irrespective of whether the IRB approach is normally applied to the guarantor.

We do not believe this is consistent with Basel 3.1 requirements as set out in CRE22.70 and CRE32.23.

Specifically, our reading of CRE22.70, which refers to risk weights more generally, is that this relates to the use of the risk weight function of the guarantor and resulting risk weight. This allows for cross approach recognition of unfunded credit protection, where the risk parameters of an internally rated guarantor may be used when it guarantees an exposure subject to the standardised approach. Furthermore CRE 22.79 refers to ‘The protected portion is assigned the risk weight of the protection provider. The uncovered portion of the exposure is assigned the risk weight of the underlying counterparty.’ This again does not explicitly refer to any standardised risk weight that would be applicable to an IRB guarantor.

Similarly, the legacy EU CRR did not explicitly address this scenario. Although EU guidance has covered the reverse scenario of a standardised guarantor for an IRB exposure. The historical lack of clarity is also implied by the EBA in its 2019 [Policy Advice on Basel III reforms - Credit Risk.pdf \(europa.eu\)](#) as it recommended: ‘Clarification should be provided that in this case the RW should be calculated based on the RW function applicable to the protection provider rather than that applicable to the original obligor.’

It is our view that the PRA should allow IRB firms to substitute an IRB risk weight for a standardised risk weight where the underlying exposure is on standardised and the guarantor is on IRB. This approach will ensure a more risk sensitive approach and importantly enable firms to meet the overarching CRM requirement where the risk weight derived from application of CRM is not greater than that for a comparable direct exposure to CRM protection provider.

This approach is also consistent with existing practice amongst some of our members who use internal frameworks reflect unfunded CRM provided by a parent that is on the IRB approach to a subsidiary that is on the standardised approach. Or, alternatively, in situations where IRB member banks have permission to use the standardised approach for certain types/portfolios of exposures, but the guarantor is on IRB. Some members have relied on their own interpretations while some also sought and received bilateral clarification/guidance on the treatment in this scenario from the PRA as far back as 2013 post the publication of the legacy EU. This is subject to the PRA being aware of such practices but not subject to formal approval in the same way IRB permissions are.

Recommendation

Permit risk weight substitution using the risk weight applicable to the guarantor rather than a standardised risk weight. This would allow the risk weight to be calculated using IRB parameters and the guarantor's risk weight function, for example the application of multipliers such as the AVC charge.

For the purpose of the output floor calculation, the risk weight substitution should however involve substituting using standardised risk weights.

5.2.2 Risk Weight Substitution - Expected Loss Calculation

The Risk Weight Substitution Method can be applied for exposures on the Foundation IRB approach where the protection provider is on the standardised approach. The CP includes a formula for calculating the expected loss ("EL") for such an exposure in such a way that it nets-off the EL – provisions part of the calculation for the protected part of the exposure. It is unclear why this is necessary if the exposure is to be reported under the standardised approach, as EL would not need to be calculated.

Clarification

Could the PRA confirm their expectations for how such protected exposures should be reported?

5.2.3 Eligible Criteria for Unfunded Credit Protection – New Clause

A new eligibility requirement for unfunded credit protection ("UFCP") is included in the CP. This requires that the UFCP is only eligible where it contains no clause that would allow the protection provider to change the credit protection unilaterally to the detriment of the lender. While this is not an unreasonable thing to require of the UFCP there are already a number of eligibility criteria so it is not clear what further value this clause would add, given it is a divergence from the BCBS standards.

Recommendation

If this additional criteria is applied, it should be grandfathered in such that evidence of compliance is not required for existing UFCP arrangements in order to avoid operational complexity of specifically obtaining information just for this additional requirement.

5.3 Question 36

Do you have any comments on the PRA's proposals for FCP?

5.3.1 Treatment of trading book instruments used as collateral for SFTs

Relevant Article

299A – “When calculating risk weighted exposure amounts for counterparty risk of securities financing transactions booked in the trading book, an institution may recognise as eligible collateral any financial instruments and commodities that are ~~eligible~~ **included** in the trading book.”

There are operational concerns that arise due to this amendment:

When an firm enters into an SFT transaction for the purposes of market making in SFT markets (trading related SFTs) under which it receives securities as collateral this collateral remains off of the balance sheet of the firm with respect to the SFT itself as the firm is obligated to return the bonds (and performance) back to the counterparty and as such is not included in the trading book market risk calculations as the firm has no market risk against the security.

To require a firm to have the collateral in its trading book in order for the securities to be considered eligible collateral would run counter to the principles of the trading book as the firm would actively need to also purchase an inventory position in the securities for which we would presume a need to hold throughout the life of the SFT to ensure the collateral remains eligible and as such this would fail the trading book entry criteria with respect to trading intent as there is now an intent to hold.

This requirement would also introduce significant market risk for the firms undertaking the SFTs which would require significant RWA to then be calculated against these risks.

The concerns flagged in the CP that a firm may not be able to liquidate the securities in practice could instead be addressed via the following considerations:

- 1) Firms must assess the market liquidity of the security received as collateral under an SFT to demonstrate that there is a sufficient depth of market to exit the position. This assessment is already performed as part of the MPOR requirements for increasing liquidation periods for more illiquid collateral which adjust the volatility adjustments applied to reflect the amount of time it would take the firm to exit the position. Even illiquid collateral with a 20 day liquidation period is capable of being traded, albeit at a possible discounted price for which the higher volatility adjustment already captures this potential loss on default risk to the firm;
- 2) A firm must have the capability to trade the particular security in the relevant markets –i.e. the firm must have a desk which can actively sell the position if required and related systems and infrastructure to execute a trade; and
- 3) A firm must have the capability to risk manage the position within its trading book in line with the trading book entry requirements if upon enforcement following a default it did have to recognise the security in inventory. Broadly however we would expect to be able to exit the security in the market before close out of the SFT with any price movements for the sale being captured within the close out price of the repo. If the realised sale price of the security were to be below the amount owed by the client this would be recognised as an unsecured claim against the client.

Recommendation

In order for the instruments to be eligible to be included in the trading book institutions must ensure that they are able to meet the trading book entry requirements for the instrument set out in the Trading Book (CRR) section of the PRA Rulebook upon default of the collateral.

In this context the firm must ensure it has appropriate market access to sell the instrument and the relevant infrastructure and risk management capabilities to manage the market risk of the instrument during any period between close out of the SFT and sale of the collateral.

As such, we believe the existing provision focusing on eligibility for inclusion in the trading book to be appropriate, rather than a requirement for the asset to be in inventory and suggest a reversion to the following requirement:

“When calculating risk weighted exposure amounts for counterparty credit risk of [securities financing transactions OR repurchase transactions and securities or commodities lending or borrowing transactions] booked in the trading book, an institution may recognise as eligible collateral any financial instruments and commodities that are **eligible to be** included in the trading book”

The PRA’s concerns around a firm’s ability to trade the collateral could instead be addressed via a supervisory statement.

5.3.2 Transactions in scope of SFTs

Article 299A has been updated to include securities financing transactions (SFTs). SFTs are defined in the Capital Requirement Regulations (as on shored into UK Law) as a “*repurchase transaction, a securities or commodities lending or borrowing transaction, or a margin lending transaction*”. Current CRR Article 299(2)(c) only refers to “repurchase transactions, or commodities lending or borrowing transactions” while Basel refers to “*Repo-style transactions*” which does not include margin lending.

Recommendation

The Industry welcomes the adoption of the terminology of “securities financing transactions” as this ensures that margin lending transactions that meet the Trading Book eligibility rules will come into the scope of Article 299A.

Traditional Margin Lending transactions are booked in the banking book (e.g. Lombard Lending products where clients can borrow cash against a pool of equity assets – these typically have infrequent margin calls) however **other** Margin Lending transactions ~~that are governed by a Prime Brokerage Margin Agreement, and~~ which meet the requirement of the Trading Book (**e.g. Margin Lending transactions under a Prime Brokerage Margin Agreement**), share the same economic risks as repurchase transactions or securities or commodities lending or borrowing transactions. Furthermore, from a client’s perspective they represent analogous products to the extent that clients will often switch positions between them. Therefore, it is logical that, when provided as collateral, Trading Book ~~Prime Brokerage~~ margin lending transactions should result in a

consistent regulatory outcome when compared to repurchase transactions and securities or commodities lending or borrowing transactions that are also booked in the Trading Book.

The existing criteria in Article 299(2)(c) (and those proposed in Article 299A) requiring positions to be eligible for the Trading Book will ensure only Margin Lending transactions that are economically similar to repurchase (or securities or commodities lending or borrowing) transactions will be brought into scope; banking book margin loans will remain out of scope of Article 299A. Therefore, we urge the PRA to retain the wording of Article 299A, as originally proposed in CP 16/22, and maintain the scope of this article to SFTs.

Furthermore, on this basis we recommend that the 5 day liquidation period that is currently afforded to repurchase transaction in Article 224(2)(a) is applied more broadly to Securities Financing Transactions.

5.3.3 Securities or commodities lending or borrowing transactions

Unlike other types of SFT transactions, the CRR does not contain a definition of ‘securities or commodities borrowing or lending transaction’. We believe the updates currently being made to the Credit Risk Mitigation (CRR) Part of the PRA Rulebook presents a good opportunity for the PRA to address this omission.

Recommendation

The PRA could align with the FCA Glossary definition of ‘securities or commodities lending or borrowing transaction’ which refers to the following definition in Article 3(7) of the [UK version](#) of the *Securities Financing Transactions Regulation* (SFTR) (Regulation (EU) 2015/2365 of the European Parliament and of the Council of 25 November 2015 on transparency of securities financing transactions and of reuse and amending Regulation (EU) No 648/2012):

‘securities or commodities lending’ or ‘securities or commodities borrowing’ means a transaction by which a counterparty transfers securities or commodities subject to a commitment that the borrower will return equivalent securities or commodities on a future date or when requested to do so by the transferor, that transaction being considered as securities or commodities lending for the counterparty transferring the securities or commodities and being considered as securities or commodities borrowing for the counterparty to which they are transferred.’

5.3.4 Material Positive Correlation

Relevant article

Article 207(2) – “The credit quality of the obligor and the value of the collateral shall not have a material positive correlation. Where the value of the collateral is reduced significantly, this shall not alone imply a significant deterioration of the credit quality of the obligor. Where the credit quality of the obligor becomes critical, this shall not alone imply a significant reduction in the value of the collateral.

The institution may not use securities issued by the obligor, or any related group entity, as eligible collateral. This notwithstanding, the institution may use the obligor's own issues of CRR covered bonds which meet the requirements to be eligible for the preferential treatment set out in paragraphs 4 to 5 of Credit Risk: Standardised Approach (CRR) Part Article 129 as eligible collateral when they are posted as collateral for a repurchase transaction, provided that they comply with the condition set out in the first subparagraph."

Issue

The key provisions of section 8 of SS17/13 on Credit Risk Mitigation require firms to consider the characteristics of the transaction, collateral and obligor to determine in a robust manner whether there is any material positive correlation present in the transaction which would result in the collateral not providing an effective mitigant to loss at the point of default of the obligor.

Examples of own issued securities which may still provide an effective mitigant include:

- Covered bonds (including those issued in third countries not meeting the definition of CRR Covered Bonds and hence the preferential risk weight treatment in Article 129)
- Securities backed by third party (e.g. sovereign guarantees)
- Other structural features which segregate a specific pool of assets for the benefit of the security holder which will not be available to other creditors of the obligor following a default

As such restricting the scope of own issued securities to only CRR covered bonds eligible for the preferential risk weight treatment in Article 129 is counterintuitive to the SS provisions to assess whether or not material positive correlation is present and therefore it would make sense to amend the CRR to present a broader requirement in line with the SS requirements.

We would consider this approach to be in line with Basel CRE22.7 where own-issued securities (without any specified mitigating features) are only presented as a possible example of circumstances where material positive correlation could arise with the overall principle that the CRM technique should not have material positive correlation with the credit quality of the counterparty.

If required, the SS could be updated to include specific requirements for covered bonds.

Recommendation

We believe the following amendments to Article 207(2) and the introduction of new paragraph within supervisory statement SS17/13 will address this issue as outlined below:

Article 207(2) – "The credit quality of the obligor and the value of the collateral shall not have a material positive correlation. Where the value of the collateral is reduced significantly, this shall not alone imply a significant deterioration of the credit quality of the obligor. Where the credit quality of the obligor becomes critical, this shall not alone imply a significant reduction in the value of the collateral.

For example, ~~The institution may not use securities issued by the obligor, or any related group entity, as eligible collateral.~~ will generally not qualify as eligible collateral. This notwithstanding, the institution may use the obligor's own issues of ~~CRR covered bonds which meet the requirements to be eligible for the preferential treatment set out in paragraphs 4 to 5 of Credit Risk: Standardised Approach (CRR) Part Article 129~~ securities as eligible collateral ~~when they are posted as collateral for a repurchase transaction, provided that they comply with the condition set out in the first subparagraph.~~ subject to a detailed assessment of the characteristics of the obligor, the transaction

and the collateral evidencing that there is no material positive correlation such that the collateral can still be relied upon to mitigate loss at the point of default.”

SS17/13 – New point 8.3A – Where a financial collateral asset is an own issued covered bond, the assessment of material positive correlation shall specifically consider the following requirements:

- The asset pool must be in line with Article 129(1)
- Any immovable property collateral must be valued in line with the requirements of Article 208 and 229(1)
- The institution must receive portfolio information in line with Article 129(7)
- The covered bond must be subject to law which is designed to protect the bond holders in an event of the default of the obligor

5.3.5 Transactions with Negative Correlation

SS17/13 8.4 – “In the context of transactions where the lender has no or limited recourse to other assets beyond the financial collateral assets, a fall in the value of the financial collateral assets may itself sometimes trigger the default of the obligor. The PRA considers that any financial collateral asset whose value has a material positive correlation with the total value of all of the assets to which the lender has legal recourse (including collateral posted by the obligor and any other assets to which the firm has legal recourse), would meet the definition of material positive correlation set out in Article 207(2) of the Credit Risk Mitigation (CRR) Part.

Issue

The wording of this paragraph is problematic for transactions which actually have negative correlation present in the overall structure e.g. covered calls or collar financing structures as the value of the collateral and the value of the derivative exposure to the obligor will move in line and as such the assessment of material positive correlation for limited recourse trades should not be assessed solely between the value of the collateral asset and all assets of the obligor but should also consider the correlation against the value of the exposure, as for transactions such as covered calls a decline in the value of the collateral asset will still cover the exposure to the obligor as this will have reduced in direct proportion to the collateral. Any losses would be incurred by a firm would be reflective of ineffective market risk hedging rather than counterparty credit risk.

Recommendation

We believe the following addition to SS17/12 8.4 would address the case of collateral assets with material positive correlation with the value of the transaction:

“In the context of transactions where the lender has no or limited recourse to other assets beyond the financial collateral assets, a fall in the value of the financial collateral assets may itself sometimes trigger the default of the obligor. The PRA considers that any financial collateral asset whose value has a material positive correlation with the total value of all of the assets to which the lender has legal recourse (including collateral posted by the obligor and any other assets to which the firm has legal

recourse), would meet the definition of material positive correlation set out in Article 207(2) of the Credit Risk Mitigation (CRR) Part.

This notwithstanding, when the collateral assets are negatively correlated with the value of the transaction they may be recognised as eligible collateral.”

5.3.6 Using the Supervisory Volatility Adjustments Approach or the Own Estimates Volatility Adjustments Approach for master netting agreements

5.3.6.1 *Group of securities vs. index that denotes separate securities, commodities, cash*

Background:

- Art. 220(2)(a) introduces the calculation of a net position in each group of securities, where ‘group of securities’ is defined in Art. 220(5) as “group of securities’ means securities which are issued by the same entity, have the same issue date, the same maturity, are subject to the same terms and conditions, and are subject to the same liquidation periods as indicated in Article 224.’
- However, this concept of group of securities is not then used consistently in the subsequent parts of the article. Instead in Art. 220(3) the sum of the exposure (E) and collateral (C) is over index I and j respectively which is redefined as ‘ ... all separate securities, commodities or cash positions under the master netting agreement ...’.
- I can’t see a reason why the summation in part (3) would be different from that presented in part (2) using the definition in part (5).

Recommendation

Reword Art. 220(3) to

‘I = the index that denotes all separate **groups of** securities, **separate** commodities or cash positions under the master netting agreement, ...’

‘E_i = the exposure value of a given **group of** securities, **separate** commodity ...’ and

5.3.6.2 *Signage of net position Enet in Art. 220(3)*

Background:

- Enet is defined in Art. 220(3) as ‘the net exposure of the master netting agreement, calculated as follows: $Enet = |\sum_m E_{secm} \cdot H_{secm}|$
Where:
E_{secm} = the net position (positive or negative) in a given group of securities ...
H_{secm} = the volatility adjustment appropriate to a given group of securities The sign of H_{secm} shall be determined as follows: (a) it shall have a positive sign where the group of

securities or commodities m, is lent or sold ... (b) it shall have a negative sign where the group of securities or commodities m, is borrowed, purchased ...

- As a result, both Esecm and Hsecm will have a negative sign when the net group of securities is net borrowed or purchased, and as a result, the product of the two will always have a positive sign and all elements in the summation will be positive resulting in no netting between them (i.e. Enet would give the same value as calculated for Egross).
- This is inconsistent with the definition of net exposure in BCBS CRE22.65(6) where Es (the BCBS equivalent of the PRA Esecm) is defined as 'Es is the net current value of each security issuance under the netting set (always a positive value)'

Recommendation

Reword the definition of Esecm in Art. 220(3) to be consistent with CRE22.65(6) to always show a positive sign 'Esecm = the **absolute value of the** net position ~~(positive or negative)~~ in a given group of securities ...

5.3.6.3 *Clarity the scope of the calculation of volatility adjustments and the interaction between Art. 220(2)(c) and Art. 220(3)*

Background:

- Art. 220(2)(c) describes the application of the volatility adjustment which is represented as Hsecm in Art. 220(3). Part (2) notes that the calculation should exclude:
'(i) the net position calculated in point (a) of paragraph 2 is negative, or
(ii) the securities or commodities either (A) are not included in the lists of eligible collateral ... or (B) do not meet the requirements laid down in paragraphs 2 to 4 of Article 207.'
- However, in the actual calculation of the volatility adjustment for the collateral in part (3), i.e. Enet and Egross as part of E*, the quantification of the component Esecm makes no note of any exclusion which would be expected in order to be consistent with Ei and Cj in this paragraph. While the calculation of Hsecm in paragraph 3 references point (c) of paragraph 2, it is unclear whether the exclusions are expected to be reflected here and if so, how that would be achieved.
- Finally, we note that the exclusion of net ineligible collateral is not referenced at all in the calculation of the foreign exchange volatility adjustment but would expect it to be treated consistently.

Recommendation

Reword Art 220(3) to be specific about the exclusion of net ineligible collateral for volatility adjustments as follows:

Efxk = the net position in a given currency k other than the settlement currency of the master netting agreement as calculated under point (b) of paragraph 2. **Subject to Article 229 of CRR and Counterparty Credit Risk (CRR) Part Article 299A, this calculation should exclude securities or commodities where:**
(a) the net position calculated in point (a) of paragraph 2 is negative; and
(b) the securities or commodities either:
(i) are not included in the lists of eligible collateral set out in Articles 197 and 198; or
(ii) do not meet the requirements laid down in paragraphs 2 to 4 of Article 207;

Esecm = the net position in a given group of securities ... calculated in accordance with point (b) of paragraph 2. **Subject to Article 229 of CRR and Counterparty Credit Risk (CRR) Part Article 299A, this calculation should exclude securities or commodities where:**

(a) the net position calculated in point (a) of paragraph 2 is negative; and

(b) the securities or commodities either:

(i) are not included in the lists of eligible collateral set out in Articles 197 and 198; or

(ii) do not meet the requirements laid down in paragraphs 2 to 4 of Article 207;

Hsecm = the volatility adjustment appropriate to a given group of securities, or a given type of commodities m, **determined in accordance with point (c) of paragraph 2.**

5.3.7 Own estimates of volatility adjustments under the Financial Collateral Comprehensive Method

Relevant Article

Article 225(2)(c) “institutions may use volatility adjustment numbers calculated in accordance with shorter or longer liquidation periods, scaled up or down to the liquidation period set out in point (b) for the type of transaction in question, using the square root of time formula: $H_m = H_n \times \text{SQRT}(T_m/T_n)$ where:”

Issue

The formula for the scaling up or down of volatility adjustments for different liquidation periods should be included in the requirements of the Financial Comprehensive Method as this is required to scale up to e.g. 40 day liquidation periods if required as a result of the MPOR adjustments set out in Article 285.

Recommendation

We propose inclusion of same wording within Article 225(2)(c) as a further subparagraph of Article 224(2):

“institutions may use volatility adjustment numbers calculated in accordance with shorter or longer liquidation periods, scaled up or down to the liquidation periods as required per the first subparagraph for the type of transaction in question, using the square root of time formula: $H_m = H_n \times \text{SQRT}(T_m/T_n)$ where:”

5.3.8 Treatment of CIUs as collateral

Relevant Paragraph

CP16/22, Paragraph 5.59 “The PRA proposes to clarify that in instances where an equity investment in a collective investment undertaking (CIU) is used as collateral, and the firm would apply the look-through approach to calculating the risk weight for a direct exposure to the CIU, the applicable volatility adjustment would be a weighted average of the volatility adjustments applicable to the CIU’s exposures.”

Issue

There appears to be a divergence between the intention expressed by the PRA in the CP and the draft regulation, where the PRA has amended Article 224(5) as follows:

“For eligible units in CIUs: (a) where the institution would be able to apply the look-through approach to a direct exposure to the units under Credit Risk: Standardised Approach (CRR) Part Article 132A, the institution shall apply the volatility adjustment is the weighted average volatility adjustments that would apply, having regard to the liquidation period of the transaction as specified in paragraph 2, to the assets in which the fund has invested; (b) in all other cases, the institution shall apply the ~~highest volatility adjustment that would apply to any of the assets in which the fund has the right to invest.~~ Where the assets in which the fund has invested are not known to the institution, the volatility adjustment is the highest volatility adjustment that would apply to any of the assets in which the fund has the right to invest.”

The stated intention of the PRA is to allow firms to apply a look-through approach (LTA) for CIUs held as collateral, however in our view this update by the PRA to Article 224(5) cannot be applied by firms in practice.

Article 197/198, which contain the rules on the treatment of CIUs received as collateral, do not explicitly refer to the LTA. Article 197(5) cross-refers to the look-through conditions in Article 132(3) for CIUs that are limited to investing in eligible assets and go beyond a simple look-through approach by requiring firms to check CIU mandates to confirm the assets which the CIU is permitted to invest in and restrict the LTA by these mandated thresholds. It is also clear from an assessment of mandates that even the most widely-traded CIUs, such as ETFs on indices, give the fund manager a lot of latitude to invest in assets outside the index, enter into financing transactions or use derivatives. This means that LTA is either not possible or is severely restricted to a practical mandate-based approach (MBA) application of the rules.

Recommendation

We therefore propose that the PRA amends Article 197/198 to allow firms to use a simple look-through approach, aligning with Basel standards.

Under Basel standards, UCITS/mutual funds are eligible collateral where a price for the units is publicly quoted daily and the UCITS/mutual fund is limited to investing in the eligible instruments. For such UCITS/mutual funds, firms can apply a look-through approach, and use weighted average haircuts of the underlying instruments, where they meet the look-through conditions for equity investments in funds in RBC 25.8(5)(a). These simply require that “the bank is able to look through the

fund to its individual components and there is sufficient and frequent information, verified by an independent third party, provided to the bank regarding the fund's composition".

We believe the PRA's intention to allow a look-through approach, which can be applied in practice by firms could be achieved by amending Article 197(6) and Article 198(2) as follows:

- 197(6). For the purposes of paragraph 5, where a CIU ('the original CIU') or any of its underlying CIUs are not limited to investing in instruments that are eligible under paragraphs 1 and 4, institutions may use units or shares in that CIU as collateral to an amount equal to the value of the eligible assets held by that CIU ~~under the assumption that that CIU or any of its underlying CIUs have invested in non-eligible assets to the maximum extent allowed under their respective mandates.~~
- 198(2). Where the CIU or any underlying CIU are not limited to investing in instruments that are eligible for recognition under Article 197(1) and (4) and the items mentioned in point (a) of paragraph 1 of this Article, institutions may use units or shares in that CIU as collateral to an amount equal to the value of the eligible assets held by that CIU ~~under the assumption that that CIU or any of its underlying CIUs have invested in non-eligible assets to the maximum extent allowed under their respective mandates.~~

5.3.9 Equities traded on a recognised exchange

The text of Article 224(4) has been amended as follows:

For non-eligible securities ~~or for~~ and commodities lent or sold under ~~repurchase transactions or securities or commodities lending or borrowing~~ financing transactions, the institution shall apply the same volatility adjustment ~~is the same as for non-~~ it would for equities which are not equities included in a main index ~~equities listed or traded~~ on a recognised exchange.

We note that Table 3 of Article 224 has not been similarly amended and still refers to 'Other Equities or Convertible Bonds listed on a recognised exchange'.

Recommendation

We recommend changing Table 3 to read 'Other Equities or Convertible Bonds ~~listed~~ traded on a recognised exchange' to align with Article 224(4).

5.3.10 Capital market-driven transactions

Relevant Paragraph

In Article 224(2)(c), the following change has been made:

“The calculation of volatility adjustments in accordance with paragraph 1 shall be subject to the following conditions:

- (a) for secured lending transactions the liquidation period shall be 20 business days;
- (b) for repurchase transactions, except insofar as such transactions involve the transfer of commodities or guaranteed rights relating to title to commodities, and securities lending or borrowing transactions the liquidation period shall be five business days;
- (c) for ~~other~~ capital market-driven transactions for which no liquidation period is set out in point (a) or (b), the liquidation period shall be 10 business days.”

Issue

The cross-reference in point (c) to point (a) implies that ‘secured lending transactions’ are ‘capital market-driven transactions’. However, this is not the case as the definition of ‘capital market-driven transactions’ states that there must be daily margining whilst the definition of ‘secured lending transaction’ states that there is no daily margining for such transactions. A secured lending transaction is therefore not a capital market-driven transaction. The definitions in the Credit Risk Mitigation (CRR) Part are as follows:

- capital market-driven transaction means a transaction giving rise to an exposure secured by collateral which confers on the institution the right to receive margin at least daily
- secured lending transaction means any transaction giving rise to an exposure secured by collateral which does not include a provision conferring upon the institution the right to receive margin at least daily.

The removal of the word ‘other’ could also be problematic depending on how the PRA decides to address the erroneous cross-reference to point (a) in point (c).

Daily margined repurchase transactions and securities lending or borrowing transactions are a subset of capital market-driven transactions.

If the cross reference to (b) is maintained, this recognises that repurchase transactions and securities lending or borrowing transactions are ‘capital market-driven transactions’ and therefore that daily margining for these transactions is required to apply a 5-day liquidation period.

If the cross-reference to (b) is also removed, then the word ‘other’ would need to remain. If it is removed, a distinction is drawn between repurchase transactions and securities lending or borrowing transactions, and capital market-driven transactions, meaning that repurchase transactions and securities lending or borrowing transactions without daily margining would be captured in point (b) and a 5-day liquidation period would be incorrectly applied.

Recommendation

We therefore propose either of the following changes:

(c) for capital market-driven transactions for which no liquidation period is set out in point (b), the liquidation period shall be 10 business days.

Or

(c) for other capital market-driven transactions the liquidation period shall be 10 business days.

5.3.11 Consequential clarifications required since revisions to foundation collateral method

The scope of Article 208 - Requirements for immovable property collateral under the foundation collateral method, has been confined to banks using the “Foundation Collateral Method”. For the equivalent exposure under the standardised approach, the relevant approach is now under Article 124A to 124c. However, these articles are silent on the use of statistical methods for valuation (still contained under Art 208 Foundation Collateral Method).

Clarification Questions

Is the change intentional or part of the wider approach to remove modelling options for banks using the Standardised approach?

The requirement of insurance is not in the new Articles ART 124A to Art 124C. Is this an oversight? We would expect that this continues to be a requirement under all approaches.

It is not clear for receivables, other physical collateral and collateralized lease exposures the approach when not applying the foundation collateral method under Article 209, 210 and 211 respectively.

Clarification Question

What is the relevant approach when not applying the foundation collateral approach for these exposures?

6 Chapter 6. Market risk

Executive Summary

The Industry welcomes the opportunity to provide comments on the PRAs Basel 3.1 consultation on the Fundamental Review of the Trading Book (FRTB). We continue to support balanced, risk-sensitive and robust regulatory standards that enhance financial stability, but also preserve banks' capacity to support wholesale markets.

We commend many of the PRA's proposals, including:

- the one-year transitional period after the FRTB goes live in-line with the BCBS standards, during which the P&L attribution test (PLAT) will not be binding for internal model approach (IMA) eligibility,
- the proposal to allow recognition of RNIMs in PLAT,
- the flexibility on the treatment of CIUs in IMA, as well as the permission to use a risk weight calculated in accordance with the look-through approach provided by a third party,
- the proposal of a new risk bucket for carbon trading,
- the ability to include risk factors that are considered non-modellable (NMRFs) in the calculation of trading desks' value at risk for back-testing purposes, and
- the permission to issue structured notes from the Trading Book (TB) or the Banking Book (BB) and prudentially split the product into two components.

Overall, we appreciate PRA's primary objective to promote safety and soundness of the firms it regulates and the pragmatic steps to improve the measurement of risk. However, the Industry remains concerned by certain elements across all three components IMA, Standardised Approach (SA) and TB/BB in the proposed revised market risk framework and the impact those could have on capital requirements for specific product and risk categories.

One of the most material components under the PRA's current market risk framework is the 'risks not in VaR' (RNIV) add-on, which is not part of the Basel 2.5 Pillar 1 rules. The application of RNIVs in the UK is very prescriptive compared to other jurisdictions, which more commonly apply Pillar 2 add-ons for risks not captured in market risk models. The RNIV framework requires firms to identify any risks which are not captured or not captured adequately by the current models and to hold additional Pillar 1 own funds against those risks. Under the new framework, it is expected that the introduction of the non-modellable risk factor (NMRF) framework will either replace or mitigate the effects of RNIVs.

To assess the market risk RWAs impact of the revised rules, the Industry conducted a Quantitative Impact Study (QIS)²³. Given that RNIVs are specific to each bank and are based on their own model specification, we measured the total impact by excluding RNIVs from the current market risk framework. The study results showed an increase of 54% in market risk RWAs assuming banks maintain their current model permissions and an increase of 116% assuming all desks are capitalised using SA.

²³ QIS exercise for COB December 2021 conducted for 7 banks (both UK and international) with significant operations in the UK market.

The overall impact could either be lower, depending on the effects that RNIVs could have under the revised market risk framework for each bank, or could be higher given the fact that the NMRF framework has not been fully implemented by many banks yet, and estimated NMRF RWAs could materially increase upon completion of the implementation.

As we note below, maintaining current model permissions is an unlikely scenario and the actual RWA inflation will be somewhere between the modelled and SA-based RWA increases.

We also ran a survey asking banks a number of questions related to their current and intended application of the internal modelling approach. The results (see chapter 6.2.6) indicated that there will be a material reduction in the use of IMA for market risk. For PRA supervised banks, nearly all (94%) participating firms currently have internal model permissions under Basel 2.5, while under FRTB the number of banks planning to adopt internal models is significantly lower (65%). Further to this, the trading desk coverage of internal models is likely to also reduce materially, down from an average of 82% under Basel 2.5 to only 45% under FRTB.

Under the revised FRTB rules, the NMRF framework has been introduced to address the issue where risks are not captured or not captured adequately by the current models. However, the industry survey highlighted that most firms (60%) do not plan to use NMRF as an internal risk metric.

In addition, the PRA's Aggregated Cost Benefit Analysis (Appendix 7 to CP16/22)²⁴ indicates the direct costs on the Industry due to the implementation of the proposed rules. In particular, the total operational compliance costs are estimated to be **£4.9 billion**. The largest share of these costs stem from the changes to the market risk framework, which accounts for **£3.8 billion** mainly incurred by large banks.

As shown in our survey, the challenges associated with the revised IMA framework alongside the operational costs of model maintenance are the root causes for the reduction in banks planning to use IMA.

More broadly, we outline below some areas which would benefit from being further considered by the PRA:

- **IMA Default Risk Charge (DRC):** The Industry proposes removing the 3 basis-point floor in the IMA DRC for the exposures subject to 0% risk weight in the SA DRC (see chapter 6.2.2.3.1).
- **RFET/NMRF:** The Industry survey shows the decrease in IMA adoption and an area of particular concern is the RFET and NMRF framework, where the Industry would welcome further engagement to find an appropriate solution to improve banks' ability to practically meet the requirements (see chapter 6.2.4).
- **Model Approval Process:** The PRA should provide guidance in advance on the extent of evidence required for model approval for IMA, as well as clarification on the scope of those approvals from an operational perspective (see chapter 6.2.2.1).

²⁴ <https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/consultation-paper/2022/november/cp1622app7.pdf>

- **Profit and Loss Attribution test (PLAT):** The Industry recommends that the PRA should review the thresholds for the PLA test once banks are able to develop the system capabilities and produce sufficient and reliable data (see chapter 6.2.2.2).
- **Collective Investment Undertakings (CIUs):** The Industry proposes that under the External Party Approach (EPA), data vendors should be included in the list of 3rd party providers. In addition, for the calculation of risk-weighted (RW) exposures, a correlation parameter should be introduced rather than using an absolute simple sum, and DRC and RRAO RWs should be provided separately (see chapter 6.1.3).
- **FRTB SA Authorisations:** Industry seeks clarity and guidance from the PRA on the components of the SA that require supervisory approval, particularly when a firm wishes to use alternative sensitivities (see chapter 6.2.1.4).
- **Residual Risk Add-on (RRAO) - clarification on the term “instrument”:** The Industry proposes in line with the Basel standards to allow exemption of exactly matching back-to-back transactions from the RRAO as well as recognizing the hedge benefit for the same “instrument” (see chapter 6.2.1.3).
- **Fair Valued Through P&L (FVTPL) trades:** The Industry recommends to amend the PRA’s proposal so that TB would not capture instruments that are not held for trading purposes but are FVTPL (see chapter 6.2.3.1).
- **Re-assignment:** The Industry seeks clarity from the PRA in specific cases where notification or permission is required. In addition, the Industry recommends specific cases that should fall out of scope for re-assignment (see chapter 6.2.3.2).

These Industry responses are divided into the below separate sections:

- (i) PRA Consultation Questions;
- (ii) Industry Recommendations

6.1 PRA Consultation Questions

6.1.1 Question 38

Do you have any comments on the PRA's proposed definition of 'gross jump-to-default' in the ASA default risk charge?

Recommendation(s)

The PRA has aligned the gross jump-to-default (JtD) calculation with the EU CRR RTS requirement and further simplified the JtD computation. The formulae and components of JtD calculation are different than the BCBS specification, but the JtD outcomes are likely to be aligned for simpler linear products. BCBS standards use a formula that leverages on LGD, Notional and the P&L and provide examples on some products. As the PRA noted in its consultation (reference CP16/22, Chapter 6, para 6.47), its specification would only rarely lead to different outcomes relative to BCBS standards. This difference in outcomes should only be limited to the products where BCBS formula fails to appropriately compute JtD, therefore the PRA proposal is an improvement compared to BCBS standards. The PRA's approach is also aligned to market practice in JtD calculation and will therefore simplify implementation.

The Industry preference is for the Basel Committee to update the global standard formula for the JtD calculation via a FAQ to avoid divergence across other jurisdictions.

6.1.2 Question 39

Do you have any comments on the PRA's proposal for carbon emissions certificates? What additional information could be considered for the calibration of risk weights and correlations, particularly relating to any historical period of stress?

The Industry supports the PRA's proposal of a new carbon bucket for carbon emissions certificates, however we believe the proposed risk weight of 60% and tenor basis correlation parameter of 99% is too conservative.

The appropriate treatment of carbon emission certificates is important as overly stringent capital requirements would impair the functioning of the carbon market. The European Commission in the CRR 3 proposal has introduced a separate bucket for Carbon Trading with a risk weight of 40%. We believe that is aligned with the data we have analysed and further elaborate below.

ISDA has produced two papers on the implications of the FRTB for carbon certificates from both European and a Global perspective²⁵. The results of our analysis suggest the PRA proposal unduly

²⁵ ISDA White Papers: [Implications of the FRTB for Carbon Certificates](#) and [Implications of the FRTB for Carbon Certificates A Global Perspective](#)

penalizes carbon credit trading.

The FRTB treatment of carbon certificates appears out of sync with underlying risks in two key areas: i) Risk weight of carbon certificates and ii) the tenor correlation parameter and how this impacts carry positions. This is problematic as it could impair the ability of banks to act as intermediaries in the emissions trading systems (ETs), which have become a central tool for governments in the transition to a carbon-neutral economy around the globe.

The EU ETS is the most developed market, which covers 79% of the volume of carbon certificate trades. Following the EU ETS, the Regional Greenhouse Gas Initiative (RGGI) and the Western Climate Initiative (WCI) in Northern America, covering around 19% of all carbon certificate trades and in total, these three markets cover around 98% of all carbon certificate trading.

All markets (including the UK) set emissions reduction targets and compliance periods and allocate allowances through auctioning or free allocation. However, the overall and annual reduction targets and the respective compliance periods vary across ETs. The price development of carbon certificates is determined by the demand for and supply of carbon allowances as well as developments in climate policies.

Risk weight of carbon certificates

Under the FRTB, carbon certificates have been allocated a risk weight bucket of 60%. The rationale for designated risk weights is closely related to the implied volatility (the higher the volatility of the security, the higher the capital charge to cover losses in a market downturn). The results of our paper using data from the EU ETS market, showed a volatility of 56% which converts to a risk weight of 37%. The results of our global paper which included data for the RGGI and WCI markets showed a volatility of 33% and 20% which converts into risk weights of 22% and 13% respectively. There was limited data available for the UK ETS market at the time the analysis was conducted, however, calculating volatilities based on the period when prices are observable, results in an annualized volatility of 44%.

Since the EU ETS market is the most developed market – in terms of size, trading volume and maturity, the Industry proposes that the appropriate risk weight for carbon certificates should be based on the higher volatility in the EUA market (56%). This volatility results in a risk weight of 37%, which is well below the volatility levels underlying the FRTB risk weight of 60%. Thus, the Industry encourages the PRA to consider a risk weight of 40% for carbon emission certificates, which is also in line with the European proposal.

Treatment of carry positions

The FRTB SA framework introduces a correlation factor of 0.99 for positions of different maturities, meaning market participants cannot fully offset spot and forward positions. This has implications for banks as they carry out their role as intermediaries in the carbon certificate market by taking carry positions (i.e., buying spot and selling forward).

As an example, carry positions for commodities are generally subject to a capital charge. Most commodities are physical, meaning carry positions entail storage costs. These storage costs can fluctuate, meaning spot and forward positions are not perfectly correlated. However, carbon certificates

are not typical commodities as there are no physical storage costs, meaning spot and futures positions should be more closely correlated than other commodities. In the EU market, empirical evidence from an academic study from 2020²⁶, found the correlation to be 0.9999, which is much higher than the prescribed FRTB correlation of 0.99. The regression analysis undertaken as part of the ISDA papers also resulted in a higher correlation of 0.996. In the RGGI and WCI markets, the analysis indicates correlations of 0.995 and 0.993, respectively. In the UK markets the correlation this was found to be 0.997 (all higher than currently prescribed). The relatively lower correlation in the North American markets versus the EU ETS is not surprising. As these two markets are less mature and exhibit lower trading volumes, single transactions can significantly impact the correlation. Thus, the Industry encourages the PRA to consider a tenor correlation of 0.996.

Recommendation(s)

The Industry recommends a reduced risk weight of 40% for the separate carbon bucket and also setting a tenor correlation parameter (medium correlation scenario) for carbon certificates of 0.995-0.999, reflecting empirical observations²⁷. This is still a conservative approach: as low and high correlation scenarios are calculated based on this parameter, with the largest capital requirement taken from the three scenarios. This will help contribute to the development of a well-functioning forward carbon certificate market that provides certainty about the future costs of emissions, allowing companies to plan ahead.

6.1.3 Question 40

Do you have any comments on the PRA's proposals to include the EPA for the treatment of CIUs in the new ASA?

The Industry position paper on treatment of CIUs under FRTB published in January'22²⁸ documented key challenges under the standardised approach.

The challenges centred around appropriate capitalisation for positions in those CIUs that could not use the Look-through Approach (LTA); which, given the operational issues of other approaches such as the Mandate-based Approach (MBA), usually end up being capitalised through the Fall-back Approach (FBA). These affected CIUs are mostly UCITS-regulated mutual funds that follow a diverse set of strategies/investment themes.

One of the recommendations in the Industry position paper was to allow the usage of FRTB capital per unit of the fund, calculated and published by arms-length 3rd parties. We welcome PRA's proposal of the external party approach (EPA), as it allows banks to use a more risk-sensitive risk-weight, calculated by a 3rd party.

