
AFME response – CP14/24 – Large Exposures Framework

January 2025

On behalf of the Association for Financial Markets in Europe (**AFME**), we welcome the opportunity to respond to **CP14/24 - Large Exposures Framework**.

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

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Executive Summary

We welcome the opportunity to provide feedback on the PRA Large Exposures consultation paper (CP14/24). In general, while we recognise the PRA's objective of adjusting the UK Large Exposures (LE) framework post Brexit, to better align with UK circumstances, we do have reservations with several of the PRA's proposals. In this response, we propose several alternatives which we believe are more suitably aligned with the role of the LE framework as a backstop regulatory regime, whilst still achieving the PRA's stated aims.

Primarily, our suggestions relate to the following topics:

- **Implementation date of the proposed changes:** we would strongly recommend that the PRA delays the implementation date of the entire package to the 1 January 2027 deadline it has set for Basel 3.1 implementation. This is particularly relevant to the proposal on mandatory substitution (or any alternative tool), should the PRA proceed with it. The current proposed timeline will be extremely challenging for firms to build into their book of systems development work, particularly considering the competing pressures of Basel 3.1 implementation and there are elements of the proposals which are dependent upon new credit risk methodologies being implemented in Basel 3.1. In addition, we would also recommend allowing firms with existing Non-Core Large Exposures Group (NCLEG) permissions/ modifications by consent expiring before the introduction of the new rules to maintain these until the implementation date, without the need to reapply for renewal under the current framework given the limited life of the current framework and a desire to avoid duplicate applications in a short period of time.
- **Changes to NCLEG limits for intragroup exposures:** we support the proposal to maintain the excess allowance approach for intragroup exposures in the trading book. However, we would recommend that the PRA does not set a maximum in addition to the firm specific process or increases the limit to at least 350%, based on further review of impact from the removal of IMM for SFTs. The 250% limit requires recalibration, particularly considering this limit was originally designed to offset the impact of removing IMM for derivatives in accordance with PS 22/21 and is not adequate to additionally absorb the impact of the removal of IMM for SFTs. This proposal has significant implications and could affect firms' operating models. For the same reason, we also believe it is crucial for the PRA to retain the ability to grant a higher non-trading book limit (i.e., >100%) to compensate for a material impact on intragroup SFT exposures arising in the non-trading book.
- **The mandatory substitution approach:** we would strongly recommend the PRA to not proceed with its mandatory substitution approach (MSA) proposal. We question the need for an approach which places more stringent limits on indirect than direct exposures. A review is particularly warranted given the lack of technical details in the Basel standards. The current proposal could provide a significant impediment to the ability of firms to intermediate between different repo market end-users, which could in turn impact the interbank repo market and overall market liquidity of the securities. In particular, the proposed treatment of sovereign exposures could significantly impact the sovereign

market liquidity. Members are concerned that the proposals are also likely to lead to a more general reduction in market capacity in certain repo and collateralised derivatives markets. This includes corporate bond markets given recent trends in the UK towards greater use of non-gilt collateral among certain groups of end users. In turn, this is likely to increase costs faced by end-users in meeting their liquidity, financing, and risk management objectives, at odds with the PRA's secondary competition and growth objectives. Further, it is likely to reduce liquidity in certain markets, particularly in stressed scenarios, likely reducing market resilience and amplifying impact of stress such as that set out in the System-wide exploratory scenario (SWES).

We recommend that if the PRA proceeds with the current proposal, it should at a minimum remove all sovereign exposures from the scope of large exposures limits for mandatory substitution, and work to create a more proportionate approach for non-sovereign collateral to avoid adverse market and real economy impacts. We would further highlight the need for further clarity in the formulation of the approach to mandatory substitution calibrated specifically to each credit risk methodology under which collateral is recognised and stand ready to work with yourselves to further design an approach which addresses these concerns to avoid the possibility for interpretative inconsistency whilst achieving compliance with the Basel standards.

- **The removal of the trading book excess allowance for trading exposures to third parties:** we would like to highlight that there is a potential for relatively short periods of time in which firms may have large third-party trading book exposures, caused by volatility in market prices. These are managed down very quickly via additional margin calls and active management and we do not consider these a significant source of concentration risk. We would therefore recommend the implementation of a short-term allowance for trading book exposures in excess of the 25% limit which, could be capitalised in the same way as proposed for intragroup excesses (i.e., 100% risk weighted exposure requirement). The allowance would only be applied to exposure in excess for less than 10 days before being considered as a breach of the limits.
- **Additional recommendations:** we have also taken the opportunity to provide feedback on several issues concerning the current UK LE framework which, although outside of the formal scope of CP14/24, we think would help clarify the framework and support a more proportionate, prudentially sound approach and align to areas of the Basel standards which are absent from the current proposals. In addition, we have provided a list of apparent inconsistencies contained in CP14/24 within section 7.

2. Implementation Date

On the proposed implementation deadline, we would strongly recommend that the PRA delays the implementation date to the 1 January 2027 deadline it has set for Basel 3.1 implementation. This is particularly pertinent to the proposal on mandatory substitution should the PRA proceed with it or a variant thereof.

There are a number of references to the existing UK CRR which will need to be repointed to the PRA Rulebook following the UK implementation of Basel 3.1 and the associated assimilated law proposals requiring further revision of the rulebook – examples are listed below. Therefore, we believe that there are efficiencies to be gained both to the PRA and to affected firms in alignment with the implementation date of Basel 3.1.

- the definition of ‘exposure’ in rule 1.2
- definition of ‘transactions’ in rule 1.4
- rule 2.5 explanation of consolidated situation
- references to parts 2 and 3 of CRR
- all exemptions referring to standardised approach

Secondly, any implementation deadline earlier than 1 January 2027 will be extremely hard for firms to build into their book of systems development work, particularly considering the competing pressures of Basel 3.1 implementation, and the uncertain timeline for release of the final large exposures policy statement. Furthermore, project resources are generally managed with long lead times, involving yearly budget allocations for example, which is one of the reasons that firms need stable and longer-term timelines they can adhere to.

Given that the standardised calculation of SFT exposures within a master netting agreement (MNA) is changing, we believe that it would be more appropriate and efficient to implement the PRA’s LE proposals after the adoption of this new MNA methodology, particularly in light of the mandatory substitution proposals.

Implementing the substitution approach before the move away from IMM modelling of SFT exposures creates additional complexity and throw-away work. Firms would be required to implement the substitution approach for IMM for a period of a few months prior to the implementation of Basel 3.1 and then also under the new standardised approach from 1 January 2027. Further, the operational challenges which are to be expected with respect to managing business activities and client legal arrangements to adjust for the new limitations on collateral receipts arising from the MSA will require significant time to adjust to if implemented in the form currently proposed and therefore firms will require a period of at least 1 year post finalisation of the rules to implement this element of the framework to manage this impact in a controlled manner.

If the PRA decide not to align with Basel 3.1 implementation date, we would request that this should be 12 months post PS publication, at a minimum, with the exception of the removal of IMM for SFTs and MSA for the reasons described above. This is consistent with other large-scale changes which have been implemented by the PRA.

We would also recommend allowing firms with existing NCLEG permissions/ modifications by consent expiring before the introduction of the new rules to maintain these until the implementation date without the need to reapply for renewal under the current framework given the limited life of the current framework. This would reduce the operational burden on firms and the PRA permissions team arising from the submission of multiple NCLEG permissions/ modifications by consent applications in a short period of time. It would also ensure permission applications are now made only under the new rules with less requirement to rely on the Legacy NCLEG transitional provisions. In particular, it is unclear from the proposals the length of time between the firm's existing permission expiring and the publication of the final rules. It would also allow time for firms to apply new NCLEG permissions, particularly Higher NCLEG permissions or requiring increased scope of entities within their NCLEG as a result of the changes to the framework by the implementation date of the revised LE framework. In this context, we recommend an extension of existing permissions, in particular any modifications of consent to 1 January 2027. Confirmation of the PRA's intention in this area as soon as possible would also be very helpful for planning purposes.

We discuss the potential implications of the mandatory substitution in Section 5 below. They are significant and wide-ranging, and if implemented in full would mean that banks will need to review existing arrangements with clients. If the PRA proceeds with its proposals, regardless of the implementation date of the remainder of the package, banks will need at least a year after the publication of final rules to prepare for the implementation of the mandatory substitution proposals (notwithstanding members' views that, the proposal is dropped or significantly amended in line with our recommendations in Section 5).

3. Removal of Internal Model Method for calculating SFT exposures

We understand the PRA's rationale for the removal of the internal model approach for SFT exposure calculations. We believe it to be generally in line with the design of the large exposures framework and the Basel intent for the framework to operate as a conservative backstop. However, we would encourage the PRA to review the significance of this change to exposure amounts as the immediate impact to firms is expected to be material and will interact with the PRA's other proposals in CP14/24.

