BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

Publication

Consultation Paper | CP5/21

Implementation of Basel standards

February 2021

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Responses are requested by Monday 3 May 2021.

In light of current measures to help prevent the spread of COVID-19, please address any comments or enquiries by email to: CP5_21@bankofengland.co.uk.

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1 Overview

1.1 This Consultation Paper (CP) sets out the Prudential Regulation Authority's (PRA's) proposed rules in respect of the implementation of international standards through a new PRA Capital Requirements Regulations (CRR) rule instrument.

1.2 The purpose of these rules is to implement some of the set of international standards that remain to be implemented in the UK. This CP also sets out the proposed new PRA CRR rules in full, including parts of the onshored CRR that are not changing but are being transferred into PRA rules (although, where these do not change, they do not form part of this consultation).[1]

Policy material	Proposals
PRA Rulebook: CRR Rules Instrument 2021	The instrument would introduce new Parts of the PRA Rulebook, as follows: • Own Funds and Eligible Liabilities (CRR); • Trading Book (CRR); • Standardised Approach and Internal Ratings Based Approach to Credit Risk (CRR); • Counterparty Credit Risk (CRR); • Operational Risk (CRR); • Credit Valuation Adjustment Risk (CRR); • Large Exposures (CRR); • Liquidity (CRR); • Liquidity Coverage Ratio (CRR); • Reporting (CRR); and • Disclosure (CRR).
PRA Rulebook: CRR Firms: (CRR2 Revocations and Other Amendments) Instrument 2021	The instrument would amend the following Parts of the PRA Rulebook: • Glossary;

[1] The onshored and amended UK version of Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 is referred to as the 'CRR' in this CP.

	• Interpretation; • Capital Buffers; • Counterparty Credit Risk; • Groups; • Internal Capital Adequacy Assessment; • Internal Liquidity Adequacy Assessment; • Large Exposures; • Permissions; and • Regulatory Reporting.
PRA Standards Instrument: The Technical Standards (Definition Of Capital) Instrument 2021	The instrument would amend Regulation (EU) 241/2014.
Supervisory Statements (SS)	This CP would amend: • SS15/13 'Groups'; • SS12/13 'Counterparty credit risk'; • SS16/13 'Large Exposures'; • SS24/15 'The PRA's approach to supervising liquidity and funding risks'; • SS34/15 'Guidelines for completing regulatory reports'; and • SS2/19 'PRA approach to interpreting reporting and disclosure requirements and regulatory transactions forms after the UK's withdrawal from the EU'.
Statements of Policy (SoPs)	This CP would amend: • SoP 'Pillar 2'. This CP would introduce: • SoP 'Liquidity and funding permissions'.

1.3 This consultation is relevant to banks, building societies, PRA-designated investment firms and PRA-approved or –designated financial or mixed financial holding companies (firms).

Background

1.4 In response to the financial crisis of 2007-8, the Basel Committee on Banking Supervision (BCBS) agreed a series of reforms to the financial services regulatory framework intended to enhance the resilience of internationally active banks. These measures are known as 'Basel III' standards. Some of the standards were implemented into EU law[2] and subsequently converted into UK law through:

- the CRR;[3] and
- related onshored EU level 2 regulations that are made under the CRR (CRR level 2 Regulations).[4]

1.5 However, some Basel III standards were not implemented in the EU before the end of the transition period and so remain to be implemented in the UK.

1.6 HM Government's Financial Services Bill (the FS Bill) proposes to enable the implementation of those standards. The FS Bill proposes to give a power to the PRA to make rules that restate elements of the CRR and CRR level 2 Regulations revoked by HM Treasury and also to make new rules in those areas to give effect to the outstanding Basel III standards and adapted versions of those standards where appropriate (these rules are referred to as 'CRR rules').[5] The proposed new rules therefore broadly correspond with the set of issues covered by the EU's Capital Requirements Regulation 2 (EU CRR II),[6] which addresses the same set of outstanding Basel III standards.

1.7 The proposals in this CP have been designed in the context of the UK having now left the EU and the transition period having come to an end. Unless otherwise stated, any references to EU or EU derived legislation refer to the version of that legislation which forms part of retained EU law. The PRA will keep the policy under review to assess whether any changes would be required due to changes in the UK regulatory framework.

Approach to making CRR rules

1.8 The PRA's proposed implementation of the Basel III standards in this CP has been determined in accordance with its statutory objectives and informed by the regulatory principles and the matters

2 Before the end of the transition period under the Withdrawal Agreement with the European Union (11pm on 31 December 2020) (the transition period).

3 Before the end of the transition period.

4 These EU regulations also formed part of UK framework under the European Union (Withdrawal) Act 2018 and have been amended by HM Treasury or the PRA using powers under that Act. For more details, see: https://www.bankofengland.co.uk/prudential-regulation/publication/2020/uk-withdrawal-from-the-eu-changes-before-the-end-of-the-transition-period.

5 At the time of publication, HM Treasury is consulting on its proposed CRR revocations. This includes consulting on the deletion of all requirements relating to large exposures, liquidity, reporting and disclosure. 'Implementation of the Investment Firms Prudential Regime and Basel 3 standards consultation', see: https://www.gov.uk/government/consultations/implementation-of-the-investment-firms-prudential-regime-and-basel-3-standards-consultation.

6 Regulation (EU) 2019/876 of the European Parliament and of the Council of 20 May 2019 amending Regulation (EU) No 575/2013 as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, reporting and disclosure requirements, and Regulation (EU) No 648/2012. The EU CRR II entered into force on the 28 June 2019, but the majority of its provisions apply in the EU from 28 June 2021.

to which it must have regard in making policy. In this specific case, the PRA used the implementation of the standards in the EU CRR II as an initial basis for developing many of the proposed draft rules.