²⁶ Chen et al. (2020) The Linkages of Carbon Spot-Futures: Evidence from EU-ETS in the Third Phase

²⁷ ISDA White Papers: [Implications of the FRTB for Carbon Certificates and Implications of the FRTB for Carbon Certificates A Global Perspective](#)

²⁸ ISDA white paper: <https://www.isda.org/a/Ht6gE/Capitalization-of-Equity-Investments-in-Funds-Under-the-FRTB.pdf>

Recommendation(s)

1. The EPA hinges on 3rd parties calculating and providing the RWs. However, the linkage with Art 132 (4)(a) restricts the 3rd parties to depository institution of the CIU or the CIU management company itself. Since large institutions can have thousands of different funds in their Trading Book, putting in place a data sharing arrangement with numerous 3rd parties is impractical. The rules should allow data vendors to act as 3rd parties to facilitate the development of a one-stop solution for firms' requirements for capitalisation of CIUs. The calculation provided by the vendors will be under the same requirements stipulated in Art 325j(4a): i) an external audit should confirm the adequacy of the calculation and ii) the institution verifies the appropriateness of the vendor's calculation.
2. The RW to be determined by the 3rd party, per paragraph 4a of Art 325j, is calculated as stand-alone own fund requirements (OFR) of the CIU using the LTA, divided by delta sensitivity determined by treating the CIU as a single equity position. The Industry interprets the numerator in the RW calculation to imply a stand-alone SBM OFR of a cash position in 1 unit of CIU calculated using LTA, and the denominator to imply the price of 1 unit of CIU. Industry would welcome confirmation of the above interpretation.
3. For CIUs using EPA as an approach, we are looking for guidance on how DRC and RRAO RWs are to be determined.
4. The EPA provides the option to determine a more risk-sensitive RW for a CIU, which indeed is an improvement to the fixed 70% RW in the FBA. However, a major reason for the punitive SBM capital charge from the FBA, is the absence of any diversification in the intra-bucket charge calculation (Kb). For a portfolio of different mutual funds, with a diverse set of investment strategies, the capital charge rapidly becomes disproportionate to the level of risk. The EPA inherits this serious limitation of the FBA, as Art 325j (1) (b)(iii) requires to calculate own fund requirements on a stand-alone basis. Thus, we recommend that the risk-weighted CIU exposures should be correlated rather than absolute simple summed.

6.1.4 Question 41

Do you have any comments on the PRA's proposals to recognise NMRFs in your model for the purposes of back-testing at the trading desk level? To what extent would you be able to incorporate NMRFs into your model for back-testing?

Recommendation(s)

The Industry welcomes the ability to include risk factors that are considered non-modellable (NMRFs) in the calculation of trading desks' value at risk for back-testing purposes (325bf(1)). It is also noted that for the calculation of the multiplication factor for the overall portfolio, NMRFs must be excluded from the value at risk calculation in first instance (325bf(6)); however, an overshooting may be excluded from the count if it is not attributed to a model deficiency and if it is attributable to an

NMRF with the one-day change in portfolio value not exceeding the value at risk calculated including both modellable and non-modellable risk factors (325bf(8)). The Industry notes that it may prove an operational challenge to exclude NMRFs from their value at risk calculation. The Industry recommends to include NMRFs in both trading desk-level and portfolio-level value at risk calculations to avoid complexity in the implementation and the occurrence of overshootings not linked to a model deficiency.

6.1.5 Question 42

Do you have any comments on the PRA's proposal to allow firms a greater degree of modelling flexibility for CIUs in IMA?

We welcome PRA's response to Industry's concerns by increasing the flexibility provided in the proposed rules for IMA.

6.2 Industry Recommendations

6.2.1 Advanced Standardised Approach (ASA)

6.2.1.1 Sensitivities Based Method (SBM)

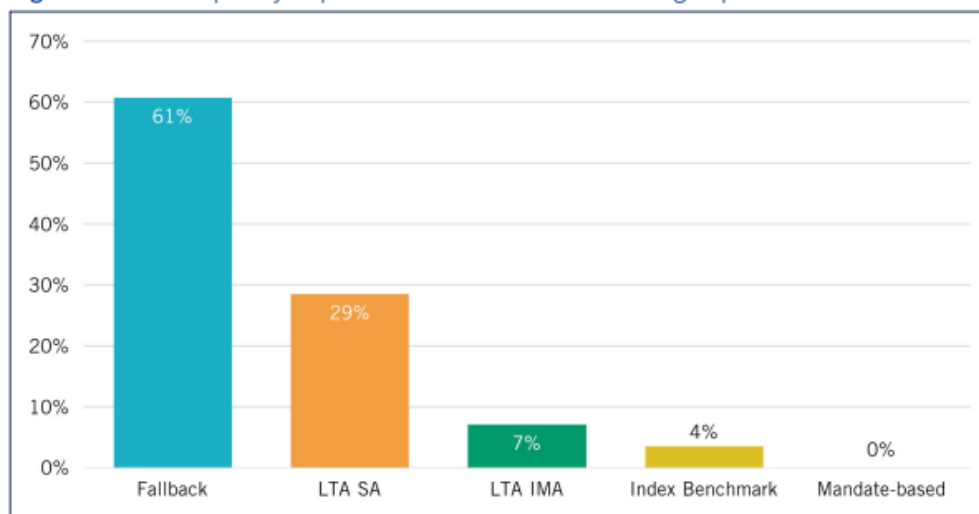
6.2.1.1.1 Alternative Methods to Capitalize Equity Investments in Funds

We welcome PRA's response to Industry's concerns by increasing the flexibility provided in the proposed rules, both for IMA and SA.

The PRA's proposed risk weight for funds in the sensitivities-based method (SBM) is 70% (i.e., bucket 11 with the risk-weighted sensitivities aggregated via absolute simple sum). We have produced a paper²⁹ that highlights the overly conservative treatment of funds which is disproportionate to the underlying risk. To measure the impact, we conducted a survey based on qualitative and quantitative data provided by 22 banks with operations across the globe.

The survey results showed that the majority of banks plan to use the fallback approach under the SA, despite it being the most punitive method. That is because the other proposed methods cannot be applied to most mutual funds (see figure 2).

Figure 2: Most Frequently Implemented Method For Calculating Capital for Funds.

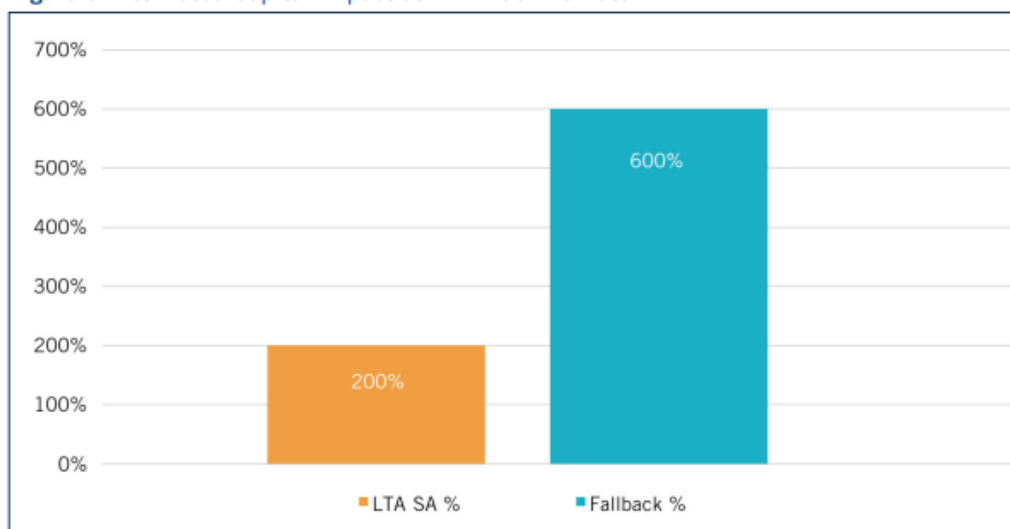


²⁹ <https://www.isda.org/a/Ht6gE/Capitalization-of-Equity-Investments-in-Funds-Under-the-FRTB.pdf>

Examples of the punitive treatment of funds can be found on the white paper. An example of that is the *closed-ended investment companies (ICs)* that are categorised as CIUs, notwithstanding that they are also LSE Main Market listed equities. They represent a material component of the FTSE250 Index and the conservative treatment under the FRTB ASA will have a serious and negative impact, severely reducing liquidity for a sizeable segment of the FTSE250.

Figure 3 below shows the estimated capital impact of the two most popular methods for calculating capital for CIUs at the FRTB go-live date.

Figure 3: Estimated Capital Impact at FRTB Go-live Date



Recommendation(s)

6.2.1.1.1.1 Permitting Use of Correlation Structure

The Industry proposes the correlation structure for funds which allows for some diversification benefit in the SBM computation as the risk weighted exposures will be correlated rather than be subject to absolute simple sum as per the 'other sector' (bucket 11) specification.

Table B illustrates the magnitude of the SBM equity capital outcome under the fallback approach when applied to a portfolio.

Table B: Capital Charges Under the SA Fallback Approach

Fund Issuer	Fund Delta (USD Mn)	Risk Weighted Delta (70%)	Abs Risk Weighted Delta	Capital
A	400	280	280	805
B	-200	-140	140	
C	160	112	112	
D	-150	-105	105	
E	140	98	98	
F	-100	-70	70	

Table C illustrates the capital outcome if the same portfolio is considered using a correlated SBM aggregation, where Rho = intra bucket correlation parameter.

Table C: Capital Charges Under the SA Correlated SBM Aggregation

Rho	RW	Comment	Capital	vs MAR 21.36(3)
N/A	70%	MAR 21.36(3) Simple Absolute Sum	805	
50%	70%	Typical single equity Rho, High RW	288	-64%
	50%	Typical single equity Rho, Med RW	206	-74%
	25%	Typical single equity Rho, Index RW	103	-87%
80%	70%	Rho Per Index Bucket 13, High RW	227	-72%
	50%	Rho Per Index Bucket 13, Med RW	162	-80%
	25%	Rho & RW Per Index Bucket 13	81	-90%

6.2.1.1.1.2 Further Calibration of Risk Weights

It is proposed to have specific risk weights for funds that take the diversification of funds into account, and to ensure the rules are simple, transparent, and easy to implement while not underestimating the risk. If fund mandates specify a VaR limit to which the manager has to adhere, banks should be permitted to consider these limits when mapping these funds to their appropriate risk weights. These provisions should also be recognized when creating the hypothetical portfolio under the mandate-based approach.

6.2.1.1.2 CIUs – Fall back approach (FBA)

The PRA's proposal does not specify how to RW a CIU, for SA DRC, under the Fall-back Approach (FBA), whereas both BCBS and the proposed EU CRR3, propose to assign such FBA CIUs to the unrated category.

Recommendation(s)

For the purposes of the own fund calculation for the CIUs under the fall-back approach as per Article 325j(1)(b)(i), the PRA should clarify the treatment of default risk charge where the mandate of the CIU implies that some exposures in the CIU shall be subject to those own funds requirements. The Industry recommends that in line with BCBS standards and the proposed CRR3 in Europe, the institution shall consider the position in the CIU as a single unrated equity position allocated to the bucket "Unrated" in Article 325y(1), Table 2.

6.2.1.1.3 Definition of instruments with Optionality

The Industry would like to highlight that there is an inconsistency between the PRA rules and the corresponding BCBS standards on the definition of optionality for Curvature and Vega risks under the Advanced Standardised Approach. In the article 325e(2), the PRA text states that embedded options, such as prepayment or behavioural options, shall be considered to be stand-alone positions in options for the purpose of calculating the own funds requirements for market risk, whereas BCBS (MAR21.2)³⁰ standard does not require such options to be treated on a stand-alone basis. The BCBS standard simply provides a clarification that embedded options are in scope for Vega and Curvature calculation.

Curvature risk of the optionality feature in the embedded options, such as prepayment or behavioural options, is generally incorporated in the pricing of the instruments as part of value of the whole instrument. As such the prepayment risk or behavioural risk is not managed on a stand-alone basis. Similarly, Vega risk of the embedded options does not require split by vanilla options and embedded options.

Recommendation(s)

The Industry proposes that, to be aligned with the BCBS, the PRA text in Article 325e(2) should be amended as follows:

*For the purposes of this Part, instruments with optionality include, among others: calls, puts, caps, floors, swap options, barrier options and exotic options. **Instruments with** Embedded options, such as prepayment or behavioural options, shall be considered ~~to be stand-alone positions in options as instruments with optionality~~ for the purpose of calculating the own funds requirements for market risk.*

6.2.1.1.4 Inter Bucket Correlation for Credit Spread Risk (CSR)

Under article 325aj for Inter bucket correlation for CSR, the PRA draft rules specify $\gamma_{bc}(\text{rating}) = 1$ where the two buckets have the same credit quality category (either credit quality step 1 to 3 or credit quality step 4 to 6), otherwise it shall be equal to 50%. The Industry has the following proposals associated with the $\gamma_{bc}(\text{rating})$ requirement:

Recommendation(s)

1. Article 325aj defines correlation calculations in terms of credit quality category (CQS) whereas the RW table in Article 325ah is based on rating categories (IG/Non-IG). The Industry proposes that articles 325aj and 325ah should be consistent, as such article 325aj should be amended to refer to rating categories (IG/Non-IG) instead of CQS steps.

³⁰ BCBS: Calculation of RWA for market risk:

https://www.bis.org/basel_framework/chapter/MAR/21.htm?inforce=20230101&published=20200327

2. The correct value of $\gamma_{bc}(\text{rating})$ under article 325aj of the draft rules is unclear when one of the two buckets is an index bucket (either bucket 17 or 18) or other sector bucket (bucket 16). The UK text was drafted based on CRR2 as amended by the delegated act but ignoring the further clarification included in the CRR3 draft which provides specific correlations for index buckets and other sector buckets. The Industry proposes that the PRA should amend the Article 325aj text to clarify the correlation requirements, noting that the BCBS requires correlation=100%, while CRR3 introduces a divergence and proposes correlation=50% when aggregating IG index bucket with non-IG buckets (similar requirements for HY bucket).

6.2.1.1.5 Risk Weights for Foreign Exchange Risk

In the Article 325av, the PRA proposal requires a risk weight of 15% for FX delta and curvature risks. The risk weight shall be divided by square root of 2 for the specified currency pairs and their first order crosses.

Recommendation(s)

The Industry recommends the following targeted FX adjustments:

1. Calibrate FX risk weights in line with the fluctuation range of the currencies, especially for pegged and heavily managed currencies like HKD, AED, BHD, OMR, QAR and SAR, which always fluctuate within a much narrower band than the prescribed risk weights. As such, the risk weight for pegged and heavily managed currencies should be adjusted.
2. Allow recognition of matched / closely correlated currencies (i.e., allow offsetting between correlated currencies) with a reduced risk weight, in line with the article 354 in the current framework, which now sits under the SSA in the revised framework.

It is important that the PRA also considers the risk weight calibration for pegged and heavily managed currencies from a level playing field perspective, as other regulators have already made such changes, for example:

- a) In Hong Kong, the HKMA Consultation paper³¹ prescribes a risk weight of 1.3% for USD/HKD on the rationale that this risk weight captures the fluctuation of USD/HKD within the Convertibility Undertaking range (i.e., 7.75 to 7.85) under the Linked Exchange Rate System.

³¹ HKMA consultation on market risk: https://www.hkma.gov.hk/media/eng/regulatory-resources/consultations/Annex_3_SPM_MR-1_Market_Risk_v1.pdf

- b) EU CRR2 (Article 325av)³² allows for a reduced risk weight for the currencies defined under the Economic and Monetary Union (ERMII) which fluctuate within the narrower band.

6.2.1.1.6 Government Sponsored Entities

The PRA proposal does not provide guidance on the BCBS FAQ1 under MAR 22.12³³ response to clarify the treatment for government-sponsored agency exposures (such as Fannie Mae and Freddie Mac mortgage-backed securities (MBS)).

The BCBS FAQ1 clarifies that such exposures shall be assigned to bucket 2 i.e. 'local government, government-backed non-financials, education, public administration'.

Fannie Mae/ Freddie Mac exposures are considered low risk as they are supported by the underlying mortgages and an implicit guarantee by the US government. Currently the US capital rules for Credit Risk classify both entities in a separate category, 'government sponsored enterprise'. It is our view that the PRA considers the risk profile of exposures to government sponsored entities, such as the type of assets supporting the exposures as well as any conditional or implicit guarantee by a sovereign government.

Recommendation(s)

The Industry recommends that the PRA should include the response on the BCBS FAQ1 under MAR 22.12, as this is crucial for the level playing field because it clarifies that Government Sponsored Entities MBS exposures are assigned to bucket 2 (local government, government-backed non-financials, education, public administration) for Credit Spread Risk with a risk weight of 1.0%. Without this clarification, the exposures would get assigned to bucket 3 (Financials including government-backed financials) with a risk weight of 5.0%.

6.2.1.1.7 Underwriting Positions

Securities underwriting can come in various forms and are an important part of raising funds for an issuer. To facilitate customer needs, the regulatory rules provide for a reduced net underwriting position for a certain number of business days.

The Industry would like to highlight that the PRA proposal has left the article 325k blank under the Advanced Standardised Approach (ASA), and removed the corresponding process set out in this Article in the EU CRR2 text for calculating the own funds requirements for market risk of underwriting positions

³² EU CRR2 Art 325av: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02019R0876-20200627&from=EN>: 2. The risk weight of the foreign exchange risk factors concerning currency pairs which are composed of the euro and the currency of a Member State participating in the second stage of the economic and monetary union (ERM II) shall be one of the following: (a) the risk weight referred to in paragraph 1, divided by 3; (b) the maximum fluctuation within the fluctuation band formally agreed by the Member State and the European Central Bank, if that fluctuation band is narrower than the fluctuation band defined under ERM II

³³ Calculation of RWA for market risk: https://www.bis.org/basel_framework/chapter/MAR/22.htm?inforce=20230101&published=20200327

of debt or equity instruments. However, the corresponding provision has been retained under the article 345 of the Simplified Standardised Approach (SSA).

Furthermore, we note that the definition of ‘business day 0’ in BIPRU 7.8³⁴ provides additional clarity lacking in EU CRR Article 325k and the draft UK CRR article 345. This clarity is particularly important for rights issues where the price and quantity are specified during the subscription period which may last several weeks. The more generic definition in EU CRR Article 325k and the draft UK CRR article 345 may potentially be interpreted to mean that ‘business day 0’ is the beginning, rather than the end, of the subscription period.

Recommendation(s)

The Industry proposes that the requirements of the EU CRR2 article 325k and the draft UK CRR article 345 pertaining to underwriting provisions should be retained under the Advanced Standardised Approach (ASA) in the UK implementation of Basel 3.1. This article allows adjustment of net sensitivities of the unsubscribed debt and equity instruments, where the institute has become committed to accepting a known quantity of securities at an agreed price. Furthermore, to account for the various forms of securities underwriting, the Industry also recommends clarifying the definitions of “business day 0” based on BIPRU 7.8, as well as clarifying that the multiplying factors apply to the sensitivities-based method and the default risk charge.

6.2.1.1.8 Commodity risk weights, correlations and bucketing

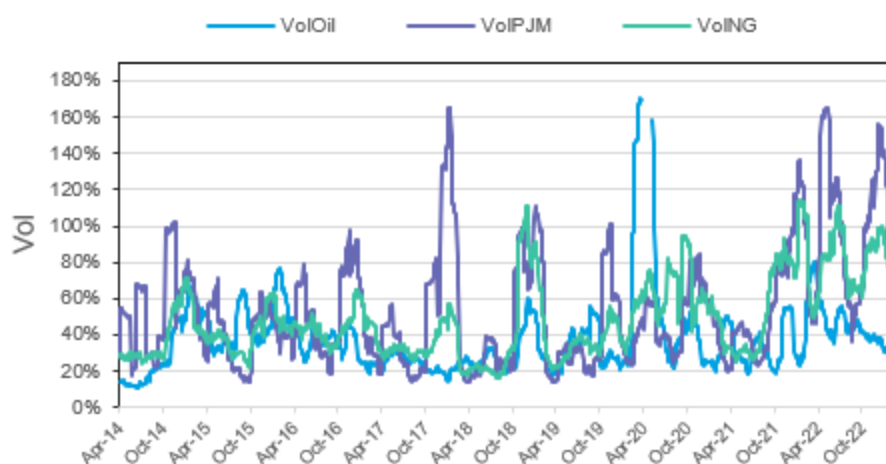
Forward markets provide a stronger conceptual and empirical foundation for calibrating FRTB SA risk weights for Electricity and Natural Gas than spot markets. Market participants often hedge their forward commodity exposure:

- To plan for future capital expenditures, such as power plant construction
- Electricity wind farms may execute ten-year energy forward contracts with banking organizations to “lock in” supply prices in support of lending covenants necessary to obtain financing for building new turbines
- In addition, banking organizations’ energy derivative exposures typically have maturities far beyond day-to-day fluctuations in spot markets

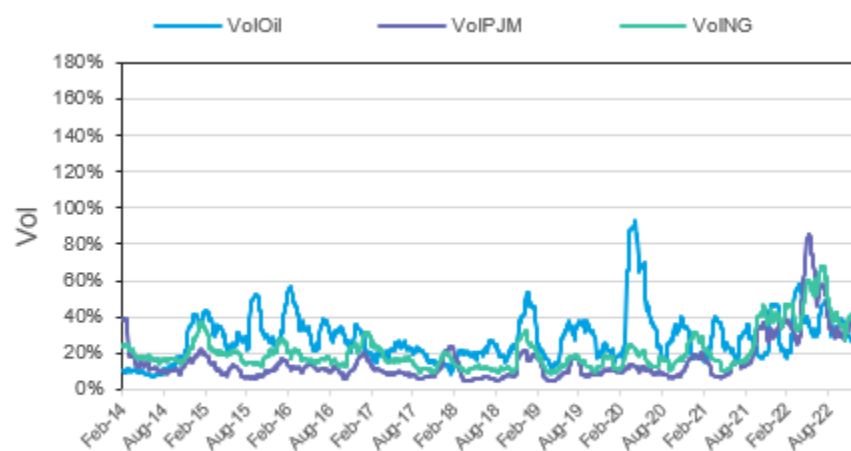
These medium - to long-term plans require hedges in the corresponding time frame. We recommend that FRTB SA risk weights represent the periods of risk being managed rather than spot market prices.

Below charts demonstrate volatility levels for Electricity and Natural Gas over the historical period when measured using forward market history.

³⁴ BIPRU 7.8 Securities underwriting: <https://www.handbook.fca.org.uk/handbook/BIPRU/7/8.html#D2025>



Energy asset class front month contract market volatility



Energy asset class front two years forward market volatility

Both the final FRTB rule and previous Basel Committee releases have stated that the calibration of risk weights in the sensitivities-based method is intended to be consistent with stressed ES calibration, accounting for variations in liquidity horizons.

This consistency holds if the risk weights for each bucket are chosen such that $RW \approx 2.33 * \sigma_{LH}$, where σ_{LH} is the volatility of risk factors in a bucket over the prescribed ES liquidity horizon (20 days for Energy and carbon emissions trading price)³⁵

This relationship can be adjusted using time scaling similar to the ES approach to $RW \approx 2.33 * \sigma_{250} * \sqrt{LH/250}$

³⁵ Based on BCBS intent to match RW calibration to stressed ES calibration: *Minimum capital requirements for market risk*, MAR21.40 (January 2019 (rev. February 2019)): "The prescribed risk weights and correlations in [MAR21.41] to [MAR21.89] have been calibrated to the liquidity adjusted time horizon related to each risk class." and *Explanatory note on the revised minimum capital requirements for market risk*, Section 3.3 (January 2016); (rev. February 2019); assuming normal distribution of returns.

Even based on 2022 unprecedented Commodity market volatility, using the average two-year forward contract markets involving electricity and natural gas and converting the observed standard deviation to corresponding FRTB SA RW using the above formula, a risk weight of 30% for the new combined bucket remains conservative:

Asset category	Calendar year of greatest volatility	St. deviation of forward markets in calendar year of greatest volatility	Implied FRTB SA risk weight	FRTB SA prescribed risk weight
Electricity	1/1/22-12/31/22	46%	30%	60%
Natural gas	1/1/22-12/31/22	46%	30%	45%

While calendar years are used for ease of reference, the results of forward market data would be broadly consistent across any two-year time series within the 2012 to 2022 period.

Historical correlations of North American Electricity and Natural Gas are found to be greater than the prescribed correlation parameters, even if they are moved to the same bucket.

Recommendation(s)

We estimated that risk weights have the highest impact on Commodity capital charge and recommend the following:

1. FRTB SA Electricity and Natural Gas risk weights are reduced to 30%;
2. Buckets should be revised such that commodities currently in Bucket 3 and Bucket 6 be placed in the same **global** bucket, subject to a risk-weight of 30% and a minimum intra-bucket correlation factor of 75%

6.2.1.1.9 General Interest Rate Risk Factors

The Industry would like to highlight an inconsistency between two provisions in the PRA's proposal.

Article 325af(6) states that: *"Between any given weighted sensitivity of inflation risk factor WSk and any given weighted sensitivity of a different inflation risk factor in the same currency WSl, an institution shall set the correlation at 99.90%."*

Article 325l(5) states that: *"An institution shall calculate the sensitivity of the instrument to the additional risk factor for inflation risk referred to in paragraph 4 as the change in the value of the instrument, according to its pricing model, as a result of a one basis point shift in each of the components of the vector. Each currency shall constitute a separate bucket. Within each bucket, an institution shall treat inflation as a single risk factor, regardless of the number of components of each vector. An institution shall offset all sensitivities to inflation within a bucket, calculated as described in this paragraph, in order to give rise to a single net sensitivity per bucket."*

The BCBS standards state that as per MAR21.47, FAQ1³⁶, “a 99.90% correlation should apply to different inflation curves in the same currency.”

Recommendation(s)

The Industry would like to ask the PRA to clarify which provision should apply.

6.2.1.1.10 CSR curvature

The PRA’s prescribed SA curvature shocks for CSR non-securitizations range from a few hundred to thousands bps; in practice, credit spreads have a natural floor as they will never drop below zero. Applying a downward shock without due consideration to economic behavior creates an artificial charge that doesn’t reflect actual risk.

For example, a long callable bond with negative delta issued by Prudential Financial and current credit spread of 57 bps, receives a shock of 500bps (Bucket 3, IG Financials) is naturally floored for shocks of less than -57bps; this flooring, however, is not reflected in the curvature calculation.

Recommendation(s)

The Industry proposes that for risk factors where losses are naturally bounded, to be allowed to adjust curvature risk calculation to reflect this.

6.2.1.1.11 Curvature calculations

The Industry highlights a disconnect between Delta and Curvature as unrepresentative outcomes have been observed with the current interpretation of the Delta used for the linear estimation embedded in the Curvature formulation.

Banks have detected some extreme CVR_k figures linked to options for whom regulatory shock takes the spot far from the zone where delta value makes financial sense. Since FRTB is not considering the complete performance of delta throughout the spot movement - especially when the shock changes the status of options without temporal value or leads the spot to cross barriers - oversized delta estimations are generated, and their respective unrealistic CVR_k results.

Recommendation(s)

One way to mitigate this undesirable effect could be the option to use an alternative approach which banks should be able to adopt without too much difficulty both from methodology as well as

³⁶ BCBS – MAR 21.47: https://www.bis.org/basel_framework/chapter/MAR/21.htm?inforce=20230101&published=20200327

implementation perspective. This proposal would be the inclusion of a Delta Ladder in the Curvature Formulation, so that the Regulatory Shock would be split in a consistent way with the levels of this more realistic delta use. This recommendation could provide a more accurate and stable capital consumption, without losing sight of the curvature philosophy.

The Industry believes that this is an area that should be reviewed by the PRA, if not at the Basel level to ensure global consistency.

6.2.1.2 Default Risk Charge (DRC)

6.2.1.2.1 Jump-to-Default of Derivatives and Hedges with Contractual or Legal Term (BCBS 22.13 and FAQ1 under 22.18)

The Industry would like to highlight that there is an important provision missing in the PRA proposal around the treatment of a derivative where contractual or legal terms of the derivative allow for unwinding of the instrument with no exposure to default risk. BCBS standards in MAR 22.13, and in the FAQ response under MAR 22.18, allow JtD for such a position to be zero.

Without the BCBS provision in the UK CRR, the banks will suffer from uneconomical default risk charge due to mismatch in the maturity of the derivatives and the underlying hedges, and client offerings in the market will be impacted, resulting in reduced liquidity.

Recommendation(s)

The Industry proposes that the PRA should include a similar provision in the UK CRR rulebook to allow JtD equal to zero. This is important for the Prime Financing business where clients are offered Total Return Swaps (TRS), and the bank hedges the exposure in the market with the underlying stocks or bonds. All such transactions are fully hedged, and banks would unwind the exposures and hedges at the same time. As the long and short exposures always offset, there is no default risk to the underlying constituents in such strategies. Furthermore, there is no settlement risk as derivative and cash equity/bond positions are settled at the same price based on the executed price of the stock/bond; and the contractual hedge disruption clauses allow unwinding of the positions at the same time with no exposure to default risk beyond that point.

6.2.1.2.2 Guaranteed Bond Offset Optionality

BCBS MAR 22.19 (2) states that a guaranteed bond may be considered an exposure to the underlying obligor or to the underlying guarantor following credit risk mitigation requirements. PRA article 325x (5) states that an institution shall treat a guaranteed bond as an exposure to the guarantor.

Recommendation(s)

The Industry recommends that PRA Article 325x (5) adopts the same language as BCBS MAR 22.19 (2). This provides institutions with the flexibility to determine whether a guaranteed bond is an exposure to either the underlying obligor or guarantor. The additional optionality to utilize obligor information is a generally more conservative approach. In comparison to guarantor information, obligor information is generally less granular with worse credit rating.

6.2.1.2.3 Equity Maturity Mismatch

The scaling of equity exposures is punitive for well-hedged cash and derivative positions with maturity less than 1 year, due to weighted JtD by the ratio of exposures' maturity to 1-year capital horizon. [MAR22.19(3)b]. In practice, exposure with short maturity usually will be rolled over when expired to keep the hedging relationship intact. Clarification or rule adjustment is required in order to receive full credit for derivatives with maturity less than 1 year against their respective cash equity hedges.

Recommendation(s)

The Industry recommends that the PRA should allow alignment of maturity of offsetting derivatives and equities to 3 month or to 1 year, so that derivatives with maturity less than 1 year do not result in net position risk if hedged with cash equity positions.

6.2.1.2.4 CTP decomposition

The Industry would like to highlight that the PRA rule is not entirely clear on the CTP decomposition. We believe decomposition of CTP indices would enable firms to appropriately reflect the net risk of CTP positions across tranches, different series, single names, and untranching indices.

Recommendation(s)

The Industry appreciates the clarifications from PRA on CSR where banks allowed to use decomposition approach. We recommend that for DRC, banks should also be allowed to decompose tranches into single names, with applicable default risk weights, and LGD consistent with non-securitization methodology as laid out in Article 325w.

6.2.1.3 Residual risk add-on (RRAO)

The residual risk add-on (RRAO) is a capital charge intended to only apply to exotic risks. Its design, a flat risk weight on the gross notional of affected products, is risk insensitive and in some cases penalises well-hedged portfolios, which can result in overly high capital charges for banks, and lead to trading services becoming overly expensive. Moreover, the Industry is concerned with the excessive RRAO charge for interest rate (IR) yield curve options and spread options. IR yield curve options are widely used as hedging instruments against interest rate curve exposure by clients such as pension funds, life insurance companies, corporates, asset managers and the RRAO charge could significantly increase their cost of hedging.

6.2.1.3.1 Clarification of the term ‘instrument’

The consultation introduces a divergence against Basel Standards in MAR 23.7 which allows exemption of exactly matching ‘back-to-back’ transactions from the RRAO capital. In the draft article 325u(4), there is no provision to exclude back-to-back transactions from the RRAO capital, and article 325u(3) requires RRAO as the sum of gross notional amounts of the instruments without defining the term ‘instrument’. The omission of back-to-back exemption and lack of clarity for term ‘instrument’ opens an area for interpretation.

Our understanding is the UK PRA intends to align with Basel requirements for the calculation of RRAO. The Basel requirement on back-to-back transactions (MAR 23.7) ensures that exactly matching equal and opposite transactions are excluded from the RRAO capital requirement. We propose that, at a minimum, the PRA rules permit exemption of exactly matching ‘back-to-back’ transaction, but also address the issue of uneconomic capital for less than exactly hedging transactions under the Basel framework. We have provided below examples in relation to Basel Standard in MAR 23.7, which penalises well offsetting transactions with offsetting market risk.

Example: consider an instrument ‘A’ = ‘Dec 2022 4000 EUR call on SX5E Quanto USD’ with positions in different portfolios/books as shown below. All of these “transactions” have the exact same cash flows at expiry. For SBM purposes, the sensitivities across transactions are netted.

Portfolio	Transactions	Notional as per Basel Requirement
A	Long 100m on instrument ‘A’ versus counterparty X Short 99m on instrument ‘A’ versus counterparty Y	Notional = 199mn (100m+99m)
B	Long 1m on instrument ‘A’ versus counterparty X	Notional = 1mn
C	Long 1m on instrument ‘A’ versus counterparty X Long 99m on instrument ‘A’ counterparty X Short 99m on instrument ‘A’ counterparty Y	Notional = 1mn (back-to-back transactions of 99m are excluded)
D	Long 100m on instrument ‘A’ counterparty X	Notional = 100mn

Issues with only excluding exactly offsetting back-to-back transactions:

1. Portfolio A attracts about 200 times as much capital than Portfolio B and C, when they are actually identical from a market risk standpoint.
2. Portfolio A attracts about twice as much capital than Portfolio D, while Portfolio D is actually 100 times riskier than Portfolio A.

We propose the PRA should simply allow the netting of notionals across transactions on an identical instrument and then capitalise RRAO on gross basis across instruments. This would ensure correct capital outcomes for sets of transactions with offsetting market risk. This essentially aligns with the PRA's aim of adherence with BCBS standards as netting of notional is equivalent to excluding the back-to-back transactions.

Recommendation(s)

The Industry proposes the following amendments in the UK draft rules to address the above issues:

1. In line with the Basel standards, allow exemption of matching back-to-back transactions from the RRAO.
2. The PRA rules should clarify the term 'instrument' that refers to a particular set of transactions, which, other than for notional value, share the same contractual terms on the instrument (e.g. strike, payoff, cash flow structure). Within each instrument, the notional is fully nettable across all transactions. This will ensure recognition of offsetting market risk within each instrument (over and above exactly matching back-to-back transactions), and that only net residual risks are subject to the RRAO capital requirement.

6.2.1.3.2 CMS spread options

The Industry would like to raise a concern on the excessive RRAO charge from IR yield curve options and spread options and in particular for Constant Maturity Swap (CMS) spread options³⁷.

These products are generally wrapped into a note and bought by pension funds and insurers as a strategy to manage yield curve risk. The risk from the client risk trade is decomposed into caplets or floorlets on CMS and hedged in the interbank market where a liquid broker market exists. The market hedges mitigate to a large extent the correlation risk. Thus, even though the residual RRAO-eligible correlation risk is low, both the client trade and the market hedges fall within scope of RRAO on a gross

³⁷ EBA CP response: <https://www.isda.org/a/r2EgE/ISDA-and-AFME-Respond-to-EBA-on-FRTB-Residual-Risk-Add-On.pdf>

EBA RTS Final report:

https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Draft%20Technical%20Standards/2021/RTS%20on%20residual%20risk%20add-on/1022462/Final%20Report%20on%20draft%20RTS%20on%20RRAO.pdf

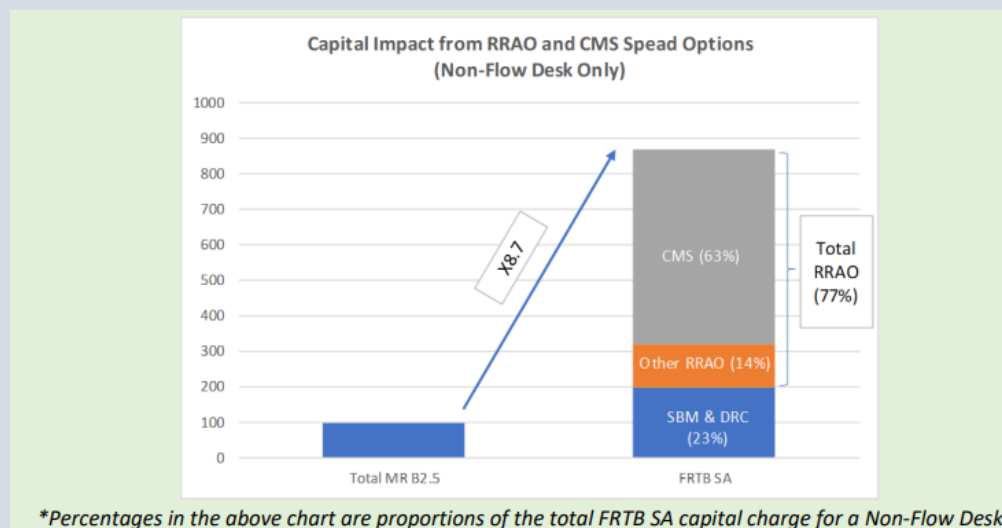
notional basis. Moreover, because the interbank hedges are executed with a single fixing, their notionals are very large compared to an equivalent swap. The proposed regulation disincentivises banks to hedge the correlation risk of the client trade and may hurt the liquidity on CMS options market.

Lastly, we would like to highlight that the economic meaning of the term “notional” is different for interest rate derivatives (where the cash flows of the trade are calculated as the notional times some interest rate) and other asset classes (where the cash flows of the trade potentially include a payment of the notional). This means that the notional, and therefore the RRAO, is much higher for an exotic interest rate derivative than for other RRAO-attracting positions subject to similar economic risk (measured using the SbM or banks’ internal models).

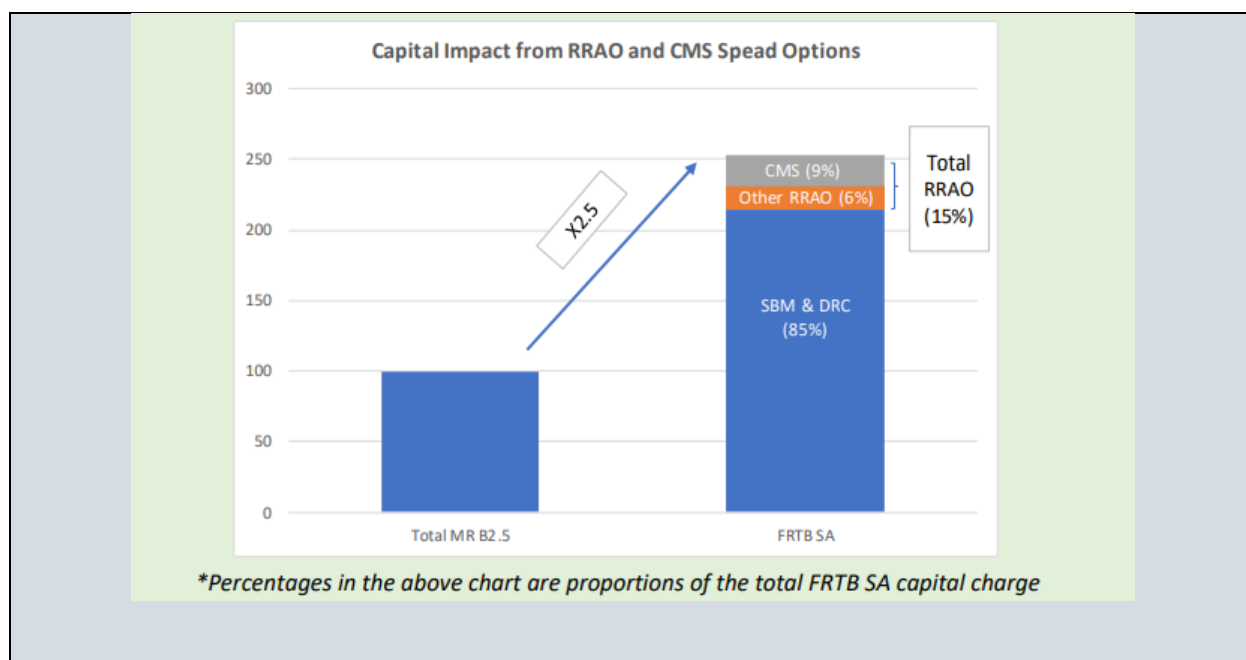
Recommendation(s)

The Industry recommends that it should be clarified, via paragraph 7 or Art 325u, that correlation risk arising from simple CMS spread options shall not cause them to be subject to RRAO. Such an exemption avoids vastly inflated RRAO charges on a hedged versus the much lower RRAO charge attracted by the unhedged position. This may have negative impact for end users that make use of those products

The below graph (EBA CP response) illustrates the excessive RRAO contribution to the total SA-FRTB capital requirement for non-flow interest rate desks, as well as a comparison to the current capital levels under Basel 2.5.



Investigating the issue on a broader scale shows that the impact is still visible in firm-level capital charges as visualized in the chart below.



6.2.1.3.3 Basket options – correlation risk

Under article 325u(6)(b) for instruments bearing correlation risks, the PRA draft rules specify that basket options, excluding options with multiple underlyings, are subject to correlation risk. The Industry has the following proposals to clarify the requirement.

Recommendation(s)

Given that all basket options are 'options with multiple underlyings', the Industry recommends reducing the exclusion scope from 'options with multiple underlyings' to 'multi-underlying European or American plain vanilla options and options on index instruments', to align with BCBS standards. Under the recommendation, only options on bespoke baskets underliers are subject to correlation risk.

6.2.1.4 *FRTB SA Authorisations*

An area of concern is the process for FRTB SA authorisation approvals. Industry is keen to support the standardisation of approval process where those are applicable with the ultimate goal to maximize efficiency and reduce operational burden.