We encourage the PRA to consider the significant immediate impacts to exposure amounts resulting from this change to ensure that the broader framework remains calibrated appropriately, to prevent disproportionate impacts to firm's capital requirements and to avoid firms having to make changes to their booking models. This is essential in the industry's view for the PRA's expectations in para 6.7 to hold true in practice, i.e. that "no firm would have to make changes to their booking models to align with the new proposals".

Firms have found that SFT exposures under the Financial Collateral Comprehensive Method (FCCM) can be materially higher than under IMM – some firms have found they could as much as double. While the PRA notes in para 2.4 that it does not expect this proposal to have a material impact on firms, firms are concerned about their ability to absorb this scale of increases. Firms have noted that the calibration of the NCLEG limit (250%) and the calibration of capital requirements for excesses does not allow them to absorb the impact of the removal of IMM without significant changes to their BAU operating model.

In this context, the industry also notes that EU large exposures rules continue to allow the use of IMM for SFT activities and is also more flexible with higher or no set limits on intragroup exposures. As such the EU LE framework would become less restrictive than the UK towards the hosting of large international group with significant SFT activities, despite firms meeting all the PRA's expectations on risk management, booking arrangements and wind-down capabilities. This uneven playing field in the framework could contribute to a change in the status quo in terms of firms booking models and have repercussions on the UK's attractiveness as booking location.

We therefore urge the PRA to reconsider the treatment of intragroup exposures, as set out in section 4.2. In the industry's view the NCLEG limit should be set on a firm-by-firm basis as part of the permission application process. To the extent the PRA requires to set a limit it should be at least 350% to avoid repercussion on operating models.

4. Limits to large exposures – trading book exposures

4.1 Trading book exposures to third parties

We would recommend that the PRA continues to recognise the potential for relatively short periods of time in which firms may have large third-party trading book exposures, particularly as such exposures are generally caused by volatility in market price factors outside of their direct control to prevent but within their control to address and manage subsequently. We believe that it would be appropriate to allow at least some short-term flexibility, to permit firms to take actions to resolve any excess exposures arising from market price volatility, without this being considered a hard limit rule breach with resultant supervisory engagement/action. Actions firms would typically take could include re-margining, selling of positions, execution of hedges etc.

Therefore, as an alternative proposal, we recommend that the PRA considers implementing a short-term allowance for trading book exposures in excess of the 25% limit which, while being capitalised in the same way as currently done (i.e., an additional capital requirement that is the equivalent of 100% risk weighted exposures amount, aligned to what you are proposing on the intragroup), would be applied to exposure in excess for less than 10 days. Exposures still in excess of the 25% limit after 10 days would then be considered a breach of large exposure limits and would be reported as such to the PRA along with details of the outstanding plan of action and timeline for resolution.

Additionally, we would request consideration for recognition of collateral in transit for all exposures – similar to that allowed for IMM CCR calculations in order to reflect that margined trade exposure volatility from price movements is broadly self-correcting on a T+1 basis once margin calls settle.

The recommendation above that firms experiencing short-term market price volatility should not have trading book limit breaches, but rather, incur an additional capital charge would also avoid the situation

that firms would have to maintain large risk appetite buffers to operate considerably below the regulatory LE limit in an attempt to prevent the occurrence of these breaches. Such capital buffers by their nature could not prevent all circumstances of breaches of large exposures limits depending upon any particular market stress events occurring, how long these occur for and how these impact the exposure values for any particular client.

We would also note that firms are more likely to experience trading book excesses and volatility in the future if the mandatory substitution proposals are implemented as proposed (see section 5 below) resulting in a greater need to have some trading book flexibility without this being an automatic breach of a hard limit.

Lastly, we would further note that the flexibility granted by Article 396 for firms to exceed the limits in “exceptional circumstances” subject to reporting the exposure to the PRA who can then permit a period of time for firms to address the excess may not provide the same outcome as a temporary “soft” limit in this context for the following reasons:

1) The lack of clarity on what would be considered “exceptional circumstances”. We would recommend the PRA provide additional supervisory guidance on the circumstances under which firms would be able to take advantage of this requirement, and particularly clarify whether market price volatility outside of any particular significant market stress event would be considered sufficiently “exceptional” to warrant application of this approach given this could occur on a day to day and more frequent basis. We would note that the EBA has seen the need for additional clarity in this space and post Brexit published guidelines for EU entities on their views on this approach although we would note the context of their guidelines is only for banking book exposures.

2) Provide additional guidance on the supervisory implications for exceeding the limits in Article 395 and operating under Article 396, particularly with respect to the connection with the broader context of PRA supervision of breaches of rules/limits as set out in the PRA approach to banking supervision. Given SMF responsibility to prevent regulatory breaches and the potential for supervisory enforcement action related to breaches this results in management actions and behaviours to prevent any rule breaches and avoid the uncertain consequences related to their occurrence. Even a well-meant exemption due to exceptional circumstances, such as the current one, effectively works as a hard limit when a breach needs to be reported straight away to the supervisor, needs internal escalation potentially up to board level and falls under internal risk management reporting requirements or similar. Given that trading book breaches are likely to be driven by market price moves outside of the firms control, the key tool available to SMFs is to introduce significantly conservative risk appetite buffers below the 25% limit in order to attempt to limit these occurrences and the need to trigger Article 396. These risk appetite buffers will therefore provide a significantly greater than expected restriction to the provision of services to end users and will be tantamount to introducing a hard limit substantially lower than 25%. As evidence we would like to highlight the well documented reluctance of firms to dip into capital buffers through the Covid-19

pandemic given the implications of increased supervisory engagement resulting from their use and perceived unfavourable market reaction to their use and in the same vein for large exposures firms can be expected to be reluctant to have large exposures breaches under Article 396. Examples include the PRA's [Q&A on the usability of liquidity and capital buffers | Bank of England](#) and a more conceptual discussion by the ECB of [Macroprudential capital buffers – objectives and usability](#).

4.2 Trading book exposures to intragroup entities

We welcome the PRA's recognition on the fragmentation and risk management issues which a hard limit on intragroup trading book exposures would create and the proposal to maintain the excess allowance approach. We also support the PRA's proposals to allow a higher NCLEG exemption.

We note in para. 6.7 that the PRA does not intend firms to make changes to their booking book models to align with the Consultation Paper. However, our members' review of the proposals show that these would require them to raise significant amounts of capital in order to maintain the current operating models. Hence, we find that the proposed 250% limit is too low and will in practice restrict firms' booking practices. This could contribute to a change in the status quo in terms of firms booking models and have repercussions on the UK's attractiveness as a booking location.

As a starting point, the industry generally agrees that the 250% NCLEG limit was sufficient to absorb the impact of moving from IMM to SA-CCR for derivatives. But this is no longer sufficient for also removing IMM for SFTs. SFTs make up a significant portion of intragroup flows within international groups, and as noted in section 3, SFT exposures under FCCM are expected to double. In the industry's view the NCLEG limit could therefore continue to be set on a firm-by-firm basis as part of the application process. To the extent the PRA requires a set limit, it should be set to at least 350% to avoid repercussions on operating models. We would also point to the EU framework where limits for intragroup exposures are higher (e.g. Germany has a maximum of 400% and France and Luxembourg are unlimited). As discussed in the UK Finance/ AFME meeting in December 2024, members will reach out to the PRA on a bilateral basis, with impact assessment data on the issue described above.

Under the proposed rules, a firm may only use its NCLEG or higher NCLEG where the total amount of non-trading book exposures to its NCLEG does not exceed 100% of the firm's Tier 1 capital. However, firms also have large portfolios of SFT transactions in the non-trading book which are predominantly used for liquidity management purposes performed by the Treasury function, and thus will also incur a significant increase in EAD as a result of the shift to using the FCCM. Therefore, in line with the arguments for an increase in the higher NCLEG limit for the trading book exposures, we also believe that the PRA should retain the ability to grant a higher non-trading book limit (i.e. >100%) to compensate for a material impact on intragroup exposures arising in the non-trading book. This is crucial as without an increase in the limit the only way to create additional capacity for such exposures would be to an equivalent amount of additional capital (i.e., for every £1 in exposure capacity required, a firm would be forced to raise £1 in additional capital).

We would further note that concentration risk is already covered within the Pillar 2A and stress testing frameworks to supplement the Pillar 1 framework, including for intragroup, which ensures comprehensive consideration of the concentration risks incurred by firms. Further, the current Pillar 1 framework with the additional capital requirement incurred upon excesses already disincentivises firms to maintain long term/significant trading book excesses as observed in point 3.5 of the Consultation Paper and therefore the current soft limit is operating in an effective manner to limit concentration risk whilst permitting some flexibility to manage exposures deriving from market price movements which firms cannot anticipate in advance.