To adhere with the deadlines the Industry proposes that the PRA should provide guidance and clarity in advance on the components of the SA which would require supervisory approval.

We acknowledge the view that any difference from the regulatory prescription may require a regulatory permission, however we believe that minor deviations should not require regulatory permission. This will help to streamline the approval process, which will also be important to help avoid a high volume of applications.

In this context, the Industry has proposed a template to allow for a consistent approval process for banks and the relevant supervisory team to assess the authorisation applications. In addition, the Industry has proposed particular cases where regulatory approval would be required for the use of alternative sensitivities. Proposals can be found in Appendix 14.2.1 and 14.2.2.

6.2.2 Internal model approach (IMA)

6.2.2.1 *Model approval process*

Industry would welcome clarity on the PRA's model approval strategy. There is uncertainty around the model submission package requirements and approval timeline. The FRTB IMA standard has never been tested, and firms have yet to go through the supervisory approval process (see section 6.2.6.2).

Recommendation(s)

To adhere with the deadlines, the PRA should provide guidance in advance on the extent of model approval required for IMA capitalisation.

The model approval process will become a broader and more complex exercise under FRTB, and the size of the documentation of the applications is expected to be significantly large. Therefore, clarity is required on what is expected from banks, and where there is greater flexibility in data requirements as part of the model application and approval process.

Given the limited time for model development, validation and application after the publication of the final PRA rules the Industry would recommend a phased model submission approach which would ease pressure on the banks and the PRA supervisory teams. In addition, the Industry would recommend that the PRA engages closely with other relevant jurisdictions to achieve alignment on timing and scope.

Viability of the internal model approaches.

While the Industry supports a number of methodology and supervisory measures that will lead to a more robust IMA, we are concerned there are elements that may challenge the viability of IMA altogether.

In particular, PLAT requirements, which requires testing on real portfolios to ensure appropriate calibration before becoming a requirement for IMA eligibility as well as inconsistencies between IMA and SA DRC approaches, are potentially undermining IMA as a viable option for banks (see sections 6.2.6.2 – 6.2.6.4).

6.2.2.2 Profit and Loss Attribution Test

The Industry welcomes the PRA's proposals for the P&L attribution (PLA) test which include significant enhancements to the framework. The proposals provide a transitional provision to delay the application of the PLAT test for the purposes of capital requirements until one year after the proposed IMA rules are implemented. In addition, we welcome the PRA's proposal to allow for recognition of RNIMs in the PLA test (subject to receiving an explicit waiver from the PRA). This would allow banks to avoid 'double counting' the impact of RNIMs.

6.2.2.2.1 Thresholds for the PLA test

The PLA test has not been tested on actual portfolios and through time. A conservative calibration could result in too many desks failing the test and be forced to be capitalised under the standard approach.

Evidence shows that portfolios with lower degree of hedging have a higher probability of passing the PLA test than well hedged portfolios. Therefore, the Industry recommend that the determination of appropriate thresholds for PLA is based on tests using real portfolios to ensure appropriate calibration before becoming a requirement for IMA eligibility³⁸.

Recommendation(s)

The Industry recommends that the PRA should review the thresholds for the PLA test once banks are able to develop the system capabilities to produce sufficient and reliable data for both the risk theoretical and hypothetical profit & loss.

6.2.2.2.2 PLA test: Penalty function

The PRA's proposal states that a desk that falls into the red zone will only be able to move back away from Red when all PLA test metrics are green. This differs to the treatment in backtesting which allows a portfolio to move from being in the Red zone back to Amber when metrics fall inside the Amber zone. This may result in inconsistent and volatile capital requirements which are contrary to the purpose of the traffic light approach and would not reflect model improvements made by a firm sooner when metrics fall-back to amber.

In addition, IMA approval should be grandfathered for desks that may result from a split of a desk that has been granted IMA permission. For example, it can be a desk containing exotic and /or structured trades, with their gamma hedges. If a market evolves in a more fragmented market, gamma hedging

³⁸ Extract [BCBS monitoring report](#) published in September 2021 (p. 78) – "Overall, 15 banks in eight countries were able to provide sufficient data to perform VaR backtesting versus 20 in the end-2019 data collection. Banks provided enough data for 474 desks for all tests to be performed, a significant improvement in the banks' capabilities versus the 311 desks in the end-2019 data collection. Of these desks, 43 were able to pass all tests in the green zone and a further 24 desks passed in the amber zone for a total pass rate of 14.2%"

benefits may go away and market participants may change. In this case a decision can be made to split / restructure a desk. Ultimately, it can be a desk restructuring / split for any business reason, the point of our proposed advocacy is to allow to use IMA for the resulting desks while data collection is in progress for a year.

Recommendation(s)

The Industry proposes a symmetrical traffic light approach that permits trading desks to switch from red to yellow, amber to green, similar to how desks in the green zone switch from green to amber to yellow to red and consistent with the backtesting framework.

The Industry also recommends that IMA approval should be grandfathered for desks that may result from a split of a desk.

6.2.2.3 Default risk charge (DRC)

6.2.2.3.1 DRC floor for sovereign and covered bonds

The PRA as part of its Basel 3.1 consultation has retained the BCBS floor for the probability of default (PD) of 3 basis points (bp) in the internal models approach (IMA) default risk charge.

This floor is not applicable to the standardized approach (SA) default risk charge (DRC). This imposes additional capital charge on internal models, even the most creditworthy country would not be permitted to use a PD under 3bp. This has a significant impact on capital and undermines the use of internal models in the DRC.

The Industry has produced a statistical, data-driven paper³⁹ which highlights the inconsistency that exists in the DRC between IMA and SA and explains why it is not appropriate for this floor to be applied to the IMA DRC.

6.2.2.3.1.1 The Sovereign Bond Market

Sovereign bond markets are among the largest and most important financial markets in the world. Sovereign debt instruments are issued by governments to finance investment and grow their economies. Therefore, it is vital there is liquidity in this market.

³⁹ [ISDA White Paper: FRTB IMA DRC and the 3 Basis Point Floor](#)

Since rating agencies first began rating sovereigns until the end of 2021, no sovereign issuer has ever defaulted after starting the year with an investment-grade rating.

The proposed floor of 3 bp is not risk-sensitive which puts disproportionately high capital requirements on bonds issued by high credit quality issuers, e.g. AAA rated government, as they are expected to have the lowest default probability, which could impact liquidity negatively. In the ISDA paper, the Bayesian technique was applied to estimate the distribution of PD for AAA-rated sovereigns based on historical data for corporate bonds (spanning 1981–2021) and for sovereigns (spanning 1990–2021). The results show that the mean of the distribution is below 1bp. In addition, the sensitivity analysis shows that the results are not overly sensitive to any one idiosyncratic event that might occur in the future, such as the default of Russia (BBB-rated) in early 2022.

6.2.2.3.1.2 Extension to Covered Bonds

The Bayesian inference model is not suitable for application to covered bonds to estimate distributions of PD with a reasonable level of significance due to the low number of data points. There is no instance of a rated covered bond that has defaulted after starting the year with a specific rating category. Thus, the low risk of AAA covered bonds, together with empirical data, indicates that the conclusion for sovereigns should also be relevant for covered bonds.

6.2.2.3.1.3 The Role of Banks

Banks help to facilitate the link between borrower and lender, but they also have other incentives to participate in the sovereign debt market. Sovereigns are useful for a bank's balance sheet management – specifically, liquidity management, as they are among the most liquid assets and are therefore suitable for use as collateral. They also play a role in market making as many banks hold sovereign debt as part of their role as primary dealers or market makers for such exposures.

Regional banks active in markets dominated by AAA and AA rated issuers are particularly affected by the combination of the proposed 3 bp PD floor and the overall design of the DRC, which penalizes less diversified portfolios, both in terms of sector and regional concentration as well as issuer concentration, i.e. in our view, the DRC overcharges for concentration in AAA/AA assets. Furthermore, the liquidity of these assets needs to be considered in the context of a 1 year PD horizon. In practice, given that these are typically high quality liquid assets, a bank will have the ability to manage such portfolios if credit quality deteriorates.

Recommendation(s)

The Industry proposes to remove the 3 basis-point floor for Sovereigns in the IMA DRC. In FRTB DRC SA, exposures that receive a 0% risk weight in the credit risk SA (sovereigns, public sector entities and multilateral development banks as well as international organizations that are treated similarly to

a sovereign in CRR), shall be assigned a 0% risk weight. All exposures which would receive a 0% risk weight under SA for Credit Risk shall not be subject to the 3bps floor. In addition, a more appropriate calibration for Covered Bond issuers as a separate risk class, reflecting their distinct characteristics and risk should be defined.

6.2.2.3.2 Simplified approaches for Equity Derivatives

The Industry would like to highlight that there is an inconsistency between the PRA rules and the corresponding BCBS on allowance of simplified modelling approaches for Equity Derivatives under the Internal Models Approach. Article 325bp(3) of the PRA rulebook on DRC requires *‘An institution shall ensure that its internal default risk model reflects the nonlinear impact of options and other positions with material nonlinear behavior with respect to price changes.’* The corresponding BCBS standard in MAR 33.32 allows the use of simplified modelling approaches (for example modelling approaches that rely solely on individual jump-to-default sensitivities to estimate losses when multiple underlyings default) for equity derivatives positions with multiple underlyings subject to regulatory approval.

Recommendation(s)

The Industry supports the BCBS guidance as it is reasonable to apply the sensitivity based simplified approach for modelling the default risk of the constituents of multi-underlying equity derivatives. Applying the full revaluation for millions of scenarios for multi-underlying instrument may not be always possible for an institution due to nature of the product or operational complexity. Therefore, Industry proposes that the PRA should include similar provision to allow simplified approaches in the UK CRR rulebook which would be subject to regulatory approval.

6.2.2.3.3 Particular Requirements for PD Calibration

The Industry would like to highlight that the draft UK CRR rulebook introduces divergences against the BCBS standards for the probability of default (PD) requirements.

1. PRA’s rule specified in Article 325bp(5)(d) that *“if the institution has been **granted permission** to estimate default probabilities in accordance with the Credit Risk: Internal Ratings Based Approach (CRR) Part, it shall use the methodology set out therein to calculate default probabilities.”* The rule is similar for LGD.

BCBS rules (MAR33.37) specifies that “where a bank has **approved** PD estimates as part of the internal ratings-based (IRB) approach, this data must be used. **Where such estimates do not exist, or the bank’s supervisor determines that they are not sufficiently robust**, PDs must be computed using a methodology consistent with the IRB methodology and satisfy the following conditions.” The rule is similar for LGD.

2. The BCBS text in MAR 33.37(3) allows PDs may be derived on a theoretical basis (e.g. geometric scaling) provided that the bank is able to demonstrate that such theoretical derivations are in line with historical default experience. The draft UK CRR does not provide such provision.
3. Additionally, both PRA and BCBS do not provide any guidance on the ‘Unrated’ exposures where PD is unavailable from the IRB approach or from external sources. It must be noted that this issue exist in the Basel 2.5 implementation of the Incremental Risk Charge (IRC) model as well, and the ECB Guide to Internal Models (EGIM) provides a credible fallback approach.

Recommendation(s)

1. The Industry would like more clarity and recommends the PRA rule (Article 325bp(5)(d)) to align with BCBS (MAR33.37) (given more details specified in Basel rule on usage of IRB PD/LGD).
2. The Industry proposes that the PRA should provide further flexibility on PD calibration similar to the BCBS standards in MAR 33.37(3) and allow use of PDs derived on a theoretical basis. For example, banks may want to use a 3-month Equity liquidity horizon and have 3-month PDs derived from scaling the 1-year PD to generate the default event.
3. The Industry proposes that the PRA should adopt the current ECB Guide to Internal Models (EGIM)⁴⁰ fallback approach (section 6.5.4) where unrated issuer will be assigned to the equally weighed average PD of rated issuers and floored to the worst investment grade rating. This is particularly important under the revised market risk rules as Equity exposures are in scope of the Default Risk Charge, and a significant proportion of Equity issuers are likely to be unrated. The proposed fallback approach can be consistently applied by the IRB approved as well as non-approved banks.

6.2.2.4 Replacing the PRA’s risks not in value-at-risk framework with a risks not in model framework.

Recommendation(s)

Despite the divergence this causes with other jurisdictions, the RNiV/RNiM frameworks were deemed at one point necessary measures in the UK to account for deficiencies in firms’ market risk methodologies. However, given the significant risk measurement improvements expected from the

⁴⁰ ECB Guide to Internal Models:

https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.guidetointernalmodels_consolidated_201910~97fd49fb08.en.pdf

introduction of the FRTB framework, including the introduction of the NMRF component, taking into account Industry efforts over the past years to reduce the RNIV component, there seems to be little justification towards maintaining this element of capital under the new RNIM, at least within the Pillar 1 framework. As Pillar 2 is the clear candidate to cover risks which are not (adequately) covered under Pillar 1, it would be the obvious candidate for maintaining full risk coverage while remaining in alignment with BCBS principles across all risk areas. All regulatory requirements falling under the RNIV/RNIM framework, including with regards to backtesting exceptions (Article 325bf(8)(b)(ii)), should remain applicable under Pillar 2.

The Industry would appreciate if the PRA could provide additional clarification regarding the interplay between RNIMs, PLAT, and NMRF. For example: the fact that PLAT passes for a certain trading desk should be a sufficient condition for an institution not to capitalise against any RNIMs related to the VaR/ES/NMRF measures. Additionally, Industry would welcome guidance on which types of risks could classify as a RNI DRC. Lastly, while assessing if the backtesting overshooting is attributable to RNIMs (under article 325bf(8)(b)(ii)), the Industry would like to know to what extent it must demonstrate the RNIM is driving the portfolio value change and whether this can apply to a group of RNIMs instead of one RNIM.

6.2.2.5 *Reduced Set Requirement*

The PRA text requires reduced set 75% threshold assessment shall be performed at the trading desk level. If threshold is breached then the data set should be updated within two weeks, failing which, a trading desk will be assigned to the Standardised Approach.

The Industry would like to highlight that the PRA proposal introduces a divergence against the BCBS standards and the EU CRR. The BCBS standards under FAQ2 of the MAR33.5⁴¹ requires the reduced set of risk factors must be able to explain a minimum of 75% of the variation of the full ES model at the 'group level for all desks with IMA model approval', whereas the PRA proposal goes further and require assessment to be made on all IMA trading desks. Furthermore, the corresponding EU CRR article (Art. 325bc(2)(a)⁴²) requires assessment of 75% criteria for the 'portfolio which has been chosen by the institution', to the satisfaction of the competent authorities, this can be interpreted as group/entity portfolio level.

Additionally, we believe that updating the reduced set of risk factors within two weeks will be challenging and, in some cases, even impossible. Moreover, it could be cases where updating the reduced set of risk factors has an impact on identifying the stress period. There may be genuine cases of breaching the threshold, and where data imputation and data calibration maybe required for updating the reduced set of risk factors. Such calibration will need appropriate testing before the impact can be assessed and it will be a time-consuming exercise. Furthermore, since the metric requires average measure over the preceding 60 business days; even after updating the subset of modellable risk factors, the average measure may need significant number of days to recover above the 75% threshold unless

⁴¹ BCBS – MAR33.5:

https://www.bis.org/basel_framework/chapter/MAR/33.htm?inforce=20230101&published=20200605

⁴² CRR2 Article 325bc(2)(a): <https://eur-lex.europa.eu/legal-content/EN/TEXT/PDF/?uri=CELEX:02019R0876-20200627&from=EN>

bank performs a retrospective adjustment which will be operationally challenging to perform within two weeks.

Furthermore, we believe that the requirement to assess the 75% criteria at the desk level, and penalising the desks failing the requirements to capitalise under the Advanced Standardised Approach (ASA) will act as an additional eligibility criterion over and above already very challenging eligibility tests – Back testing and Profit & Loss Attribution Test. This will also lead to capital volatility arising from the cliff effect between the IMA and ASA charge.

Recommendation(s)

The Industry would like to propose the below:

1. The PRA should align with BCBS and amend the draft text to assess the 75% requirement at the group/entity portfolio level.
2. The PRA should allow provisions to discuss the remediation plans beyond initial two weeks.
3. Trading desks should only be penalised on the ASA in the extreme cases where remediation plan is not feasible by the next quarterly assessment of the reduced set.

6.2.2.6 Liquidity Horizon mapping

The PRA's proposal in Article 325bd(6), introduced a requirement that institutions should verify the appropriateness of the liquidity horizon (LH) on a monthly basis. Provided a bank has robust LH mapping rules, a process for handling new risk factors, daily data quality checks and error handling process, should be allowed for LH mapping to be revised on a quarterly basis, in line with the frequency of review and reporting of FRTB IMA risk measures outlined in BCBS FRTB text such as inputs into ES (MAR 33.7, 33.8)⁴³ and reporting requirements for PLAT, Backtesting, NMRF and FRTB capital (MAR 31.13, 32.2, 32.7)^{44,45}.

Recommendation(s)

The Industry proposes that the PRA should remove the requirement to review LH mapping on a monthly basis and align with BCBS on the frequency of review and reporting of FRTB IMA risk measures.

⁴³ https://www.bis.org/basel_framework/chapter/MAR/33.htm?inforce=20230101&published=20200605

⁴⁴ https://www.bis.org/basel_framework/chapter/MAR/31.htm?inforce=20230101&published=20200605

⁴⁵ https://www.bis.org/basel_framework/chapter/MAR/32.htm?inforce=20230101&published=20200327

6.2.2.7 Liquidity Horizon Cap

The Industry would like to raise a significant concern on the liquidity horizon capping to the maturity of the related positions as specified in CRR II Article 325bd(4). This capping requirement, if made mandatory, is inconsistent with market practices and not coherent with general FRTB framework and would introduce unrealistic hedge breaks and undesired impact to capital and risk management. We therefore propose that capping the LH capping by position maturity to be optional, not mandatory.

From a theoretical standpoint, the maturity cap implies that no position shall be renewed beyond the expiry date, which does not reflect the nature of trading and client behavior whereby positions are often rolled over at maturity of the contract. From the coherence of the framework perspective, it is inconsistent with the general constant risk assumption prevailing in the ES formula itself, in which risk factors (from 0d to 10d, from 10d to 20d, from 20d to 40d, etc.) is deemed constant throughout the life of the positions in spite of the portfolio ageing. In addition, it contradicts the allowance provided in the FRTB as in CRR II Article 325bd(3), to increase the LH of a broad risk factor category at the desk level to avoid breaking of hedges.

If this capping requirement were imposed as mandatory, it would have unrealistic and undesired impact on risk management practices, including but not limited to the following:

1. Unrealistic hedge breaks between the same risk factors across different instruments. For example, short dated index options are frequently used as liquid hedges to credit exposures of longer maturity. Another example is in FX market, where FX spot trades for non-specified currency pairs (with a few days to maturity) are often used to hedge FX spot risk of associated options. The business practice is to roll them as they mature (hence the risk from the risk factor would continue) but forcing instrument maturity cap on them would lead to unrealistic break of hedge while the true risk is hedged out. Finally, if banks are forced to adopt this capping for capital purpose, it might incentivise a hedging strategy of using less liquid longer dated instruments which is a risky strategy in practices.
2. Unnecessarily volatile capital charges even when there is no change to the true underlying risk. For example, the maturity of certain instruments tends to cluster around a particular date (e.g. listed futures have clustered maturity on third Fridays of expiring month, or monthly equity/index/currency option expiration date, or IMM date), and the capping would lead to drastically volatile capital changes near those particular date.
3. Incorrect representation of risk: For example, physically delivered futures or options would continue to carry the risk exposures to relevant risk factors beyond expiration date. If capped at position maturity, the risk on those risk factors would not be correctly captured.

Recommendation(s)

We therefore recommend that banks should be allowed to treat the LH capping at instrument maturity as optional.

The Industry recommends revising the Article 325bd and reverse the order of Article 325bd(3) and Article 325bd(4) to align with BCBS (MAR 33.12). This is to allow banks to extend LH of risk factor

category at desk level as prescribed in Article 325bd(3) after the capping of LH by position maturity as prescribed in Article 325bd(4).

6.2.2.8 *Market Cap on Index*

The Industry would like to raise an additional concern on the mapping methodology for equity index instruments. As per PRA's Article 325bdx(4), the liquidity horizon for an index instrument must be rounded up to the shortest liquidity horizon which is greater or equal to the weighted average of its constituents' liquidity horizons. This approach can lead to punitive estimates for liquid indices where a single immaterial constituent could impact the mapping.

For example, in the case where an index is composed of 99 large cap names and a single immaterial small cap name the index would be mapped to the small cap bucket, whereas the index instrument itself may have a much larger liquidity than the single names.

Recommendation(s)

The Industry proposes using a weighted average of market caps to determine the liquidity horizon for the index instrument.

6.2.2.9 *Data Principle 6 – Data inputs for stress period*

The Industry recommends PRA to further consider the requirements in Article 325bh(12)(b), which states that the idiosyncratic component of name-specific risk factors should not be included in the reduced set, if the risk factor did not exist in the stressed period. It would not be a reasonable outcome that an idiosyncratic RF is barred from the reduced set. The PRA proposal is more severe than the BCBS standards in MAR 31.26 (principle six), which only specifies exclusion from the reduced set as standard case (use of the word "presumption").

We believe that the name-specific risk factors that did not exist in the reduced set, but are currently traded, maybe backfilled using appropriate backfilling techniques/models involving the data that are consistent with the level of changes observed in similar risk factors and empirically justified. The data backfilling techniques/models shall ensure that the risks corresponding to the general risks as well as the idiosyncratic risks in the stress period are appropriately captured.

If banks are strictly not able to include the name-specific idiosyncratic risk factors in the reduced set then it may impact the 75% coverage requirement under article 325bc(2)(a).

In addition, it further contradicts with the requirements for some of the other risk factors like risk free rate curve 'SOFR' and offshore 'CNH' currency which did not exist in the stress period (2007-2008). We understand that the risk factors like SOFR and CNH can be fully included in the reduced set via appropriate data modelling.

Recommendation(s)

The Industry proposes that the PRA should allow use of backfilling techniques that account for name-specific idiosyncratic risk in the stress period, so that a given risk factor with the appropriate backfilling could be included in the reduced set.

6.2.2.10 *Mandate Tainting*

Under Basel 2.5, non-securitization products on securitized desks can use internal models, while under the PRA's proposal, the use of models for securitized desks is disallowed and the entire desk needs to be on standardized approach (SA). In particular, any de-minimis securitization underlies would "taint" the entire mandates to be on SA.

Recommendation(s)

The Industry proposes that the PRA should address securitization tainting by either allowing de minimis positions in an IMA desk and/or allow flexibility in bifurcation of securitization and non-securitization positions for regulatory capital purposes.

6.2.2.11 *Calculation of Stress Scenario Risk measure: Fallback extreme scenario*

1. The BCBS rules (MAR33.16(3))⁴⁶ require estimating the maximum possible loss, if an extreme scenario cannot be determined.

The final draft of EBA RTS⁴⁷ provided further guidance when the maximum possible loss is not finite: Using qualitative and quantitative information, a 10-business day loss of the NMRF, that is not exceeded with a confidence level of 99.95%.

The PRA's proposal (Article 325bk(12)) adds a further prescription where introduces the floors of loss_{Hist+} and loss_{Hist-}

The loss that will not be exceeded with 100% confidence is the maximum possible loss. If the maximum possible loss is not finite, an estimate of a loss with 99.95% confidence is reasonably conservative, with low probability.

⁴⁶ BCBS – MAR33.16: https://www.bis.org/basel_framework/chapter/MAR/33.htm?inforce=20230101&published=20200605

⁴⁷ EBA RTS:

https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Draft%20Technical%20Standards/2020/RTS/961600/Final%20draft%20RTS%20on%20the%20calculation%20of%20stress%20scenario%20risk%20measure.pdf

2. The PRA's proposal (Article 325bk(12)(d)) states that *"An institution shall not use the regulatory extreme scenario of future shock to calculate a single stress scenario risk measure for more than one non-modellable risk factor in a standardised bucket."*

The Industry interpretation is that within a standardised bucket, the fallback extreme scenario approach can be used for only one risk factor within that bucket. However, neither BCBS nor the final draft of EBA RTS have this restriction.

If the fallback method is to be used for a curve, then the fallback method should be allowed to be used for multiple risk factors for a standardised bucket of that curve. Absence of that allowance incentivises to define less granular curves such that there is one risk factor in a standardised bucket to be able to use the fallback approach to use the extreme scenarios.

Recommendation(s)

1. The Industry recommends the RTS approach of giving banks the freedom to estimate a loss not exceeded with 99.95% confidence, without requiring the backstop of the losses from the largest 10-day up and down moves from 1 Jan 2007. Thus, our recommendation is to not get more restrictive than the EBA RTS by keeping $\text{loss}_{\max} = \text{loss}_x$
2. Our recommendation is to remove the below sentence in Article 325bk(12)(d), to not get more restrictive from either BCBS standards or EBA RTS.

~~*"An institution shall not use the regulatory extreme scenario of future shock to calculate a single stress scenario risk measure for more than one non-modellable risk factor in a standardised bucket."*~~

6.2.3 Trading Book (TB) / Banking Book (BB) Boundary

6.2.3.1 TB treatment of instruments which are “trading assets or liabilities” for accounting purposes.

Article 104(6)(a) of the draft UK regulatory text creates a presumption that instruments which are treated as “trading assets” for accounting purposes are also assigned to the trading book for regulatory capital purposes. The proposal is not consistent with the analogous proposals in other jurisdictions:

instruments held as accounting trading assets or liabilities; BCBS, RBC 25.9(1)

Under IFRS (IAS 39) and US GAAP, these instruments would be designated as held for trading.

Under IFRS 9, these instruments would be held within a trading business model. These instruments would be fair valued through the P&L account. BCBS, footnote to the above

financial assets or liabilities classified unambiguously as having a trading purpose under the accounting framework applicable to the institution; CRR3, Art 104(2)(d) of CRR as amended

an instrument that is accounted for at fair value, with changes in the value of that instrument reported in the profit and loss account of the institution; UK draft regs, Art 104(6)(a)

Under IFRS 9, assets are fair valued through P&L (FVTPL) unless they meet both legs of the test in either paragraph 4.1.2 (for amortised cost treatment) or 4.1.2A (for fair value through OCI). The first leg in each case relates to the business model. The second leg of the test means that an asset must be FVTPL unless “the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding” (the SPPI test).

The BCBS and EU wordings (which mean the same thing for IFRS 9 banks) mean that assets which are FVTPL because of the business model test are presumed to be on the trading book. The proposed UK wording would also apply to assets which are FVTPL because of the SPPI test. The consultation paper does not provide any policy rationale for this significant divergence.

The most important instruments which are affected by this change and where banking book treatment is correct under the general principles in Article 104 (4) are derivatives used to hedge interest rate risk in the banking book (unless they meet the strict rules to qualify for hedge accounting under IFRS) – there is no reason for an accounting technicality to override the principle that hedges should be assigned to the same regulatory book as the exposures they are hedging.

Recommendation(s)

The Industry recommends that the PRA should modify Article 104(6)(a) to align with the EU or BCBS text (updated to reflect the replacement of IAS39 by IFRS 9). In our view, the EU text is preferable because it is clearer. If the divergence here is intentional, then banks will need some form of blanket permission under Article 104(8) to hedge interest rate risk in the banking book without seeking separate permission for each trade.

6.2.3.2 Re-assignment (Article 104a)

The Industry welcomes the distinction made by the PRA in Article 104a(1) in terms of the positions where a notification is required and where a permission will be necessary. We would request the PRA to provide more clarity around the scope of positions requiring notification under Article 104a(1). Does this provision refer to initial recognition of items per FRTB rules or does it allow the move for example from Trading book list items to Banking book list items as well? A change in the circumstances e.g. listed equity becoming delisted and vice versa or change in the conditions related to CIU might require a change in the classification. Are these changes covered by notification provision or will an approval due to extraordinary circumstances provisions be required for such reclassifications?

Furthermore, per Article 104a(5), firms would be required to take an additional own funds requirement until the reassigned instruments mature or expire, if net change is a reduction in own funds requirements. The Industry would propose to delete the requirement to calculate the net change in own fund requirements where a re-assignment happens in accordance with paragraphs 1 of Article 104a. The re-assignments between the presumptive lists (i.e., an unlisted equity became a listed equity) are outside of a firm's control and not intended to achieve a reduction in capital requirements. Operational cost to calculate the net change in own funds requirements immediately before and after the reassignment would exceed the relative benefit to safety and soundness of overall financial stability.

Recommendation(s)

We seek more clarity around the positions covered by paragraph 1 of Article 104(a).

We believe intra-day boundary changes would be out of scope of Article 104a as any intra-day position would not be reflected in the end of the day books and records on which the capital requirement is calculated. In a less frequent scenario, when a bank makes a correction on the boundary designation within a few business days of the initial booking due to an operational reason, it should also not be seen as a re-assignment.

Any arms-length transactions between trading and banking book desks should not be treated as re-assignments. Under the proposed rule, when a banking book desk (e.g., liquidity management desk) wants to purchase an instrument already existing in the bank's trading book portfolio, the bank will be forced to sell the instrument to a third-party and to purchase it back to avoid boundary reassignment. This will add unnecessary cost for the firms and may hamper the efficiency of the market. We propose to amend Article 104a(2) as below.

"An institution may only reassign an instrument between trading book and non-trading book (including a reassignment of an instrument by way of an outright sale made at arm's length) in extraordinary circumstances..."

6.2.3.3 Presumptive list - Instruments resulting from securities underwriting commitment

The Industry is proposing PRA to consider trading intent for below requirement.

Article 104 (5) Inclusion in Trading book . An institution must assign to the trading book an instrument that meets the requirements of points (a) and (b) of paragraph 3 and is any of the following:

- a) an instrument in the correlation trading portfolio;
- b) an instrument that would give rise to a non-negligible net short credit or equity position in the non-trading book;
- c) an instrument that results from securities underwriting commitments, which relates only to securities that the institution is expected to purchase on the settlement date.

Recommendation(s)

An institution can purchase from their own underwriting into banking book portfolio. For example, in investing the firm's excess liquidity they may purchase high quality securities, such as muni bonds underwritten by their Market making businesses. This provision could imply that such activity would be treated the same as those purchased with trading intent.

Applying this rule will force banks to classify banking book purchases as trading book instruments and also unnecessarily give rise to potential reassignment issue during underwriting and settlement stages.

Therefore we believe that for proposing to take trading intent into account when assigning designation, the rule should be clarified to mean only those securities underwritten that are being held for the purposes set out in Article 104 (4) (i.e. short-term resale; profiting from short-term price movements; locking in arbitrage profits; or hedging risks that arise from these activities), such that if the intention is to hold-to-maturity or to account for them as available-for-sale, then these could be treated as banking book securities.

6.2.3.4 Definition of Trading Book

The Industry would like to highlight a deviation in the wording regarding the definition of trading book between BCBS and UK.

Point (86) of Article 4(1) of CRR 'trading book' means "*all positions in financial instruments and commodities held by an institution either with trading intent or to hedge positions held with trading intent in accordance with Article 104*"

BCBS text: 25.3 "*Banks may only include a financial instrument, instruments on FX or commodity in the trading book when there is no legal impediment against selling or fully hedging it*

Clarification(s)

The Industry would like to ask for clarification as to whether the omission of “*instruments on FX*” was accidental and to recommend for the PRA text to align with BCBS.

6.2.3.5 CIU designation of boundary

The Industry welcomes the PRA’s proposed approaches on CIUs; EPA under ASA and modelling approach under new IMA. To achieve the PRA’s intended outcome to accommodate operational difficulties of trading book CIU, we believe CIUs boundary would also need to be amended as below along with those proposed approaches.

Recommendation(s)

The Industry recommends the following edits to Article 104 (2)(f):

“Article 104 (2). An institution must assign to the non-trading book instruments that are:

(f) shares or units in a CIU, except where either:

- i. the institution has the ability to look through the CIU to its individual components and or there is sufficient and frequent information, verified by an independent third party, provided to the institution regarding the individual components of the CIU; or*
- ii. the institution obtains ~~daily~~ sufficient and frequent price quotes for the CIU and it has access to the information contained in the mandate of the CIU or in the national regulations governing the CIU;”*

This change in Article 104(2)(f)(i) will allow firms to utilize EPA when the firm is not practically looking-through the CIU. Also, the change in Article 104(2)(f)(ii) would prevent a firm to be forced to change the boundary of CIU from trading to banking when a particular day’s price is missing due to operational reasons.

6.2.3.6 Classification of hedge fund and other CIUs

The Industry would like to highlight that there is an inconsistency between Articles 104(2)(f) and 104(2)(g) in the PRA’s proposal. In particular, more clarity is required by the PRA as there is an ambiguity in these two articles which leads to a confusion on how the Industry should classify a hedge fund that

can be looked through with a daily price. In addition, how should we classify an exchange-traded fund (ETF), which applies hedge fund strategies?

The assignment of trading book should be driven by trading intention, i.e., Funds used to hedge P&L for a trading desk should be assigned in the trading book so long as the firm is able to obtain sufficient information for the fund. In EU, CRR rules emphasise the importance of trading intention and provide more flexibility to firms.

An institution shall assign to the trading book a position in a collective investment undertaking that is held with trading intent and where the institution meets one of the following conditions:

(a) the institution can obtain sufficient information about the individual underlying exposures of the CIU;

(b) the institution is not able to obtain sufficient information about the individual underlying exposures of the CIU, but the institution has knowledge of the content of the mandate of the CIU and is able to obtain daily price quotes for the CIU.

Recommendation(s)

The Industry recommends the following edits to Article 104 (2)(f) or 104 (2)(g):

- *remove subparagraph (g), similar to EU CRR, or,*
- *revise wording in subparagraph (f) to exclude hedge funds and provide guidance on what should be defined as hedge funds.*
- *revise wording in subparagraph (f) to consider of trading intent and to make exceptions more flexible.*

6.2.3.7 Trading-related SFTs

The Industry would like to highlight a deviation between the PRA's proposal and BCBS. In particular, the current PRA's text in Article 104.6, point (e) implies that SFTs that are entered for liquidity management purposes are part of trading-related securities, and those that are fair valued should be classified as trading book.

The BCBS definition does not include SFTs entered for liquidity purpose: *"trading-related repo-style transactions comprise those entered into for the purposes of market-making, locking in arbitrage profits or creating short credit or equity positions."*

In addition, BCBS further clarified that *"Repo-style transactions that are (i) entered for liquidity management and (ii) valued at accrual for accounting purposes are not part of the presumptive list of trading-book instruments in RBC25.9."*

As per BCBS standards, an SFT that is entered into for liquidity management purposes is not considered as a trading-related repo-style transaction, hence should still be classified as banking book even if it is fair valued.

Recommendation(s)

The Industry recommends the PRA to provide updated definition of trading-related SFTs and align with BCBS standards.

6.2.3.8 Requirement for Notional trading desk

The Industry believes there is ambiguity in terms of the level of requirements that needs to be fulfilled for having notional trading desks stated in the text below

Article 104b (3), *“an institution shall treat all foreign exchange and commodity positions assigned to the non-trading book as if they were held on notional trading desks within the trading book”*.

Clarification(s)

It is unclear from the current rule whether notional trading desks would be subject to the same requirements as a normal trading desk.

As notional trading desks are not managed as normal trading desks, we propose to exempt such desks from requirements set out under the section Article 104b apart from ensuring FX and commodity positions and exposures from these desks are subject to market risk capital calculation.

6.2.3.9 Treatment of internal hedges

Article 106 requires that an institution should externalize internal hedges between the banking book and the trading book. The original intent of the externalisation requirement appears to be preventing potential regulatory capital arbitrages⁴⁸.

However, the current wording of the rule does not seem to be meeting this objective in practice. Indeed, internal hedges could be executed through an external counterparty while making no net

⁴⁸ <https://www.bis.org/bcbs/publ/d305.htm>

difference in the risk profile of the banking book, the trading book, or the overall firm. As a result, the externalisation requirement bears no economic or risk management benefit.

A significant side effect of this ineffective externalisation is to impose onerous monitoring and segregation requirements, with the associated operational risk and cost, which appears disproportionate when we know that the measure does not bear any benefit. Hedging will be disincentivised and become more expensive for banks, with the cost likely to be reflected in customer trades. The requirement also potentially impacts the ability to clear and compress trades through CCP's, which runs counter to the system-wide drive to clear more trades and reduce systemic risk.

In practice, in addition to the detrimental impact to genuine hedging activities, the externalisation requirement would significantly affect internal funding trades. The Industry's interpretation is that the externalisation requirements are not intended to apply to internal funding trades, which are generally between a Treasury function in the banking book and individual trading desks, and where any risk transfer between the books is de minimis and incidental to the goal of transferring liquidity. Explicit clarification on this point, either in the regulatory text or in accompanying guidance, would be helpful.

Clarification(s)

The Industry would recommend not imposing the externalisation of internal hedges in general or, at the very least, allowing for exceptions where such an externalisation is impractical, which includes funding activities

6.2.3.10 Internal risk transfer for Credit risk exposure in banking book

PRA rules require transaction with eligible third-party protection provider to meet the requirements for "unfunded credit protection" in the non-trading book as set out in Credit Risk Mitigation. Applying the rule constrains the type of hedge to be only a derivative by the inclusion of the term "**unfunded credit protection**" whereas BCBS standards allow for a wider scope. For example, protection with funded forms such as credit-linked notes (CLNs).

Clarification(s)

Therefore, Industry would recommend PRA widening the scope for the eligibility requirement of credit protection from "unfunded credit protection" to include funded forms such as CLNs.

6.2.3.11 ALM Mandate: Funding and Liquidity Activities

The Industry appreciates that movements between Trading and Banking Books are not permitted as they could constitute regulatory arbitrage. However certain ALM activities require significant interaction between banking and trading books.

Generally, banks designate a centralized function to be responsible for measuring, monitoring, reporting and managing banks' liquidity, funding and structural interest rate and foreign exchange risks, as well as

executing the banks' capital plan. Such centralized function contributes to the safety and soundness of financial institutions.

Such a function extensively interacts with the trading business, which transacts in products such as securities, derivatives, deposits and repo in their banking book portfolios. Neither the IRT treatment nor the re-designation provisions are fully suitable for allowing these ongoing ALM activities being carried out across the TB/BB Boundary, e.g. securities and repos for the liquidity buffer, and FX instruments for managing currency imbalances.

Clarification(s)

The Industry proposes an option for banks to have explicit recognition of ALM mandate under pre-defined policy to recognise the need for 'ongoing' transactions to be conducted across the TB/BB Boundary – and exempted for general requirements of instruments moving between regulatory books and internal risk transfer.

The following oversight and controls for ALM related activities should be in place:

- internal review by senior management and external approval by national supervisors for policies around ALM activities
- activities conducted in compliance with bank policy and fully documented
- periodic review of arrangements (i.e. annual)

6.2.3.12 Own credit spread (OCS)

Own issuances in the banking book should be exempt from any boundary discussion, as they are generated for funding purposes without trading intent.

Industry view is that OCS should be excluded from Market Risk capitalisation, otherwise simulation of OCS would clearly be detrimental of the quality of the resulting Market Risk figures in that:

- an instrument issued for funding purposes would be influencing the market risk measurement of the trading book
- scenarios where the credit quality of the institution improves would generate a loss
- this loss could potentially dwarf any other loss scenario in case the issuance size is significantly higher than the Trading Assets.

Additionally, for own liabilities issued out of the Banking Book (i.e. funding rather than trading intent), which naturally embed a short credit position in OCS, absence of OCS exemption could lead to further ambiguity around the quantification of the net short credit position as in RBC 25.6(2).

Therefore, own issuances in the banking book should be exempt from any boundary discussion, as they are generated for funding purposes without trading intent.

Clarification(s)

The Industry recommendation is that OCS is excluded from Market Risk capitalisation, and therefore e.g. from the quantification of the net short credit position as in [RBC 25.6(2)].

6.2.3.13 Internal Hedges – General interest rate risk (GIRR)

The PRA’s proposal in Article 106(9)(d)(ii) states the conditions under which a set of positions with third parties exactly matches an internal GIRR hedge.

Clarification(s)

The Industry highlights that the conditions in Article 106(9)(d)(ii) are not specified and would welcome further clarifications on potential latitude for determining the definition of or tolerance levels around what constitutes an “exact match” between the third party trades and the internal hedge.

6.2.4 Risk Factor Eligibility Test (RFET) – Non-Modellable Risk Factor (NMRF)

The Industry would like to highlight some key issues with certain components of IMA and in particular the RFET and NMRF frameworks. On a recent Industry survey, the results indicate a material reduction in IMA usage (between Basel 2.5 and Basel 3) by global firms (from 97.5% to 52.5%) as well as PRA supervised firms (94% to 65%) (see section 6.2.6.1). One of the major drivers for this reduction can be attributed to the challenges with RFET and NMRF (see section 6.2.6.4).

The PRA's proposal includes the RFET (Article 325be), which is a test that determines modellability of risk factors and is performed quarterly.

When the RFET criteria are met, risk factors are identified as modellable and can be capitalised in banks' expected shortfall (ES) calculations. Failure to pass the test will result in risk factors being calculated under the NMRF framework which leads to punitive capital charges. NMRF capital can be typically a large fraction, if not multiples, of the level of ES, which does not seem reasonable from a prudential perspective.

Most FRTB risk indicators have meaningful purposes in either capitalizing for actual market risk or providing metrics to ensure the robust capture of risk. RFET and its associated capital charge as part of NMRF in its current form is an exception. The survey shows that most firms (60%) (see section 6.2.6.5) don't plan to use NMRF as an internal risk metric, yet it remains the most challenging metric from an implementation perspective.

The only meaningful way to reduce NMRF is to either generate more observations through trading or buying observability data from 3rd parties. Either option would NOT impact the actual market risk of the firm. Therefore, RFET and NMRF are not deemed to be useful for day-to-day risk management and arguably fail the 'use test'.

The lack of observable market liquidity is the key issue, even though market liquidity risk is already captured by ES via Liquidity Horizons. RFET failures are common across a broad range of risk factors and maturities, even for many risk factors that would be associated with relatively liquid markets (see section 6.2.6.3). In an attempt to overcome this issue, 91% of banks indicated that they intend to use multiple vendors to provide transaction data that can be combined with the firm's own transaction data. A majority of banks (63%) also confirmed that they intend to use quotes to improve RFET results (see section 6.2.6.3). The annual cost of sourcing vendor data is significant while not adding any further value to the bank other than passing RFET. According to the Industry survey (see section 6.2.6.4) PLAT is equally challenging for firms wanting implement IMA, yet provides a clear motivation to improve the accuracy of risk capture in ES.

In summary, the difficulties to pass the RFET still remain and act as a barrier for firms to be on a more risk-sensitive framework (i.e., IMA). Therefore, the Industry believes that this is an area that should be reviewed more fully by PRA, if not at the Basel level to ensure global consistency.

We would welcome further engagement on this and stand ready to help collaborate on a suitable outcome that continues to support banks using IMA to capitalize their risks.

In the interim, the Industry would like to highlight the below issues and recommend proposals on how these could be addressed.

6.2.4.1 Representativeness of verifiable prices for risk factors (Article 325be)

The Industry would like to highlight that there is an inconsistency between the PRA rules and the corresponding BCBS standard on the representativeness of verifiable prices for risk factors. As currently drafted, the article in PRA draft rules may lead to liquid risk factors being flagged as non-modellable. For example, from a transaction on a listed equity future, institutions may only tag as observed one of the equity price, dividends or funding spreads (equity repo) risk factors, which could highly deteriorate the ability to tag as modellable either dividends or funding spreads. Moreover, as described, derivative products pricing typically requires as an input more than a single risk factor value (e.g. swaps, futures, vanilla options, exotic options) and the allocation of a verifiable price to exactly one risk factor input for the purpose of the RFET would be of high operational complexity. The Industry would welcome additional flexibility when counting verifiable prices for more than one risk factor. We would recommend to the PRA to allow institutions to count a verifiable price for all risk factors which materially impact the pricing of the transacted instrument, and where the materiality conditions would require previous approval by the PRA for the institution.

6.2.4.2 Criteria for the modellability of risk factors belonging to parametric curves, surfaces, and cubes

The Industry would welcome additional flexibility when assessing the modellability of parameters of the parametric functions used in their risk measurement models. Firstly, verifiable prices pertaining to non-vanilla products function of parametric curves, surfaces or cubes may not map to any single specific bucket referred to in paragraph 9 of article 325be – an example of such a case would be that of volatility risk factors for path-dependent options. Secondly, certain parameters may be directly marked by the trading desk rather than calibrated based on a set of points on the curve, surface, or cube; these trader marks undergo a price verification process that ensures the marking quality, similar to other trader marks. As such, we would recommend to the PRA to allow institutions to count a verifiable price for all parameters which materially impact the pricing of the transacted instrument, and where the materiality conditions would require previous approval by the PRA for the institution.

Recommendation(s)

We would recommend to the PRA to allow institutions to count a verifiable price for all risk factors (whether these correspond to parameters or not) which materially impact the pricing of the transacted instrument, and where the materiality conditions would require previous approval by the PRA for the institution.

6.2.4.3 Calculation of Stress Scenario Risk Measure – Zero Correlation test

The Industry acknowledges that the requirement to have ‘negligible’ correlation amongst idiosyncratic risk factors is in line with the BCBS standards, which requires institutions to prove by means of statistical tests that aggregating the stress scenario risk measures with a zero-correlation assumption under article 325bk(13) is appropriate.

However, the Industry believes that the PRA’s requirement to ensure ‘no subsets have non-zero correlation’ is the hardest to satisfy and conflicts with the above requirement to have ‘negligible’ correlation. It must be highlighted that this requirement is neither prescribed in the BCBS standards nor in the EU CRR. The PRA requirement to satisfy the zero-correlation requirement for a subset of risk factors will lead to a large portion of idiosyncratic risk factors failing the requirement.

The issue with defining the zero correlated subset is that there could be an NMRF that is zero correlated with most risk factors but fail with respect to small number of risk factors. This will exclude it from the zero subset and will lead to small number of risk factors in the subset that do not represent the true behaviour of correlation among risk factors.

Recommendation(s)

The Industry proposes that the PRA should remove the requirement that ‘*no subsets have non-zero correlation*’ and align the requirements with the BCBS and EU CRR to simply have ‘*negligible*’ correlation amongst risk factors.

6.2.5 Drafting and Typos

6.2.5.1 RFET – modellable risk factors

The PRA’s proposed approaches on RFET (Article 325be) are broadly aligned with the BCBS. However, we have identified that the CP does not include a BCBS provision and in particular Footnote 3 (MAR31.13) where *“a bank may add modellable risk factors, and replace non-modellable risk factors by a basis between these additional modellable risk factors and these non-modellable risk factors. This basis will then be considered a non-modellable risk factor. A combination between modellable and non-modellable risk factors will be a non-modellable risk factor.”*

Recommendation (s)

The Industry would recommend that in line with BCBS standards, the PRA should include similar provision in the rules.

6.2.5.2 Components of the sensitivities-based method

The PRA’s proposal in Article 325e(3) states: *“By way of derogation from point (b) of paragraph 2, an institution may with the prior permission of the PRA to the extent and subject to any modifications set out in the permission, subject all the positions of instruments without optionality to the own funds requirements referred to in points (b) and (c) of paragraph 1.”*

The reference should be to the delta and not vega risk.

Recommendation (s)

The Industry would recommend the text should be amended as below:

By way of derogation from point (b) of paragraph 2, an institution may with the prior permission of the PRA to the extent and subject to any modifications set out in the permission, subject all the positions of instruments without optionality to the own funds requirements referred to in points ~~(b)~~ (a) and (c) of paragraph 1.

6.2.5.3 Risk weights for general interest rate risk

The PRA's proposal in Article 325ae(3) states: *"The risk weights of all risk factors relating to the currencies included in the most liquid currency sub-category as referred to in point (b) of paragraph 8 of Market Risk: Internal Model Approach (CRR) Part Article 325bd and to the domestic currency of the institution shall be the risk weights referred to in Table 3 and paragraph 2 divided by $\sqrt{2}$."*

The PRA's proposal introduces an error by referring to point (b) which is for FX pairs. The reference should be to point (a) which pertains to GIRR.

Recommendation (s)

The Industry would recommend the text should be amended as below:

The risk weights of all risk factors relating to the currencies included in the most liquid currency sub-category as referred to in point ~~(b)~~ (a) of paragraph 8 of Market Risk: Internal Model Approach (CRR) Part Article 325bd and to the domestic currency of the institution shall be the risk weights referred to in Table 3 and paragraph 2 divided by $\sqrt{2}$.

6.2.5.4 Intra-bucket correlations for credit spread risk for non-securitisation

The PRA's proposal in Article 325ai(1) states: *" $\rho_{kl}(name) = 1$ where the two names of sensitivities k and l are identical, otherwise it shall be equal to 35%,"*

The PRA text doesn't distinguish correlations for index buckets 17 and 18. BCBS requires $\rho_{kl}(name) = 0.80$

Recommendation (s)

The Industry recommends the PRA rules should be amended and align to BCBS and CRR3, proposal as follows:

$\rho_{kl}(name) = 0.80$

6.2.5.5 Intra-bucket correlations for credit spread risk for non-securitisation

The PRA's proposal in Article 325ai(2) states: *"The correlation parameters referred to in paragraph 1 of this Article shall not apply to bucket 18 in Table 4 of paragraph 1 of Article 325ah. The own funds requirement for the delta risk aggregation formula within bucket 18 in Table 4 of paragraph 1 of Article 325ah shall be equal to the sum of the absolute values of the net weighted sensitivities allocated to that bucket: $Kb(bucket\ 18) = \sum |WSk|$ "*

The PRA introduces an error by referring to bucket 18 instead of bucket 16.

Recommendation (s)

The Industry recommends the PRA rules should be amended as follows:

The correlation parameters referred to in paragraph 1 of this Article shall not apply to bucket ~~18~~16 in Table 4 of paragraph 1 of Article 325ah. The own funds requirement for the delta risk aggregation formula within bucket ~~18~~16 in Table 4 of paragraph 1 of Article 325ah shall be equal to the sum of the absolute values of the net weighted sensitivities allocated to that bucket:

$$Kb(bucket\ ~~18~~16) = \sum |WSk|$$

6.2.5.6 Risk weights for credit spread risk for securitisations not included in the ACTP

The PRA's proposal in Article 325am(3) states: *"The assignment of a risk exposure to investment grade or non-investment grade and unrated shall be on the basis of an external credit assessment by a nominated ECAI of the corresponding issuer. For an individual issuer for which a credit assessment by a nominated ECAI is not available, an institution using the approach referred to in the Credit Risk: Internal Ratings Based Approach (CRR) Part shall map the internal rating of the issuer to one of the external credit assessments."*

The PRA introduces an error by requiring credit rating to be assigned based on 'Issuer' rating. The securitisations are rated for 'tranches' not 'issuer'. Furthermore, IG vs. Non-IG split is not required per the Securitisation DRC framework.

Recommendation (s)

The Industry proposes to remove this requirement as it is not relevant to securitisations framework.

6.2.5.7 Vega and curvature risk weights

The PRA's proposal in Article 325ax(3) states: *"The share referred to in paragraph 2 shall be made dependent on the presumed liquidity of each type of risk factor in accordance with the following formula:*

$$RW_k = (\text{Value of risk factor } k) \cdot \min\{RW \sigma \sqrt{LH} \text{ risk class} \sqrt{10}; 100\% \}$$

The PRA requires $RW = \text{value of the risk factor} \times RW$. This is a duplication as value of the risk factor (i.e., implied vol) is already multiplied to the Vega sensitivity in article 325s.

Recommendation (s)

The Industry proposes that the multiplication with the 'value of the risk factor' should be removed from the risk weight calculation in article 325ax.

6.2.5.8 Vega and curvature risk weights

The PRA's proposal in Article 325ax(1) states: *"Vega risk factors shall use the delta buckets referred to in Subsection 1."*

The requirement contradicts the Foreign Exchange Vega risk factors definition requirement under article 325q. As per article 325q(2), the vega risk factors are defined as implied volatilities of exchange rates between all applicable currency pairs, whereas article 325q(1) defines delta risk factors against the reporting currency.

Recommendation (s)

The Industry proposes the below amendment to ensure consistency between the risk factor definition and the bucketing structure for FX Vega risk factors.

"Vega risk factors shall use the delta buckets referred to in Subsection 1, except for Foreign Exchange Vega risk buckets which shall use the buckets between the underlying currency pairs."

6.2.5.9 Liquidity Horizons

The PRA's proposal in Article 325bd(7) – table 2 seems to have introduced an error in the text for Credit Asset class, where refers to the EU 'member states'.

Recommendation (s)

The Industry proposes the below amendment.

Broad categories of risk factors	Broad sub-categories of risk factors	Liquidity horizons	Length of the liquidity horizon (in days)
Credit spread	Central government, including central banks, of Member States	2	20
	Covered bonds issued by credit institutions in Member States (Investment Grade)	2	20

→

Broad categories of risk factors	Broad sub-categories of risk factors	Liquidity horizons	Length of the liquidity horizon (in days)
Credit spread	Central government, including central banks, of Member States	2	20
	Covered bonds issued by credit institutions in Member States (Investment Grade)	2	20

6.2.5.10 Calculation of stress scenario risk measure

The PRA's proposal in Article 325bk(7) states: *"By way of derogation from paragraph 3 of this Article, where an institution has simultaneously assessed the modellability of more than one non-modellable risk factor by assessing the modellability of a single standardised bucket in accordance with paragraph 6 of this Article, the institution may instead develop joint extreme scenarios of future shock for all risk factors in that single standardised bucket for the purposes of paragraph 2 of this Article such that the resulting stress scenario risk measure is at least as conservative as:"*

The PRA text introduces an error by referring to paragraph 6 of article 325bk which does not talk about the standardised bucketing.

Recommendation (s)

The Industry believes that the PRA's intention is to cross refer to article 325be paragraph 9(b) which defines standard buckets for the risk factor eligibility test. Thus, we propose the PRA to update the requirement with the correct reference.

6.2.5.11 Documentation required in respect of changes and extension permission applications and notifications

The PRA's proposal in Annex 2 part c states: *"For the purposes of notifying the PRA in accordance with paragraph 4 of Article 325azx for changes or extensions to the use of internal models or changes to the institution's choice of the subset of the modellable risk factors which are not material, institutions shall submit documentation referred to in points (a), (b), (c), (f) and (g) of Part 3 of this Annex."*

Recommendation (s)

The Industry believes this is an incorrect reference as Part 3 doesn't exist. Thus, we propose the PRA to update the requirement with the correct reference.

For the purposes of notifying the PRA in accordance with paragraph 4 of Article 325ax for changes or extensions to the use of internal models or changes to the institution's choice of the subset of the modellable risk factors which are not material, institutions shall submit documentation referred to in points (a), (b), (c), (f) and (g) of Part 3C of this Annex.

6.2.5.12 Curvature Risk Weights

The PRA's proposal in Article 325ax misses the rules for determining curvature RWs.

Recommendation (s)

The Industry recommends Article 325ax to be amended to add the relevant rules (paragraphs 4, 5, and 6 from EU CRR2 should be introduced in the PRA rules)

4. Buckets used in the context of delta risk in Subsection 1 shall be used in the curvature risk context unless specified otherwise in this Chapter.

5. For foreign exchange and equity curvature risk factors, the curvature risk weights shall be relative shifts equal to the delta risk weights referred to in Subsection 1.

6. For general interest rate, credit spread and commodity curvature risk factors, the curvature risk weight shall be the parallel shift of all the vertices for each curve on the basis of the highest prescribed delta risk weight referred to in Subsection 1 for the relevant risk class.

6.2.5.13 Commodity delta risk factors

The PRA's proposal in Article 325p(2) states: "An institution shall apply commodity delta risk factors to commodity sensitive instruments which shall be all the commodity spot prices per commodity type and per each of the following maturities: 0.25 years, 0.5 years, one year, two years, three years, five years, ten years, 15 years, 20 years, 30 years. An institution shall only consider two commodity prices of the same type of commodity, and with the same maturity to constitute the same risk factor where the set of legal terms regarding the delivery location are identical."

Recommendation (s)

The Industry recommends the tenor "0 years" should be added to other tenors used for the commodity delta risk factors (consistent with MAR 21.13 paragraph (1) and FAQ 2).

6.2.5.14 Calculation of the own funds requirement for the default risk for the ACTP

1. The PRA's proposal in Article 325ad(1) states: *"An institution shall multiply net JTD amounts by:*
 - (a) for tranching products, the default risk weights corresponding to their credit quality as specified in paragraphs 1 and 2 of Article 325y;*
 - (b) for non-tranching products, the default risk weights referred to in paragraph 1 of Article 325aa."*

Recommendation (s)

The Industry believes this is a typo and should be amended as follows:

1. *An institution shall multiply net JTD amounts by:*
 - (a) for tranching products, the default risk weights referred to in paragraph 1 of Article 325aa.*
 - (b) for non-tranching products, the default risk weights corresponding to their credit quality as specified in paragraphs 1 and 2 of Article 325y;*

6.2.6 FRTB Survey

ISDA conducted a survey on FRTB covering a broad range of topics including IMA applications, strategic capitalization, SA authorisations, and CVA methodologies.

We received 40 responses from banks, which have a global footprint across 16 countries and 5 regions, of which 23 are G-SIBs.

A subset of responses from PRA supervised firms (i.e., firms headquartered in the UK or firms with subsidiaries subject to PRA supervision) consists of 17 banks, 12 of which are G-SIBs. In this section we present the results of the survey for PRA supervised firms.

The key themes that have emerged from the survey in support of the Industry's response to the PRA Consultation Paper are as follows:

6.2.6.1 Internal Model applications

Nearly all (97.5%) participant firms have internal model permissions under Basel 2.5, while under FRTB the number of banks planning to adopt internal models is significantly lower (52.5%). (see Figures 1 & 2) Further to this, the trading desk coverage of internal models will also significantly reduce, down from an average of 86% under Basel 2.5 to only 31% under FRTB (see Figure 3).

For PRA supervised firms, there is a less significant decrease in internal model coverage (82% to 45%) versus the global sample, due to the prevalence of GSIBs (see Figure 4).

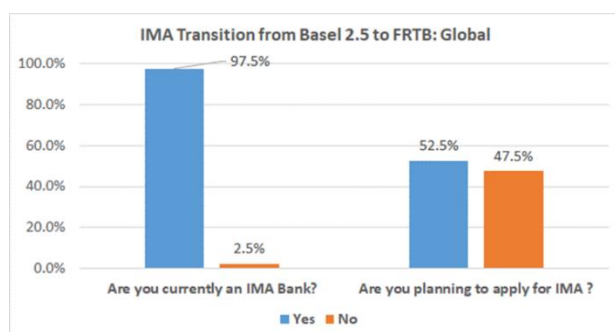


Figure 1

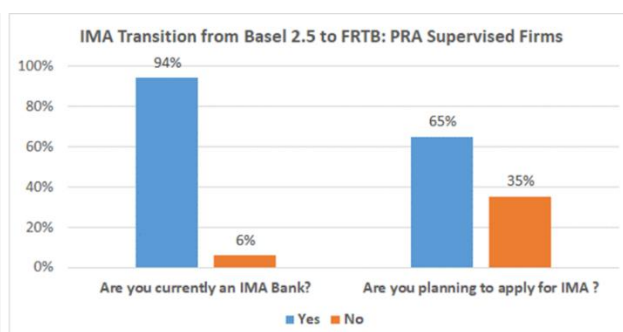


Figure 2

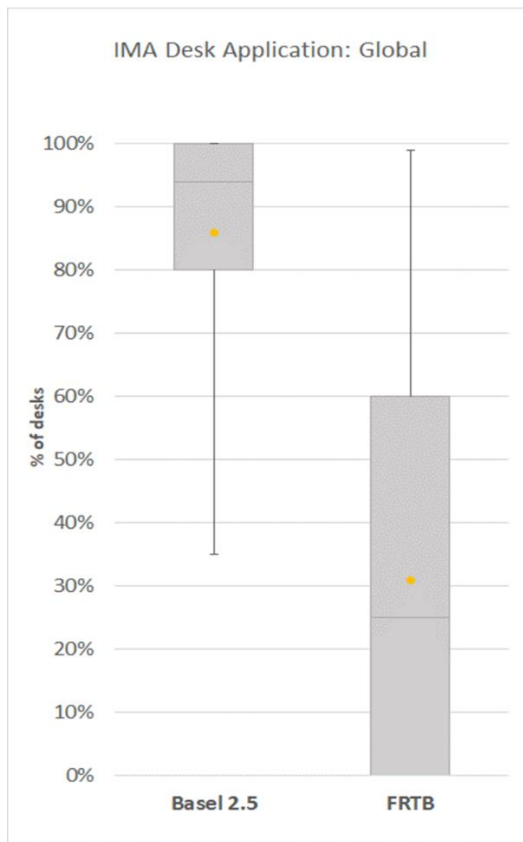


Figure 3

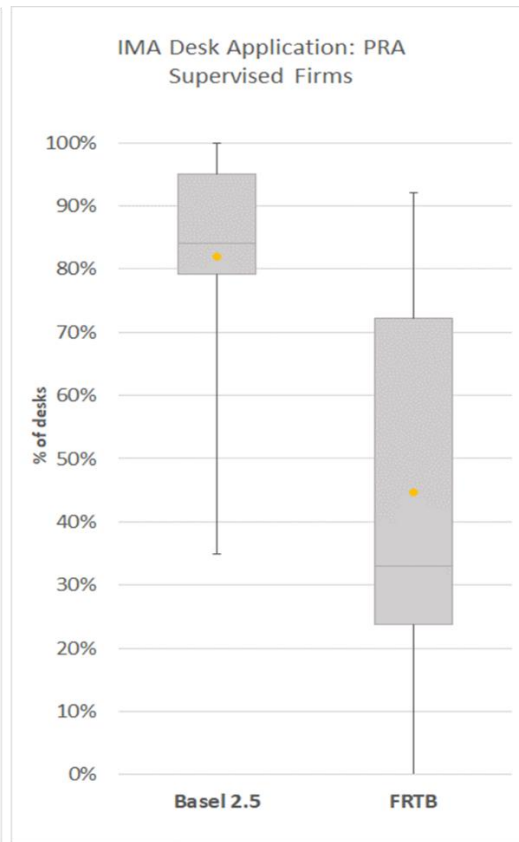


Figure 4

6.2.6.2 IMA Application timelines

92% of firms confirmed that a staggered application process (e.g., initial submission excluding PLAT data) would be beneficial and would potentially allow them to submit an IMA application sooner than they are currently planning to (see Figure 5).

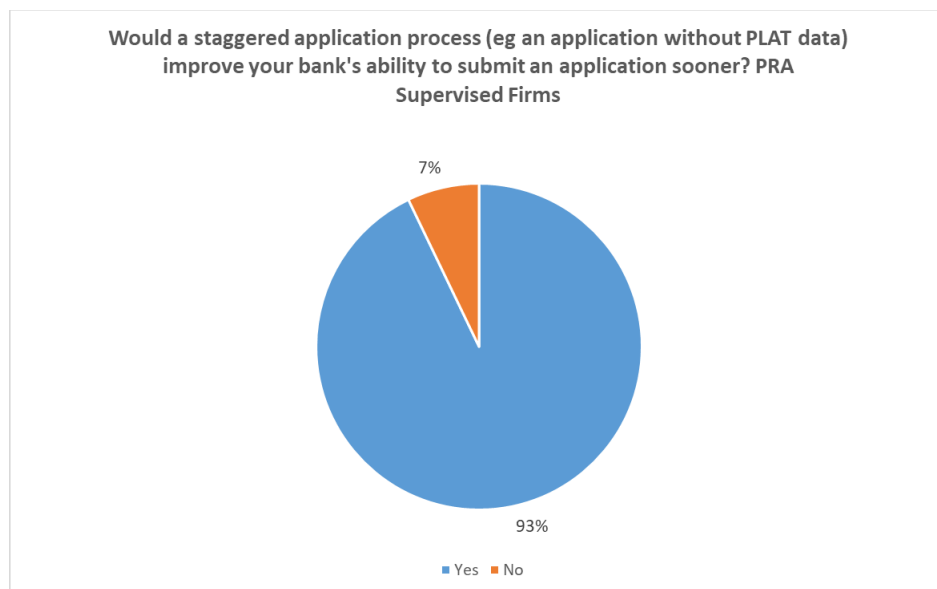


Figure 5

6.2.6.3 Cost

The cost & complexity associated with IMA implementation is reported as the biggest driver of uncertainty in respect of IMA adoption under FRTB (see Figure 6).

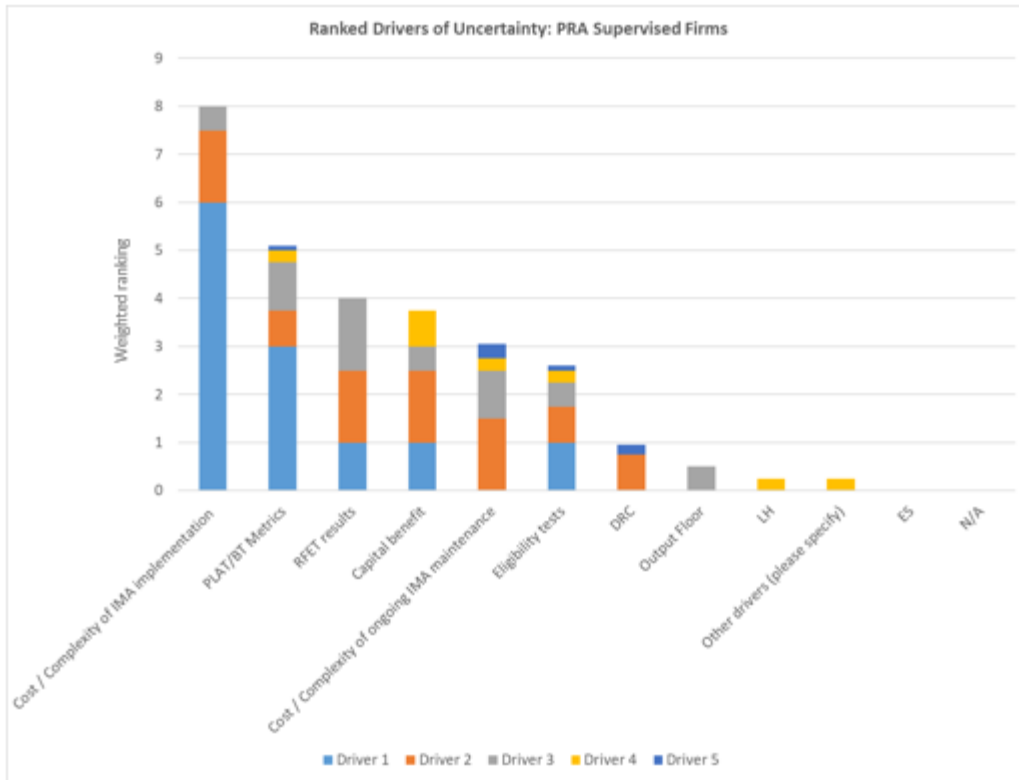


Figure 6

Lack of observable market liquidity as required by RFET is one of the main challenges facing banks who want to adopt IMA under FRTB. RFET failures are common across a broad range of risk factors and maturities, even for many risk factors that would be associated with relatively liquid markets (see Figure 7).



Figure 7

The risk factor groups exhibiting liquidity challenges include:

- volatilities (ATM and ITM/OTM) for most risk classes across most maturities
- long-dated interest rate yield curves (including G10 currencies)
- inflation yield curves across all maturities
- equity dividend and repo across all maturities
- corporate credit spreads across all maturities
- commodity spot and forward prices

This survey responses also indicate a trend towards the use of data vendors as a potential source of mitigation, with 91% of firms pursuing internal models indicating that they intend to use at least two data vendors (see Figure 8). A majority of members (63%) also confirmed that they intend to use quotes to improve RFET results (see Figure 9).

Alternatively, data pooling does not appear to be at this point in time a preferable solution, with 73% of members participating in the survey indicating that they do not intend to participate in any data pooling initiatives (see Figure 10).

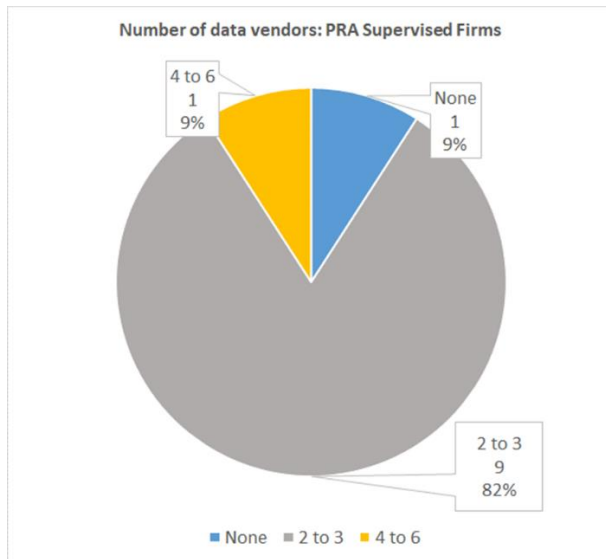


Figure 8

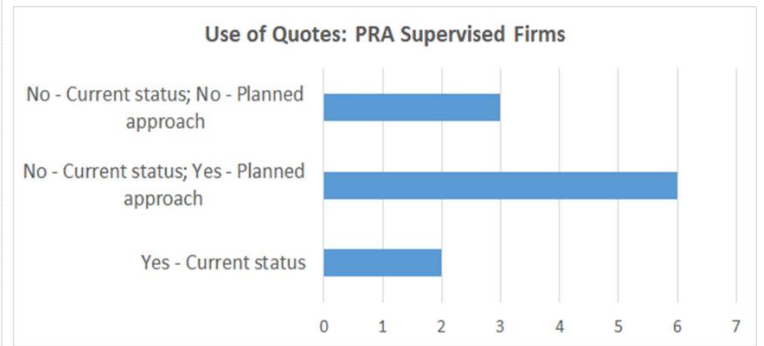


Figure 9

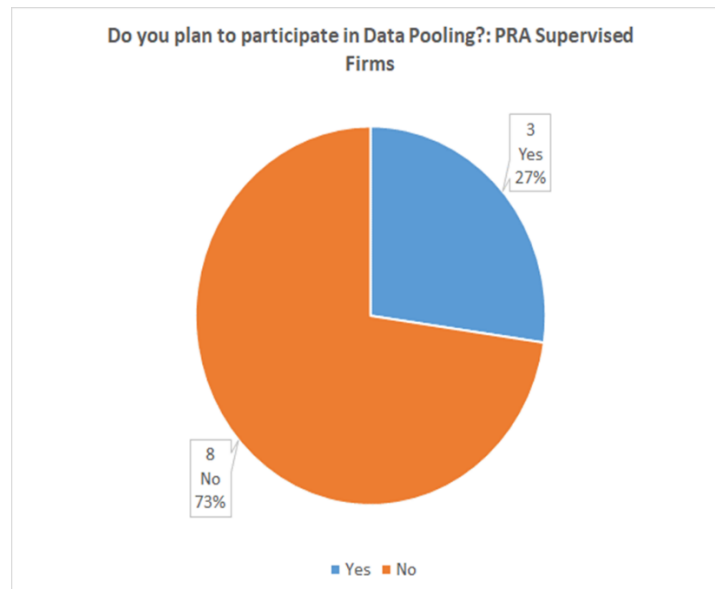


Figure 10

6.2.6.4 PLAT

PLAT features prominently in the survey results as one of the main drivers of uncertainty in respect of the adoption of internal models (see Figure 6 above) and is regarded as being one of the most challenging implementation aspects of the framework (see Figure 11).

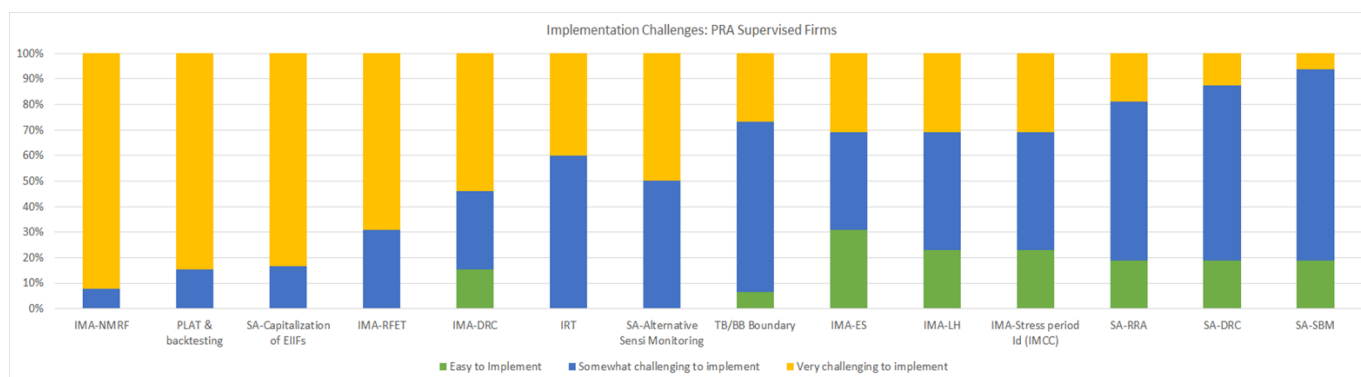


Figure 11

6.2.6.5 NMRF as an internal risk metric

Most FRTB risk indicators have meaningful purposes in either capitalizing for actual market risk or providing metrics to ensure the robust capture of risk. RFET and its associated capital charge as part of NMRF in its current form is an exception. The survey shows that most firms (60%) don't plan to use NMRF as an internal risk metric, yet it remains the most challenging metric from an implementation perspective.

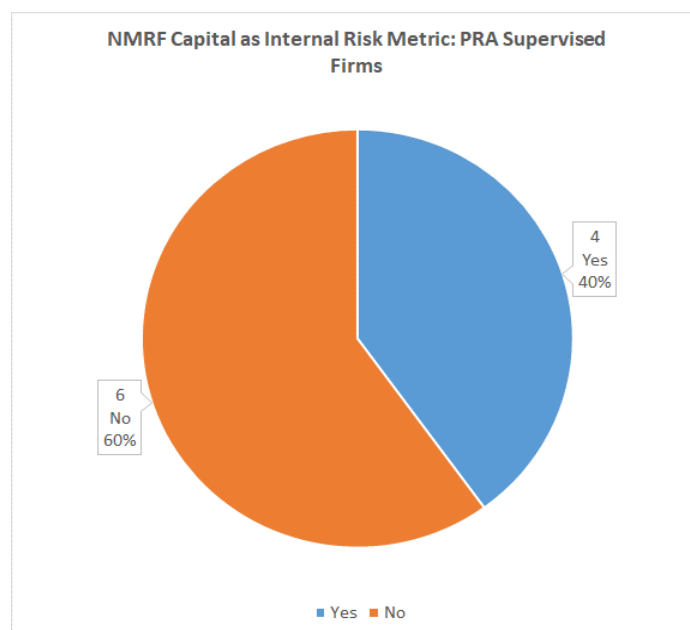


Figure 12

6.2.6.6 NMRF capitalization

Only 18% of PRA supervised firms have confirmed that they intend to use only Full Revaluation approaches to calculate NMRF capital charges (see Figure 12).

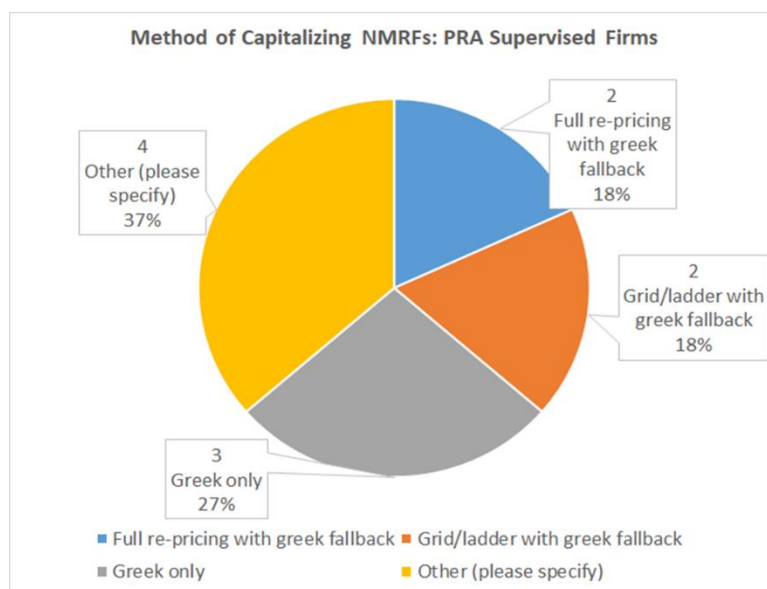


Figure 13

6.2.6.7 NMRFs in backtesting

36% of firms plan to include NMRFs in the VaR used for both desk level and entity level backtesting, with a further 27% awaiting finalised rules. The current PRA proposal allows for the inclusion of NMRFs in VaR used for desk level backtesting and so the Industry recommends that this allowance is extended to cover entity level backtesting.

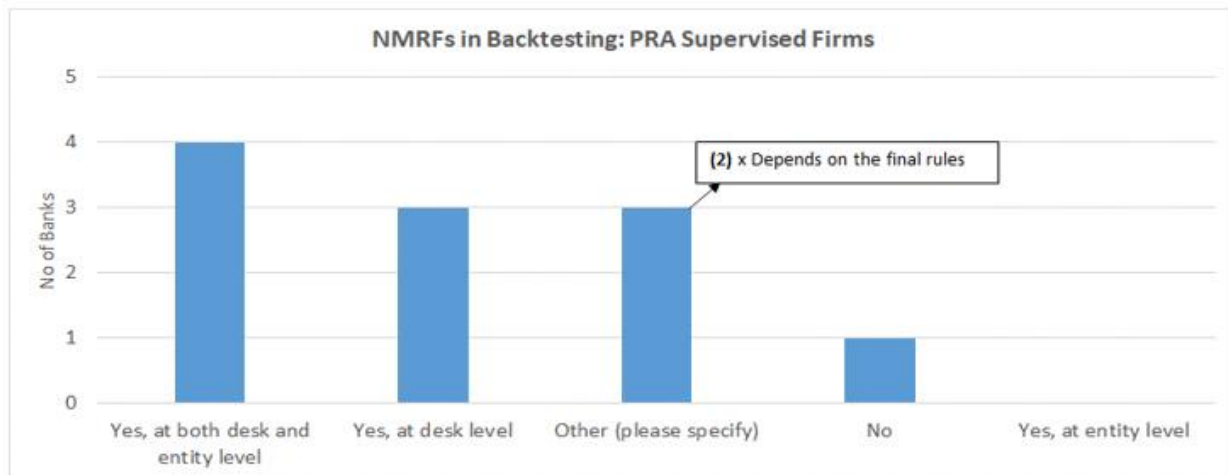


Figure 14

6.2.6.8 CIUs

The survey responses suggest that for the treatment of CIUs under the FRTB Standardised Approach, the mandate-based approach is not viable for most firms based on the current requirements. The prevalence of the use of the fallback approach among firms also suggests that many funds may not be well-served by the proposed approaches (see Figure 14).

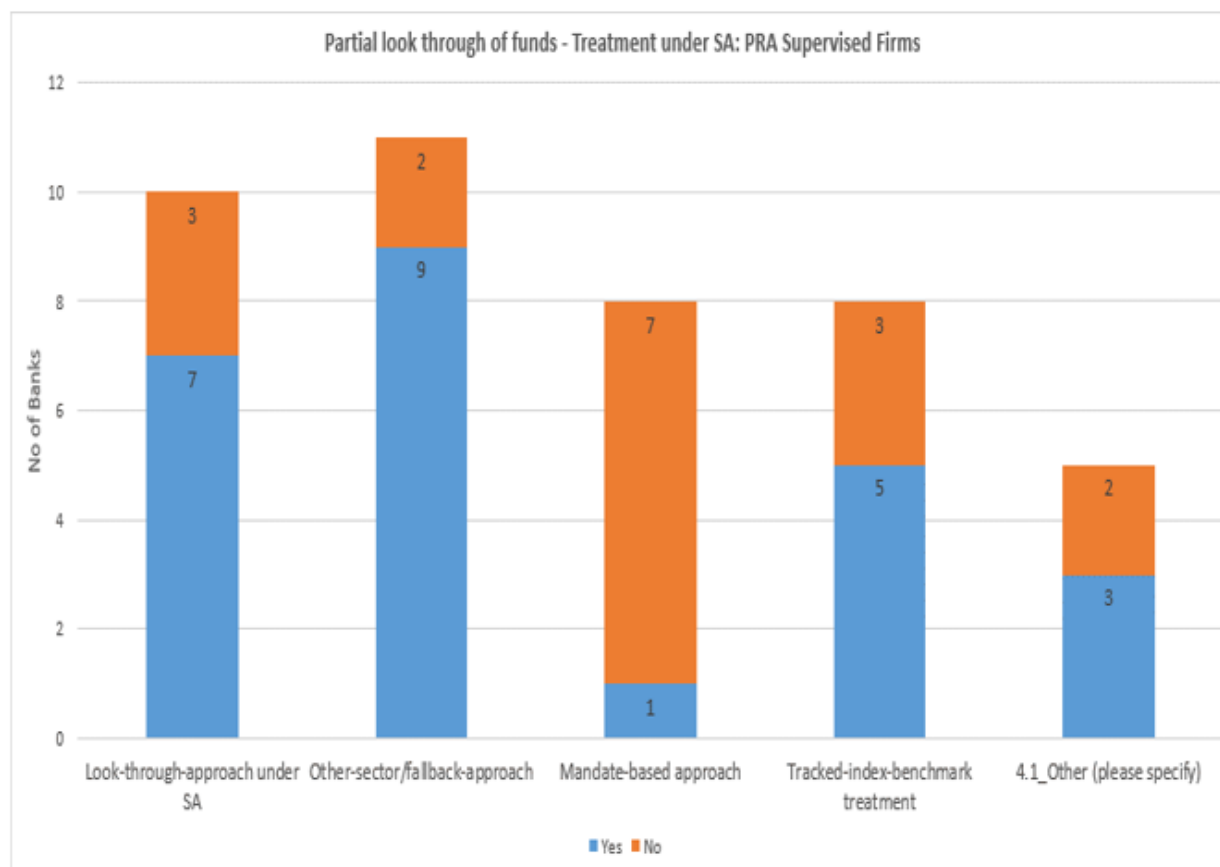


Figure 15

6.2.6.9 FRTB SA Authorisations

A majority of members (80%) indicated that they intend to apply to their supervisors for one or more authorisations under the FRTB SA (see Figures 15 & 16); with most intending to apply for the authorisation to use their own sensitivity definitions (across most asset classes) as this is used by their front office and risk management (see Figure 17). To facilitate standardized approval of authorisations and timely approvals, the Industry would like to propose:

1. A template for a consistent approval process
2. Define the types of “alternative” sensitivities for which regulatory approval would be required



Figure 16

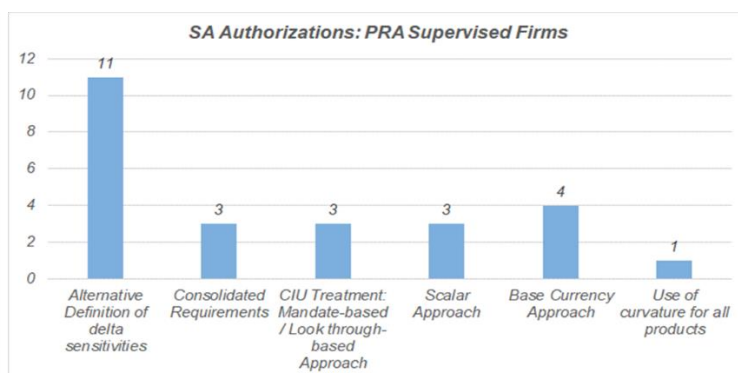


Figure 17

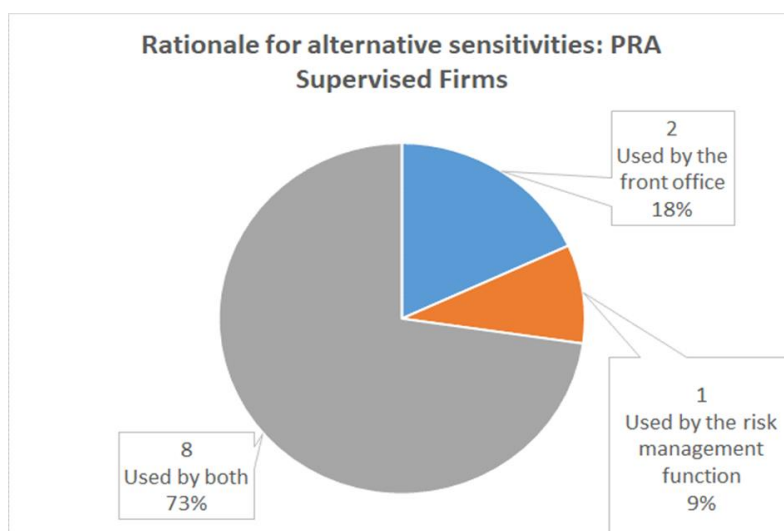


Figure 18

6.2.6.10 SA model production status

Responses indicate that 88% of PRA supervised firms have not yet brought their SA model to production standard.