The PRA has clarified in the UK Finance/ AFME meeting in December 2024, that the additional capital requirement on the part of the exposure that exceeds the LE limit “equal to 100% of the amount of the excess” refers to a 100% risk weighted exposure amount and not a 100% own funds requirement.

This should be explicitly clarified in the final Policy Statement to be a 100% risk weighted exposure amount as opposed to an own funds requirement since para. 3.16 of the Consultation Paper and Article 395(5)(b) of the proposed amendments to the rulebook are not clearly worded to that effect.

As a result, we propose that Article 395(5)(b) be redrafted as follows:

“(b) the firm meets an additional **risk-weighted exposure amount** ~~own funds requirement~~ in respect of the part of the exposures in excess of the limit laid down in paragraph 1 of this Article equal to 100% of the amount of that excess; and”

4.3 NCLEG Waivers & Permissions

From a permissions perspective, we would appreciate the PRA clarifying how firms should approach renewals of their NCLEG permissions, in relation to the new Trading Book Wind-Down (TWD) requirements for an NCLEG permission.

We would recommend that the PRA adopt a single future implementation date as referenced in section 2 which provides sufficient time for firms to make the necessary permission applications under the new regime after TWD has been adopted. This is particularly important where, as noted in section 3, the removal of the IM for SFTs would further increase intragroup exposures resulting in the possibility for firms to breach limits or be in non-compliance with the terms of the permission, which have not thus far had the equivalent of a higher NCLEG permission.

We would also ask that the PRA consider the timing issues around expiry of existing NCLEG permissions and modifications by consent and the relationship with the implementation date for changes in the calculation of exposures and particularly where these would expire before the introduction of the new rules set out in this Consultation Paper consider permitting an extension of the permissions without the need for reapplication under the current regime to facilitate firms and the PRA permissions team working on only one set of applications under the new rules only. This would be efficient for impacted firms and

depending upon the implementation timeline would generally result in only short-term extensions to permissions which had previously required renewal every 3 years and sets well against a background of very rare changes to the legal and regulatory regimes of third countries which could otherwise change the status of firms in scope of the permissions and create impediments to transfer of funds/repayment of liabilities, particularly as firms already have a standing obligation to inform the PRA of any changes which could impact the existing permissions. We would suggest extensions are granted to align to the determined implementation date considering the feedback provided in section 2 of this response.

In this context, we note that currently the PRA are only envisaging in point 1.14 of the Consultation Paper an extension for the higher NCLEG permission. However, it is important to consider this extension for the NCLEG permissions more broadly, which allow firms to reassess their NCLEG permission requirements holistically and ensure the correct scope is considered and the new TWD requirements adequately reflected in the application. Both the required level of future NCLEG limit and scope of NCLEG permission require time for firms to assess and recalibrate for the new rules.

We also note that the PRA have maintained a notification requirement if firms have a Core UK group (CUG), if the largest CUG counterparty goes over 25% of Tier 1 capital, to any single member of the NCLEG. We would highlight that this information is already contained in firms' COREP returns (presuming that they do not have an individual consolidation waiver) and would therefore query the benefits of retaining the additional notification requirement. It is extremely likely that in the context of permitting a 250% higher NCLEG permission (or ideally higher as noted in section 4.2 above) that the exposure to any single member of the NCLEG would regularly exceed 25% and therefore the PRA could expect to see frequent notifications to this effect providing the same information as contained in the COREP returns.

If the notification requirement is retained, we would appreciate greater clarity on the context of the notification, and particularly whether this is a single point in time or an ongoing requirement which would then apply on a particular frequency whilst any single member exceeds 25%. We would note if the former as a single point of time notification when an excess first occurs this would likely result in more frequent notifications for firms with exposures hovering around the 25% level and would not indicate any particular risk beyond normal day to day volatility. Ongoing exposures exceeding this level are reported quarterly as part of COREP returns and therefore we would appreciate clarity as to whether this is effectively tantamount to e.g. a daily/weekly/etc. reporting requirement.

Finally, for firms wishing to apply for a higher NCLEG permission, it is not possible to determine how the PRA will set the limit between 100% and 250%. There is a general comment in the new paragraph 3.8B of the Large Exposures Supervisory Statement SS16/13 that a firm must demonstrate it meets the Trading activity wind-down expectations in SS1/22 and a comment in paragraph 3.25 of CP14/24 that the firm must meet the booking arrangement expectations in SS5/21. However, more specific guidance on the principles that the PRA will apply in calibrating the NCLEG limit would be helpful to allow firms to gauge the level of NCLEG they could achieve and better assess the impact of the rule changes in CP14/24 on their capital position. This could be facilitated by adding more detailed guidance in paragraph 3.8B of SS16/13 and amending the CRR Non-core Large exposures group template required for firms to complete as part of the permission application process. The industry would welcome the opportunity to provide feedback

and highlight any unintended consequences prior to the additional guidance and template amendments are being finalised.

As noted in section 2 above, confirmation of the PRA's intention in this area as soon as possible would be very helpful for planning purposes.

5. Calculating the effect of the use of credit risk mitigation techniques

5.1 Mandatory substitution approach to funded credit protection

The proposals specify that when firms reduce an exposure to a counterparty using eligible CRM, they must recognise an indirect exposure to the issuer of the funded credit protection or the protection provider of unfunded credit protection.

The option to recognise the indirect exposure to the protection provider of unfunded credit protection is a requirement of the existing rules and is appropriate since it reflects the default risk inherent in the protection provider making payment which could otherwise lead to a loss if the protection provider were to fail. Firms have no concerns with this approach being retained but would recommend the PRA to clarify the flexibility for firms to disregard the credit risk mitigations and recognise a gross exposure to the original counterparty and place no reliance on the secondary protection offered by a guarantee for both risk-based calculation and large exposures purpose.

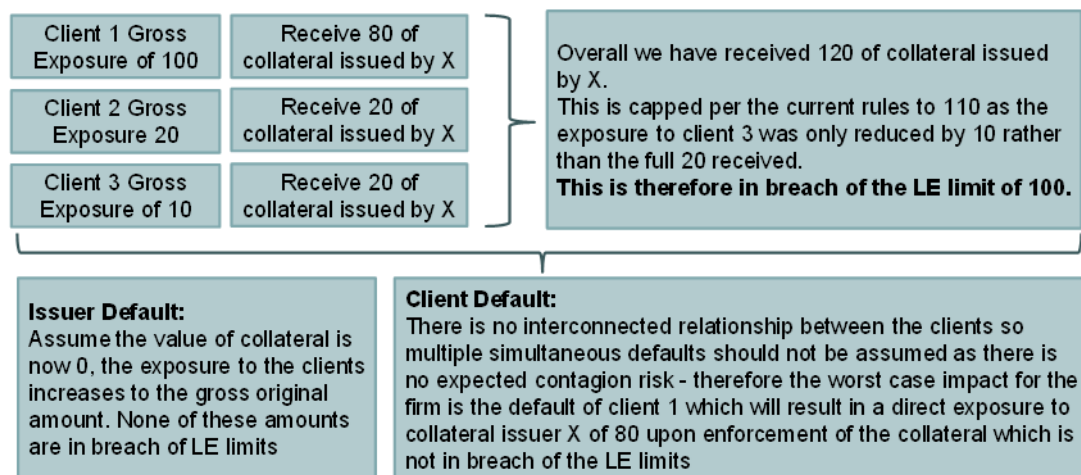
However, the mandatory requirement to recognise indirect exposures to the issuer of the collateral would require firms to reassign the portion of the exposure that is reduced to a counterparty as an exposure to the issuer of the collateral.

On the other hand, the incremental requirement to recognise that indirect exposures to guarantee providers and collateral issuers introduces a risk of loss linked to the default of the guarantee provider/collateral issuer. However, the proposed rules do not provide sufficient risk differentiation in that they do not distinguish between guarantors and collateral issuers and do not differentiate between concentrated positions and diversified positions. We would challenge in particular whether the proposed aggregation of multiple exposures, from various groups of connected clients (GCCs), but linked to the same collateral issuer (which would mean that the reduced part of these exposures will be substituted by a single GCC) would align to the core principle behind the Basel large exposures (LE) framework. The LE rules are designed to restrict potential losses from the failure of only a single counterparty / GCC and not multiple, unconnected GCCs. Concentration risks of this nature are more appropriately captured under the Pillar 2 framework as they are under the current framework.

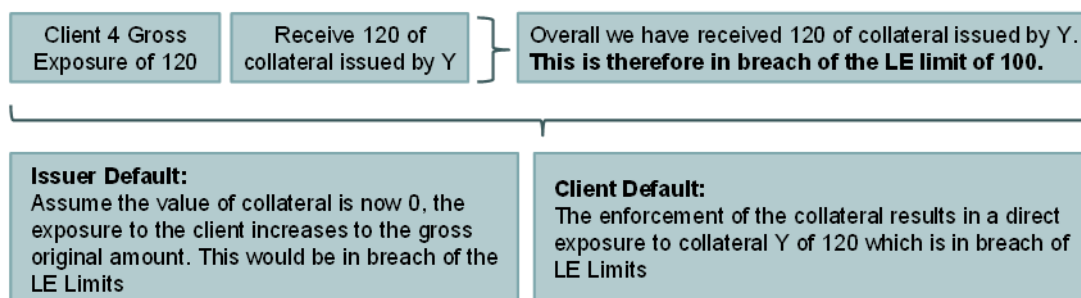
Aggregation of exposures to collateral received from multiple unconnected clients would place tighter limits on collateral than on direct exposures to the same counterparty group – i.e. triggered by multiple unconnected client defaults rather than one single client group default and the proposal includes no provisions for netting agreements to reflect the possibility of different issuances of the same issuer being both received and posted as collateral.

Further, as illustrated in the diagram below, if an issuer of collateral were to default this will lead to increased exposures to separate unconnected counterparty groups (not a direct loss) and should not present a large exposure concern as long as these are not individually material. An unconnected counterparty group would not be expected to default due to the default of the collateral issuer; otherwise, this correlation would have implied specific wrong way risk (SWWR) /material positive correlation which would have rendered the collateral ineligible CRM in the first instance under the Credit Risk Mitigation rules. Standard practice for SFTs would result in a call for replacement collateral to rectify the increased exposure of the netting set such that any increased exposure from the default of a collateral issuer should be individually small and short-term in nature. Therefore, there is no risk of loss arising in this scenario absent of specific wrong way risk/correlated collateral.

Scenario 1:



Scenario 2:



Assumptions for the above scenarios:

- 1) LE Limit is 100
- 2) There is no relationship between any of the clients or the collateral issuer through either control or interconnectedness and there is no SWWR/ material positive correlation with respect to any of the collateral (If there were a relationship, these should be considered on a group level basis in the same manner as these examples)
- 3) The analysis ignores haircuts and the intricacies of any exposure calculations for simplicity of the illustration. Further consideration of these intricacies is covered in section 5.1.3 below.

The risk to the firm from the issuer of the collateral in scenario 1 is significantly less than that in scenario 2 which is concentrated with a large amount of collateral X from one client but the current proposed approach does not allow for any sensitivity to this differential in level of risk which is of significant concern to firms as to how this will impact overall repo market intermediation activities as further expanded upon in the section 5.1.1 below.

Concentration risk to collateral issuers should be subject to controlling limits but only within a framework of connected client defaults to align with the broader LE framework purpose as set out in LEX10 and the risk sensitivity which would be applied for direct exposures.

5.1.1 Market Impact Considerations

As an Industry we are unable to provide any meaningful quantitative support of the points listed below, due largely to time constraints resulting from the deadline for the CP response. However, we believe it is important to highlight these qualitative points at this time. We would welcome further engagement and a quantitative impact study with the PRA in order to better understand the impact of mandatory substitution on financial markets. Now that the implementation of Basel 3.1 in the UK has been delayed we hope that there is an opportunity for the PRA to conduct a more in-depth impact assessment which would overcome firms confidentially issues and meet the PRA requirements.

- Firms are concerned that the proposals are unclear as to what amounts should be reported as indirect exposures when several repos/reverse repos have been transacted under a master netting agreement, with multiple different securities being posted/received. When the securities posted/received are from the same issuer full netting should be allowed. With SFTs under MNAs often collateral is being exchanged by counterparties without the exchange of any cash. In case of default of the immediate counterparty the risk faced by the bank is the basis risk between the collateral posted and received. There are therefore strong arguments supporting netting of these securities, even when from different issuers, since this is more reflective of what would happen in case of an actual default. Assuming a worst case scenario which only requires an exposure for all received collateral with no netting, this will provide a significant impediment to the ability of firms to intermediate between different repo market end-users (particularly companies such as asset managers, pension funds, hedge funds and insurance companies which typically provide collateral in return for cash and e.g. money market funds and corporate treasurers which invest cash whilst receiving collateral) and for institutions to finance their market-making inventory, source short-term funding or invest cash. Firms are also concerned that this could impact the interbank repo market and overall market liquidity of the securities if firms are then effectively restricted on what they can post as collateral to other firms in scope of the same requirements.
- Members are concerned that this would exacerbate fragilities such as those set out in the Bank of England's SWES around market functioning, particularly in corporate bond markets given trends towards greater use of non-cash collateral (for example, as raised in the SWES "a significant proportion

of insurer CSAs have been renegotiated since 2020 to increase flexibility around types of eligible collateral, and so there has been an increase in the use of corporate bond collateral. Overall, around 30% of IM and VM calls are met with corporate bond collateral by insurers under the SWES scenario, similar to the shares met with gilts and with cash”). Members would also expect the shadow banking sector to pick up some of the activity pushed out of the banking system, making it more difficult for authorities to monitor and mitigate financial stability risks.

- We would already note some instances where this concern has been realised in smaller EU entities subject to these rules on a gross basis where firms are being prevented from receiving sufficient amounts of collateral from clients in order to then post to other clients as collateral. Given this is of particular concern for smaller entities this could thereby lead to a reduction in competition in the market as only the largest firms will be able to continue to provide SFT intermediation services at any scale and could result in more activities being conducted outside of the regulated banking sector. It is hard to provide tangible data on this as it relates to trades not executed but as a recent example, the EU subsidiary of one of our members had a client which has EUR denominated EEA government bonds it was willing to post as collateral however the firm is now unable to accept these as they are not eligible for large exposures exemptions given the local competent authority has not permitted exemption under EU CRR Article 500a(2) as EUR is not yet the domestic currency of the EEA country. The firm has another client who would have accepted the bonds as collateral but is unable to intermediate this activity given the gross limits placed on the amount it can receive from the first client. The trades have therefore not been executed resulting in the loss of a client and related revenue opportunities.
- As a result, this could further increase costs for firms and end-users and also concentrate the types of collateral firms are willing to intermediate into only high-quality sovereign debt eligible for 0% risk weights and hence large exposures exemption only. This is particularly a challenge for smaller firms and for those with business models operating with clients in emerging markets which will typically only have the sovereign debt of their country available to post as collateral and therefore this could be considered as running counter to the PRA's secondary objectives of competition and facilitating the international competitiveness and growth of the UK economy. To the extent that smaller firms are disproportionately affected in certain markets, it would also adversely impact the PRA's secondary competitiveness objective.
- We would also note that this could require substantial legal work to renegotiate legal agreements with clients as they generally have a range of collateral quality/types which they are able to post within certain concentration limits on an individual client basis and therefore firms would have limited ability to control in aggregate on a gross basis across unrelated clients on a day to basis the exact amount of collateral received in relation to a particular issuer. These client rights would need to be restricted thus exacerbating the concentrated risk concerns.
- Overall, the receipt of collateral should be seen as a risk mitigant rather than something which can be risk increasing unless received in concentrated amounts from a single client/ GCC. It may in fact become preferable to run unsecured/less-secured exposures to certain counterparties rather than receive the collateral they could provide in order to avoid additional large exposures to the collateral

issuer – thereby increasing overall economic risk for the firm. This would of course have an RWA consequence if not received from a 0% risk weighted counterparty.

Recommendation:

- Substitution should remain optional, not mandatory.
- Where substitution is applied, the indirect exposures to a single issuer arising from collateral posted by different counterparties that are not connected to each other or to the collateral issuer should not be aggregated. Rather they should, at a minimum, be treated as separate individual exposures for the purposes of the large exposure rules.

5.1.2 Treatment of sovereign exposures

- All sovereigns are specified as exempt from the Basel LE framework but are currently only exempt from the UK approach if eligible for a 0% risk weight. However, the consultation paper maintains in Article 400(1)(a) that only exposures to sovereigns that are risk-weighted at 0% under the standardised credit risk approach are excluded from the application of the large exposure limits.
- Under standardised credit risk rules, to achieve a 0% risk-weight, several alternative conditions must be met: either the credit rating must be: either the external credit rating must be AA- or above to qualify for CQS1; or in the case of lower externally rated third country sovereigns: (1) HMT must have granted an equivalence status to the relevant regulations applied by the third country regulator, (2) the third country regulator must apply a 0% risk weight and (3) the exposures must be 'denominated and funded in the domestic currency for sovereigns with an external rating mapped to CQS 2 or below.
- Therefore, we would question the rationale for aligning the conditions in the large exposure rules to the credit risk rules, particularly, with regards to the following in the context of the MSA proposals:
 - The connection to the credit risk regime and scope restriction of the exemption vs Basel: we would argue that the importance and extent of usage of sovereign bonds as collateral warrants their exclusion from the large exposure limits. Particularly for exposures to counterparties in emerging markets this will limit their usage as collateral and many counterparties are likely to only have their local sovereign bonds as collateral. This could potentially have knock on impacts to the pricing of sovereign debt as the lack of robust repo markets will reduce the ability to re-use and fund sovereign debt. The PRA could either align to Basel fully in exempting sovereign exposures from large exposures limits or alternatively consider retaining the large exposure limits to direct sovereign exposures (not eligible for the 0% risk weight) whilst treating the indirect element arising from the substitution approach as a reporting item only to allow the PRA to monitor indirect exposures to sovereigns and take action if deemed necessary without having a market restricting impact on this important source of collateral. We would note that this approach would be capable of being assessed as compliant with the Basel standards under any RCAP assessment.