47% of the PRA supervised firms expect to have completed their SA model by end of 2023, with a further 29% completing in H2 2024.

This may need to be considered in the context of the timing of the UK SA Benchmarking proposals.

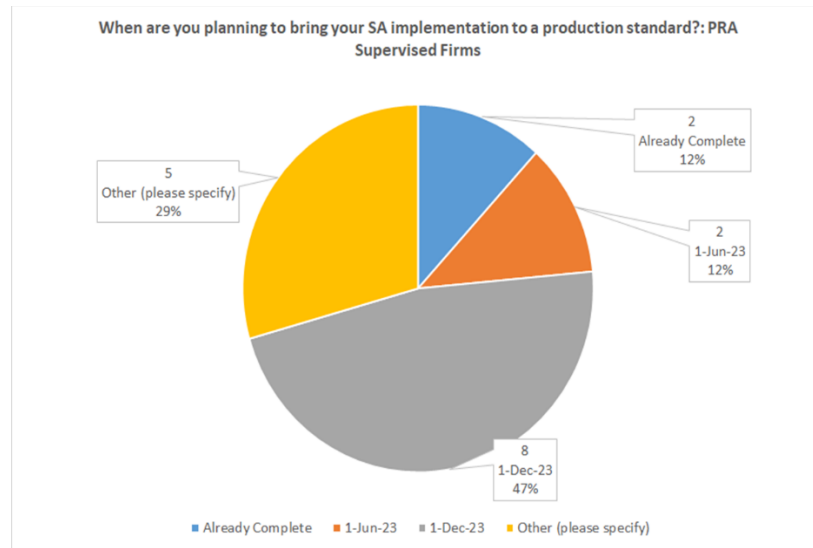


Figure 19

7 Chapter 7. Credit valuation adjustment and counterparty credit risk

Executive Summary

The Industry welcomes the opportunity to provide feedback on the revised Credit Valuation Adjustment (CVA) and Counterparty Credit Risk (CCR) frameworks.

Overall, we support many of the proposals from the PRA including the targeted changes that would better capture risk and support the competitiveness of the UK. These include, among other proposals, the introduction of a reduced 'alpha factor' of one for calculating exposures to non-financial counterparties and pension funds in the standardized approach to counterparty credit risk (SA-CCR) framework. We furthermore support the proposed increased granularity of risk weights in CVA with the introduction of a separate risk weight bucket for pension funds. Greater granularity in the CVA framework has long been an Industry recommendation, as it would bring improved risk sensitivity which is particularly important as the revised framework for CVA does not include advanced approaches for the calculation of CVA capital requirements.

The Basel 3.1 capital framework is an important element of preserving financial stability. However, it is equally important that capital requirements are in line with real economic risk incurred by banks. In light of that, the Industry believes that if there are no further amendments made to the CVA and CCR frameworks to improve risk sensitivity, it could result in significant impact on banks' capital requirements. Disproportionate capital requirements have an impact on banks' ability to provide key financing, liquidity, hedging services and products to end-users.

The Industry notes that the PRA has proposed not to follow the EU in providing an exemption from CVA capital requirements for trades with non-financial counterparties, pension funds, central banks, debt management offices, central and local governments. This proposal has a significant impact on the CVA risk RWA. To assess the impact of the proposed rule, the Industry conducted a Quantitative Impact Study (QIS)⁴⁹, which showed that under the BCBS 3.1 CVA risk framework, CVA risk RWA increase by 88% with the removal of exemptions.

In addition, the industry performed a targeted QIS⁵⁰ to further understand the impact of the CVA and CCR proposals in CP16/22. This highlighted that the PRA proposal to reduce pension funds risk weights would lead to a 5% decrease in CVA risk RWA compared to the BCBS methodology. Additionally, the study also assessed the impact of extending the PRA's proposed pension funds bucket to include all regulated and sovereign-backed financials. This is a proposal which the industry strongly advocates for given the overall increase in CVA risk RWA and the under-recognition of hedges in the framework. The results showed that the industry proposal would further reduce CVA risk RWA by 15%, which is incremental to the reduction observed due to PRA's proposal for pension funds. The Industry notes that even with the extension of the pension funds bucket to regulated financials and sovereign backed financials, there still remains a significant overall increase in CVA risk RWA.

⁴⁹ QIS exercise for COB December 2021 conducted for 7 banks (both UK and international) with significant operations in the UK market

⁵⁰ QIS exercise for COB June 2022 conducted for 5 banks (both UK and international) with significant operations in the UK market

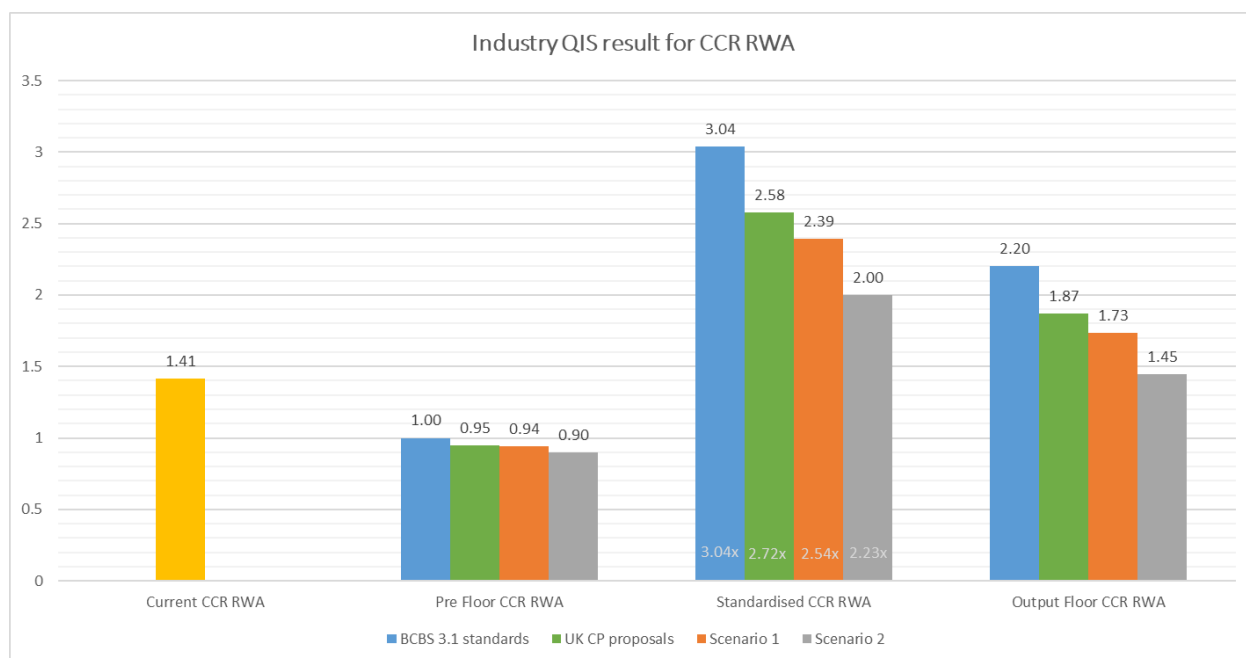
The revised QIS⁵¹ also investigated the impact of CCR RWA under a number of scenarios: the implementation of the BCBS 3.1 standards, the implementation of the PRA's CP 16/22 proposals, and 2 further scenarios in line with Industry recommendations.

- **Scenario 1:** The Industry scenario 1 is an incremental scenario on top of the PRA's CP 16/22 proposals. It requires banks to apply discount scalars to the risk weights under the standardized approach to credit risk (SA-CR). This is based on the Industry recommendation in section 7.2.4, '*M-factor read across to SA-CR, Slotting and Securitisation risk weights*'.
- **Scenario 2:** The Industry scenario 2 was an incremental scenario on scenario 1 which required banks to extend the application of the SA-CCR alpha factor to 1 for all counterparties.

The below graph shows a summary of the industry QIS results. Amounts are rebased to pre-floor CCR RWA under BCBS 3.1 standards, i.e. the pre-floor CCR RWA under BCBS 3.1 standards are set to 1 and all other amounts are expressed relative to this amount. This shows the impact of the UK CP 16/22 proposal and the industry scenarios compared to BCBS 3.1 standards. The BCBS 3.1 standards and the UK CP proposal includes the application of maturity factor cap under the IRB approach for netting sets capitalised under CVA framework which is not applied under the current framework. This is also consistent with the way the CVA risk QIS numbers have been presented in this CP response.

- **Current CCR RWA:** This shows the CCR RWA as per the current framework and permissible methods.
- **Pre-Floor CCR RWA:** The four bars in the graph show the CCR RWA before the application of the RWA output floor under the BCBS 3.1 standards, UK CP proposed rules, industry scenario 1 and 2 respectively. Pre-floor CCR RWA are lower than current CCR RWA primarily due to the impact of the maturity factor cap under IRB approach for netting sets capitalized under the basic approach (BA-CVA) or the standardized approach (SA-CVA).
- **Standardised CCR RWA:** The four bars represent the CCR RWA if only standardized methodologies are used for calculating the CCR RWA.
- **Output Floor CCR RWA:** The four bars represent the contribution of CCR RWA to the fully phased-in output floor, that is 72.5% of CCR RWA calculated solely using the standardized approaches.
- Amounts at the top of the bars show the impact of various scenarios on CCR RWA as compared to pre-floor BCBS 3.1 standards. The amounts presented at the bottom of the Standardised CCR RWA bars demonstrate the relative impact of using standardized method only compared to the corresponding pre-floor CCR RWA scenario.

⁵¹ QIS exercise conducted for COB June 2022 with 5 banks (both UK and international) with significant operations in the UK market



In summary, it was expected that there would be mitigating effects between the increase in CVA risk RWA versus CCR RWA due to the introduction of the maturity cap and the reduction of alpha factor for pension funds and NFCs. However, the graph above shows that any potential mitigation in CCR framework is undermined by the application of the output floor. Thus, both CVA and CCR revised frameworks result in an increase in RWA for the banks in aggregate.

Along with the PRA rules for implementation of the Basel 3.1 standards, the PRA has also published the Aggregated Cost Benefit Analysis (Appendix 7 to CP16/22). This cost benefit analysis (CBA) shows the direct costs that the PRA estimates will be placed on the Industry by implementing its proposed rules. Based on the CBA results, the total operational compliance costs are estimated to be **£4.9 billion**⁵² and the CVA framework accounts for £0.7 billion (or 14% of total costs for all firms), of which £0.6 billion (or 88% of total CVA costs) are incurred almost entirely by large banks.⁵³

The latest revisions in CP 16/22 have allowed for greater sensitivity in the determination of the CVA risk linked to specific exposures e.g., pension funds. Nonetheless, further changes to the framework are necessary to ensure that the rules are commensurate with the underlying risk. It is crucial that the revised framework meets its intended objectives to capture all CVA risks appropriately by recognizing the full potential of CVA hedges, aligning regulatory CVA risk with treatment of CVA risk from an accounting perspective under IFRS rules, and aligning with proposed revisions to the market risk framework.

The Industry Recommendations section details some of the below proposals for further revisions to the CVA and CCR framework:

⁵² Ibid.

⁵³ <https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/consultation-paper/2022/november/cp1622app7.pdf>, p. 16

- **Improve the calibration and granularity of risk weights (RWs) for financial counterparties:** Proposal to extend the proposed pension funds sub-sector to prudentially regulated financial entities and funds with similar risk profiles to PSA (see chapter 7.2.2.1).
- **Exemptions on CVA intragroup transactions:** Proposal to simplify the framework and allow UK institutions that are subsidiaries of non-UK banking groups to maintain their ability to exempt transactions with group companies outside a UK consolidated group (see chapter 7.2.2.2).
- **SA-CCR scope and application:** Proposal to re-calibrate alpha to 1 for all applications of SA-CCR: un-floored CCR RWAs, output floor CCR RWAs, Leverage Ratio and Large Exposure. Permit IMM for Large Exposure requirements (see chapter 7.2.3).
- **M-Factor read across to Standardised Approach for Credit risk (SA-CR), Slotting and Securitisation risk weights:** Proposal to adjust the risk weights for positions in the scope of the CVA risk framework to avoid a double count for downgrade risk (see chapter 7.2.4).
- **Adjustment to the SA-CR risk weights for SFT:** Proposal to amending the SA-CR treatment of SFTs by introducing a short-term maturity adjustment (see chapter 7.2.5).
- **Alignment between regulatory and accounting CVA:** Proposal to allow banks to reflect key legal terms within the calibration of MPoR resulting in a lower MPoR (see chapter 7.2.2.3).
- **Improve the recognitions of CVA Index hedges:** Proposal for better recognition of indices used to hedge CVA risk, particularly in terms of their usage linked to the hedging of systemic credit risk (see chapter 7.2.2.4).
- **SA-CVA Application:** The Industry seeks guidance from the PRA on what needs to be included in the application for SA-CVA permission and encourages the PRA to publish the final SA-CVA rules much in advance so that firms can complete a detailed self-assessment and submit the application by 1 January 2024 (see chapter 7.2.2.5).

Herein the structure of this section is the following:

7.1 PRA consultation Questions

7.2 Industry Recommendations – Credit valuation adjustment and counterparty credit risk

7.1 PRA Consultation Questions

The Industry has provided below responses to the four targeted questions related to section 7 of the PRAs consultation paper.

7.1.1 Question 43

Do you consider the proposed CVA transitional arrangement appropriate from risk and operational perspectives?

For the counterparties exempted from CVA risk own funds requirement under the current regulations, the PRA proposes to apply a transitional arrangement to CVA risk capital requirements for legacy trades with those counterparties (sovereign and supranational agencies, NFC- counterparties, and Pension Scheme Arrangements “PSA’s”).

The Industry believes that some firms could have significant practical and operational challenges in separating legacy trades and new trades in their counterparty risk calculation systems. The separation between exempted legacy trades and new trades during the transitional period would result in operational challenges when calculating the regulatory CVA risk sensitivities for SA-CVA, or SA-CCR/IMM EAD exposures for BA-CVA. Both exposure calculations are determined at a netting set level and may reflect collateral and margining associated with the whole netting set.

Furthermore, by removing legacy trades from exposure estimates, a disconnect arises between regulatory CVA risk and accounting CVA risk which falls short on one of the key objectives of the new capital framework. This potential misalignment could impact the transitional approach and also raise several issues regarding collateral splits and hedge allocations. Given the exemption of the legacy transactions for the transitional period, there would also be issues in determining if any trade lifecycle events such as partial unwinds etc. should be considered as a material economic change which results in the legacy trade being re-classified as a new trade, and thus a need for the trade to move back in scope of CVA risk RWA.

We believe the changes to CVA risk RWA need to be considered in combination with those for CCR RWA, and where there is likely to be a material impact due to removal of CVA risk exemptions taken in combination with the other changes, it may be practical to consider a simplified form of temporary taper relief over the phase-in period for firms which require it for operational reasons. We highlight such a proposal in the response to question 44 given that the PRA does not expect firms to split the netting set and hedging into legacy and new trades, and re-run the SA-CCR calculation for only the new trades to determine the exposure that would feed into the CVA calculation (i.e. BA-CVA in this case).

Where firms are willing to support the carve out of legacy trades, they should also have the ability to include a subset of legacy trades into the regulatory CVA scope, for example if this supports their accounting and regulatory CVA alignment, whilst leaving the other legacy transactions out of scope. Legacy transactions initially out of scope would be brought in scope at the end of the transitional period at the latest.

7.1.2 Question 44

Do you consider the SA-CCR transitional arrangement appropriate from risk and operational perspectives?

The PRA proposes that firms electing to calculate CVA risk RWA excluding legacy trades will be required to hold additional capital in Pillar 1 equal to the day 1 capital benefit from the reduction of the alpha factor for PSA and NFC counterparties. Furthermore, this capital benefit should be calculated as the capital requirements corresponding to the reduction of CCR RWAs based on the differential SA-CCR exposure (“alpha add-on”) and applicable risk weights from the credit risk framework. The additional Pillar 1 capital charge would reduce linearly over the five-year transitional period, or until legacy trades are included in the CVA risk RWA calculations. After the five-year period, all the legacy trades would need to be reintegrated within the scope of CVA risk.

The Industry believes that, whilst not challenging to implement, the transitional arrangement proposed for SA-CCR alpha should be reviewed in the wider context of those proposed for CVA risk. The operational and risk management implications associated with the proposed transitional arrangement for CVA risk coupled with the significant increase of CVA risk capital requirements – due to the combined impact of the new methods and the loss of some exemptions - would warrant an alternative approach of temporary relief over the phase-in period for firms which have significant practical and operational challenges in separating legacy trades.

To ensure that no misalignment arises between the accounting and regulatory CVA risk scope, firms should have the option to calculate CVA risk and CCR RWAs on a fully loaded basis from day 1, i.e. inclusive of all the new provisions. To mitigate the combined material impact of the new CVA risk framework and the loss of exemptions with sovereign and supranational agencies, NFC, and PSA counterparties, we propose CVA risk RWAs to be phased-in over a transitional period of 5 years from the implementation of the new framework.

Based on the Industry Quantitative Impact Study (QIS)⁵⁴, it was seen that the CVA risk RWA under the revised BCBS framework without exemptions was 88% higher than the revised BCBS framework with exemptions. This broadly indicates that the revised RWA without exemptions is twice the RWA with exemptions. So, to mitigate the impact of this increase on CVA risk RWA for the transitional period, the Industry proposes a starting point of the discount scalar of 50% for the phase in period of 5 years.

To implement the phase-in period, we propose the following calibration phase-in arrangement:

Date	CVA risk calibration
1 Jan 2025	50%
1 Jan 2026	60%
1 Jan 2027	70%
1 Jan 2028	80%
1 Jan 2029	90%
1 Jan 2030	100%

⁵⁴ QIS exercise for COB December 2021 conducted for 7 banks (both UK and international) with significant operations in the UK market

During each year of the phase-in period, CVA risk requirements would be set by the output of the new CVA risk methods with no legacy exemptions, multiplied by the corresponding CVA risk calibration percentage. For example, from 1 Jan 2028 until 31 Dec 2028, CVA risk requirements would be set as 80% of the output of the new CVA risk methods.

Firms choosing to opt for the alternate arrangement proposed by the Industry would establish a semi-annual process where the future CVA risk capital requirement is compared to that as of Jan 2025. For comparability over time and for the purpose of this process, the CVA risk capital requirements should be calculated under the reduced BA-CVA method, that is without hedges, on the full portfolio, and with SA-CCR exposures only.

To cap the benefits of the proposed CVA risk calibration scalars, that is $\omega(T)$ ranging from 50% to 100%, to the proportion of CVA risk capital requirement as of Jan 2025, the following formula will be used to calculate an equivalent capped scalar $\omega_{\text{capped}}(T)$ ranging from $\omega(T)$ to 100%

$$\omega_{\text{capped}}(T) = \max \left(\omega(T), \frac{K_0}{K_T} \cdot \omega(T) + \frac{(K_T - K_0)}{K_T} \cdot 100\% \right)$$

Where: K_0 is the CVA risk capital requirement as of 01 Jan 2025 and K_T is the CVA risk capital requirement calculated at time T post Jan 2025 using the reduced BA-CVA method with SA-CCR EAD.

During the transitional periods, CVA risk requirements would be set by the output of the new CVA risk permissible methods, including SA-CVA, eligible hedges, and no legacy exemptions, multiplied by the corresponding calibration scalar $\omega_{\text{capped}}(T)$.

We consider that this approach would allow some supervised firms to keep a better alignment between CVA risk capital and the underlying economic risk by retaining all covered transactions and their eligible hedges within the scope of calculations and incentivise prudent risk management throughout the phase-in period. Furthermore, it would ensure consistency and comparability of RWAs across firms irrespective of size of the legacy portfolio.

Summarising the two proposals in the table below – the proposal by the PRA and the alternate Industry proposal which some firms might opt for given the reduced operational burden and alignment of the regulatory and accounting CVA risk calculations.

PRA proposal for CVA and CCR Transitional Arrangement	Industry proposal for CVA and CCR Transitional Arrangement
- For the counterparties which were earlier exempted from CVA risk RWA calculations, firms can elect to exclude legacy trades (traded before 1 Jan 2025) with those counterparties from CVA risk RWA calculation for a period of 5 years. - Since SA-CCR exposure groups all trades with a counterparty, firms would be	- Firms should calculate CVA risk RWA on a fully loaded basis i.e., without exempting any legacy trades for the transitional period. - To avoid a cliff edge impact due to the combined impact of new CVA framework and loss of exemptions with sovereign and supranational agencies, NFC and PSA, there

permitted to apply an alpha factor of 1 on both legacy and new trades with pension funds and non-financial counterparties. However, firms electing to exclude legacy trades will need to hold additional pillar 1 capital equal to day 1 capital benefit from reduction of alpha for PSA and NFC counterparties. 3. The additional Pillar 1 charge would reduce linearly over the five-year transitional period or until legacy trades with counterparties with alpha equal to 1 are included in the CVA risk RWA calculation.	should be a phased-in approach for the transitional period of 5 years by applying a discount scalar on the fully loaded CVA risk RWA. The discount scalars would be as per below: - 50% from 1 Jan 2025 to 31 Dec 2025 - 60% from 1 Jan 2026 to 31 Dec 2026 - 70% from 1 Jan 2027 to 31 Dec 2027 - 80% from 1 Jan 2028 to 31 Dec 2028 - 90% from 1 Jan 2029 to 31 Dec 2029 - 100% from 1 Jan 2030. 3. Any additional CVA capital requirement in excess of the CVA capital requirement calculated as of 01 Jan 2025 will not benefit from the scalars proposed in this approach and will be capitalised at 100%. For comparability of CVA risk RWA over years, the RWA should be calculated under the BA-CVA method on the full portfolio without any hedges.
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Furthermore, when the SA-CCR standards were implemented, the PRA noted⁵⁵ that, given CVA risk exemptions, a premature reduction of the SA-CCR alpha multiplier would lead to material under capitalisation of risks. However, in line with recent comments about SA-CCR as overly conservative for some counterparties, we believe that the proposed provisions to reduce alpha should be introduced for other applications of SA-CCR in Leverage Ratio and Large Exposures for derivative contracts and long-settlement transactions. Also, to establish a level playing field across jurisdictions, CCR internal models should be reinstated as permissible methods for Large Exposures calculations.

Recommendation(s)

As an alternative option to the PRA's proposed transitional arrangements, firms that have significant practical and operational challenges in separating legacy trades should be able to phase-in CVA risk RWAs over a transitional period of 5 years based on linearly increasing calibration factor for firms which have significant practical and operational challenges in separating legacy trades.

Any phase-in RWA arrangement based on SA-CCR should not impact Leverage Ratio and Large Exposure requirements. Thus, the SA-CCR transitional arrangement ('alpha add-on') linked to the CVA risk transitional arrangement should not be applied to Leverage Ratio and Large Exposures requirements.

To ensure a level playing field across jurisdictions and in recognition of SA-CCR as overly conservative for some counterparties, reduce alpha for PSAs and NFCs when SA-CCR is applied to Leverage Ratio and Large Exposure capital requirements, and permit IMM banks to use internal models for Large Exposure requirements from June 2023.

⁵⁵ See section 9.22 of <https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/policy-statement/2021/july/ps1721.pdf?la=en&hash=4BD47B3FF7D0A9ACBA6A7CBD213AAC25E332975C#page=36>

7.1.3 Question 45

To what extent do you consider the targeted recalibration on risk weights for pension funds and the proposed reduction in the SA-CCR alpha factor to be appropriate?

The Industry welcomes areas where the PRA has proposed amendments for PSAs in the calculation of CVA RWA and CCR RWA.

We are supportive of the PRA's proposal to recalibrate the risk weights for PSAs in the CVA risk framework compared to BCBS standards and consequently introduce an additional sub-sector for PSAs with lower risk weights within the Financials sector bucket.

The Industry also welcomes the reduction of the Alpha Factor to 1 for PSAs and non-financial counterparties. However, we encourage the PRA to reconsider the application of the Alpha factor in the SA-CCR exposure calculation more broadly. It is proposed that in addition to setting alpha to 1 for PSAs and non-financial counterparties, the alpha factor should be reduced to 1 for all counterparty types.

7.1.4 Question 46

To what extent do you think the proposed CVA and SA-CCR package appropriately aligns the risks with the capital requirements for derivatives transactions?

The Industry strongly supports the competitiveness of the UK and welcomes areas where the PRA has proposed amendments to CVA and SA-CCR to improve risk sensitivity, such as the introduction of an additional sub-sector bucket for PSAs, alignment with BCBS to introduce a new 'index bucket' for the counterparty credit spread risk class and reduction of alpha factor from 1.4 to 1 for transactions with PSAs and non-financial counterparties. However, the Industry believes that consideration should also be given to some additional proposals regarding the granularity of risk weights for regulated financials for CVA and application of alpha factor in the calculation of SA-CCR for all counterparty types.

For the calculation of CVA RWA, all financials (except PSAs) are grouped in a same sector bucket attracting the same risk weights irrespective of the type of entity and risk profiles. This sector is very broad and covers a diverse set of counterparties ranging from highly regulated institutions (such as UCITS, commercial and investment banks) to unregulated and highly leveraged institutions (e.g., hedge funds, private equity). We recommend reconsidering the granularity of risk weights for financials sector bucket, since the risk weights for regulated financial institutions should be lower than the risk weights assigned to the financials bucket i.e., 5.0% for IG and 12.0% for HY and NR entities. Thus, it is proposed that the PRA extends the definition of proposed PSAs sub-sector with lower risk weights to include regulated financial entities.

For the calculation of CCR RWA using the SA-CCR approach, the Industry welcomes the reduction of the alpha factor from 1.4 to 1 for transactions with PSAs and non-financial counterparties, but we encourage the PRA to reconsider the application of the alpha factor more broadly. The Industry recommends a re-calibration of the alpha factor to 1 for all applications of SA-CCR i.e., un-floored CCR RWA, Leverage Ratio and Large Exposures.

7.2 Industry Recommendations - Credit valuation adjustment and counterparty credit risk

7.2.1 Overall scope and calibration of capital requirements for derivative exposures

The Industry welcomes the reduction of the alpha factor from 1.4 to 1 for transactions with pension scheme arrangements (“PSA”) and non-financial counterparties (“NFC”), the recalibration of risk weights in the CVA risk framework compared to the BCBS standards for exposures to PSAs, and the continuation of the existing CRR exemption for intra-group and client clearing transactions from CVA capital requirements.

The Industry believes that the same arguments behind the reduction of alpha factor and recalibration of risk weights in the CVA risk framework apply to all pension fund entities that would otherwise have benefited from the CVA risk exemptions as defined in the UK on-shored EMIR Articles 2(10) and Article 89:

- UK PSAs⁵⁶
- EEA PSAs⁵⁷
- Entities established to provide compensation to members of PSAs in case of default⁵⁸

Failing to extend the pension fund concessions as proposed above would lead to a significant increase of capital requirements in relation to legacy transactions, and potentially inhibit new trades with these entities.

Recommendation(s)

In recognition to similar risk profiles, all entities that fall under UK on-shored EMIR article 2(10) Article 89 to benefit from a reduced alpha and reduced risk weights for CVA risk.

⁵⁶ See UK on-shored EMIR Article 2(10) at <https://www.legislation.gov.uk/ukxi/2019/1416/regulation/26>

⁵⁷ See UK on-shored EMIR Article 89(1) at <https://www.legislation.gov.uk/ukxi/2019/1416/regulation/34>

⁵⁸ See UK on-shored EMIR Article 89(1) at) at <https://www.legislation.gov.uk/ukxi/2019/1416/regulation/34>; which also refers to the original EU EMIR text at <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02012R0648-20220812&from=EN#page=133>

7.2.2 CVA risk framework – scope, methodology and application

7.2.2.1 *Improve the calibration and granularity of risk weights for financial counterparties*

Improve Risk weights for Regulated Financial for Counterparty Credit Spread

In response to the PRA's request for comments on re-calibration of the CVA risk framework, the Industry recommends that further consideration is given to how the counterparty credit spread component is designed and calibrated.

We believe amendments to the granularity of the counterparty credit spread component are critical to ensure that the calibration of the CVA risk framework reflects the underlying economic CVA risk. This is particularly relevant as the counterparty credit spread component is the dominant risk factor of the CVA capital requirement. Based on the most recent QIS⁵⁹ study under the UK CP 16/22 Basel 3.1 implementation, 73% of the SA-CVA risk RWA was from the counterparty credit spread (CCS) risk class when compared to the total SA-CVA RWA.

The Industry is supportive of the PRA's proposal to introduce an additional sub-sector for PSAs with reduced risk weights within the Financials sector bucket. However, we would propose to extend the definition of the new sub-sector to include all regulated financial entities. The combination of the new CVA risk methodology without sufficient recognition of hedges and the removal of certain exemptions proposed by the PRA, despite the adjustment proposed for PSAs, would lead to a significant increase in CVA capital requirements in excess to the underlying economic CVA risk. Therefore, we strongly encourage the PRA to improve risk sensitivity.

As noted above, we conducted an Industry Quantitative Impact Study⁶⁰ and the results showed that, under the revised framework, removing CVA exemptions increases CVA risk RWAs by 88%.

Based on an additional targeted QIS⁶¹, it was observed that the proposed PRA rules under CP16/22 would lead to a 5% decrease in CVA risk RWA as compared to the BCBS methodology. Additionally, the CVA risk RWA would reduce by a further 15% if the proposed pension funds bucket with lower risk weights was extended by the PRA to include all regulated financials and sovereign backed financials.

In the revised CVA risk framework, acknowledging the proposed treatment for PSAs, financial entities are grouped in the same sector bucket attracting the same risk weights irrespective of the type of the entity and distinct risk profiles. This sector bucket is very broad, encompassing a diverse set of

⁵⁹ QIS exercise for COB June 2022 conducted for 5 banks (both UK and international) with significant operations in the UK market

⁶⁰ QIS exercise for COB December 2021 conducted for 7 banks (both UK and international) with significant operations in the UK market

⁶¹ QIS exercise for COB June 2022 conducted for 5 banks (both UK and international) with significant operations in the UK market

counterparties ranging from highly regulated institutions with multiple financial business lines (e.g. commercial and investment banks, insurance companies to unregulated and highly leveraged institutions (e.g. hedge funds, private equity). It also includes regulated funds which are subject to minimum leverage requirements, and have a similar risk profile to PSAs (e.g., UCITS funds, mutual funds).

The Industry believes that the risk weight for *prudentially* regulated financial institutions⁶² including banks, broker dealers and insurance companies that are subject to minimum solvency requirements as well as highly regulated funds should be lower than the current 5.0% for investment grade (“IG”) and 12.0% for and high yield (“HY”) and non-rated (“NR”). It should be pointed out that capital requirements across regulated financial institutions have substantially increased since the financial crisis of 2008-9 reducing the likelihood of default and the volatility of credit spreads for regulated financials when compared to the period during the financial crisis. Differentiating the risk weights between regulated and unregulated financials would be more representative of the underlying economic CVA risk.

The differentiation between prudentially regulated financial institutions and other unregulated financial institutions is consistent with their treatment in the Credit Risk framework.

Furthermore, PRA should extend the treatment of PSAs to those counterparties that have similar risk profiles, such as funds subject to UCITS or equivalent regulation. These funds are well-regulated and present much lower CVA risk than other financial counterparties.

We recommend that PRA extends the definition of the proposed PSAs sub-sector to include regulated financial entities, and UCITS or equivalent funds, and assign risk weights of 3.5% and 8.5% for IG, and HY and NR entities respectively.

Industry sector mapping of CVA exposure

In addition to more granular risk weights, the Industry recommends that the PRA allows for more flexible mapping of CVA exposures to sector buckets. In the rules, there is already an allowance for firms to use appropriate proxies to determine the SA-CVA risk factor sensitivities. We recommend that the same criteria, which is set out in CRR Article 383a point (ii) of subparagraph 2, for mapping illiquid risk exposure to liquid credit spreads, can also be used to assign CVA risk exposure to a sector.

This would allow for a closer alignment of the CVA capital framework and the risk management and accounting CVA framework, where the risk to financial sector entities can be marked to the credit spreads of other sectors.

Examples cited in the rules include municipalities, project finance and funds. We believe this flexibility for mapping risk exposures to sector buckets could be applied more broadly if there is a credible economic justification that is demonstrated to a firm’s supervisor.

For example, government-backed entities, e.g. government-backed financials; state-backed pension funds, should be allocated to the sovereign bucket where they are backed by the sovereign or local

⁶² Prudentially regulated as defined in Article 142(1)(4)(b), that is PRA regulated or subject to the prudential regulation that is at least equivalent to those applied in the UK.

authority.

Recommendation(s)

In recognition of the range of risk profiles of different financial entities, the Industry proposes that the PRA extends the proposed pension funds sub-sector to prudentially regulated financial entities and funds with similar risk profiles to PSA (e.g., UCITS or equivalent), and assigns them reduced risk weights, namely the 3.5% for IG and 8.5% for HY and NR.

The following table reflects the proposed changes with reference to the PRA CP's structure and risk weights for the Financial sector bucket:

<i>Investment grade</i>								
Bucket Number	Credit Quality	Sector	Risk Weight (percentage points)		Bucket Number	Credit Quality	Sector	Risk Weight (percentage points)
2a	Credit quality step 1 to 3	Financials including government-backed financials, excluding pension funds	5.00%		2a	Credit quality step 1 to 3	Other financial sector entities	5.00%
2b	Credit quality step 1 to 3	Pension funds	3.50%	→	2b	Credit quality step 1 to 3	Pension scheme arrangements, prudentially regulated financial entities, regulated funds, entities incorporated or established by a central government, regional government, or a local authority, and promotional entities.	3.50%
<i>Non Investment grade</i>								
Bucket Number	Credit Quality	Sector	Risk Weight (percentage points)		Bucket Number	Credit Quality	Sector	Risk Weight (percentage points)
2a	Credit quality step 4 to 6	Financials including government-backed financials, excluding pension funds	12.00%		2a	Credit quality step 4 to 6	Other financial sector entities	12.00%
2b	Credit quality step 4 to 6	Pension funds	8.50%	→	2b	Credit quality step 4 to 6	Pension scheme arrangements, prudentially regulated financial entities, regulated funds, entities incorporated or established by a central government, regional government, or a local authority, and promotional entities.	8.50%

Additionally, the Industry recommends that the PRA allows for more flexibility mapping of CVA exposures to sector buckets. It is encouraged that the criteria set out in CRR Article 383a point (ii) of subparagraph 2, for mapping illiquid risk exposure to liquid credit spreads, should also be used to assign CVA risk exposure to a sector.

7.2.2.2 Exemptions on CVA intragroup transactions

HM Treasury's consultation confirms that it intends to keep the CVA intragroup exemption. This exemption links to the conditions for the application of the intragroup exemption in Article 3 EMIR. This includes the requirement for an equivalence decision under Article 13 of UK EMIR for transactions with group companies established outside the UK. It also includes the additional conditions specified in Article 3 EMIR, in particular the requirement for affiliated counterparties to qualify as particular types of entity subject to prudential supervision, the requirement for the counterparties to the transaction to be subject to centralised risk evaluation, measurement and control procedures and the requirement for the counterparties to be included in the same UK prudential or accounting consolidation or an equivalent non-UK prudential or accounting consolidation.

The PRA also proposes that, as an additional approach, "following notification to the PRA, both domestic and cross-border intragroup transactions would be exempt from CVA capital requirements if firms meet the following conditions:

- (1) the counterparty is included in either: (a) the firm's prudential consolidation group on a full basis; or (b) the same accounting consolidation in accordance with accounting principles;
- (2) both the counterparty and the firm are subject to appropriate centralised risk evaluation, measurement and control procedures; and
- (3) there are no current or foreseen material practical or legal impediment to the prompt transfer of own funds or repayment of liabilities from the counterparty to the firm."

We note that the legislative proposal to amend EMIR (EMIR 3.0) proposes to remove the requirement for the adoption of an equivalence decision under Article 13 EU EMIR as a condition for EU institutions to benefit from the CVA intragroup exemption under the EU Capital Requirements Regulation (CRR).

Under the EU proposal, the CVA intragroup exemption would be available for transactions with non-EU affiliates in equivalent jurisdictions. For this purpose, it empowers the European Commission to adopt specific equivalence decisions for this purpose determining "whether a third country applies prudential supervisory and regulatory requirements at least equivalent to those applied in the Union". The additional conditions to the application of the intragroup exemption in Article 3 EMIR referred to above would not apply.

The Industry considers that the PRA's proposed rule would not address the concerns of UK institutions that are subsidiaries of non-UK banking groups as to their ability to rely on an exemption from CVA charge for transactions with many of their group companies.

For example, a UK institution that is a subsidiary of a non-UK bank would not be able to rely on the exemption under the PRA's proposed rule for transactions with its non-UK parent bank because the non-UK parent bank would not be included in:

- The UK institution's prudential 'consolidation group' (as defined in PRA rules) because that group would only cover the UK institution, any intermediate UK holding company of the UK institution and the subsidiaries of the UK institution or such a holding company; or

- The same accounting consolidation as the UK institution "in accordance with accounting principles" because the PRA's definition of "accounting principles" is limited to the accounting principles that are applied by the UK institution for the purposes of its own financial reporting (i.e., in most cases, UK accounting principles or IFRS as it applies in the UK) and the only consolidated accounts that include both the UK institution and its non-UK parent bank would be those of the non-UK parent bank (or any non-UK bank holding company) and those accounts would be prepared under applicable non-UK rules (e.g., US GAAP for US banking groups)

Similar issues would arise for such a UK institution in relation to transactions with other UK or non-UK subsidiaries of its non-UK parent bank or other non-UK holding company (unless those subsidiaries were also subsidiaries of the UK institution or an intermediate UK holding company of the UK institution).

In its current form, the Industry therefore has concerns about relying on the regime proposed by the PRA. For some transactions, the Industry would therefore look to using the link to UK EMIR Article 13 equivalence. However, the number of existing equivalence decisions made by the UK authorities under UK EMIR Article 13 is limited – it has only been granted to three jurisdictions - the USA, Japan and the E–A - and no new determination has been made since the end of the Brexit transition period. For example, Singapore, Hong Kong, Switzerland and Australia have not received UK EMIR Article 13 equivalence despite also receiving the highest classification in implementation progress across OTC derivatives reforms from the Financial Stability Board (FSB). This highlights the challenges posed by reliance on the UK EMIR equivalence framework as the basis for the intragroup CVA exemption.

Recommendation(s)

The Industry proposes a simple, single framework. The own funds requirements from CVA risk should not apply to:

- transactions in OTC derivative instruments
- entered into by an institution with a parent undertaking of the institution, other subsidiaries of such a parent undertaking or its own subsidiaries (i.e. a “group” defined without reference to UK prudential or UK accounting consolidation)
- in so far as those undertakings are covered by the supervision on a consolidated basis to which the firm itself is subject, in accordance with the UK CRR or the PRA rules on the supervision of groups or financial conglomerates
- or with equivalent standards in force in a country or territory other than the UK. This links the exemption to the UK CRR equivalence decisions, under which the UK already recognises 25 jurisdictions to have equivalent prudential and supervisory requirements.

In the view of Industry, the additional conditions to the application of the intragroup exemption in Article 3 EMIR need not apply as the proposal would only make the exemption available for transactions within a group subject to UK or non-UK equivalent prudential consolidation where the consolidating supervisor is able to assess any risks involved. This proposal could replace both the existing CVA intragroup exemption and the proposed PRA regime.

The Industry expects that the UK authorities would recognise the equivalence of the standards of consolidated supervision that apply in most major jurisdictions whose banks have UK subsidiary institutions that may be subject to own funds requirements for CVA risk. The UK already recognises that 25 jurisdictions (including the EU) have prudential and supervisory requirements for banks that are at least equivalent to those applied in the United Kingdom for the purposes of the UK CRR, and we would support that the intragroup CVA exemption as based on prudential consolidation and equivalence be made available to firms as soon as possible.

Proposed legal drafting to replace the PRA's proposed rule 3.2

3.2 A *firm* may exclude from its calculation of own funds requirements for *CVA risk* transactions that meet the following conditions:

(1) the counterparty is:

- (a) its *parent undertaking*;
- (b) another *subsidiary* of that *parent undertaking*; or
- (c) its own *subsidiary*; and

(2) the counterparty is covered by the supervision on a *consolidated basis* to which the *firm* itself is subject [in accordance with the *CRR*, provisions implementing Directive 2002/87/EC]* or with equivalent standards in force in a *third country*.

3.2A For the purposes of 3.2(2), the rules in force in a *third country* shall be considered to be equivalent standards if the *third country* is considered to apply prudential and supervisory requirements that are at least equivalent to those applied in the United Kingdom for the purposes of Article 107(3) of the *CRR*.†

Notes:

*This wording may need to be updated if there are changes to the referenced provisions as part of the implementation of Basel 3.1.

†This wording may need to be updated if HM Treasury decides to alter the existing provisions of CRR referred to as part of the implementation of Basel 3.1.

This legal drafting is designed to be illustrative - the Joint Associations do not wish to propose how HM Treasury and the PRA wish to split such a rule between legislation and the rule book.

7.2.2.3 *Misalignment between regulatory and accounting CVA*

The Industry agrees with PRA's proposal to set the MPoR floor at 4+N for securities financing transactions (SFTs). However, we strongly believe that the MPoR floor should be revisited for all transactions for SA-CVA. There are significant mismatches between the regulatory CVA per BCBS standard, and the way those charges are treated from an accounting perspective, through IFRS rules. In order to ensure that CVA capital requirements are not overstated, the CVA risk framework should

be more closely aligned with market practices, specifically by adjusting the length of the Margin Period of Risk (MPoR) – which accounts for lags in timing within which the nominal and market value of the contract can widen.

The current MPoR floor is based on outdated information about risk management and accounting practices. The market structure has changed substantially over the last ten years due to greater monitoring and active reduction of interbank risk exposure following the large financial institution defaults that took place during the global financial crisis. The current proposals mean that the MPoR is set equal to a minimum of 9+N business days irrespective of master agreement documentation, jurisdiction legal differences, or type of counterparty.

This approach does not reflect the legal terms negotiated between parties that dictate and reduce the MPoR. For example, the implementation of margin requirements under EMIR has reduced grace periods and imposed ‘same-day’ settlement for margin transfers. In contrast, the conventional regulatory MPoR has not changed to reflect these market developments.

Finally, since banks hedge their exposures based on economic CVA risk rather than regulatory CVA the impact of hedges is reduced in the CVA charge compared to how hedges would mitigate actual CVA losses. Regulatory CVA risk sensitivities are in most cases materially larger than the equivalent Accounting CVA risk sensitivities which hedges are sized against. This is in conflict with the objective of the new framework to reduce the gap between Accounting and Regulatory CVA.

Recommendation(s)

The Industry encourages the alignment between regulatory and accounting CVA. This could be achieved by allowing banks to reflect key legal terms within the calibration of MPoR resulting in a lower MPoR, e.g. from 9+N days to 4+N, where appropriate.

Adjusting the MPoR floor would make the regulatory CVA more aligned with accounting market practices.

7.2.2.4 Improve the recognitions of CVA Index hedges

Credit-default-swaps (CDSs) are a type of insurance taken against the loss arising from the default of a counterparty and widely used to hedge the CVA PnL variability due to credit spread changes. Banks also use standard baskets of CDSs, called CDS indices (analogous to equity indices), which are more liquid than the over-the-counter CDSs and provide a useful tool to hedge systemic credit risk. These are especially useful to hedge the exposure to many small and mid-cap companies, as they do not have any direct “hedges” that would allow mitigation of PnL changes arising from credit spread risk – meaning that hedging must occur at a more macro- level for the entire portfolio, using these indices as reference.

The July 2020 BCBS revisions have introduced new ‘index buckets’ for these indices, namely for: (i) counterparty credit spread risk class; (ii) reference credit spread risk class; and (iii) equity risk class of the

SA-CVA, in alignment with the BCBS market risk framework (the Fundamental Review of the Trading Book). Before this introduction, separate credit spread deltas were calculated for each index component, and each of these are then assigned to buckets 1-7 based on the sector of the index component name. This provides for netting and diversification benefits within buckets 1-7 directly. Alternatively, post the introduction of the 'index bucket', firms may want to have a high value for the supervisory correlation applied between the qualified index bucket (no.8) and buckets 1 to 7, as this would tend to increase the available degree of diversification benefit at the cross-bucket consolidation step.

The Industry is supportive with the introduction of the counterparty credit spread index bucket (Bucket number 8). The scope of eligible hedging instruments is limited to qualifying indices. However, the implied cross-bucket correlation between the CVA portfolio (buckets 1 to 7) and the index bucket (bucket 8) does not provide sufficient recognition to index hedges and does not reflect the observed historical correlation between the typical CVA portfolio and CDS index hedges.

The new rules therefore leave firms with disproportionate CVA capital requirements, that firms are not able to appropriately manage with hedging. This outcome does not incentivize prudent hedging practices and may lead to inadequate protection against the real economic CVA risk. Treating the entire CVA portfolio as an index and aligning its correlation with the index bucket to a level matching the calibration of SA-TB⁶³ is one approach to improve the hedge recognition.

Furthermore, the cross-bucket correlation between bucket 8 ('Qualified Indices') and bucket 7 ('Other') is currently specified as 0%, suggesting no correlation between these buckets. Given that credit spreads are determined in part by reference to market comparables, it seems unrealistic that bucket 7 and bucket 8 would not have a material positive correlation (similar to that between bucket 8 and other sector buckets), and that index hedging would provide no economic mitigation against generally wider credit spreads. As currently drafted, the SA-CVA proposal therefore creates a misalignment between risk and capital requirements, potentially driving inappropriate risk management practices. Moreover, SA-CVA is more conservative than BA-CVA for bucket 7 in respect of the recognition of index hedges, since BA-CVA aligns bucket 7 with Financials, whereas SA-CVA treats bucket 7 more conservatively than Financials, at odds with the aim of increased risk sensitivity in SA-CVA. The Industry therefore recommends that the correlation between bucket 8 ('Qualified Indices') and bucket 7 ('Other') in SA-CVA is aligned to the correlations between buckets 1-6 and bucket 8 (currently drafted as 45%).

Recommendation(s)

A better recognition of indices used to hedge CVA risk, particularly in terms of their usage linked to the hedging of systemic credit risk, rather than specific sectoral or counterparty risk.

In addition, the Industry recommends that the correlation between bucket 8 ('Qualified Indices') and

⁶³ As it relates to the correlation between to Credit Default Swap (CDS) indices: Under the revised market risk approach, the calculation of the sensitivities-based method under the standardised approach for market risk sets the correlation between two sensitivities within the same index bucket at 80%.

bucket 7 ('Other') is aligned to the correlations between buckets 1-6 and bucket 8.

7.2.2.5 SA-CVA Application

The Industry's understanding is that UK rules will be finalised after the US and EU frameworks are known (likely Q4 2023 or early 2024). Furthermore, we appreciate the efforts by the PRA to engage proactively with the Industry in advance of implementation to collaborate on SA-CVA applications and other operational issues.

Nonetheless, these timelines combined with the PRA's expectation to receive applications 12 months before implementation (i.e. 1 January 2024) will be challenging. This is likely to leave firms very limited or no time to conduct the thorough self-assessment work necessary to demonstrate compliance with final rules.

We encourage the PRA to continue to communicate their expectations for SA-CVA applications in a timely manner to ensure final pre-application materials are as complete as possible. Trade association forums can provide a helpful mechanism to do this.

Recommendation(s)

The Industry seeks guidance from the PRA on what needs to be included in the application for SA-CVA permission. The Industry believes that some of the areas where such guidance will be useful are:

1. clarification of which pro-forma application forms the PRA expects firms to submit;
2. Basis (i.e. final or draft rules) and level of detail for self-assessments; and
3. PRA's expectation of the granularity and frequency of capital impact data to be included in SA-CVA applications.

7.2.3 SA-CCR scope and application

The Industry welcomes the reduction of the alpha factor from 1.4 to 1 for transactions with pension funds and non-financial counterparties. However, among the major reasons for the disproportionate impact of SA-CCR are its design and outdated calibration objectives, since the alpha factor of the formula, which increases exposures by 40%, was set at 1.4 in 2005 by the Basel Committee and was meant to be used to account for general wrong way risk and perceived flaws in internal models, not for standardised approaches.

Further, the Industry encourages the PRA to reconsider the application of the Alpha Factor in the SA-CCR exposure calculation more broadly. The fair value of derivatives is captured on a firm's balance sheet and by its nature is not subject to additional model uncertainty with respect to the replacement

cost (RC). As SA-CCR is a non-modelled approach it does not require an adjustment to account for model risk in the context of the Potential Future Exposure (PFE) component. It is important to consider the recalibration of the Alpha Factor based on recent data and its application to the RC and PFE component instead of simply importing the Alpha Factor from the IMM.

Additionally, it will be important to address the impact of SA-CCR under the PRA Basel 3.1 framework. SA-CCR is the only permissible method for derivative positions in the RWA output floor calculation, it will continue to negatively impact un-floored RWAs where SA-CCR is applied, and also feeds into the Leverage ratio and the Large Exposures framework. The impact of SA-CCR is distinct in each of these areas:

- Un-floored RWAs - In its current design and calibration, SA-CCR led to disproportionate increases in capital requirements for banks and increased costs for end-users (e.g., corporates – including SMEs, pension funds, etc.) which typically use non-cleared derivatives to hedge business risks.
- Leverage Ratio - It is becoming a more binding constraint given the addition of the G-SIB surcharge, Pillar 2 requirements, Pillar 2 guidance, and notwithstanding the impact from its input into TLAC calibration.
- Large Exposures framework - the intent of the Large Exposures framework is to measure the propensity for concentration. The increased exposure values will reduce capacity to provide hedging products to end-users, and hinder recovery from the ongoing covid crisis.

A simple approach to remediate this impact would be to re-calibrate the alpha factor to 1 for all counterparties and for all applications of SA-CCR and at a minimum the below.

- RWA output floor
- Leverage Ratio and Large Exposure requirement

The question of recalibration of SA-CCR also calls for a broader review at the Basel Committee to ensure global consistency, especially given some of the developments in major jurisdictions outside the UK. In the US, the alpha factor has been recalibrated to 1 on a permanent basis in relation to exposures to commercial end-users. In the EU, the European Commission (EC) has proposed to lower alpha to 1 for the purpose of the output floor calculations as part of the transitional implementation period.

Recommendation(s)

Re-calibrate alpha to 1 for all applications of SA-CCR: un-floored CCR RWAs, output floor CCR RWAs, Leverage Ratio and Large Exposure.

Permit IMM banks to use their internal models to calculate Large Exposures requirements, in line with US Agencies retaining the use of IMM in the Single Counterparty Credit Limit (SCCL).

7.2.4 M-factor read across to SA-CR, Slotting and Securitisation risk weights

In line with the final Basel 3.1 standards, the proposed rules allow banks that use BA-CVA or SA-CVA for calculating the own funds requirement for CVA to cap the M factor at 1 year when they calculate CCR RWA using the IRB Risk Weight formula (per CRR Article 153.1). This in effect eliminates the double counting of downgrade risk between CCR and CVA capital requirement since, without the adjustment, the counterparty's downgrade risk is captured by both the CCR and CVA risk frameworks.

No similar adjustment is currently proposed for other risk weight methods, such as the Standardised Approach to Credit Risk (SA-CR), Slotting or Securitisation methods, when used for derivatives in scope for CVA capital. Therefore, the double counting of downgrade risk between CCR and CVA persists where banks use these methods for derivatives, leading to a misalignment between risk and capital.

To avoid this misalignment between risk and capital, and to avoid impacting the cost and affordability of derivative contracts for end users, appropriate adjustments should be made to these risk weights when used for derivatives in scope for CVA capital.

i. Standardised Approach for Credit Risk (SA-CR)

For derivative contracts, the calibration of SA-CR risk weights does not account for the fact that the counterparty's downgrade risk is already captured by the CVA risk framework.

The flat calibration of SA-CR risk weights embeds in its horizon the downgrade risk of the associated counterparties and therefore overlaps with the capitalisation of downgrade risk for positions in scope of the CVA risk framework.

For the institutions using BA-CVA and SA-CVA (BCBS, MAR50.7)⁶⁴ to calculate the own funds requirement for CVA risk, the risk weights used for in Title II Chapter 2 Section 2 (BCBS, CRE20)⁶⁵ should be multiplied by a discount scalar (provided in table below) for calculating the RWA for CCR for the same transactions, as referred to in Article 92(4), points (a) or (f), (BCBS, RBC20.6)⁶⁶, as applicable;

⁶⁴ BCBS – MAR50.7:

https://www.bis.org/basel_framework/chapter/MAR/50.htm?tldate=20230101&inforce=20230101&published=20200708

⁶⁵ CRR legislative rules - Title II Chapter 2 Section 2: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02013R0575-20190426&from=EN#page=115>

BCBS CRE20 :

https://www.bis.org/basel_framework/chapter/CRE/20.htm?inforce=20230101&published=20201126

⁶⁶ CRR legislative rules - Article 92: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02013R0575-20190426&from=EN#page=94>

BCBS – RBC20.6 :

https://www.bis.org/basel_framework/chapter/RBC/20.htm?tldate=20230101&inforce=20230101&published=20201126#paragraph_RBC_20_20230101_20_6

Credit quality step	1	2	3	4	5	6
Discount scalar	60%	65%	75%	85%	90%	100%

The above discount scalars for standardized approach are estimated as the average ratio between the IRB risk weights calculated with M factor capped to 1 year and M factor set to 2.5 years, consistent with the calibration of SA-CR risk weights⁶⁷ using minimum and maximum PD values derived from publicly available sources. The IRB discount scalar used to calibrate the proposed SA-CR discount scalar is expressed as follows, with M set to 2.5⁶⁸.

$$\begin{aligned}
 RW_{SA} &= DS_{SA-maturity-cap} \cdot RW_{SA} \\
 RW_{IRB} &= DS_{IRB-maturity-cap} \cdot RW_{IRB} \\
 DS_{IRB-maturity-cap} &= \frac{RW_{IRB}}{RW_{IRB}} = \frac{(1 + (1 - 2.5) \cdot b)}{(1 + (M - 2.5) \cdot b)} \\
 DS_{IRB-maturity-cap(M=2.5)} &= 1 - 1.5 \cdot b
 \end{aligned}$$

ii. Slotting risk weights

For institutions using BA-CVA and SA-CVA to calculate the own funds requirement for CVA risk, the Slotting Risk weights (per CRR Article 153.5) should be applied as if the Remaining Maturity of the transactions is 1 year.

iii. Securitisation risk weights

For institutions using BA-CVA and SA-CVA to calculate the own funds requirement for CVA risk, the SEC-IRBA and SEC-ERBA risk weights (per CRR Article 259 and 263 respectively) should be applied as if the Tranche Maturity is 1 year, and the SEC-SA risk weights (per CRR Article 259) should be multiplied by a discount scalar (as per the proposal for standardised risk weights above).

Recommendation(s)

The Industry proposes that when applied to derivative positions, SA-CR, Slotting and Securitisation risk weights should be adjusted for positions in the scope of the CVA risk framework to avoid a double count for downgrade risk.

For the institutions using BA-CVA and SA-CVA to calculate the own funds requirement for CVA risk:

- (i) the risk weights used for in Title II Chapter 2 Section 2 (BCBS, CRE20) should be multiplied by a discount scalar (provided in table below) for calculating the RWA for CCR for the same transactions.

⁶⁷ BCBS – Risk weight methodology: <https://www.bis.org/bcbs/publ/d307.pdf#page=12>

⁶⁸ BCBS – IRB risk weighted formula : https://www.bis.org/basel_framework/chapter/CRE/31.htm

Credit quality step	1	2	3	4	5	6
Discount scalar	60%	65%	75%	85%	90%	100%

- (ii) the Slotting risk weights should be applied on the basis that the Remaining Maturity of the transactions is 1 year.
- (iii) the Securitisation risk weights should be applied on the basis that the Tranche Maturity of the transactions is 1 year (if applicable) or multiplied by a suitable discount scalar (if not)

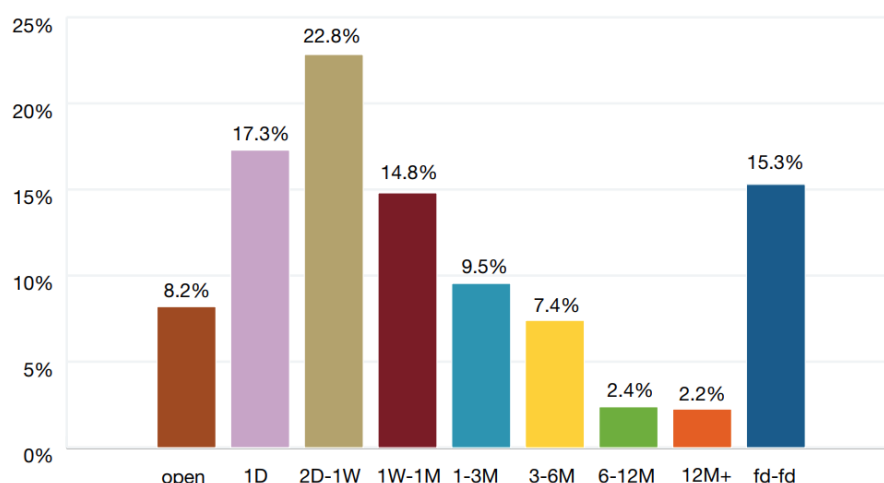
7.2.5 Standardised Approach for Credit Risk (SA-CR) and its application to SFT

One area where the revised Basel 3.1 framework results in a significant increase in capital requirements relates to SFTs. Under the revised framework, there is no significant change to how the Internal Model Method (“IMM”) exposures and the IRB risk weights are calculated. However, the standardized approach for credit risk, or SA-CR, adds a significant level of conservatism through the application of the output floor by not recognizing the very short-term nature of SFTs. The unintended impact of the RWA output floor could lead to an increase in RWAs, thereby potentially rendering the SFT business uneconomical for the banks that are active in the wholesale market, of which SFTs form a very important component. Such an outcome could threaten liquidity benefits for all stakeholders, from issuers (higher cost) to end-investors (lesser liquidity).

On unfloored basis, banks have the option to use internal models to better capture the underlying low risk profile of SFT transactions. However, the SA-CR calibration directly impact all banks through the application of the RWA output floor. SFTs are typically short term positions. Based on the ICMA European Repo Market Survey in October 2022, 95% of outstanding SFTs have maturities below six months and 87% below three months (see chart below). The short maturity of both derivative transactions and SFTs can be reflected in internal models for credit risk, or IRB-CR, but not in SA-CR with the exception of bank counterparties. For all other counterparties, this will result in capitalising short-term derivative and secured transactions similarly to long-term transactions. Maturity is an objective risk parameter, not depending from internal models. Short maturities are taken into account in other aspects of SA-CR, and therefore, we strongly believe that SFTs in particular should be allowed to benefit from these short term adjustments.

Graph: Maturity analysis of outstanding repo transactions

Figure 2.24 – Maturity analysis (main survey)



Source: ICMA, European Repo Market Survey, October 2022

Furthermore, implementing the SA risk weighting rules without a sensible maturity adjustment for repo-like transactions will undermine the existing measures that target facilitation of market-making in other parts of UK prudential regulation, whether on Net Stable Funding ratio (NSFR) and Liquidity Coverage Ratio (LCR).

Notably:

- LCR: no LCR cost when Level 1 HQLA are used as an SFT collateral. On the contrary, monetising High Quality Liquid Assets (HQLA) often depends on ability to repo the securities
- NSFR:
 - SFTs generate no regulatory Required Stable Funding if backed by HQLA Level 1 collateral
 - Beyond six-month maturity, SFT are subject to a 50% Required Stable Funding ratio

Such measures would fail to reach their goals if liquidity in HQLA assets is undermined by such a punitive capital treatment in the credit risk framework, forcing market-makers to possibly restrict their inventories and therefore the liquidity they can provide to the market.

Recommendation(s)

The Industry recommends the PRA to amend the SA-CR treatment of derivatives and SFTs by introducing a short-term maturity adjustment. The Current CRR2 Regulation already assign lower risk weights for selected short-term exposures:

- In the Standardized Approach, specific short-term RW exist for exposures to “institutions”, externally rated (Art 120 – Table 4) or unrated (Art 121 – Table 5), below 3 months for all exposures, and below 6 months for exposures related to “the movements of goods across national borders”, i.e. trade finance

- In the IRB-Foundation Approach, a 6 months maturity applies for derivatives and SFTs, instead of the fixed 2.5y maturity for all other exposures (Art 162)

7.2.6 Other Items – Clarifications and Amendments in CVA framework

The Industry recommends some more clarifications and amendments in the CVA risk framework in relation to treatment of the below.

7.2.6.1 Hedging

In the PRA Rulebook under Credit Valuation Adjustment Risk, Article 1.2 mentions *“eligible SA-CVA hedge means a transaction used for the purposes of mitigating CVA risk that: (1) is not split into several effective transactions; (2) either: (a) hedges variability of the counterparty credit spread; or (b) hedges variability of the exposure component of CVA risk; and (3) is eligible for the internal models approach for market risk in accordance with the Market Risk: Internal Model Approach (CRR) Part”*.

This contrasts with the definition of eligible hedges per the CRR3 proposal. Per Article 386(2) of CRR3, eligible hedges comprise of *“For the calculation of the own funds requirements for CVA risk in accordance with Article 383, only positions in the following hedging instruments shall be recognised as eligible hedges: (a) instruments that hedge variability of the counterparty credit spread, with the exception of instruments referred in to Article 325(5); (b) instruments that hedge variability of the exposure component of CVA risk, with the exception of the instruments referred in to Article 325(5).”*

The CRR3 explicitly carves out securitisation or positions included in the alternative correlation trading portfolio (ACTP) from being considered as eligible hedges. The explicit removal of the above leaves the possibility of other IMA ineligible hedges as eligible SA-CVA hedges which the definition adopted by PRA does not allow. It is recommended that the PRA aligns with the proposal in the CRR3.

Recommendation(s)

The recommendation is to align the definition of eligible hedges with that provided in CRR3 proposal. Hence, the definition in Article 1.2 can be changed to:

eligible SA-CVA hedge means a transaction used for the purposes of mitigating CVA risk that:

(1) is not split into several effective transactions;

(2) either:

(a) hedges variability of the counterparty credit spread, **with the exception of instruments referred in to Article 325(5);** or

(b) hedges variability of the exposure component of CVA risk, **with the exception of instruments referred in to Article 325(5); and**

(3) is eligible for the internal models approach for market risk in accordance with the Market Risk: Internal Model Approach (CRR) Part”

7.2.6.2 Expected Loss Given Default (ELGD)

The calculation of the expected loss given default (ELGD) to be used by firms is not clear in the guidance provided by PRA. Article 5.8(1) mentions that the ELGD must be the same value used to bootstrap PD from credit spreads any time the credit spread referenced the counterparty directly. This would be a material deviation from BCBS standards (MAR 50.32 (4)).

However, Article 5.8(3) in CP 16/22 then aligns with BCBS standards stating that the ELGD should be adjusted to reflect the difference in seniorities. The PRA does not mention the requirement for the firm to demonstrate to the PRA the difference in seniority as is required by BCBS standards. The CRR3 aligns with BCBS on this requirement.

There is a requirement to clarify the method of calculating the ELGD per the PRA rules.

Recommendation(s)

The recommendation is to align the definition and methodology of calculating expected loss given default (ELGD) with BCBS standards MAR(50.32(4)).

It is proposed to amend the Article 5.8 to the below:

5.8 For the purposes of 5.6(2)(b):

(1) **Notwithstanding the derogation in (3),** the market-consensus expected loss given default value used by the firm must be the same as the one used to calculate the risk-neutral probability of default from credit spreads; **~~unless market-consensus of expected loss given default is inferred from credit default swaps or bonds of similar counterparties and of similar seniority~~**

(2) the firm must ensure that collateral provided by the counterparty does not change the seniority of the derivative exposure;

(3) if the seniority of the transactions with the counterparty differs from the seniority of senior unsecured bonds that is implied by the value of expected loss given default, the firm must reflect this difference in seniority by adjusting the value of expected loss given default.

7.2.6.3 FX Pairs

In Article 5.26 (7), PRA elaborates on the approach for the calculation of FX vega sensitivities which aligns with BCBS requirements. It requires sensitivities for all FX vega pairs vs reporting currency. However, for transactions that reference an exchange rate between a pair of currencies where neither is the firm's reporting currency, the PRA requires the cross-FX to be decomposed into two FX rates vs reporting currency.

Whilst the approach is sensible for FX spot, since a EUR/GBP and USD/GBP FX spot can be uniquely defined as EUR/USD FX spot, it might be problematic for FX vega, there is an issue with decomposing cross-FX into two FX rates vs reporting currency for FX vega. For example, if the base currency is GBP and we consider a EUR/USD FX option, then due to weak arbitrage, the sensitivity to EUR/USD FX vol cannot be represented in the model as a sensitivity to EUR/GBP vols and USD/GBP vols. The BCBS standards drafting risks firms reporting a zero FX vega for such an option, since firms must report FX vega to the currencies vs reporting currency only. It is recommended that the PRA align the FX pair requirement for vega sensitivity for CVA with the requirement in FRTB. We encourage the PRA to align with SBM and allow the calculation of FX vega risk for all currency pairs and not only against base/reporting currency.

Secondly, the Industry recommends that the PRA should explicitly clarify if it is required to distinguish between onshore and offshore variants of a currency. We encourage the PRA to align with the proposal in the CRR3 where the onshore and offshore currencies can be treated as the same currency. Treating onshore and offshore currencies in the same bucket for FX, IR components also aligns with the market risk SBM approach.

Recommendation(s)

The Industry recommends that the PRA aligns the FX pair requirement for vega sensitivity for CVA with the requirement in FRTB. The PRA should align with SBM and allow firms to calculate FX vega risk for **all** currencies and not only against firm's reporting or base currency.

The below can be added to article 5.26(6):

"set the foreign exchange vega risk factor to a simultaneous relative change of all volatilities for an exchange rate between ~~the firm's reporting currency and another given currency~~ all foreign exchange rates."

Article 5.26(7c) can be amended as:

~~"for transactions that reference an exchange rate between a pair of currencies where neither is the firm's reporting currency, the volatilities of the foreign exchange spot rates between the firm's reporting currency and each of the referenced currencies that are not the firm's reporting currency;~~ the foreign exchange vega risk factors to be applied by institutions to instruments in the CVA portfolio sensitive to foreign exchange volatility shall be the implied volatilities of **all** foreign exchange rates."

and

Additionally, the Industry also recommends that PRA should explicitly clarify if it is required to distinguish between onshore and offshore variants of a currency. It is recommended to add the following to Article 5.26(7):

“Institutions shall not be required to distinguish between onshore and offshore variants of a currency for foreign exchange delta and vega risk factors.”

7.2.6.4 Vega Shift – Relative or Absolute

The Industry supports the alignment of the definition of vega risk sensitivity with BCBS. The PRA states that sensitivity to the vega risk factor should be calculated by *“shifting the volatilities by 1% relative to their current values and dividing the resulting change in the aggregate CVA and the value of the eligible SA-CVA hedges by 0.01.”*

The Industry notes the consistent definition of vega risk sensitivity across all asset classes which is aligned to the BCBS requirement. The definition maintains the flexibility for individual firms to choose to either apply absolute or relative 1% shift. The Industry supports this alignment given there is no unique approach for calculating vega sensitivity across firms and asset classes. For example, in the case of IR Vega an absolute shock of 1% (100bps) when market implied normal volatilities are around 50-200bps is considered a stress scenario and not a sensitivity definition in line with a firm’s internal risk management framework. Even though the PRA aligns with BCBS standards and maintains the flexibility, it is noted that some firms may still choose to use alternate definitions of sensitivity for calculation of vega risk sensitivity.

The PRA should permit the firms to re-use the existing risk management sensitivities for SA-CVA as is aligned with BCBS (MAR 50.47 and FAQ1).

Additionally, unlike the definition of vega risk sensitivity defined for most risk classes which includes *“dividing the resulting change in the aggregate CVA and the value of the eligible SA-CVA hedges by 0.01”*, PRA seems to have missed *“and the value of the eligible SA-CVA hedges”* in the definition for FX vega risk factor in Article 5.26 (7a).

Recommendation(s)

The Industry supports PRA’s decision to allow for flexibility in the definition of vega risk sensitivity as there is no unique approach for calculating vega sensitivity across firms and asset classes.

It is recommended to amend the Article 5.26(7a) to below:

“the sensitivities to the foreign exchange volatilities by simultaneously shifting all volatilities for a given exchange rate between the firm’s reporting currency and another currency by 1% relative to their current values and dividing the resulting change in the aggregate CVA, and the value of the eligible SA-CVA hedges, by 0.01;”

7.2.6.5 Alternate Definitions of Sensitivities

In Article 5.18, the PRA aligns with BCBS standards to use smaller values of risk factor shifts than the prescribed shifts for each risk class if doing so is consistent with its internal risk management calculations. Moreover, due to the Monte Carlo nature of CVA sensitivities some sensitivities are calibrated using larger shocks to provide model converges and stability. Therefore, the banks should be allowed to use alternative sensitivity definitions for CVA purposes as they are allowed under FRTB SA. The CVA capital framework should be aligned with the recommendations of Appendix 2 of the Industry response to FRTB (PRA CP Chapter 6), which proposes to better define the scope of what constitutes an alternative sensitivity as well as the corresponding application process. It also seems that the PRA might have missed to map across and align with BCBS FAQ (MAR 50.47 FAQ1), which provides more clarifications and includes that banks may use adjoint algorithmic differentiation (AAD) or similar computational techniques to calculate CVA sensitivities under SA-CVA.

Recommendation(s)

The Industry recommends providing clarification in the techniques which can be used to calculate CVA sensitivities in case of using different values of risk factor shifts. It is recommended to include the below in Article 5.18.

“A bank may use AAD and similar computational techniques to calculate CVA sensitivities under the SA-CVA if doing so is consistent with the bank’s internal risk management calculations and the relevant validation standards described in the SA-CVA framework.”

7.2.6.6 Large and Small Cap

The PRA defines market capitalisation in article 5.29 of the CP 16/22 as *“the sum of the market capitalisation of the same legal entity or group across all stock markets globally.”* The Industry recommends clarifying the definition of “group” in the above article.

The current definition of market capitalization contradicts the market capitalization defined in BCBS standards in MAR 50.70 (1). BCBS standards explicitly prohibits summing of the market cap of multiple related entities to determine whether a listed entity is large or small cap. The Industry also encourages to align the definition of market cap provided in CP 16/22 with BCBS.

Recommendation(s)

The Industry recommends clarifying the definition of “group” by adding “consolidated” in the article 5.29 of CP 16/22.

"the sum of the market capitalisation of the same legal entity or consolidated group across all stock markets globally."

Additionally, it is also recommended to align the definition of market cap with that provided in BCBS MAR(50.70(1)) and include the below in Article 5.29:

"The reference to "consolidated group" covers cases where the listed entity is a parent company of a group of legal entities. Under no circumstances should the sum of the market capitalisations of multiple related listed entities be used to determine whether a listed entity is "large market cap" or "small market cap"

7.2.6.7 Eligibility to use BA-CVA and SA-CVA

In article 5.3(1) of the consultation paper CP16/22, the PRA states firms that have permission from the PRA to use SA-CVA *"must use SA-CVA to calculate its own funds requirement for CVA risk in accordance with this Chapter to the extent and subject to any modifications set out in the permission"*. However, article 5.3(2) mentions that firms *"may choose to use BA-CVA to calculate its own funds requirement for CVA risk for one or more netting sets in respect of which it has permission from the PRA to use SA-CVA"*.

The Industry recommends aligning with BCBS standards (MAR 50.8) which mentions that *"banks which have received approval of their supervisory authority to use SA-CVA may carve out from the SA-CVA calculations any number of netting sets. CVA capital requirement for all those netting sets must be calculated using BA-CVA"*.

Recommendation(s)

For the calculation of CVA own funds requirement, the Industry recommends the PRA to align with BCBS standards (MAR 50.8) to clarify that banks which have received approval of their supervisory authority to use SA-CVA may exclude from the SA-CVA calculations any number of netting sets. CVA capital requirement for all those netting sets must be calculated using BA-CVA.

7.2.6.8 Netting set Split

In Article 5.4(3) of the CP 16/22, the Industry recommends the PRA to clarify and mention explicitly that a firm is allowed to split a netting set into multiple netting set and also the conditions under which the split is permitted.

It is encouraged to align the requirement with BCBS standards as stated in MAR(50.8) which allows the firms to do the following.

“When applying the carve-out, a legal netting set may also be split into two synthetic netting sets, one containing the carved-out transactions subject to the BA-CVA and the other subject to the SA-CVA, subject to one or both of the following conditions:

(1) the split is consistent with the treatment of the legal netting set used by the bank for calculating accounting CVA (eg where certain transactions are not processed by the front office/accounting exposure model); or

(2) supervisory approval to use the SA-CVA is limited and does not cover all transactions within a legal netting set”

Recommendation(s)

The Industry recommends the PRA to clarify and mention explicitly that a firm is allowed to split a netting set into multiple netting set and also the conditions under which the split is permitted. It is recommended to add the below to Article 5.4 of the CP 16/22.

“When applying the split, a legal netting set may also be split into two synthetic netting sets, one containing the transactions subject to the BA-CVA and the other subject to the SA-CVA, subject to one or both of the following conditions:

(1) the split is consistent with the treatment of the legal netting set used by the bank for calculating accounting CVA (eg where certain transactions are not processed by the front office/accounting exposure model); or

(2) supervisory approval to use the SA-CVA is limited and does not cover all transactions within a legal netting set.”

7.2.6.9 Alternate Approach Threshold

Article 6.1 of the CP 16/22 lays down the eligibility criteria for a firm to use Alternate approach to calculate own funds requirement for CVA. It mentions *“has non-centrally cleared derivatives of a notional aggregate amount less than GBP 88 billion”*. However, given the intragroup exemptions applied by the PRA, the Industry believes that the notional of derivatives which are subject to CVA risk requirements and are non-centrally cleared derivatives should only be considered as opposed to all non-centrally cleared derivatives.

Recommendation(s)

The Industry recommends the PRA to clarify that the notional of non-centrally cleared derivatives subject to CVA risk requirements should be taken into account when aggregating notionals to determine eligibility of Alternate approach. It is recommended to add the below amendment to the Article 6.1 of the CP 16/22.

“A firm that:

- (1) has non-centrally cleared derivatives subject to CVA risk requirements of a notional aggregate amount less than GBP 88 billion; and*
- (2) does not have permission from the PRA to use SA-CVA;”*

7.2.6.10 Effective maturity for netting sets under BA-CVA

Article 4.3 of the PRA rulebook mentions that the effective maturity of the netting set M_{NS} for non-IMM trades should refer to Article 162(2)(b). However, this article mentions that M shall be at least 1 year. The Industry believes that PRA should at least align with BCBS standards MAR 50.15 which is more comprehensive and includes a shorter M treatment for the fully or nearly fully-collateralised derivatives related to the MPOR through broader reference to CRE32.46 to CRE32.54. Furthermore, the Industry believes that any floor to the netting set maturity is unwarranted. As the mark-to-market value of a bank's exposure to its counterparties' creditworthiness, the CVA risk sensitivity should be measured with reference to the duration of the corresponding hedges and there is no good reason for flooring the duration of the netting set in excess of an expected liquidation period of 10 business days. The Industry recommends that the reference in Article 4.3 of the PRA rulebook should not be limited to Article 162(2)(b) instead encourages the PRA to set the maturity floor at 10 business days irrespective of the collateralisation of the exposure.

Recommendation(s)

The Industry believes that the PRA should remove the maturity floor applied to the netting sets irrespective of the collateralisation of the exposure. The PRA should at least align with BCBS standards MAR50.15 and make the below amendment to the Article 4.3:

*“for a firm not using the methods set out in Part Three, Title II, Chapter 6, Section 6 of CRR, M_{NS} is the average notional weighted maturity as referred to in Credit Risk: Internal Ratings Based Approach (CRR) Part Article 162(2), **points (b) to (d)**, except M_{NS} is not capped at five years but instead at the longest contractual remaining maturity in the netting set;”*

7.2.6.11 Unrated Entities

The Industry welcomes the alignment of PRA rule with the BCBS option for internal ratings to be used in case of unrated entities. However, PRA allows this only for IRB firms, rather than as a separate permission. However, there is a presumed 'typo' in the article 3.6 of the PRA rulebook which grants the permission for the purposes of (5.28) and (5.29), which are reference credit spread risk and *equity* risk. Instead, it should be (5.27) (counterparty credit spread risk) rather than (5.29).

It would be welcomed if the PRA could expand the scope to also cover the newly introduced permission for the risk sensitive approach for unrated corporates and further consider allowing Grade A and Grade B unrated institutions to also be mapped to investment grade. This would provide consistency with the application of investment grade risk weights under the standardised approach for credit risk.

Recommendation(s)

It is recommended that Article 3.6 of the PRA rulebook should be amended as below:

For the purposes of 4.4, ~~5.29~~ 5.27 and 5.28, where a counterparty is not externally rated, a firm that has been granted permission from the PRA under the Credit Risk: Internal Ratings Based Approach (CRR) Part Article 143 to use the internal rating based approach to calculate credit risk own funds requirements must map the internal rating to an external rating and assign a risk weight corresponding to either investment grade or high yield.

Additionally, the Industry would encourage the PRA to expand the scope to cover the newly introduced permission for the risk sensitive approach for unrated corporates and further consider allowing Grade A and Grade B unrated institutions to also be mapped to investment grade.

7.2.6.12 Clarity on CVA desk being considered as "line of business"

The Industry notes that in Article 5.13 (14a) PRA states "A firm must ensure that: It uses in its exposure models current and historical market data that is acquired **independently** of the lines of business."; As this article states the qualitative requirements for SA-CVA application, we would encourage the PRA to provide more background around this requirement and specify how the firms could address any concerns the PRA might have with respect to this article. This would allow firms to ensure the SA-CVA application is complete and meets all PRA's requirements. Given a centralized CVA desks perform the calculation of accounting CVA, we would seek clarity that the PRA does not consider it as line of business for implementation of SA-CVA, which would meet both the BCBS and PRA rules. However, the Industry encourages the PRA to clarify this.

Recommendation(s):

The Industry encourages the PRA to clarify if the PRA considers CVA desk to be a "line of business".

7.2.7 Drafting and Typos in CVA Framework

The Industry also recommends referencing and definitional clarifications with respect to the standard in relation to treatment of the below.

7.2.7.1 Referencing in Article 1.2

Article 1.2 references the commodity delta risk factor (5.29(3)), commodity vega risk factor (5.29(4)) and counterparty credit spread risk delta risk factor ((5.26(3)). However, the above referencing is incorrect. The Industry recommends correcting the referencing as per the recommendation below.

Recommendation(s)

The Industry recommends the PRA to correct the referencing in Article 1.2 of the CP 16/22 as below:

"commodity delta risk factor

means the risk factor set in accordance with ~~5.29(3)~~ 5.30(3).

commodity vega risk factor

means the risk factor set in accordance with ~~5.29(4)~~ 5.30(4).

counterparty credit spread risk delta risk factor

means the risk factor set in accordance with ~~5.26(3)~~ 5.27(3)."

7.2.7.2 Reporting requirement for SA-CVA

In article 5.5 of Chapter 7 of the CP16/22, the PRA has mentioned that a firm must calculate its own funds requirement for CVA risk on a monthly basis. However, the frequency of the reporting requirement of SA-CVA has not been mentioned. A clarification is requested by the PRA if the calculation of SA-CVA should be on a monthly basis, but the reporting should be in line with COREP reporting i.e., on a quarterly basis?

Recommendation(s)

A clarification is requested by the PRA if the calculation of SA-CVA should be on a monthly basis, but the reporting should be in line with COREP reporting i.e., on a quarterly basis?

A recommendation would be to amend the article 5.5 as below:

"A firm must:

- (1) Calculate its own funds requirement for CVA risk on a monthly basis and report to supervisors on a quarterly frequency."*

7.2.7.3 Sign convention for Regulatory CVA risks included in the SA-CVA calculation

For the calculation of Regulatory CVA risk, the Industry notes that the PRA intends to align the calculations with BCBS standards MAR50. The BCBS standard MAR 50.32(1) explicitly mentions that “In expressing the regulatory CVA, non-zero losses must have a positive sign”. However, in the PRA rulebook, the drafting of the rules from 5.22 to 5.24 does not explicitly specify the same assumption. The Industry supports the alignment of the PRA rules with the BCBS standards in this area but recommends the addition of a minor clarification regarding the sign convention.