- If indirect exposures to sovereigns as collateral issuers are not fully exempted from the large exposures limits per the above considerations, then we would note that the requirement for such exposures to be funded in the domestic currency of the sovereign as set out in Article 114(7) to obtain a 0% risk-weight is problematic for indirect exposures taken under the MSA. The collateral received is off-balance sheet and is not funded by the institution and there is no way to ascertain how the counterparty is funding it. Furthermore, having liabilities/ funding in the relevant currency would have no impact of the firm's ability to liquidate that same collateral in the event of a default of the underlying counterparty and has no bearing on the actual default risk of the collateral issuer. Even in the context of repos/reverse repos with a cash leg it is likely that on-balance sheet netting will occur and result in insufficient corresponding liabilities vs. a gross exposure on only received collateral.

In its 2017 consultation on the regulatory treatment of sovereigns (BCBS425) the BCBS noted that "funding sources are somewhat fungible and not necessarily linked to specific assets". The context of this requirement originally was to mitigate foreign exchange risk and as discussed by the committee these risks would be captured under the market risk framework even when arising from banking book exposures. Therefore, in our view there is no need to require exposures to be funded in the same currency in terms of application of a 0% risk weight for credit risk, the purpose of which is to cater for the default risk of the issuer. We agree that the credit risk arising is somewhat differentiated for currency of denomination as the issuer has more latitude to avoid domestic currency defaults through currency devaluation. However, even for foreign currency issuances sovereign exposures are the most liquid global assets which perform a fundamental key role in financial markets as the most commonly utilised collateral and the Basel Committee is clearly comfortable with their broad exemption as a result.

Without an exemption we are concerned about the impact on sovereign market liquidity. A reduction in sovereign repo activity is likely to have significant costs for cash investors as limited repo markets may no longer be able to support the low-risk investment of cash as firms will be limited in the amount of sovereign bonds they can receive against the cash they lend and conversely will therefore not have the collateral available to provide to cash investing clients. Further, by limiting the flow of collateral and the financing of market-making, it could increase liquidity premia, reduce price discovery and cash market functioning, and ultimately lead to an increase in the costs to government primary market issuance. A restriction in repo markets could be particularly acute in periods of stress where investors will instead have to sell their securities as banks will be unable to provide short term liquidity against them.

- Beyond the concerns noted with respect to emerging markets and the funded condition above, there are also concerns which arise due to the EBA Q&A 2017_3262 particularly for e.g. Japan, Spain, Italy, etc. Article 114(7) when combined with the Q&A implies that a bank must have sufficient corresponding liabilities in the currency of the exposure in order to apply a 0% risk weight to it if not

CQS1 rated. However, this may not be the case on a net basis when considering e.g. repo balance sheet netting which could occur. This should not however restrict the firm from applying a 0% risk weight to the collateral exposures as the default risk of the issuer is unchanged by whether or not the firm has net matching liabilities in this currency and similarly the firm is not exposed to FX risk on a net basis to the collateral.

Recommendation:

- Overall, we argue that including this “funded” condition in the large exposure rules is not necessary to support the PRA’s safety and soundness objective, it is overly burdensome and we recommend that the PRA simplifies the sovereign exemption. Ideally this would be by aligning to Basel and permitting all sovereign exposures to be fully exempt from the large exposures limits.
- As a minimum, all indirect sovereign exposures, arising from the MSA, including for regional governments and public sector entities treated as exposures to the central government or subject to guarantees from the same, should be exempted. Should the PRA proceed with mandatory substitution with a sovereign exemption, it should also consider a more proportionate approach to the risks of other indirect exposures given the risks to market functioning and the PRA’s secondary objectives set out above.
- If the PRA decide not to align with Basel and not exempt sovereign exposures entirely, we would recommend removing the ‘funded’ condition required as part of Art. 114(7) or deem this condition to always be met for the purposes of mandatory substitution under the large exposures rules. Otherwise provide further rationale for the condition and clarify how firms are expected to implement this in practice for received collateral.

5.1.3 Article 403 considerations

Whilst we have reservations to the overall design of the MSA under the stated objectives of the Basel large exposure regime and in particular its application to sovereign collateral as covered in the previous sections we would further like to raise certain technical points to ensure a consistent implementation across the industry. If the PRA decides to go ahead with the proposed approach to mandatory substitution as currently drafted in the consultation paper, additional consideration will be required to address the methodology issues and avoid inconsistent interpretation and application being made by firms when implementing. Particularly, we would highlight the following issues and recommendations:

- With regards to Article 403(1)(b), the wording could be improved by changing “treat the portion of the exposure **collateralised by the market value** of recognised collateral as exposure to the third party rather than to the client” to “treat the portion of the exposure **which is secured by** recognised collateral as an exposure to the third-party collateral issuer rather than to the client”. It seems that the PRA proposal contains a typo as “market value” above has been deleted.

- Under Article 403(1)(b) we would like to clarify that collateralised exposure that needs to be treated as exposure to the collateral issuer, is the difference between EAD without non-cash collateral and EAD with all collateral. While we think this approach is aligned with the intent behind the requirement and is easy to implement at an aggregate level, it does present some idiosyncrasies under FCCM for SFTs under an MNA and under SA-CCR which will need to be addressed in the final rules.
- In SFT netting sets under an MNA, where securities are both pledged (where haircuts increase the exposure amount) and received (where haircuts decrease the collateral amount), the aggregated amount to substitute to the collateral issuers can be greater than the market value of the collateral received. This is because the effects of haircuts within the netting set increase the difference between EAD without non-cash collateral and EAD with collateral and diversification benefits exist in the calculation. Under the proposed wording of Article 403(1)(d) it is not sufficiently clear what “after applying supervisory volatility adjustments” means in this context.
- Similarly, under SA-CCR (Article 403(1)(e)), due to the alpha of 1.4, the substituted amount to the collateral issuer can also be greater than the market value of the collateral received. The wording in Article 403(1)(e) is also inconsistent with the wording in 403(1)(d) which permits the application of volatility adjustments.

Recommendation: Where the substituted amount is greater than the market value of the collateral received, this amount should be ‘capped’ to the market value of the collateral received. In determining the MSA amount using SA-CCR, the alpha factor should be set to 1. For the margined netting sets the calculation without collateral should further still assume that the netting set is margined reflecting the benefits of this active risk management. Assuming the netting set is unmargined would inflate the actual effect of collateral since margining typically reduces the maturity of the netting set.

- Also, where one receives cash as collateral, we would like the PRA to clarify for the avoidance of doubt that mandatory substitution is not required. For example, in a repo where a bank has received cash in return for pledging bonds, there is no designated “CRM provider” for the cash and therefore it should not require substitution.

Recommendation: Where cash is received as collateral, no mandatory substitution is required.

- We would further recommend clarifying within the PRA rules in Article 403(1) itself the intent set out in 4.6 of the Consultation Paper that where the collateral includes multiple financial instruments, firms can decide which amounts to be assigned to which collateral issuers and clarify that only a single calculation is required for all collateral received to determine how much the exposure to the client was reduced. In this context it is also important to consider whether the original exposure to the client without application of collateral can be calculated with cash collateral still applied.

Recommendation: Include additional language to clarify that recognised collateral relates to issued security collateral only and not cash.

Please refer to Annex A for some hypothetical examples illustrating the impacts of the above.

- Whilst we recognise the merits underlying the proposed methodology for recognising funded CRM substitution, which address some of the potential discrepancies and interpretative issues experienced in relation to implementation of EU CRR, particularly in relation to SA-CCR, we would still query whether firms should ignore any volatility adjustments on the value of the collateral, given that there are some circumstances even on a post alpha basis, where just using the value would be too high versus the benefits that firms receive.

Recommendation: Include further language to clarify exactly how and when volatility adjustments should be considered for netting sets under each methodology.

- We would also recommend that the PRA clarify how the indirect amounts should be calculated in the circumstances that it allows firms to net posted and received securities, especially from the same issuer with the same client – possibly in line with current Trading Book netting methodology in Article 390(3).