Recommendation(s)

The Industry recommends that the PRA should explicitly clarify that the regulatory CVA risks which indicate a non-zero loss must have positive sign. It is recommended to add the below line to rule 5.22:

“Where S_k^{CVA} = the net sensitivity of the aggregate CVA to risk factor (k). Where a net sensitivity S_k^{CVA} represents a non-zero loss, it is assumed to have a positive sign. This assumption is reflected in rule 5.23 where WS_k^{Hdg} is subtracted from WS_k^{CVA} .”

8 Chapter 8. Operational risk

8.4 The following policy proposals are set out in this chapter:

- to implement the new standardised approach (SA) for Pillar 1 operational risk capital requirements; and
- to exercise the national discretion to set the internal loss multiplier (ILM) equal to 1.

8.1 PRA Consultation Questions

8.1.1 Question 47

Do you have any comments on the PRA's proposed implementation of the SA in the Basel 3.1 standards for operational risk capital requirements?

Recommendation(s)

8.1.1.1 Business indicator and FINREP

For firms reporting under FINREP, a read-across and mapping between FINREP and the Business Indicator sub-components will be appropriate and welcome (to the extent possible given the prudential trading vs. banking book items split), which will facilitate Basel 3.1 implementation and reporting.

8.1.1.2 Reporting for subsidiaries

AFME and its members note that the CP does not provide sufficient guidance on reporting entities within a complex financial group structure. Whereas the CP makes clear that Pillar 1 for operational risk under Annex K will be applicable at both consolidated and in-scope individual firm level, question marks remain, and therefore additional direction will be welcome, to what extent the qualitative and quantitative (including 10-year historical loss event) Pillar 3 disclosure requirements may or may not be rolled out to individual in-scope firms operating within a complex, consolidated group which itself will be subject to the full scope of Pillar 3 reporting.

8.1.1.3 Interaction between Pillar 1 and Pillar 2A

It would be helpful if the PRA would consider in due course reducing the Pillar 2A measures during H2 2024 in the run-up to Basel 3.1 implementation from 1 January 2025, on the basis of the latest QIS results, for those firms where Basel 3.1 would exceed materially current measures of Pillar 1.

8.1.1.4 Timing of Basel 3.1 implementation

Members raised questions on the reporting timelines and what the PRA's expectations were for the quarter-end 2024 reporting. It was also highlighted that there was a dependency on firm-specific

financial years and the timing at which point firms would transition to the Basel 3.1 aligned reporting vs. 2024 year-end.

In this context, AFME and its members would welcome, for firms with annual financial statements at calendar year-end, if the PRA would advise in due course whether firms would continue to report their Annual financial statements and Q4 COREP under the existing Pillars 1 and 3 as at 31 Dec 2024. It is expected that firms will report under Basel 3.1 with effect from Q1 2025 as part of COREP and under Pillar 3 at 2025 year-end.

8.1.1.5 Mergers, acquisitions and divestments

The PRA proposes in paragraph 8.17 to implement an approval process whereby firms can request supervisory approval to exclude divested activities from the calculation of the BI, which is in line with Basel 3.1 (OPE 25.33). However, in paragraph 5.5 (2) of Annex K , firms can only apply for a permission to exclude business acquisitions or mergers. This does not appear to extend the provisions to divested activities. AFME and its members request that the text is amended to include divestments into the scope of potential exclusions from the calculation of the BI.

8.1.1.6 Typos / Incorrect referencing

16.02

- Columns 0020 and 0030 reference row 110 and 120 of the Historical Losses Table, but these rows do not exist in the current template or instructions.

c 16.02 - Minimum Required Capital

Instructions for the Minimum Required Capital template are contained in the tables below:

Column Table

Columns	Heading	Description
0010	Internal Loss Multiplier (ILM)	Firms should calculate each row assuming the ILM is set to 1.
0020	ILM (losses greater than £20,000)	Firms should calculate each row assuming a variable ILM and a minimum threshold for including a loss event in the calculation of average losses set at £20,000 as reported in row 0110 from the Historical Losses table.
0030	ILM (losses greater than £90,000)	Firms should calculate each row assuming a variable ILM and a minimum threshold for including a loss event in the calculation of average losses set at £90,000 as reported in row 0120 from the Historical Losses table.

c 16.05 - Historical Losses

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Rows	Item
0010	Total amount of operational losses net of recoveries (no exclusions)
0020	Total number of operational risk losses
0030	Total amount of excluded operational risk losses
0040	Total number of exclusions
0050	Total amount of operational losses net of recoveries and net of excluded losses
0060	Total amount of operational losses net of recoveries (no exclusions)
0070	Total number of operational risk losses
0080	Total amount of excluded operational risk losses
0090	Total number of exclusions
0100	Total amount of operational losses net of recoveries and net of excluded losses

16.06

- Introductory sentence is a repeat of 16.05.

c 16.06 – Internal Loss Multiplier (ILM)

Instructions for the Historical Losses template are contained in the tables below

8.1.2 Question 48

Do you support the PRA's proposal to set the ILM equal to 1?

Firstly, AFME and its members support setting ILM to one for all banks in the UK. As ILM will be set at 1, it will be helpful to confirm that firms will not be required to report 10-year historical loss data and calculate the Loss Component and ILM as part of the Pillar 1 quarterly COREP submissions from Q1 2025. ILM established at 1 would allow firms to focus their quarterly COREP reporting on the Business Indicator and the Business Indicator Component.

Secondly, we note that there is a need to consider the overlap between the current Pillar 2A framework and the SA-OR. The increase in capital requirements under Pillar 1 should not be duplicated by maintaining Pillar 2 capital for risks already capitalized under P1. The latest QIS results indicate that Basel 3.1 capital requirements for operational risk would exceed current Pillar 1 measures for participating banks.

In this context, we also highlight that the SA-OR is the only part of the Basel framework under which there is no recognition of hedging. The Industry recommended capturing purchased insurance cover in the framework as a risk mitigant, but it was not included in the final Basel 3 SA-OR standard. Therefore, for the purposes of the PRA's Pillar 2 framework, we recommend that the PRA considers in the development of the updated framework the benefits of insurance cover for certain types of operational risk events.

Finally, the Industry have concerns around having two different allocation methodologies under Pillar 1 (a single event's losses recorded over time at each impact date) and Pillar 2 (impacts aggregated to date of first impact). Our concern is the potential confusion in communicating operational loss trends to stakeholders, and explaining the different loss profiles disclosed in ICAAP for Pillar 2A and in Pillar 3. The PRA has elected to set the Internal Loss Multiplier at 1. In chapter 8 of CP16/22 it is noted:

"The PRA considers that the information value of operational risk losses generally diminishes over time as business models and lending activities change. The SA's use of a 10-year window of unweighted past losses in the ILM could result in it being inappropriately affected by large historical operational risk losses near the start of the 10-year period that might be weak predictors of future losses."

In chapter 8 the PRA notes that it does, however, intend to continue to monitor and assess operational risk events as part of its sophisticated Pillar 2 assessment process. In this regard, we note that the allocation methodology for operational risk losses reported for Pillar 2 and for STDF reporting is on a different basis than is required for CAP16:05 / UKB OR1. The relevant rules are:

- CP 16/22 Appendix 4 (Draft PRA Rulebook) Annex K para 7.2.6(c) states: "it must allocate losses caused by a common operational risk event, or by related operational risk events over time but posted to the accounts over several years, to the corresponding years of the loss database in line with their accounting treatment."
- FSA form 073 (for Pillar 2 data collection) states: "Operational risk losses caused by a common operational risk event or by multiple events linked to a root event must be grouped and entered into the dataset as a single loss."

Given the proposal to set ILM at 1, the PRA's own views on the information value of operational risk losses, the requirement to submit historical loss data for STDF and Pillar 2, and the need to implement two different loss allocation methodologies to deliver COREP/Pillar 3 and Pillar 2 loss reporting, we propose that CAP 16:05/ UKB OR1 should be removed as requirements from both COREP and Pillar 3.

9 Chapter 9. Output Floor

9.1 Scope and levels of application

The proposed output floor would apply to firms in scope of the PRA's CRR requirements in the following way:

- on a consolidated basis only, at the UK consolidation level (ie the ultimate UK group level) of UK-headquartered groups;
- on an individual basis to UK stand-alone firms; and
- on a sub-consolidated basis for RFB sub-groups, or individual basis where the RFB is not part of a ring-fenced sub-group.

9.2 PRA Consultation Questions

9.2.1 Question 49

Do you support the scope and levels of application of the PRA's proposed output floor? Do you have any additional evidence on the potential impact of these proposals with respect to different activities or particular business lines?

Recommendation

Industry supports application of the output floor at the consolidated level. The proposals in this regard should be updated to ensure this is the case for all groups, and not subject ring-fenced banks to the backstop provision at a lower level. In applying the output floor at the level of the ring-fenced sub-group and non-ring fenced subgroup, this not only departs from the Basel standard but increases the impact on UK banks which do not apply to other jurisdictions. In addition, the implications will be different depending on the relative size of the ring-fenced and non-ring-fenced bank and in this sense is not business neutral. UK groups subject to ring fencing requirements, therefore, will potentially be subject to higher costs from the output floor versus banks with otherwise identical risk profiles, creating a systematic competitive disadvantage in the ability to service the real economy.

We believe therefore, the PRA's proposals should apply at the highest level of consolidation, consistently, for all groups.

Application to international subsidiaries

The PRA notes that it proposes to exclude UK-based subsidiaries of banking groups headquartered overseas ('international subsidiaries') that are subject to group consolidation outside the UK, with the exception of certain circumstances, where it would extend the output floor requirement to such international subsidiaries if it considers there to be a prudential case to do so (e.g. if the floor is not implemented, or not implemented in line with international standards, in home jurisdictions).

This process will require HMT (in consultation with the PRA) to perform an equivalence assessment in relation to how the OF has been implemented in the home jurisdiction of the international subsidiary;

transparency should be provided regarding criteria used for this assessment and introduce a mechanism to review the status of OF application in the home jurisdiction of international subsidiaries on a regular basis. This is important to ensure a level playing field between UK and international banks operating in the UK.

9.2.2 Question 50

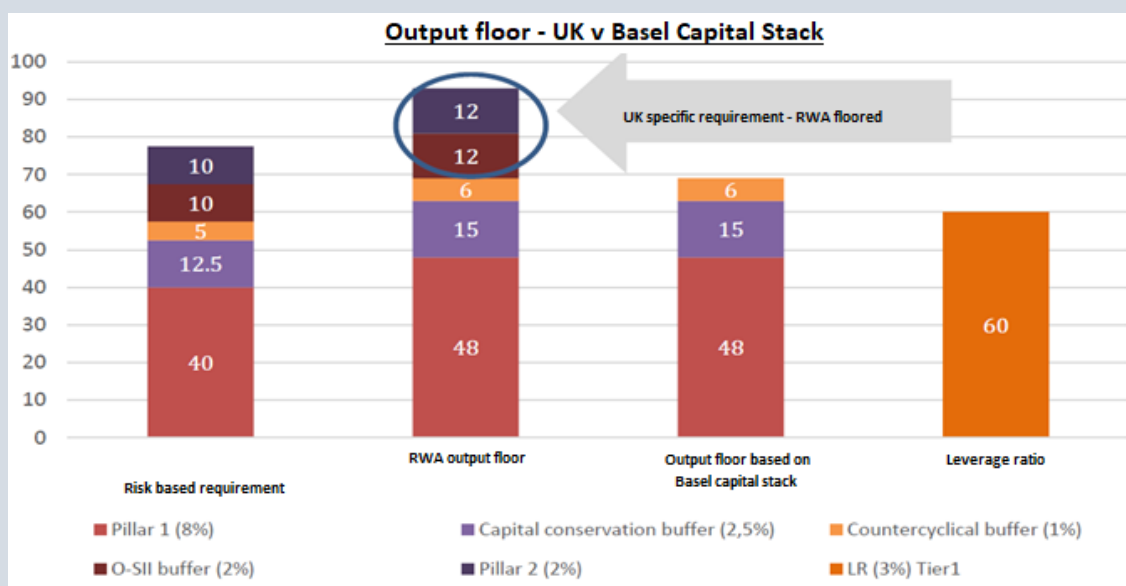
Do you have any comments on the PRA's proposal that when the output floor is activated, 'floored' RWAs should be used wherever relevant in all elements of the capital stack? Do you have any additional evidence that is relevant to this proposal to inform the PRA's analysis?

9.2.2.1 Application of the output floor to minimum requirements and buffers

Recommendation

As an Industry, our members consider the Output Floor (OF) should be applied to minimum capital requirements set through Pillar 1 and internationally agreed capital buffers. The application of the floor should deliver a capital amount which is equal to that which is required by Basel standards. However, the UK applies the OF to the full capital stack, i.e. calculated on the basis of all UK capital requirements including Pillar 2 and UK specific capital buffers. If the PRA takes this proposal forward it would be a gold-plated UK implementation of the floor, as the Basel text only requires the floor to be calculated based on Pillar 1 and international capital buffers.

The chart below is an illustrative example of the material difference in the impact of the OF based on the UK versus the Basel capital stack due to the inclusion of P2 and UK specific buffers.



Setting the OF based on the full UK capital stack could also reduce comparability across banks, which runs counter to one of the stated purposes of the measure, as it would no longer be based on one common comparable set of metrics by which UK banks calculate the floor. This is especially relevant for the inclusion of Pillar 2, a bank specific framework which is decided by supervisors, and whose

application ranges widely, even within countries, as highlighted in a Basel review from July 2019. Including a buffer that is not included in the Basel methodology e.g. O-SII buffer, would mean the floor is applied to a buffer set by supervisors to address macro-economic imbalances, not unwarranted risk-weight variability which is the target of the floor.

Were the PRA to retain application of the output floor to the full capital stack, a review of P2A methodologies to ensure there is no duplication in the framework and that any overlaps arising from interactions with the output floor are removed is even more important. As such, we support the PRA's intention for a review of P2A methodologies more fully by 2024.

Further input regarding the scope of the review and additional elements the PRA should consider are detailed in our comments relating to Chapter 10 of the consultation.

9.2.2.2 Standardised approach methodologies used in the calculation of the output floor

9.2.2.2.1 Excess Loss deduction/excess provisions in Tier 2

We are concerned that the proposed capital floor calculation does not take account of any excess expected loss deducted from capital and excess provisions included in Tier 2.

Recommendation

Other regulators have taken steps to address this. For example, in Canada, OSFI has taken the approach that an RWA equivalent of the excess EL deduction is added back to the total risk weighted assets for comparing with the output floor. It is also necessary to take into account of excess provisions that are included in Tier 2 within the calculation. The difference (i.e. the output floor impact) is added to the total risk weight assets. We ask that, rather than the calculation set out in Article 92 (2a), a similar approach to the calculation of the capital floor amount is applied. Please see the link to section 1.5 of OSFI's rule text :

https://www.osfi-bsif.gc.ca/Eng/fi-if/rg-ro/gdn-ort/gl-ld/Pages/CAR22_index.aspx

9.2.2.2.2 Securitisation

The PRA concludes that the output floor would not directly affect the supervisory assessment of commensurate risk transfer under CRR Articles 244 and 245, the calculation of maximum risk weights and RWAs in Articles 267 and 268, nor the PRA's expectations in relation to the thickness of sold or protected tranches for portfolios of SA exposures.

However, the PRA proposes to engage with firms originating SRT securitisations, including during the output floor transition period, to understand the impact of the proposed use of standardised methodologies for securitisations for the purposes of the output floor. The PRA also proposes to engage

with market participants with regards to the risk-sensitivity of the SEC-SA relative to the SEC-IRBA, and how the use of the SECSA in the output floor calculation may impact the origination of SRT. The PRA may consider carrying out a further consultation to address any issues identified, and would aim to do so during the output floor transition period.

Recommendation

We support the PRA's proposals to engage with firms originating SRT securitization and would support a further consultation to address any issues identified. Such engagement must be well in advance of phasing in of the OF given that capital planning today will be impacted by this uncertainty given that these transactions are typically long dated.

Furthermore, as outlined in AFME's position paper on adjustments to securitization framework (See: [Link](#)), until a policy position on the application of the floor to securitization is finalised, it is important that a transitional provision be put in place. We propose an adjustment to the p-factor for SEC-SA to 0.5 for non-STS securitisation and to 0.25 for STS securitisation for all bank roles i.e. originator, investor and sponsor. In conjunction with this, it is important the risk weight floor is decreased from 10% to 7% for STS securitisation and from 15% to 12% for non-STS securitisation. We recommend the PRA adopt this transitional approach until the completion of HMT's review of securitization, with the objective of avoiding a cliff effect on capital requirements for these transactions.

AFME has also produced a report that sets out the "[Impact of the SA Output Floor on the European Securitisation Market](#)", including the UK. We would welcome further discussion on this topic with the PRA.

9.2.2.3 Transition period

9.2.3 Question 51

Do you have any comments on the PRA's proposed transitional arrangements including the proposal to not apply the discretionary transitional cap?

Recommendation

We support the 5 year implementation period for the Output floor commencing 1 January 2025.

We believe this date should, however, be kept under review to ensure there is alignment with other major jurisdictions where final proposals are still under discussion and yet to be finalised. This is particularly important for global business lines to limit fragmentation in implementation of final Basel 3.1 rules.

10 Chapter 10. Interactions with the PRA's Pillar 2 framework

As outlined by the PRA, this chapter does not contain any specific new policy proposals. However, it does set out a range of topics the PRA is currently considering, these topics include:

- how Pillar 2A operational risk, market risk and credit risk methodologies, set out in full in the Pillar 2 SoP interact at a high level with the proposed changes to Pillar 1 risk-weighted asset (RWA) approaches set out within the consultation paper;
- at a high level, the consequential impacts to capital buffers including the PRA buffer; and
- the timing and setting of firm-specific capital requirements.

We support the proposed review, which we ask is complemented by an Industry consultation and suggest the following additional areas are also considered:

- A review of how P2A CVA risk methodologies interact with proposed changes to Pillar 1 RWAs given the removal of Advance CVA (ACVA) and with the reduced scope of exemptions.
- The extent to which accounting standards have developed such that associated prudential standards can be adjusted. For instance, IFRS 9 has meant that expected losses are captured via accounting provisions, rather than being based on an incurred loss model as was the case in IAS 39. Whilst accounting provisions have increased in this regard, there has been no commensurate offset in standardised risk weights. Risk weights should be reduced to account for IFRS 9, in the absence of which there should be an offset to any P2 add-ons / buffer requirements to account for this duplication.

Furthermore, as part of the review of the PRA's Pillar 2 framework, we ask that the PRA provide additional detail of differences versus the P2 requirement assessed by the firm in its ICAAP and the final requirement communicated as part of the SREP review. In particular, it would be helpful for firms to understand how much of the difference is due to :

- scope of assessed risk;
- methodology in quantifying risk;
- data inadequacies;
- shortfalls in risks management or governance;
- other

The PRA has stated the fuller review of P2A methodologies is planned by 2024 and we encourage this review to commence as soon as possible as it is important there is clarity well in advance of the 1 January 2025 implementation timeline, with updates required to the related policy statements, supervisory statements and statements of policy which firms will also need to embed into their SREP / ICAAP processes. Where possible, additional granularity should be included within these documents to specify the assessment methodology for sub-categories that contribute to the overall risk category e.g. splits within risk types for different elements of the trading book.

We welcome the PRA's recognition of the timing implications for firm specific requirements and its intention to avoid gaps or duplications in the Pillar 1 and Pillar 2 capital frameworks on day 1 of

implementation of the proposals. Without this intervention, the capital impact of an unadjusted pillar 2 requirement is likely to be significant, particularly with the introduction of the output floor for large firms and due to the longer SREP cycle for smaller firms. Again, this points to the need for the PRA's review to commence as soon as possible to allow for the PRA to assess the double counting that needs to be offset under the revised methodologies.

In addition to the above, and as noted by the PRA, the proposed changes to Pillar 1 risk weight methodologies and their cyclicalities would have consequential effects to both the combined buffer and PRA buffer frameworks. These also require a fundamental review to ensure the impact of the output floor is not double counted, which could be very significant for many firms and will be very challenging without first aligning the Pillar 1 and Pillar 2 frameworks. An Industry consultation on proposals in this regard would be welcome.

11 Chapters 11 & 12. Disclosure and Reporting

11.1 Overarching and general observations and questions

11.1.1 Regulatory Reporting

- Timeliness of the finalisation of reporting and disclosure requirements: Given that the EBA have not produced any draft reporting and disclosure requirements in relation to the EU CRR3 package as yet (believe these are expected in H2 2023), it would be appreciated if the PRA final guidelines could be shared at least 18 months prior to implementation date (or as early as possible), so that this not only allows firms enough time to implement but also allows firms with European entities to incorporate divergent rules/reporting, procedures, phase-ins, and transitional measures that may also be required by the EBA, allowing for compliance across regulators/regulation.
- Clarity on whether the PRA will be looking to establish a Q&A or similar process to manage any further interpretation questions post consultation would be useful.
- PRA Taxonomy: It was mentioned in the consultation paper that the PRA intends to publish the public working draft taxonomy following this CP for comments on the data modelling and overall technical implementation. We are not aware that this has been published as yet but we would like to ensure that:
 - Test environment availability – given that Industry will be required to follow a new and potential different (compared to the EBA) taxonomy process, there will be a need to ensure test environment timeliness (both adequate and as early as possible) of such to ensure that we can submit and correct any issues prior to full implementation. Also, generally we find that the test environments on the Regulator side do not contain the latest set of rules until late in the implementation window. Opportunities to improve this would be welcomed.
 - Increased partnership with vendors (i.e. Axiom) as part of their rules/publication process, so the vendors could potentially speed up the release of their packages to firms
- Simplified standardised approach (SSA): 12.22: The PRA does not propose to make any changes to COREP templates C18.00–C23.00 which would continue to be reported by firms that will apply the SSA. Minor amendments are proposed to the instructions for C18.00–C23.00 to replace references to the CRR with the proposed PRA Rulebook references as set out in Appendix 4, including a clarification that the new multipliers in Article 325(2) of the Market Risk: General Provisions (CRR) Part should apply to the aggregated risk class-level own funds requirements reported in COREP templates C18.00–C23.00 (as proposed in paragraph 6.31 of Chapter 6).
- Whilst Template C19 (SEC MKR) is to be retained for Firms using the Simplified Standardised Approach, this Template currently links to C14 (SEC Details) Template which no reference is made to in the CP. We would like to know if the PRA intends to also update the ITS instructions for Template C14 to clarify that Market Risk data is only to be reported where the Simplified Standardised Approach is used for Securitisation Market Risk.
- For logistical purposes, we would support deadlines for the submission of reporting templates being on business days rather than calendar days in contrast to the approach taken in Article 3(1) of the EU Implementing Technical Standards.

11.1.2 Disclosure

- BCBS standards, specifically DIS10.2, are clear that disclosure applies at the highest level of consolidation. In contrast, the PRA is proposing that UK disclosure requirements would apply even when a subsidiary is incorporated into Group disclosures in its home country which appears disproportionate. We recognise that there could be instances where local disclosure in the UK might be important, for example if a firm is heavily reliant on UK funding or has listed instruments, but for the most part we would recommend that a more proportionate approach is taken.
- The provision of a ‘mapping tool’ would be valued similar to that of the EBA to assist with the mapping of data from reporting to disclosures, thus supporting consistency in approach across the Industry.
- Clarification is requested as to whether the PRA expect institutions to follow the PRA Rulebook as a minimum in terms of disclosure requirements or would there be an expectation to consider external recommendations like from EDTF where some of the items from the 2012 version has made into the framework published so far. We did clearly see the way EBA pitched it in their ITS that the intent was to move away from multiple sources and follow single comprehensive disclosure package to ensure comparability which was duly incorporated by PRA, but apparently there seems to be agreement with large UK banks back in 2012 to meet the disclosure recommendations in EDTF.
- We would like the PRA to consider the frequency of disclosure for firms that do not publish financial information on a quarterly basis. We believe that the Pillar 3 without accompanying financial statements is not informative and does not provide meaningful information to the user, this is particularly the case for many banks at Q1 and Q3 when financial information is not published. We do not believe investors rely on or even use this information, a view which is supported by a lack of enquiries or hits on a firm’s Pillar 3 on its website. Therefore, we would like to propose that quarterly Pillar 3 information, where financial information is not published, is held over to the following half year or year end and included in those Pillar 3 documents. This would continue to provide readers with the information on a periodic basis, should it be required, but reduces unnecessary costs associated with Pillar 3 publication for firms.

11.1.3 Feedback on reporting templates:

11.1.3.1 *Market risk, CAP 25.11 Template:*

This template should not be required by firms who never intend to apply SSA or the small trading book exemptions as fuller and more valuable information would be provided as part of the wider set of market risk returns. We would note that the CAP 25.11 template has some potentially odd features, as set out below, and would appear to add little or no value where a firm is not in scope of the concessions to which the reporting relates.

Per the template instructions the disclosures for column 10 / 20 are to be made in line with article 325a.

- Per this article, non-trading book positions:
 - i. Subject to FX risk should be disclosed in line with article 352. Per this article forward positions should include the amounts to be received / paid, and therefore do not equate to the trade market value
 - ii. Subject to Commodity risk should be disclosed in line with articles 357 & 358, where derivative positions are treated as the position in the underlying
- All trading book positions should be valued at their “market value” where possible, else their fair value. **In this context it is not necessarily clear whether the market value of a position refers to the market value of a trade, or whether it refers to the market value of each underlying position of the trade.** This is explained in the example below:

The following is an example transaction such as a FX swap where we would like to clarify the correct treatment if it were booked in the trading book or the non-trading book:

- The Bank will pay a counterparty 100m EUR and receive 200m AUD on the swap at a set date in the future

- The trade settles in USD. The market value of the trade is +\$0.5m USD

If this example were in the trading book, would +\$0.5m USD (the market value of the trade) be reported? Or does the guidance require us to disclose the market value of the underlying positions, e.g. 100m short EUR & 200m long AUD where both positions are converted to USD and the absolute values of each is taken?

If this example was in the non-trading book, the guidance suggests the latter approach described above would be required, is this correct?

- If different approaches are required for trading and non-trading book it is not clear why this measure would be a useful measure of risk given the large inconsistencies that would be produced for the same trade within trading or non-trading books.
- If the underlying position values are required for either the non-trading book and / or trading book, this would add significant overhead to the reporting process. The process of deriving each position and their values in this manner is effectively part of the current rule calculations. This would no longer be required under the FRTB ASA approach and therefore parts of the current calculation process would require continued operational support to produce these numbers.

11.1.3.2 Market risk, AS1-7

Can we assume that positive/negative values are at the risk factor level (and not at the instrument level)? It is not clear what the “Own funds requirements” by bucket across Delta, Vega and Curvature would mean, though – we could interpret at the max total for the line, but that’s not something that is meaningful or calculated directly today.

11.1.3.3 Market risk, AS8

Not sure there is any such thing as an “Own funds requirements” for each rating, as the netting of long and short (accounting for HBR) is done across all ratings. There is also no split between corporates, sovereign and local gov.

11.1.3.4 Market risk, AS9 RRAO

Not clear how to split between Gap risk, Correlation risk and Behavioural risk, as these risks are not well defined in the rule and there is overlap between them. As a result, instruments may often be subject to more than one of these risks. A more meaningful split would be between 1% bucket and 0.1% bucket, which is what is usually reported in QIS and for EU entities.

11.1.3.5 Market risk, AS10 CIU

“Memorandum item: Look-through approach for CIUs” is not available directly. Once decomposed, we are not able to calculate the capital charge of the funds only, as the positions are aggregated and diversified with the rest of the portfolio. Calculating standalone capital for decomposed funds is also not meaningful as the core strategy of the firm is to hedge them with indices or baskets.

11.1.3.6 Reporting of Additional Capital for switches between the Trading and Non-Trading book:

In the C2 template a **new row (5898) has been added to capture an additional capital charge that is required when switching a position between the trading and non-trading books**. This cell is greyed out in column 10 (“all approaches”), but is not in column 20 (“standardised approaches only”). **It is not clear why this value should not be reported in column 10 given it would still contribute to the total RWA within the “all approaches” column?**

11.1.3.7 Operational risk reporting

It would be helpful to confirm that the ILM that is reporting under 16.06 (rows 0010 and 0020) is what is used to report capital and RWA in 16.02 (columns 0020 and 0030).

11.1.3.7.1 16.02

Columns 0020 and 0030 reference row 110 and 120 of the Historical Losses Table, but these rows do not exist in the current template or instructions.

c 16.02 - Minimum Required Capital

Instructions for the Minimum Required Capital template are contained in the tables below.

Column Table

Columns	Heading	Description
0010	Internal Loss Multiplier (ILM) = 1	Firms should calculate each row assuming the ILM is set to 1.
0020	ILM (losses greater than £20,000)	Firms should calculate each row assuming a variable ILM and a minimum threshold for including a loss event in the calculation of average losses set at £20,000 as reported in row 0110 from the Historical Losses table.
0030	ILM (losses greater than £90,000)	Firms should calculate each row assuming a variable ILM and a minimum threshold for including a loss event in the calculation of average losses set at £90,000 as reported in row 0120 from the Historical Losses table.

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c 16.05 - Historical Losses

Rows	Item
0010	Total amount of operational losses net of recoveries (no exclusions)
0020	Total number of operational risk losses
0030	Total amount of excluded operational risk losses
0040	Total number of exclusions
0050	Total amount of operational losses net of recoveries and net of excluded losses
0060	Total amount of operational losses net of recoveries (no exclusions)
0070	Total number of operational risk losses
0080	Total amount of excluded operational risk losses
0090	Total number of exclusions
0100	Total amount of operational losses net of recoveries and net of excluded losses

11.1.3.7.2 16.06

Introductory sentence is a repeat of 16.05.

c 16.06 – Internal Loss Multiplier (ILM)

Instructions for the Historical Losses template are contained in the tables below

11.1.3.8 CVA, CAP 26.12 Template Disclosures:

When disclosing notional amount in this template, should exempted trades still be included (including legacy CVA trade exemptions)? Is this template still required if a firm has SA-CVA approval or never intends to use the Alternative Approach?

11.1.3.9 Counterparty credit, Reporting of Alpha and Alpha Additional Capital for Legacy Trades in the C34.2 Template:

In the C34.2 template column 140 requires the alpha value to be reported as a single value for SACCR. As per the proposed Basel 3.1 rule changes in section 7.67 a lower alpha may be applied to certain counterparties such as non-financial corporates and pensions. **Given there will be multiple alpha values applied in the calculation, how should column 140 be reported?** From the relevant guidance it does not appear that this template will be amended and there is no updated guidance.

Section 7.69 requires firms who use the legacy CVA trade exemption to hold additional capital based on the day 1 capital benefit of reducing the alpha from 1.4 to 1 for non-financial corporates and pension funds. **Where should this additional capital be disclosed in the COREP C2 template?**

13 Chapter 13. Currency redenomination

The PRA proposes to redenominate certain references to Euros (EUR) and US Dollars (USD) into Pound Sterling (GBP) in the PRA rules proposed in the Consultation Paper (CP). We consider it appropriate for PRA rules to specify thresholds and monetary values in GBP, though there should be flexibility to use EUR as an alternative. Furthermore, where EUR and USD values are redenominated into GBP, we support the PRA's intention to keep the proposed GBP/EUR and GBP/USD exchange rates applied under review as specified, as well as the proposal to round the redenominated GBP values to two significant figures.

14 Appendix

14.1 Appendix - Credit Risk – SA

14.1.1 GCD data on Credit Conversion Factors for Performance Guarantees

Context

This paper⁶⁹ assesses the empirical level of Credit Conversion Factors (CCF⁷⁰) for Performance Guarantees as referred in CRR 3⁷¹.

As part of this update, the numbers have been refreshed with the latest collated data by Global Credit Data (GCD)⁷² from its consortium member banks. The total GCD defaulted data set covers cases where the borrower has defaulted (using the Basel definition) and it is composed of data from more than 55 member banks. The lending footprint, facilities, and borrower types as well as collateral practices of the GCD member banks are merged in the database. The International Chamber of Commerce (ICC) UK acknowledged the representativeness based on the geographical distribution of the contributing banks (list is in the Appendix).

Conclusions

Based on an analysis of the data collected the paper establishes:

An average credit conversion factor (CCF) of 10% for defaulted customers with a portfolio⁷³ of performance guarantees outstanding from date of default; this indicates the low conversion rate from off-balance sheet to on-balance sheet exposures for these products which only pay out when there are failures in the underlying contract/agreement even after a customer default has occurred. As the GCD data pool has been collated over a long period and covers a larger cross-section of global banks the data is not only robust but is also a representative data set. This validates the case for applying a 20% CCF (or simply conversion factor (CF) as referred to in the regulations) in determining Exposure-At-Default (EAD), for performance guarantees when calculating Risk Weighted Assets (RWA) for capital purposes.

⁶⁹ This paper updates a joint publication (2022) by the International Chamber of Commerce (ICC) and the Global Credit Data (GCD) Consortium on claims made and paid, of performance guarantees

⁷⁰ The CCF defined here is the conversion rate of off-balance sheet exposure to on-balance sheet exposure (by way of a payment on a claim) measured after default on issued amounts for those guarantees

⁷¹ CRR3 Article 111 and Annex Bucket 2 includes performance bonds, bid bonds, warranties and standby letters of credit related to particular transactions and similar transaction-related contingent items; also termed as 'technical guarantees' in certain jurisdictions.

⁷² The Global Credit Data Consortium (GCD) is a non-profit association owned by 55+ member banks. GCD operates pooled data bases on a "give to get" basis, meaning that members who supply high quality data receive detailed data from all other contributors in return. The robustness of GCD's data collection infrastructure helps place the GCD databases as the global standard for credit risk data pooling. For more info, visit www.globalcreditdata.org or contact secretary@globalcreditdata.org

⁷³ Portfolio consolidated from 16 GCD member banks (list in appendix)

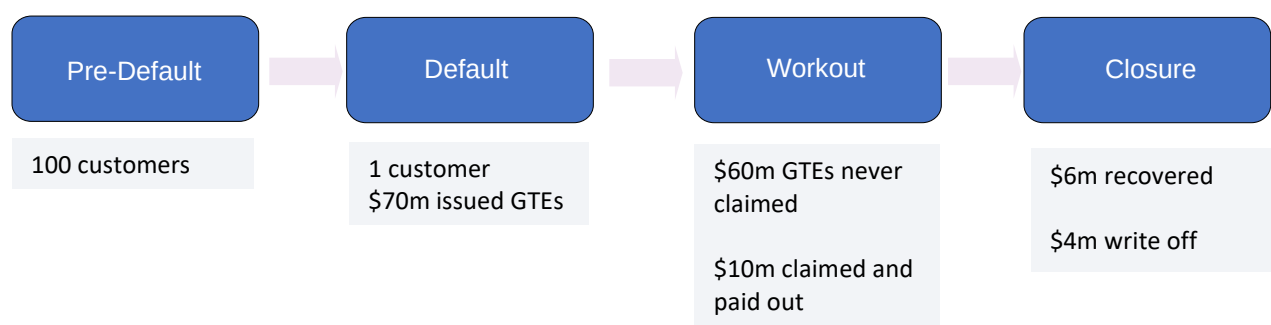
Additionally, data had been collected from ICC member banks on claim rates and paid rates for the overall book (containing both performing and defaulted exposures):

It provides an additional reference point for readers to understand the underlying CCF numbers from an overall portfolio perspective. These numbers reinforce the low claims made and paid rates for the overall portfolios (0.2% for performance and 1.7% for financial). This data has been submitted by 17 Trade Register (TR) member banks (provided in Appendix Item 3).

Importantly, the case for applying a 20% CCF for performance guarantees based on empirical data is strong (The empirical data collected for financial guarantees also establishes a case for revisiting the 100% CCF for these guarantees).

Methodology

Delineating and Bucketing of PD, LGD & EAD for Guarantees (GTEs)



- A portfolio of 100 customers pre-default to when one customer defaults is covered under Probability of Default (PD)
 - PD in this scenario would be $1 / 100 = 1\%$
- One customer default with \$70m issued guarantees of which \$10m is paid out and this amount is used for Credit Conversion Factor (CCF) estimation which is a part of Exposure at Default (EAD)⁷⁴
 - Nominal CCF in this scenario would be $10 / 40 = 14.3\%$
 - \$60m of unclaimed guarantees is not part of the CCF estimation process
- \$10m of cash outflow to \$4m of write off is covered under Loss Given Default (LGD)
 - Nominal LGD in this scenario would be $4 / 10 = 40\%$
 - Note that this LGD is only calculated on the paid out amount (which is the cash outflow generating the on balance sheet exposure); \$60m of unclaimed guarantees do not generate any cash outflow or on balance sheet exposure

The methodology uses a portfolio of defaulted customers as the starting point for collecting paid amounts on performance guarantees issued by these defaulted customers. The reference data set is then used to estimate empirical CCF, where the **CCF is defined by the following ratio**.

⁷⁴ EAD will also have a separate conversion factor on the unutilised limit (prior to default), sometimes called the 'Drawdown Factor' which takes into account outstanding guarantee amount 1 year prior to default and provides the value of further guarantee amounts expected to be issued prior to default

CCF (assessed at each facility, consistent with regulatory guidance on prudential CCF calibration):

Net present value (as on date of default) of monies paid out under claims made for a guarantee type (i.e. Perf, Fin) after the date of default

Outstanding exposure (issued amount) of the same guarantee type as on the date of default

The CCF is calculated for each facility and then averaged.

Results

The methodology has been applied to the GCD data pool of defaulted customers with performance guarantees facilities. Table 1 shows performance guarantees products. The average CCF⁷⁵ for these products is 10%.

Table 1: Performance guarantees CCF (by facility type)

	Number of Defaulted Facilities	Facility CCF (avg. Paid/Issued)
Bid or Performance Bond	265	14%
Trade Related Payment Guarantee	188	18%
Other Trade Related Bonds	1,336	8%
Grand Total	1,789	10%

From a business practice perspective, it is important to understand that not all guarantees are claimed for defaulted customers⁷⁶. Further issuing banks often extend claims subject to a mutual agreement between applicant and beneficiary, or do not pay claims if they are discrepant or subject to a legal stay order obtained by the applicant. This often results in a bank not needing to pay out against these guarantees.

Is there an impact of economic downturns (credit cycle) on the CCF for performance guarantees?

By taking a closer look at how CCFs have moved over a 20-year period, it is possible to gain useful insights on the movement of empirical conversion factors inclusive of downturn periods.

Table 2 shows average CCF by ‘year of default’ as well as by ‘year of drawing’ to provide two different lenses.

Year of Drawing is defined as the Year of default plus the Time to Drawing.

The Time to Drawing is calculated as the centre point of cash out on guarantee cashflows, and it puts a weight of the amount of the cashflow on the timing. It is defined as the cashflow weighted average period between default and cash outflow.

⁷⁵ The discount rate used is 3 month Euribor. Higher discount rate (as used by most regulators) would lead to lower CCFs

⁷⁶ In many cases, even if the customer is in declared insolvency, they are still able to fulfil their contractual obligations regarding certain projects, which explains that not all the guarantees with a defaulted customer are claimed. On some occasions, projects may be completed or close to completion which allows firms to avoid claims.

Table 2: Performance guarantee CCF (by year)

Year	By year of default		By year of drawing	
	Number of defaulted facilities	Average CCF (Paid amount / issued amount)	Number of defaulted facilities	Average CCF (Paid amount / issued amount)
2000	4	63%		
2001	16	50%	10	40%
2002	27	69%	8	72%
2003	30	31%	9	36%
2004	72	14%	44	15%
2005	59	9%	71	19%
2006	66	9%	49	18%
2007	68	7%	65	7%
2008	169	11%	138	10%
2009	281	17%	121	15%
2010	162	7%	191	10%
2011	309	6%	271	8%
2012	188	5%	269	8%
2013	131	5%	163	8%
2014	115	0%	156	5%
2015	20	9%	85	3%
2016	13	19%	66	9%
2017	36	1%	30	8%
2018	9	0%	18	1%
2019	11	4%	12	10%
2020	3	50%	11	14%
2021			2	0%
Overall	1789	10%	1789	10%
Overall (excl. greyed out)	1698	8%	1737	9%

Data for the period 2000-2003 (greyed out) suffers from a collection bias (in the early years of Basel II for some banks it was difficult to collate and deliver all the defaulted cases including cures consistently in tandem with newer defaults. Note, while the data may still be useful from an analytical perspective in the absence of cured cases, they tend to bias the results, as the reported CCF for the 2000-2003 period is higher than it would have been with a full data set. Data post 2018 (greyed out) suffers from a resolution bias (in the most recent years short workout period cases are naturally overrepresented and the view on the CCF is still incomplete).

The period 2015-2019 has relatively (compared to preceding years) lower number of defaults – which is reflective of the benign economic environment at that time.