Recommendation: Include additional language to permit a degree of netting between different issuances of the same issuer both posted and received as collateral.

- The consultation paper is silent on the netting of direct exposure and indirect exposure from mandatory substitution. Article 390 allows long positions and short positions in different financial instruments issued by a given client to be offset where the financial instrument underlying the short position is junior to the financial instrument underlying the long position or where the underlying instruments are of the same seniority. We assume that after mandatory substitution, the indirect exposure to the collateral issuer follows Article 390 rule and therefore, can be netted with short direct exposure from the same issuer.

Recommendation: Include further language to clarify the approach on the netting of direct and indirect exposures from the MSA.

- In instances where the original exposure value to a counterparty is exempt from the large exposure framework, we would recommend that the PRA clarifies that the MRSA is not applied to any collateral applied to this exposure. For example, in case an exposure to an exempted sovereign or to a guaranteed PSE counterparty is collateralised with equities, creating a new exposure to the equity issuer for the purposes of large exposure would seem inappropriate as the transaction with the counterparty is already recognised to be low risk – this would allow for a consistent application of rules and coherence with the credit risk framework.

Recommendation: Include additional language to not require MSA application when the original counterparty is eligible for exemption from the large exposures framework. This will further need to consider how to cater for the difference between full vs partial exemptions.

- With regards to Article 403(1)(a), the wording could be improved by changing “exposure which is guaranteed” to “exposure which is covered by eligible unfunded credit risk mitigation under Credit Risk Mitigation (CRR) rules”. This would provide the direct connection to the eligibility of the unfunded credit protection and ensure other eligible forms of unfunded CRM besides guarantees are covered. The wording with respect to equal or lower risk weights should also be reinstated for unfunded credit risk mitigation as given the loss of the previous text in Article 193(1) it is no longer clear that credit protection should only be used if it does not result in a higher risk weighted exposure amount.

5.1.4 Exempt mandatory substitution for certain structures of secured derivatives (e.g. collar financing trades, covered calls, etc.)

The example of collar financing trade (CFTs):

As derivatives, the exposure for CFTs is calculated using Standardized Approach for Counterparty Credit Risk (SA-CCR) and any collateral received and used as credit risk mitigation (CRM) needs to be substituted to the collateral issuer.

While mandatory substitution is relevant for traditional collateralised transactions, CFTs require specific consideration to recognise the risk of the overall structure:

- CFTs are structured derivatives that provide clients with financing for their investment in a particular stock, limiting upside potential (short call) in exchange for downside protection (long put). Clients pledge the underlying shares as collateral for financing.
- As the CFT structure includes the sale of a put option to the counterparty, any fall in collateral value supporting the client receivable would be offset by the increase in value of the put option the client has with the Bank.
- The economics of the put payable and financing receivable would net out. Note, each CFT transaction will have an external legal opinion that stipulates that all elements within the CFT can be netted in the event of client default.
- Economically there is no credit risk to the CFT counterparty on these trades. Instead, the downside risk on the underlying stock which is received as collateral is captured by the market risk on the derivative (sold put). This risk is capitalised through Market Risk Framework and hedged as appropriate. To the extent it was not hedged then the issuer risk arising from the sold put option on the stock would contribute to large exposures.
- Given the large trade size of some CFTs (they can be higher than £3bn, the application of the mandatory substitution rules would lead to substantial constraints for UK firms to competitively participate in this business and meet growing client demands across EMEA.

Recommendation: CFTs should not be subject to the mandatory substitution requirements as the risk to the collateral issuer is already captured through indirect issuer risk arising on the put option in the CFT. There is no additional credit risk in the transaction.

Please refer to Annex B for more detail on CFTs.

6. Additional Issues

6.1 Use of CCFs for off balance sheet exposures

Under the current large exposure framework, off-balance sheet exposures are taken into account without the application of credit conversion factors (CCFs). By not applying CCFs to these types of exposures we believe that the PRA is applying an overly conservative approach to the calculation of aggregate exposure value and combined with the proposed changes to disallow models and to implement MSA this, goes beyond the intention of the framework to act as a backstop to the risk-weighted capital framework.

We recommend that the PRA realigns with Basel standards (LEX30.6) which applies CCFs with a 10% floor. In the absence of realignment, we would request the PRA to set out its justification for not taking into account CCFs and not aligning to international standards. In particular we note that the PRA is not proposing to implement the Basel exemption allowing certain arrangements to not be commitments. This has further ramifications for LE and, independent of its rationale for credit risk purposes, the industry views this gold-plating as counter the PRA's secondary objectives.

Moreover, it is noted that within the Large Exposures Instrument in the PRA Rulebook, the term 'degrees of risk' is undefined in the CRR. We suggest that this consultation is a good opportunity for the PRA to clarify its meaning by explicitly stating that this refers to credit conversion factors. This would make logical sense as the intention behind this provision is to prevent the reduction of the exposure value by applying risk weights of CCFs.

6.1.1 The case of sub-participations

This is particularly relevant in the case of unfunded sub-participation (USP) arrangements.

A sub-participation is a contractual agreement whereby a lender contracts with the sub-participant to make funding arrangements related to an underlying loan facility. It is used frequently for banks to synthetically transfer rights, risks and rewards typically to either external entities or internal risk management entities.

In the case of USPs, the sub-participant will agree to fund the bank intra-day to the extent that the borrower draws on the lending commitment. In this case, the bank will continue to disclose the undrawn facilities as commitments to borrowers in the notes to its financial statements.

In the event that the client draws down on the facility, the sub-participant would be responsible for funding the loan, at which point the bank would not recognise any exposure to the client and would be de-risked as all credit risk has been transferred to the sub-participant.

Under the current framework, sub-participations are treated as eligible CRM, and a bank will risk substitute the exposure on the undrawn loan to the sub-participant itself. However, **given that the bank will not incur any exposure upon the drawdown of the loan, it is seemingly punitive to apply a 100% CCF to the exposure / sub-participant.**

The only time the bank would incur a full exposure is if the client were to draw down on the loan and the sub-participant were then to fail to fund. In the event that the sub-participant fails to provide funds upon a borrower drawdown (i.e. a settlement failure), the bank would fund the loan and then seek to sub-part it to another participant. At this point the bank would then recognise a full exposure to the client.

Importantly, failure of the sub-participant does not itself result in a default event of the loan itself. Instead, the risk that the bank is exposed to is any price decline the loan facility experiences by replacing the sub-participant. This is the same concept that underpins the settlement risk framework i.e. the exposure to the bank is the price decline of the asset being sold during the settlement period.

6.2 Covered Bonds

We would recommend that the PRA adopt the Basel proposals for Covered Bonds set out in LEX30.37 to 30.40 and allow firms to assign an exposure value of 20% of the nominal of the covered bond holding to reflect the diversity of the asset pool which provides a further backstop to the value of the covered bond beyond the default risk of the issuer itself.

6.3 Reporting Requirements

In addition to the proposed changes to rule text, we would like to emphasize the importance of relevant updates required for reporting templates and instructions, especially to accommodate the proposed mandatory substitution approach.

6.3.1 Large Exposures templates C28.00 and C29.00

The Reporting Instructions¹ to the Large Exposures templates C 28.00 and C 29.00 for columns 120-170 require the disclosure of indirect exposures. In the description for these columns it references Article 403 to the Large Exposures (CRR) Part of the PRA Rulebook. Article 403 contemplates the MSA for the allocation of exposures to collateral providers where collateral has been used to reduce the exposure value.

However, Article 390(5) also requires the recognition of exposure to underlying issuers of derivative contracts. It is unclear from the proposed instruction if such exposures shall be reported as indirect exposures.

Although not applicable to UK firms, in the EU's Commission Delegated Regulation (EU) 2022/1011², indirect exposures are described as the underlying debt or equity instrument to derivatives contracts particularly on where the underliers to derivative contracts should be captured: (a) indirect exposures, (b) direct exposures under derivatives, (c) direct exposures under debt instruments or equity instruments..

If columns 120-170 of C 28.00-C29.00 are only to capture exposures arising from the substitution approach, we would like to seek clarification on the reporting of the exposure to underliers of derivative contracts.

Further we would note that given the specification of original exposure in Article 390 this will include application of funded credit risk mitigation given the wording of Article 390(4) and therefore this creates an inconsistency between c050 for total original exposure and the requirements to populate eligible credit risk mitigation techniques in c250 to c320. This also then relates to Article 394(1) last subparagraph and how the 10% should be interpreted. Particularly, c300 "funded credit protection other than substitution effect" is now unclear in the context of application of the MSA as to when funded credit protection should be viewed as substitution.