Inferences (from Table 2)

The concept of a downturn has long been an integral part of PD (Probability of Default) and LGD (Loss Given Default) models. Consequently, we see more defaults in a downturn period (affecting PD; even though the PD actually used for capital computation is generally a 'through the cycle' PD) and lower recoveries in a downturn period (affecting LGD). The reasons why we see lower recoveries in a downturn period can be, largely attributed to the following factors

- (i) Higher workload of the resolution team (as there are higher number of defaults)
- (ii) Market forces where the supply of distressed assets exceeds demand which in turn impacts recovery rates negatively
- (iii) Longer time to resolution leading to lower net present value of the recoveries

However, to the best of our knowledge, it is difficult to establish any causal link between downturn periods and higher conversion factors for guarantee exposures. The probability (and rationale) behind the claim and pay-out on a guarantee is not fundamentally expected to change during downturn conditions. Guarantees are contingent liabilities backing commercial contracts where it is in the beneficiaries' interest to ensure the contract is completed in a timely manner. Where that is not possible, it is in the interest of all parties concerned to come to a mutually acceptable commercial agreement.

This is also evident in the empirical data where a significant increase in CCFs is not reported for the GFC period (2008 – 2012) where a higher number of obligor defaults associated with a downturn were recorded.

The average CCF across the 2008-2012 period is still ~10% (for both methods), which is similar to the overall period average.

LGD for these cases is calculated as $(1 - \text{recovery rate})$. Recovery rate is the net present value of all cash flows including external costs divided by the net present value of the cash out on the guarantee. The LGD value for these performance guarantees is 46%⁷⁷.

This value is higher than the typical unsecured LGD levels seen in other products and the proposed B3.1 LGD of 40% under the IRB-Foundation approach. As CCF and LGD parameters impact risk-weights linearly, the empirical data can be looked at with a different lens to estimate appropriate CCF values taking into account the higher empirical LGD values of c46%.

Derivation of CCFs using empirical and regulatory LGD

$$\text{RWA} = f(\text{PD}, m, \text{other factors like AVC}) * \text{LGD} * \text{CCF} * \text{Exposure}$$

Since $f(\text{PD}, m, \text{other factors like AVC})$ and exposure remain the same and we aim to arrive at the same RWA using supervisory values vis-à-vis empirical values, this would mean

$$\text{LGD (empirical data)} * \text{CCF (empirical data)} = \text{LGD (B3.1 proposed)} * \text{CCF (back calculated)}$$

$$\text{i.e. } 46\% * 10\% = 40\% * \text{CCF (back calculated)}$$

$$\text{CCF (back calculated)} = 11.5\%$$

⁷⁷ Only includes those guarantees where a claim pay-out has led to an on balance sheet exposure. Discount rate is 3 month Euribor. Calculation capped at [0%,150%]. This LGD value is the higher of the 2 periods shown in the Table 2 i.e. 2000-2020 & 2004-2018

In effect using 10% CCF and 46% LGD (both from empirical data), we establish that using 40% LGD (B3.1 recommended LGD) with 11.5% CCF (back calculated), will generate similar RWA numbers.

This makes the case for using 20% CCF for performance guarantees stronger as it shows that even after taking into account higher empirical LGD values (and normalising them into the B3.1 recommended LGD) when estimating CCFs to be used for regulatory purposes, it still remains a conservative estimate.

APPENDIX

1. Performance guarantee products explained

Market practice: It is market convention to issue guarantees subject to the provisions of the 'International Chamber of Commerce (ICC) rules Uniform Rules for Demand Guarantees (URDG) 2010, revision, ICC publication 758'. These rules having been endorsed by international organisations, multilateral financial institutions, bank regulators, lawmakers and professional federations. We broadly categorise these types of guarantees.

Bid bond/tender bond is an undertaking issued on behalf of the applicant that typically supports the applicants bid on a project for a government entity or public/private partnership. The bid often requires a specific form of Guarantee for a bid to be accepted and so amendments may be very difficult to negotiate.

Advance payment guarantee/bond is an undertaking issued on behalf of the applicant to cover receipt of an advance payment for a commercial or trade-related contract and can be claimed if the applicant does not meet its obligations under the terms of the contract.

Performance guarantee/bond is a Guarantee which guarantees a performance-based obligation to deliver some equipment or services on an agreed date. That is, an obligation that is wholly nonfinancial in nature (or in which the *primary* obligation is non-financial in nature). An example would be where the client of a bank has contracted with another party to perform a service and asks its bank to provide a Guarantee which can be called by the other party upon failure of performance.

Retention guarantee/bond is a Guarantee which is closely linked to performance-based obligations on equipment or services during the warranty period. That is, an obligation that is wholly non-financial in nature (or in which the *primary* obligation is non-financial in nature).

Financial guarantee/bond is an undertaking issued on behalf of the applicant that supports a financial obligation of the applicant where no goods are services are exchanged.

Lease or rent guarantee/bond is an undertaking issued to secure the obligations of a renter or lessee under a lease of property.

The first four of these guarantees are performance related, while the last two, characterised as Financial Bonds, can be regarded as a credit substitute alongside loan guarantees and standby letters of credit to support loan facilities. *Performance guarantees* are a special class of contingent liabilities which share the following characteristics:

- Not expected to be drawn (unlike L/Cs)
- Drawing is dependent on a commercial event (e.g., a contract breach)
- Not issued in support of loans and other financial obligations

1.1 Parties involved

- Issuing bank promises to pay on first demand and receives an indemnity from its customer
- Beneficiary/recipient receives the guarantee and may claim or not. They may do this through their own bank.
- Obligor/customer: requests issuance of the guarantee and promises to reimburse the issuing bank if the issuing bank repays the beneficiary under a valid claim presented by the beneficiary.

1.2 Performance guarantees in a default context

Performance guarantees may be claimed by the beneficiary regardless of whether the obligor is in default with their bank or not.

No default: Claim triggered and paid from customer's funds with obligor/customer not in default as per banks internal definition of default, which is also consistent with the regulatory definition of default. Though the customer has sufficient funds, because the claim has been triggered and found to be valid, it has to be paid. However, it does not necessarily translate into a loss.

Default: Claim triggered and paid from customer funds with obligor/customer in default as per banks' internal definition of default (or paid from bank funds if the customer does not have sufficient funds). As obligor is classified as defaulted customer and as a claim has been triggered the transaction counts as a defaulted transaction. If customer has sufficient funds no loss may be triggered. However, there is a strong likelihood that the transaction (or part thereof) will incur a loss as the obligor is in default.

Terms definition

Table 3: Table of terms definition

Term	Definition
Issued amount	Total outstanding exposure of a guarantee type (i.e. Perf, Fin) as on the date of default
Paid amount	Total money paid out under claims made for a guarantee type (i.e. Perf, Fin) after the date of default

2. Global Credit Data (GCD): Data and methodology

GCD started collecting historical loss data in 2004, to which member banks have exclusive access. GCD data only covers cases where the borrower has defaulted (using the Basel definition). This database now totals over 302,000 non-retail defaulted loan facilities from around the world. The total GCD defaulted data set is composed of data from the banks who have chosen to be GCD members. These banks' geographical lending footprint, facilities, and borrower types as well as collateral practices are merged in the database. In this report GCD bases the analytics on a filtered data set: using specific products,

(performance guarantees and financial guarantees) and combining elements of representativeness and data quality. The three facility types that GCD classes as performance guarantees are trade related payment guarantee, other trade related bonds, and trade finance bid or perf bond.

The different elements and the reasons for filtering are:

- **Exclusion of unresolved facilities.** Loss given default is most accurately calculated on closed (resolved) cases, where the outcome is anything from full repayment to complete loss, or something in between. Although GCD collects unresolved cases, the ultimate LGD cannot be calculated until the default is resolved.
- **Exclusion of facilities defaulted prior 2000.** Although the earliest entry in the GCD database dates back to 1983, for some banks it is difficult to deliver all the data elements required to identify cured cases for older defaults consistently with newer defaults.
- **Exclusion of data from former member banks.** When a member bank resigns from the association and/or from a Data Pool, the most recent defaulted years that it has submitted must be incomplete as it would no longer participate to submit/update its defaults.
- **Exclusion data quality issue.** GCD applies a series of validation rules during the submission process which prevents inconsistent or incomplete data from being accepted automatically. This is the major data quality insurance that protects the data base. The validation rules are updated and amended as required by our members for every submission. That said, some entries were integrated into the database before certain validation rules had been implemented. For this exercise, data points with errors that affect the integrity of the database (e.g., the event date at default must be the same for all facilities of a given borrower) or the correct calculation of LGD (e.g., balancing the cash flow between the transaction and the history table) were excluded. The structure of the GCD database reflects the full complexity of the legal relationship between a bank lender and a borrower. Usually, a single company borrower might have multiple types of facilities (revolving loans, term loans, performance guarantee facility etc.). The database is designed to deal with the simplest through to the most complex deals and GCD member banks can access the whole deals structure on facility and obligor levels. For this report, figures are aggregated at facility level.

2.1 Representativeness of GCD data sample

GCD performance guarantee data are provided by 16⁷⁸ worldwide banks.

Table 4: List of GCD member banks contributing to the sample

GCD member banks submitting performance guarantee data	
ABN AMRO	ING
BNP Paribas	KfW Bankengruppe
Commonwealth Bank of Australia	Natixis
Credit Agricole CIB	Rabobank
Credit Suisse	Scotiabank

⁷⁸ The earlier report mentioned that 36 banks had provided overall guarantee data (including performance and financial). For the purposes of performance guarantee alone, 16 banks have provided data.

Danske Bank	Skandinaviska Enskilda Banken
DNB Bank	SpareBank 1 Gruppen
HSBC Group	Svenska Handelsbanken

3. Claims made and paid on overall portfolio

Table 6: Claims made and paid on overall portfolio

Type of guarantee	Year	Number of gtees issued	Number of gtees claimed or extended	Claim rate	Number of gtees paid out	Claim paid rate	Number of gtees extended (not paid)	Ultimate drawing rate (Number of gtees paid out vs number issued)	Count of lender
Performance	2016	366,010	15,301	4%	827	5%	14,146	0.2%	16
	2017	356,850	14,930	4%	858	6%	13,635	0.2%	16
	2018	426,503	18,224	4%	964	5%	16,700	0.2%	17
	2019	319,817	15,425	5%	631	4%	14,643	0.2%	11
	2020	371,872	12,730	3%	609	5%	11,876	0.2%	11
	Total	1841,052	76,610	4%	3,889	5%	71,000	0.2%	17
Financial	2016	59,597	3,596	6%	839	23%	2,815	1.4%	14
	2017	59,280	3,375	6%	930	28%	2,388	1.6%	14
	2018	59,771	3,608	6%	738	20%	2,406	1.2%	15
	2019	44,330	2,303	5%	717	31%	1,582	1.6%	10
	2020	55,598	3,309	6%	1,510	46%	1,647	2.7%	10
	Total	278,576	16,191	6%	4,734	29%	10,838	1.7%	15

ABOUT THE INTERNATIONAL CHAMBER OF COMMERCE (ICC)

The International Chamber of Commerce (ICC) is the institutional representative of more than 45 million companies in over 100 countries. ICC's core mission is to make business work for everyone, every day, everywhere.

Through a unique mix of advocacy, solutions and standard setting, we promote international trade, responsible business conduct and a global approach to regulation, in addition to providing market-leading dispute resolution services.

Our members include many of the world's leading companies, SMEs, business associations and local chambers of commerce.

www.iccwbo.org [@iccwbo](https://twitter.com/iccwbo)

ABOUT THE GLOBAL CREDIT DATA CONSORTIUM (GCD)

Since 2004, the Global Credit Data Consortium (GCD) is owned by 50+ member banks and collects, pools, and distributes back anonymized internal credit risk data from banks' loan books, to support modelling of Probability of Default (PD), Loss Given Default (LGD), and Exposure at Default (EAD) in compliance with prudential regulatory requirement.

The PD database covers 18 years of quarterly rating migration, default rates and PDs calibration. The LGD database now totals over 350,000 non-retail defaulted loans from around the world and over 155,000 borrowers covering 11 Basel asset classes.

The robustness of GCD's data collection and quality infrastructure helps place GCD's databases as the global standard for credit risk data pooling.

www.globalcreditdata.org [@GlobalCredData](https://twitter.com/GlobalCredData)

14.2 Appendix – Market Risk

14.2.1 FRTB SA Authorisation Template

Notification to the PRA regarding an authorisation request under the Standardised Approach for Market Risk.

Select below all that apply:

A. CIU Treatment: Mandate-based / Look through-based Approach	Choose an item.
B. Scalar Approach	Choose an item.
C. Base Currency Approach	Choose an item.
D. Alternative Definition of delta/vega sensitivities	Choose an item.

1. General Information

Name of the institution	
Entities affected by the authorisation request	
Date of authorisation	
Description & rationale of the authorisation	

2. Additional Information (Mandatory – Based on authorisation applied for)

A. EIIIF Treatment: Mandate-based / Look through based Approach

Please fill out the below minimum requirements if you are applying for a permission for CIUs:
Mandate-based / Look through based approach as stipulated under MAR 21.36 (2) of the BCBS.

<i>Please provide an Executive Summary explaining the conditions as will be set out in the Basel 3.1 REGULATION pertaining to this supervisory permission request have been met.</i>	
<i>All documents (excluding this form)</i>	

<i>concerning this supervisory permission request that are submitted substantiating this request</i>	
<i>Date of internal approval by the institution's competent bodies</i>	

B. Scalar Approach

Please fill out the below minimum requirements if you are applying for a permission for the Scalar Approach as stipulated under MAR21.98 of the BCBS

<i>Please provide an Executive Summary explaining the conditions as will be set out in the Basel 3.1 REGULATION pertaining to this supervisory permission request have been met.</i>	
<i>All documents (excluding this form) concerning this supervisory permission request that are submitted substantiating this request</i>	
<i>Date of internal approval by the institution's competent bodies</i>	

C. Base Currency Approach

Please fill out the below minimum requirements if you are applying for a permission for the Base Currency Approach as stipulated under MAR21.14of the BCBS.

<i>Please provide an Executive Summary explaining the conditions as will be set</i>	
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<i>out in the Basel 3.1 REGULATION pertaining to this supervisory permission request have been met.</i>	
<i>All documents (excluding this form) concerning this supervisory permission request that are submitted substantiating this request</i>	
<i>Date of internal approval by the institution's competent bodies</i>	

D. Alternative Definition of delta/vega sensitivities

Please fill out the below minimum requirements if you are applying for a permission for alternative definitions of delta sensitivities as stipulated under MAR21.17 (FAQ1 MAR21.16) of the BCBS.

<i>Please provide an Executive Summary explaining the conditions as will be set out in the Basel 3.1 REGULATION pertaining to this supervisory permission request have been met.</i>	
<i>All documents (excluding this form) concerning this supervisory permission request that are submitted substantiating this request</i>	
<i>Date of internal approval by the institution's competent bodies</i>	

Examples

The below are examples of the type of information / supplementary documents firms might be in a position to provide with each authorisation.

Please note, the logic of these examples are that the Executive Summary provides an outline that (i) covers all regulatory requirements as per the BCBS and (ii) provides references to all the accompanying documents where full details can be found to evidence compliance with the aforementioned requirements.

Please note that the content below is provided to serve as a guide only and different authorisations may require less or more information depending on firm's different core businesses and operating models.

A. Example 2: EIIIF Treatment: Mandate-based / Look through based Approach

Please provide an Executive Summary explaining the conditions as will be set out in the Basel 3.1 REGULATION pertaining to this supervisory permission request have been met.	a) An Institution may use the mandate of an EIIIF, although only in accordance with the limits set in the EIIIF's mandate and relevant law and evidence such requirements are satisfied.
All documents (excluding this form) concerning this supervisory permission request that are submitted substantiating this request	• Description of methodology and process to determine the hypothetical portfolio from fund mandate and governing regulation including the used data sources. • Overview of the governance (e.g. Committee) structure including approval body, its responsibilities and mandate • Evidence of internal approval • Audit view on the supervisory permission application
Date of internal approval by the institution's competent bodies	DD MMM YYYY (approved by Group Capital Oversight Committee)

Example 3: EIIIF

B. Example 4: Scalar Approach

Please provide an Executive Summary explaining the conditions as will be set out in the Basel 3.1 REGULATION pertaining to this supervisory permission request have been met.	a) A firm may divide by a scalar of 1,5 the components $\llbracket CVR \rrbracket_{k^-}$ and $\llbracket CVR \rrbracket_{k^+}$ set out in MAR21.14 consistently for all the foreign exchange risk factors of instruments that do not reference the firm's reporting currency/ base currency, and subject to own funds requirement for curvature risk b) Alternatively, and subject to supervisory approval, a bank may apply the scalar of 1.5 consistently to all FX instruments provided curvature sensitivities are calculated for all currencies, including sensitivities determined by shocking the reporting currency (or base currency where used) relative to all other currencies.
All documents (excluding this form) concerning this supervisory permission	• Description of the procedure to ensure that all foreign exchange risk factors are shifted simultaneously.

<i>request that are submitted substantiating this request</i>	• Overview of the governance (e.g. Committee) structure including approval body, its responsibilities and mandate • Evidence of internal approval • Audit view on the supervisory permission application
<i>Date of internal approval by the institution's competent bodies</i>	DD MMM YYYY (approved by Group Capital Oversight Committee)

C. Example 5: Base Currency Approach

<i>Please provide an Executive Summary explaining the conditions as will be set out in the Basel 3.1 REGULATION pertaining to this supervisory permission request have been met.</i>	. a) An institution may replace its reporting currency by another currently (the base currency) and needs to demonstrate that the institution only uses one base currency. b) A firm must: - Demonstrate that the chosen currency is appropriate and does not misrepresent the firm's positions - Provide documentation on how the currency is compatible with how the firm manages foreign exchange risk - Provide the rationale why using an alternative base currency is not solely to reduce own funds - Document how the firm considers the appropriate translation risk between its reporting and base currency.
<i>All documents (excluding this form) concerning this supervisory permission request that are submitted substantiating this request</i>	• Evidence that the chosen currency does not misrepresent the firm's positions and is compatible with the firm's risk management practice. • Evidence that translation risk between reporting currency and nominated base currency is reflected in firm's OFR calculation. • Description of the rationale why a specific base currency is chosen including which legal entities are subject to the base currency and where this differs from the reporting currency of that legal entity. • Overview of the governance (e.g. Committee) structure including approval body, its responsibilities and mandate • Approval body minutes of the internal approval • Audit view on the supervisory permission application
<i>Date of internal approval by the institution's competent bodies</i>	DD MMM YYYY (approved by Group Capital Oversight Committee)

D. Example 6: Alternative Definition of delta/vega sensitivities

<i>Please provide an Executive Summary explaining the conditions as will be set out in the Basel 3.1 REGULATION pertaining to this supervisory permission request have been met.</i>	a) <i>How a bank may make use of alternative formulations of sensitivities based on pricing models that the bank's independent risk control unit uses to report market risks or actual profits and losses to senior management.</i> b) <i>The bank has to demonstrate to its supervisor that the alternative formulations of sensitivities yield results very close to the prescribed formulations.</i>
<i>All documents (excluding this form) concerning this supervisory permission request that are submitted substantiating this request</i>	Regarding a) • Risk and P&L reporting process overview • Short description of alternative definitions Regarding b) • Analysis demonstrating appropriateness, Regarding a) and b) • Documentation of monitoring put in place to ensure the ongoing compliance of the permissioned alternative sensitivities, with the relevant requirements.
<i>Date of internal approval by the institution's competent bodies</i>	DD MMM YYYY (approved by Group Capital Oversight Committee)

14.2.2 FRTB SA Alternative Sensitivities

Alternative definitions of delta/vega sensitivities

We provide below details regarding the regulatory approval to use alternative sensitivities as part of firms' FRTB Standardised Approach.

A distinction needs to be made between approaches to the calculation of sensitivities that can be considered minor deviations from the regulatory prescription and those that – albeit valid – might be characterised as “alternative” and requiring a formal approval to be used for reporting.

We provide below some examples under different common use cases aligned with the Industry response provided as part of the workshops. In these examples the Industry proposes that cases A & B should not require further approval from supervisors. Furthermore, cases C & D are considered by the Industry as ‘alternative definitions’ and therefore should require an approval.

In addition, the Industry proposes that the alternative sensitivities authorisations should come on the actual sensitivity level MAR21.19-MAR21.24 applied to the whole trading book. Further segmentation to product types significantly increases the complexity of the exercise without adding much more value to the capital impact.

We would like to point out that considering the complementary effect between delta risk and curvature risk, differences in approaches for calculation of delta sensitivities tend to be immaterial in the overall capital charge calculation when also taking into account the curvature charge. Consequently, we believe that use of different delta sensitivities will not lead to underestimation or arbitrage in total capital charge in terms of delta risk and curvature risk. Based on observations from the ISDA benchmarking exercise⁷⁹, use of different sensitivity calculations is not usually amongst the main drivers for deviations in capital charge across firms.

Lastly, the Industry would like to raise awareness of the additional ambiguity that Article 325s (1) introduces by specifying a Vega sensitivity formula to fit all asset classes. In the particular case of interest rate Vega the formula implies a 100bps absolute shift which contradicts BCBS MAR21.25 (1) as this is largely not considered a small amount of change in the implied volatility. Moreover, there is no unique approach for calculating Vega sensitivity across banks and asset classes. Since the Vega capital charge is the product of Vega sensitivity times implied volatility any difference in the calculation of Vega sensitivity will have a minor impact on Vega capital charge. The Industry believes that BCBS text MAR21.25 offers the right degree of flexibility.

Industry proposes that in cases similar to the below examples, a regulatory approval would not be required:

A. Alternative bumping methodologies under finite difference schemes

Banks rely on alternative definitions based on more traditional “bump and reprice” methodologies, such as two sided-differences and rescaling of shifts (like using 2bps instead

⁷⁹ <https://www.isda.org/a/QabTE/ISDA-SA-Benchmarking-factsheet.pdf>

of 1bp). These are close in methodological terms to the formulations prescribed in the regulatory text.

- Usage of a different bump size if the sensitivities are scaled accordingly
- Usage of a left sided or two-sided difference scheme i.e. $(V(x)-V(x-h))/h$ or $(V(x+0.5h)-V(x-0.5h))/(h)$
- Any combination of the above
- SA sensitivities with SA tenors interpolated from different tenors used for PnL reporting or Risk management
- SA sensitivities with SA tenors obtained via Jacobian transform from different tenors used for P&L reporting or Risk management
- Instances where a bump size has been tailored for specific numerical precision reasons.
- Use of parallel Delta sensitivity across all tenors for the calculation of curvature. Since curvature is a parallel bump across all tenors, use of a parallel delta sensitivity in line with internal risk management should not be considered an alternative definition.
- SA sensitivities bumping credit hazard rates instead of credit spreads,
- Concrete examples of where Industry and regulators have agreed on what constitutes an alternative sensitivity can also be found as part of the ISDA SIMM framework (e.g. definition of Vega sensitivity in paragraph 31 on page 13)⁸⁰

B. Analytical Formulas or Monte-Carlo simulation

- Another use case under which the Industry believes an approval should not be required relates to Monte-Carlo pricing method: the magnitude of a very small shock (e.g. 1bp/tenor in GIRR) could potentially be the same level of magnitude of the numerical uncertainty in the Monte-Carlo pricing. Therefore, calculating the sensitivity by using a 1bp shock may not be accurate, whereas using a larger shock (e.g. 10bps instead of 1bp) and normalizing (dividing by 10) can be more appropriate.
- For numerical precision reasons, a significant spot shock is appropriate for instruments like variance swaps, for which it is common practice to use a couple of percentage point shocks to get an accurate measure of the risk.
- On the opposite, for risk management purposes, a forex won't use the 1% prescribed spot shock but smaller ones (0.1%, 0.2%...) in order to hedge the position consistently with the actual dynamic of the market.

Approaches that – albeit accurate – implement an alternative definition of sensitivity compared to the regulatory one and require an approval:

C. Adjoint Algorithmic Differentiation (AAD⁸¹)

Some firms may use more advanced techniques, principally adjoint algorithmic differentiation (AAD). AAD across the Industry to generate sensitivities for end-of-day reporting and is computationally efficient and stable compared to “bump and reprice” methods. The Industry would like to note that BCBS FAQ (MAR 50.47 FAQ1) permits the use of AAD or similar computational techniques under the SA-CVA framework.

⁸⁰ <https://www.isda.org/a/oDHTE/ISDA-SIMM-v2.3-PUBLIC.pdf>

⁸¹ <https://arxiv.org/pdf/1004.1855.pdf>

D. Conceptionally Different Risk Representations

Banks may also consider that the below risk representation differs from the one defined by the FRTB on delta and vega risks and therefore may require an approval process;

- In particular there is not always a consensus on the model to be used for vega and this lack of consensus on vega models is actually reflected in the Delegated Act at article 325t(3a) where it is requested that the models be either normal or log-normal for general interest and credit spread vega risks. We need to stress that models may be also hybrid in-between normal or log-normal models (e.g. log-normal with shift).
- Another point is that parametric models (e.g. SABR model) are often used in order to represent the complex vega structures, and the bumps for sensitivities may be applied to model parameters rather than direct market risk factors (e.g. implied B&S volatility) ; this is particularly true for interest rates risks where the vega structure is a cube, with an option maturity axis, an underlying maturity axis, a strike axis.
- Usage of Fourier inversion to evaluate sensitivities in Heston's model may give rise to usage of alternative definition of sensitivities.

Although portfolio-wide quantitative comparisons of sensitivities may appear as prudent or informative at first sight, we must warn that they would, on the contrary, focus on false positives and be of little value in the end.

Indeed, such analysis would be ill-designed by construction because they would imply that BCBS definitions are a sound benchmark to compare against. However, BCBS's definitions are biased (one-sided shock) and rigid (unified standard shift size of 1bp or 1%). Banks' definitions are developed to be more accurate and stable under a reasonable range of shock sizes which is part of the model validation process. As a result, such a comparison can only conclude that bank's alternative sensitivities are more suitable for risk management and capital reporting.

Also, portfolio-wide analysis would create hedge breaks. Banks hedge their portfolio of non-linear products (e.g. options) with linear instruments (e.g. cash or futures/forwards) based on their internal (more precise) sensitivity definitions. BCBS's less precise definitions modifies the delta of non-linear products while leaving the delta of linear hedges unchanged, which breaks the hedging relationship between trades and their hedges. As a result, a truly well hedged position may appear not fully hedged when using BCBS sensitivities.

Finally, such analysis consumes substantial amount of bank's resources to ensure that the quality of BCBS sensitivities are at par with bank's own sensitivities that follow rigorous control and governance processes. However, the outcome of this analysis remains unclear since banks should not be expected to modify their sensitivities in order to match BCBS definition for the sole purpose of regulatory capital, as sensitivities used in capital and risk hedging/reporting would diverge thereby creating conflicting incentives.

Thus, we suggest that there should be no ongoing requirement to monitor the appropriateness of bank's own sensitivities (i.e. where a bank applies to use the alternative sensitivity approach). However, in case a regulator feels that this requirement is necessary, then they may consider using a standardized procedure to monitor the use of alternative sensitivities by reviewing the discrepancies in capital outcome through a cross-jurisdictional benchmarking exercise, such as SA benchmark exercise organized by ISDA: the SBM could be readily added to a metric computed in the annual benchmark. This kind of procedure would provide a simple and homogeneous review approach, while limiting operational burden and administrative charge for both banks and supervisors.

14.3 Appendix –SA-CCR

The Industry notes that SA-CCR retains a number of design and calibration issues beyond alpha factor recalibration that warrant attention. We believe that these issues should be an integral part of the implementation of the Basel 3.1 rules in the UK. The Industry would like to highlight the below issues to be considered by the PRA in their revision.

Ideally a comprehensive review should also be pursued at the Basel Committee level to ensure international consistency potentially through the BCBS Evaluation Task Force.

There are also some identified issues related to collateralisation of the CCR exposures which have been raised as part of the response to the Chapter 5 – Credit risk mitigation.

14.3.1 Other SA-CCR Recommendations

14.3.1.1 Allow firms to use internally calculated deltas

The SA-CCR addresses one of the main shortcomings of CEM by allowing firms to delta adjust the notional for non-linear derivatives. While the Industry welcomes the application of deltas, we are concerned by the requirement to use the Black-Scholes formula to calculate the deltas for certain types of options. Firms should be allowed to follow existing internal practices applicable to path-dependent options and other complex non-linear derivatives for which the Black-Scholes formula does not work. Use of such internal practices would be subject to a firm's internal model governance framework and supervisory oversight.

Recommendation(s)

The Industry recommends that the PRA should allow firms to use internally calculated deltas.

14.3.1.2 Recognise diversification benefit across hedging sets within an asset class

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.

Recommendation(s)

The Industry recommends that the PRA should allow for better recognition of diversification benefit across hedging sets within an asset class.

14.3.1.3 Increase flexibility in certain parts of the methodology, such as allowing index decomposition

Firms should be allowed to use a look-through approach to decompose indices within credit, equity and commodity asset classes to more accurately reflect the exposure of highly correlated long and short positions. The hedging set amount for equity and credit derivative contracts requires a firm 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 firm 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, firms are unable to decompose an index into its underlying components as they do for other capital requirements (e.g. in the FRTB under the BCBS standards).

The option to use a look-through approach to decompose credit, equity or commodity derivatives referencing an index into single-name derivatives each referencing one component of the index recognises the hedging benefit provided by the component of an index and provides enhanced risk sensitivity to SA-CCR framework.

The decomposition of indices for the purpose of calculating capital requirements is a well embedded practice for firms that is already required or permitted in other parts of the prudential framework. Therefore, the Industry would support UK policymakers providing for an option to decompose equity, credit and commodity indices within SA-CCR, should firms be able to carry out such decompositions. This approach will more appropriately represent the risk and will better align with the FRTB. It will also match the approach chosen by US regulators

Recommendation(s)

The Industry recommends that the PRA should allow firms to use a look-through approach to decompose multi-underlying credit, equity and commodity derivatives into their single-name derivative constituents to improve recognition of hedging / offsetting benefits and hence better reflect the risk associated with transactions.

14.3.1.4 Supervisory Delta: Provide methodology to deal with negative underlyings across all asset classes

The shift parameter in the Supervisory Delta formula was introduced to accommodate negative interest rates.

However, this fix is limited to interest rate options. The underlying assumption is that in other risk classes (e.g. equities and commodities), prices should always be positive. That is, however, not always the case. For example, on April 20th, 2020, the WTI futures contract turned negative. While this was a

very unusual circumstance, it is common to trade commodity spread options (e.g. Brent vs WTI or WTI Houston vs WTI Midland) where the underlying spread can be negative.

Another common example include options on the difference in performance across two equity indices which, by design, can be negative.

At the moment, firms have to use a default mechanism to handle such situations. The Industry suggests the following alternatives to address this issue:

- The preferred method is for the Industry to expand the shift parameter application to all asset classes. In this case, the shift parameter could be kept at 0.1% or a higher value given that the underlying are price-based as opposed to yield-based.
- A more simplistic and less preferred method would be to set the Supervisory Delta for all call options to 0, long put options to -1, and short put options to 1. The underlying assumption is that the strikes are positive and therefore anything close to 0 or less is out of the money for a call option or deeply in the money for a put option.

Recommendation(s)

The Industry recommends that the PRA should allow use of the lambda (λ) parameter to accommodate negative prices for all asset classes not just interest rates.

14.3.1.5 Adjusted Notional Amount

As a general principle, it is important to align the notional definition of a derivative contract with the firm's actual closeout risk. While standard notional definitions may produce reasonably accurate exposure estimates for the majority of derivatives, this would not always be the case. For some derivatives, it is impossible to accurately calculate exposure using standard notional definitions.

Recommendation(s)

Firms should be allowed to use internal definitions in cases where the rules are not prescriptive subject to internal governance practices and consultation with, and oversight from, their onsite supervisory teams.

14.3.1.6 Supervisory Factors

The UK policymakers should revisit the supervisory factors set by the BCBS for all asset classes, as they seem to be calibrated to higher volatilities than can be justified by historical data. The Industry urges the UK policymakers to consider observed volatilities during periods of varying market stress and recalibrate the supervisory factors accordingly.

Recommendation(s)

The Industry would encourage the PRA to revisit supervisory factors for all asset classes.

14.3.1.7 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. This issue would be resolved if firms were allowed to net exposures by currency instead of currency pair. SA-CCR should allow for netting by currency (excluding settlement currency) instead of currency pair but only if this is combined with a correlation parameter to aggregate currency exposures or if only the maximum of the net long and net short exposures by currency are included in the add-on calculation.

Recommendation(s)

Allow for netting by currency (excluding settlement currency) instead of currency pair, but only if this is combined with a correlation parameter to aggregate currency exposures or if on the maximum of the net long and net short exposures by currency are included in the add-on calculation.

14.3.1.8 Mandatory Use of SA-CCR in the Large Exposures framework

The introduction of SA-CCR not only affects the calculation of capital requirements for CCR, it will also be used in many other areas across the prudential framework, such as for calculating capital requirements for CVA risk, the exposure measure in the Large Exposures framework (replacing the IMM), for the Leverage Ratio, and for the forthcoming capital Output Floor requirement in the finalised BCBS standards.

Thus, it will affect all firms, regardless of their current model approvals and users of derivatives. The impact to firms and the distortion versus risk calculated under previous methods are likely to be significant.

Therefore, in the Industry's view, the significance of this change on a standalone basis warrants further review.

With specific reference to the Large Exposures framework, it should also be noted that in the US implementation of SA-CCR, US Agencies have retained the use of IMM in the Single Counterparty Credit Limit (SCCL) rule because the available standardised approaches were not deemed to be adequate replacements.

Recommendation(s)

Permit IMM banks to use their internal models to calculate Large Exposures requirements.

14.3.1.9 Treatment of volatility transactions

Article 277a (2) seems to indicate that there should be a distinct hedging set for each volatility risk driver (i.e. one distinct for each distinct equity). The BCBS text as per CRE52.47 states that “Derivatives that reference the volatility of a risk factor (volatility transactions) must be treated within separate hedging sets within the corresponding asset class. Volatility hedging sets must follow the same hedging set construction outlined in CRE52.45 (for example, all equity volatility transactions form a single hedging set).

Examples of volatility transactions include variance and volatility swaps, options on realised or implied volatility. For hedging sets consisting of volatility transactions, the supervisory factor applicable to a given asset class must be multiplied by a factor of five”.

The Industry proposes an alignment of the UK rules with the BCBS text for assigning hedging sets.

Recommendation(s)

The Industry recommends amending Article 277a (2) to read: ‘For the purposes of point (a) of the first subparagraph of this paragraph, institutions shall assign transactions to a separate hedging set of the relevant risk category following the same hedging set construction outlined in paragraph 1’.

15 Glossary

AAD	Adjoint Algorithmic Differentiation
ACTP	Alternative Correlation Trading Portfolio
AFME	Association for Financial Markets in Europe
AIRB	Advanced Internal Ratings Based Approach
A-IRB	Advanced internal ratings-based approach
ALM	Asset and Liability Management
AMA	Advanced Modelling Approach
ASA	Advanced Standardised Approach
ATM	At-the-Money
AVC	Asset Value Correlation
B2B	Back-to-Back
BA-CVA	Basic Approach CVA
BB	Banking Book
BCBS	Basel Committee on Banking Supervision
BEEL	Best Estimate of Expected Loss
BIPRU	Prudential Sourcebook for Banks, Building Societies and Investment Firms
BIS	Bank for International Settlements
Bps	Basis points
BT	Backtesting
CBA	Cost Benefit Analysis
CCF	Credit Conversion Factors
CCP	Central Clearing Counterparty
CCR	Counterparty Credit Risk
CCS	Counterparty Credit Spread
CDS	Credit Default Swap
CEM	Current Exposure Method
CET1	Common Equity Tier 1
CEU	Commercial End-User
CF	Conversion Factor
CfA	Call for Advice
CIUs	Collective Investment Undertakings
CLN	Credit-linked notes
CMS	Constant Maturity Swap
CNH	Chinese currency
COREP	Common Reporting
CP	Consultation Paper
CQS	Credit Quality Steps

CRM	Credit Risk Mitigation
CRR	Capital Requirements Regulation
CRR2	European Commission legislative proposal 2016/0360 issued on 23 November 2016 to amend the Capital Requirements Regulation (CRR)
CSA	Credit Support Annex
CSR	Credit spread risk
CTP	Correlation Trading Portfolio
CVA	Credit Valuation Adjustment
CVR	Curvature Risk Charge
DC	Documentary Credits
DoD	Definition of Default
DRC	Default Risk Charge
EAD	Exposure at Default
EBA	European Banking Authority
EC	European Commission
ECA	Export Credit Agencies
ECAI	External Credit Assessment Institutions
ECB	European Central Bank
ECL	Expected Credit Loss
ECRA	External credit rating approach
EDTF	Enhanced Disclosure Task Force
EEA	European Economic Area
EGIM	ECB Guide to Internal Models
EL	Expected Loss
ELGD	Expected Loss Given Default
EMIR	European Market Infrastructure Regulation
EPA	External Party Approach
ES	Expected Shortfall
ETF	Exchange-traded fund
ETS	Emissions Trading Systems
FAQ	Frequently Asked Questions
FBA	Fall back approach
FCCM	Financial Collateral Comprehensive Method
FINREP	Financial Reporting
FIRB	Foundation Ratings Based Approach
F-IRB	Foundation internal ratings-based approach
FRB	Federal Reserve Board
FRTB	Fundamental Review of the Trading Book
FSB	Financial Stability Board
FSE	Financial Sector Entities

FVTPL	Fair Value Through P&L
FX	Foreign Exchange
GAAP	Generally Accepted Accounting Principles
GCD	Global Credit Data
GFC	Global Financial Crisis
GIRR	General Interest Rate Risk
G-SIB	Global Systemically Important Bank
G-SIBs	Globally Systemically Important Banks
G-SII	Global Systemically Important Institution
HKMA	Hong Kong Monetary Authority
HMT	HM Treasury
HNWI	High-net-worth individual
HQLA	High Quality Liquid Assets
HY	High yield
ICAAP	Internal Capital Adequacy Assessment Process
ICC	International Chamber of Commerce
IFRS	International Financial Reporting Standards
IG	Investment Grade
ILM	Internal Loss Multiplier
IM	Initial Margin
IMA	Internal Models Approach
IMCC	Aggregate Capital Requirement for Modellable Risk Factors
IMM	Internal Model Method
IR	Interest Rate
IRB	Internal Ratings Based
IRBA	Internal Ratings-Based Approach
IRC	Incremental Risk Charge
ISDA	International Swaps and Derivatives Association
ISF	Infrastructure supporting factor
ITM	In-the-Money
JtD	Gross jump-to-default
LGD	Loss Given Default
LH	Liquidity Horizon
LR	Leverage Ratio
LTA	Look-through Approach
LTV	Loan-to-value
MBS	Mortgage-Backed Securities
MDA	Maximum Distributable Amount
MDB	Multilateral Development Bank

MDoCF	Materially Dependent on Cash Flows
MoC	Margin of Conservatism
MPoR	Margin Period of Risk
MR	Market Risk
MRC	Minimum Required Capital
NFC	Non-financial Counterparties
NICA	Net independent collateral amount
NMRF	Non-Modellable Risk Factors
NPL	Non-Performing Loan
NR	Non-rated
OCI	other comprehensive income
OCS	Own credit spread
OF	Output Floor
OMA	Overseas Model Approach
OR	Operational Risk
OTC	Over the Counter
OTM	Out-of-the-Money
P&L	Profit and Loss
P2G	Pillar 2 Guidance
PD	Probability of Default
PFE	Potential Future Exposure
PLA	Profit and Loss Attribution
PLAT	Profit & Loss Attribution Test
PPU	Permanent Partial Use
PRA	Prudential Regulation Authority
PSA	Pension Scheme Arrangements
PSE	Public Sector Entities
QIS	Quantitative Impact Study
QRRE	Qualifying Revolving Retail Exposure
RC	Replacement Cost
RFET	Risk-Factor Eligibility Test
RGGI	Regional Greenhouse Gas Initiative
RGLA	Regional Governments and Local Authorities
RNIM	Risks-not-in-Model
RNiV	Risks-not-in-VaR
ROW	Rest of World
RRAO	Residual Risk Add-On
RTS	Regulatory Technical Standards
RW	Risk Weights

RWA	Risk-Weighted Assets
S/VaR	Stressed/Value-at-Risk
SA	Standardised Approach
SA-CCR	Standardised Approach to Counterparty Credit Risk
SA-CR	Standardised Approach to Credit Risk
SA-CVA	Standardised Approach CVA
SBM	Sensitivity-Based Method
SCCL	Single Counterparty Credit Limit
SCRA	Standardised Credit Risk Assessment Approach
SEC-ERBA	Securitisation – External Rating Based Approach
SEC-IRBA	Securitisation – Internal Rating Based Approach
SEC-SA	Securitisation exposures using a standardised approach
SES	Stressed Expected Shortfall
SFT	Securities Financing Transaction
SFTR	Securities Financing Transactions Regulation
SIMM	Standard Initial Margin Model
SM	Standardised Method
SME	Small and Medium-sized Enterprises
SMF	Senior Management Function
SOFR	Secured Overnight Financing Rate
SPPI	Solely Payments of Principal and Interest
SPV	Special Purpose Vehicles
SRT	Significant risk transfer
SS	Supervisory Statement
SSA	Simplified Standardised Approach
SSM	Single Supervisory Mechanism
SyRB	Systemic Risk Buffer
T1	Tier 1
TB	Trading Book
TC	Trade Register
TRS	Total Return Swaps
UCITS	Undertakings for Collective Investment in Transferable Securities
UFCP	Unfunded credit protection
VA	Valuation Adjustment
VAA	Volatility Adjustments Approach
VaR	Value at Risk
WCI	Western Climate Initiative
WTI	West Texas Intermediate

16 About Us

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