Recommendation: We would recommend the PRA redesign the large exposures templates and reporting requirements to reflect particularly the new requirements for recognition of credit risk mitigation as the current design reflects the idea that the application of credit risk mitigation and hence mandatory substitution is only required for unfunded CRM and collateral applied under the FCSM (i.e. substitution-based approaches under the credit risk framework).

¹ [Annex IX: Instructions for reporting on large exposures and concentration risk](#)

² https://eur-lex.europa.eu/eli/reg_del/2022/1011/oj

6.3.2 Reporting Threshold

We would recommend that the PRA reviews the requirement to report all exposures greater than GBP260 million, given the limited value of this information versus the cost of reporting for firms (and in line with the principles underlying the BoE's wider data strategy review). We would recommend that the PRA either consider raising the threshold of reporting 'non-large' exposures to a level that is more meaningful based on a lesser percentage of Tier 1 capital or a more preferable approach that focuses on particular counterparty types / sectors / geographies (for example, adopting a 'top 10' exposure value approach, as for firms' current reporting of institutions and shadow banking entity exposures). We would recommend accelerating this review rather than waiting for the future outcomes of the banking data review, so that banks may focus their resources on ensuring compliance with the framework with respect to actual large exposures and in light of the substantive changes proposed in this Consultation Paper.

6.3.3 Top 10 Exposures

We would recommend the PRA consider the scope of the requirement for reporting the top 10 exposures to institutions and shadow banking entities specified in Article 394(2). It would facilitate application of the requirements if the PRA could clarify that this is the top 10 exposures to a group of connected entities containing either an institution or shadow bank respectively or where the institution or shadow bank is not part of a group then inclusion should be considered on an individual basis only. This would make it clearer to consider application on a group vs individual basis in a consistent manner, particularly where groups contain more than one institution or shadow bank.

6.3.4 Annex IX

We provide the following comments on the Annex IX – Instructions for reporting on large exposures and concentration risk amendments:

- We ask the PRA to clarify whether top 10 institutions and shadow banks should be identified at an individual obligor basis or can some Institutions/Shadow banking Groups be identified.
- We highlight to the PRA that there is still reference to "institutions" and "Member States". These need to be replaced with new PRA terminology. i.e. firms, CRR firms, etc.
- We propose the complete removal of columns related to real estate CRM to avoid future confusion, as it serves no purpose.
- We propose to delete the word "either" when referencing how SFTs should be valued (Paragraph17). "The exposure value of repurchase transaction, securities or commodities lending or borrowing transactions, long settlement transactions and margin lending transactions may be determined ~~either~~ in accordance with Part Three, Title II, Chapter 4, CRR."
- We propose to remove references to Art 462.

- As a general comment we highlight to the PRA that references to CRR will need to be updated post 1 Jan 26. If the PRA aligns implementation date with Basel 3.1 these updates need to occur simultaneously.
- The instructions are clear that firms *“shall report the original amount of the indirect exposures in the column that corresponds to the type of direct exposure guaranteed or secured by collateral such as, when the direct exposure guaranteed is a debt instrument, the amount of “Indirect exposure” assigned to the guarantor shall be reported under the column “Debt instruments”*. The instructions should clarify whether the CRM columns should be filled in a similar manner or by reference to the product providing the CRM. For example, for a loan which has a guarantee would CRM be recognised under debt instruments (column 240) or guarantees (column 280).

7. Further wording clarifications

- Paragraph 3 of Chapter 1 on the scope of institution for large exposures purposes refers to the need for third country equivalence. In this context, we note that the current transitional provision in Article 391 cross-refers to the equivalence decisions for Article 107(4) in Annex I, II and III of Commission Implementing [Decision 2014/908/EU](#) of 12 December 2014, which makes the need for a specific equivalence decision for Article 391 redundant. We would therefore suggest that the Article 391 equivalence decision is removed by HMT and the PRA amends paragraph 1.3 of the Large Exposure (CRR) Part to directly refer to the equivalence decisions made for the purposes of Article 107(4).
- For ease of accessibility, we recommend merging the contents of Chapter 1, Rule 1.4 (definitions for the purposes of chapter 5) into chapter 5 itself so it is all held together.
- In Article 395 of Chapter 4 on limits to large exposures, there is an opportunity to improve the text and eliminate any potential inconsistency by ensuring that references to Art 399-403 are described as including the exemptions, not just credit risk mitigation. We propose “after taking into account the effect of the credit risk mitigation and exemptions in accordance with Articles 399 to 403”.
- In Article 399 of Chapter 4 we would like to request clarification that CRM must be used to reduce the exposure value only where it has been used to reduce credit risk for the client. Equally, we would like to recommend clarifying further, in the case where CRR eligible credit risk mitigation has been accepted from the client for business purposes but has not been applied in the calculation of credit RWAs, then this CRM does not need to be used to reduce the exposure value for large exposure purposes and result in a substitution of exposure be substituted to the protection provider.
- Art 400(2)(g-h) of Chapter 4 related to sovereign exemptions (i.e. liquidity and minimum reserve requirements) have not changed. We would ask the PRA to explain the relevance of Art 400(8-9).
- Article 400(7) of Chapter 4 related to Core UK Group notification requirements uses the term “PRA-
authorised firm” in point (a) and “PRA-regulated firm” in point (b) (see below extract). The equivalent requirement in the current rule 2.3 of the Large Exposures part of the PRA Rulebook uses only the term

“PRA-regulated firm”. We ask the PRA to clarify whether this is intentional. In addition, as neither term is defined within the CRR or Rulebook, we ask the PRA to provide definitions of each within the Glossary and/or ‘Applications and Definitions’ chapter along with guidance of where a list of each type of firm is maintained. i.e., the FCA register and/or the ‘[Which firms does the PRA regulate?](#)’ section of the BoE website.

7. A firm with a core UK group permission and either a Higher NCLEG permission or an NCLEG permission or a legacy NCLEG permission (as applicable) must give the PRA written notice whenever:

(a) the total amount of exposures from the core UK group (including the firm) to a particular member of the firm's NCLEG is likely to exceed, or has exceeded, 25% of the Tier 1 capital of the PRA-authorised firm with the largest Tier 1 capital base in the core UK group;

(b) the total exposures from the members of its core UK group (which are not firms) to the firm's NCLEG are likely to exceed, or have exceeded, 25% of the Tier 1 capital of the PRA-regulated firm with the largest Tier 1 capital base in the core UK group.

in each case setting out details of the size and expected duration of those exposures as well as an explanation of the reason the relevant exposures were incurred.

- Art 400(7) of Chapter 4 – Core UK notification requirements: we would like the PRA to clarify that the “exposures” referred to in this paragraph are after taking into account the effect of credit risk mitigation in accordance with Articles 399 to 403 (whether or not exempted from Article 395(1)). The current drafting suggests the accounting value for assets and nominal for off balance sheet items (i.e. the original exposure value) which is not aligned with the rest of the large exposures framework. Article 400(6)(a) does not appear to apply as this is specifically in relation to the non-core permissions only. We recommend updating the text in this article to be consistent with other areas of the framework.
- With regards to Art403(1)(b) of Chapter 4, the wording could be improved by removing the word ‘of’ so that it reads “treat the portion of the exposure collateralised by the recognised collateral as exposure to the third party rather than to the client”.
- Chapter 5, article 7(2)(b) – we would like the PRA to clarify which equivalence determinations should be used for Chapter 5.

Annexes

Annex A – Mandatory Substitution Approach

Please find below some hypothetical scenarios, illustrating the mechanics of mandatory substitution.

Scenario 1: Standalone Repo

In this scenario, the bank has obtained funding via a repo and posted securities in return. However, as the collateral is cash, no amount is required to be substituted.

Scenario 1: Repo	
Exposure (E) pledged security	120
Collateral (C) received cash	120
EAD without collateral	125
EAD with collateral	5
EAD reduction due to the use collateral	120
Amount to be substituted to the collateral issuer	0

Scenario 2: Margin Loan

In a simple netting set, this is equal to the collateral amount received less haircuts that are applied to reflect potential future changes in value of that collateral, i.e. collateral received – haircuts = 110.

In this example, the benefit of the CRM was 110 and this amount will be substituted to the collateral issuer.

Scenario 2: Margin Loan	
Exposure (E) cash amount	120
Collateral (C) received security	120
EAD without collateral	120
EAD with collateral	10
EAD reduction due to the use collateral	110
Amount to be substituted to the collateral issuer	110

Scenario 3: Security for security trade (FCCM – MNA)

In a more complicated netting set that includes both pledged (where haircuts increase the exposure amount) and received (where haircuts decrease the collateral amount) securities, the difference can be greater than the market value of the collateral received when using the FCCM formula under Article 220(3).

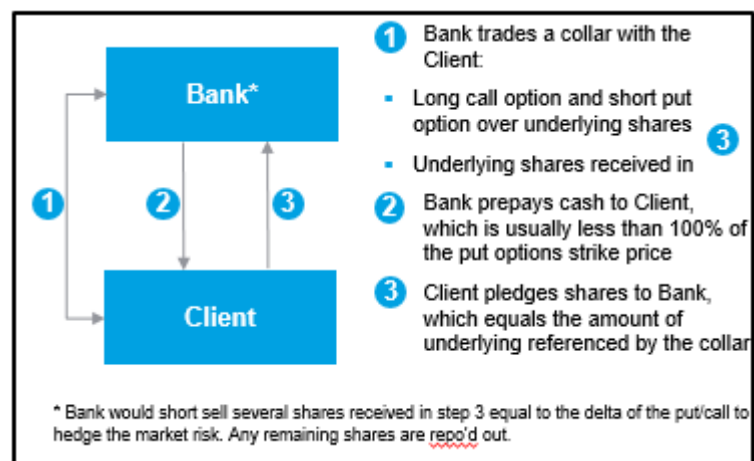
In this case the amount to be substituted is 126, whereas the market value of the collateral is only 120. Hence the proposal to cap the substituted amount to 120, based on the principle that if the collateral issuer defaults, the firm cannot lose more than the market value of the securities received.

Scenario 3: Security for security trade	
Exposure (E) pledged security	120
Collateral (C) received security	120
EAD without collateral	129
EAD with collateral	3
EAD reduction due to the use collateral	126
Amount to be substituted to the collateral issuer (capped at MV of collateral)	120

Annex B – CFT and similar structures

Structure

- A CFT is a bespoke structured derivative transaction and can be documented via different legal forms, depending on a Client's preference. Typically, the collar (put/call) and cash prepayment are under an ISDA, while the share transfer can be under various legal forms (e.g., ISDA CSA).
- Each element is done in contemplation of the other, i.e., no component of the CFT can exist without the other components.
- For accounting purposes, a CFT is treated as a single unit of account, where it may be classified as either a derivative or a hybrid loan.
- For regulatory capital purposes, specifically RWAs, CFTs are treated as derivatives as the better representation of the risk.
- CFTs are risk managed as derivatives, included in the Trading Book and subject to regulatory capital requirements for market risk and counterparty credit risk.



Economics and Risk

- Economically, there is no counterparty credit risk as the Bank will never have any receivable from clients under any scenario. This is demonstrated below, using a CFT example with £100m shares and £70m cash prepayment:

Scenario	Short Put Strike 70	Long Call Strike 120	Cash receivable	MV of Shares Payable	Net Bank Receivable (+) or Payable (-)	Zero counterparty exposure
1 Share value reduces to zero (collateral issuer defaults)	(70)	0	70	0	0	Client owes Bank £70m for cash pre-payment but this is offset by the £70m Bank owes the client for the put option. Call option is worthless.
2A Share value decrease to £90m (below collar strike levels)	0	0	70	(90)	(20)	Client owes Bank £70m for cash pre-payment but this is offset by the pledged shares Bank needs to return to the client. Put and call option are worthless.
2A Share value increases to £110m (between collar strike levels)	0	0	70	(110)	(40)	Client owes Bank £70m for cash pre-payment but this is offset by the pledged shares Bank needs to return to the client. Put and call option are worthless.
3 Share value increases to £130m	0	10	70	(130)	(50)	Client owes Bank £70m for cash pre-payment and £10m for call option but this is offset by the pledged shares Bank needs to return to the client. Put option is worthless.

Proposed treatment

- For LE purposes, the exposures considered for CFTs are counterparty credit risk exposure and issuer risk. Settlement risk is not applicable.
- For the purposes of mandatory substitution, the share issuer defaulting in a CFT is already captured in the indirect issuer risk³ requirement for the put option and does not lead to an actual loss for the bank.
 - Under a CFT, the equivalent number of shares received as collateral are also those referenced in the short put option.
 - Per Article 390(5), LE rules already capture the risk on the default of the shares referenced in put option. The shares cannot default twice and therefore substituting an amount to the collateral issuer as well would be double counting this risk.
 - This is consistent with the outcomes described above that demonstrate that in the event of collateral issuer default, the bank will always have a payable to the client due to the short put option.

Note the market risk contributions to LE allow for the hedges to be recognised. However, this would not be allowed under the mandatory substitution rules.

³ Exposures to a client arising from derivatives, where the derivatives were not directly entered into with that client but the underlying debt or equity instrument was issued by that client.

Annex C – Conceptual Discussion of the Large Exposure Regime⁴

Large exposure requirements have a long regulatory history, even before the implementation of the Large Exposure Directive in the UK in 1992⁵. The regime got an even wider international application as a result of it becoming part of the Basel Capital Framework⁶. It is noted however that the 25% effectively came about as an average of existing regulatory practices, as opposed to a bottom-up calibration exercise⁷.

More recently, the LEX chapter of the Basel Framework, and its preceding consultation, provide a good summary of the rationale of Large Exposure requirements. Particularly, it clarifies the scope of the objective: “to protect banks from large losses resulting from the sudden default of a single counterparty or a group of connected counterparties.” To put it slightly differently the scenario underpinning the large exposure is an instantaneous default with a 100% LGD. And it is calibrated as a simple backstop measure.

As such the Large Exposure requirements are an essential element for maintaining financial stability, given that any significant losses as a result of a large default above 10% is likely to raise significant questions about that bank’s ability to remain a going-concern.

Nevertheless, we would urge the Bank of England to consider if the large exposure regime as currently proposed by the PRA still achieves its objectives. Particularly, it is arguable that the regime has become so complex as to no longer being a backstop measure. Indeed, there is evidence that it is now a key constraint on banks’ ability to provide intermediation services, even more so than capital requirements.

For the avoidance of doubt the industry fully understands the need to manage concentration risks of direct exposures and manages itself accordingly. We also agree that conceptually substitution of such exposures in the case credit risk mitigation techniques has some justification, although at the same time this does reduce the risk of a large exposure event. However, that discrepancy, and possible overcalibration, was acceptable as a quid pro quo for a simple backstop measure.

We also agree that back in 1992 25% was an appropriate limit for such exposures at a time where collateral was used significantly differently to today. As a result, there is a feeling in the industry that the complexity of the regime is potentially undermining its effectiveness, particularly in relation to collateral used in the trading book and the work required for assessing economic dependencies. This last point is more one of pragmatism and agreed risk appetite and can be addressed via bank specific dialogue with its regulator. The situation is more difficult for collateral in the trading book, particularly if sovereign issuers are not exempted from a mandatory substitution requirement.

The difference is that in practice collateral provided for trading activities is very varied in terms of issuers and each security issuer only represents a small part of each collateral pool. In terms of real risk, this would foremost be a question whether the counterparty defaults or not. So, for the collateral to be unusable would

⁴ Large Exposure and Single Name Concentrations are viewed as being the same in this discussion.

⁵ [Council Directive 92/121/EEC of 21 December 1992 on the monitoring and control of large exposures of credit institutions](#)

⁶ [LEX10 - Definitions and application](#)

⁷ [Measuring and controlling large credit exposures \(January 1991\)](#)

necessitate a double default. In fact, it would seem to go significantly further. This is because a single default of an issuer in itself would be absorbed by the markets, often by the next day, as a result of additional margin request to replace the defaulted securities.

In other words, it is in our view not clear that the mandatory substitution approach is still reflective of the Basel principles of the Large Exposures requirement as it seems to no longer be sufficiently focused on the extreme stress which underpins the LE regime. As a result, a requirement for mandatory substitution across all collateral pools, and then combining it with direct exposures, amounts to a significant amount of operational complexity despite the relevant securities in the collateral pool not creating a material risk in trading activities.

We do accept however that theoretically if one ignored collateral it would be possible to build up a set of collateral that was so big as to being on a going-concern issue for the holder of the collateral. However, there is a difference between looking at the large risk, and an operationally very burdensome requirement of tracking every size of collateral to see if in accumulation with other netting sets. This might be better addressed by having a diversification requirement within and across collateral pools as opposed to being incorporated into the 25% limit. It is our contention that a 25% limit that includes such mandatory substitution in the circumstances described might be too low to achieve an appropriate balance of financial stability and tying up capital with a too risk averse requirement.

Another way of describing this is that, particularly if sovereigns are not excluded from the LE limit, it is no longer clear the calibration of 25% as hard limit is still appropriate given the changes in the markets that have taken place since the 1980's and early 1990's, when trading volumes were much lower, there were not margin requirements for most activities and the technology was not there to exchange collateral as frequently as it is today. We would therefore recommend that the Bank of England does further work, potentially via a Working Paper, analysing if the 25% large exposure limit is still fit for purpose for today's trading activities and in particular central banks desire to have banks actively participating in re-intermediation of particularly repos.

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