1.9 This approach facilitates efficient and effective implementation. The EU CRR II was designed to implement the Basel III standards set out above and was proposed, negotiated and agreed between 2016 and 2019, before the UK's exit from the EU and the UK contributed significantly to its design.

1.10 Where replication of the standards set out in the EU CRR II would not be fully consistent with the PRA's objectives, a different approach has been taken to Basel III implementation. The rationale for this approach is to:

- achieve closer alignment with Basel III standards;
- enhance proportionality;[7] and
- enable the new PRA rules to interact clearly and effectively with the requirements that remain in the CRR, and to be supported by a consistent suite of the UK version of revised supervisory Common Reporting (COREP).

1.11 The PRA's proposed approach would enable these Basel III standards to be implemented by firms from Saturday 1 January 2022; provide sufficient time for firms to embed the related supervisory reporting; and build on the progress firms have already made towards implementation.

1.12 The proposed rules have been written in a style and structure that maintains consistency with the onshored regime, with Article numbers that, where possible, correspond to the CRR and CRR Level 2 Regulations.[8]

Objectives of this consultation

1.13 The proposals in this CP seek to address some of the remaining weakness in banks' risk management systems and the regulatory framework through:

- implementing some of the remaining Basel III standards, including by implementing adapted versions of those standards; and
- restating without material modification those aspects of the CRR which HM Treasury proposes to revoke and the PRA proposes to restate in the PRA Rulebook.

Summary of proposals

1.14 The proposals covered by this CP include:

- specification of the level and scope of application of the requirements for UK firms;

7 The PRA will consider further enhancements to the proportionality of its approach in developing its 'strong and simple' framework. Speech by Sam Woods, 'Strong and Simple', November 2020: https://www.bankofengland.co.uk/-/media/boe/files/speech/2020/strong-and-simple-speech-by-sam-woods.pdf. .

8 In some cases, where a provision from the onshored regime is not needed in the PRA rules, the PRA is proposing to include the article number and title without any text. This has been done to maintain the same numbering as the onshored regime and is indicated by a note in the instrument that the provision has been left blank.

- revision to the definition of capital, in particular for the treatment of Common Equity Tier 1 (CET1) deductions for software assets and certain collective investment undertakings (CIUs);
- revised Basel standards for prudent valuation for market risk and amendments to market risk management requirements;
- revised Basel standards for calculating risk-weighted exposures to CIUs under the standardised approach and a more prudent treatment of exposures to certain CIUs located and managed in third countries;
- a new Basel standardised approach to counterparty credit risk (SA-CCR) and the revised Basel framework for exposures to central counterparties (CCPs);
- clarification of the treatment of operating leases under the basic indicator approach (BIA) for operational risk;
- implementation of the Basel III standards revised large exposures framework;
- implementation of Basel III standards liquidity coverage ratio (LCR);
- Basel III standards for the net stable funding ratio (NSFR), which would help ensure stable funding structures over a longer-term horizon;
- an update to supervisory reporting;
- revised Basel disclosure standards, which would help enhance the comparability, quality, and consistency of institutions' regulatory disclosures;
- the currency in which requirements would be set;
- the interaction between the temporary transitional power (TTP) and CRR rules; and
- enhanced proportionality for smaller firms, including:
    - revised counterparty credit risk requirements including a simpler, more conservative SA-CCR approach (sSA-CCR) for certain smaller firms and amendments to the original exposures method (OEM);
    - a simpler, more conservative NSFR (the simplified NSFR, or sNSFR) that certain smaller firms could choose to use;
    - updates to the simplified capital requirements calculation for credit valuation adjustment risk;
    - increasing the scope of more proportionate market risk capital requirements and exemptions from new market risk reporting requirements; and
    - tailored disclosure requirements.

1.15 This CP does not propose any new rules on leverage to replace proposed HM Treasury deletions from the CRR. As referenced in the September 2020 Regulatory Initiatives Grid, the Financial Policy Committee (FPC) and Prudential Regulation Committee (PRC) have announced that they will conduct a review of the UK leverage ratio framework.[9] This review is now expected to be completed in summer 2021 and will enable the Bank to take the FPC and PRC's decisions relating to the leverage ratio requirements into full consideration when reviewing minimum requirement for own funds and eligible liabilities (MREL) policy for mid-tier banks.

Structure of this CP

Chapter 3: Scope of application

1.16 The CRR applies prudential requirements to banks, building societies and PRA-designated investment firms. This ensures that these firms are subject to prudential requirements that advance their safety and soundness, in line with PRA objectives.

1.17 The PRA proposes to replicate this scope of application for the measures set out in this CP, in order to advance firms' safety and soundness.

Chapter 4: Levels of application

1.18 The PRA proposes sections specifying the levels of application within the new Parts of the PRA Rulebook where the PRA is making rules to replace parts of the CRR that HM Treasury is proposing to revoke in their entirety.[10] These new rules will ensure that the rules in those parts of the PRA Rulebook continue to be applied at an individual, consolidated and sub-consolidated levels by replicating the levels of application provisions within the CRR. As such, they will maintain the safety and soundness of firms and holding companies, enhance clarity and promote simplicity. The PRA also proposes to make rules for several other proposed new parts of the PRA Rulebook to clarify that the level of application provision for those rules will remain within the CRR. This is aimed at enhancing clarity and promoting simplicity.

1.19 The PRA also proposes to amend SS15/13 'Groups' to clarify that one instance in which it may use its powers to require sub-consolidation is where the risks posed to a firm by its third-country subsidiary or subsidiaries warrant it on a case-by-case basis. The PRA considers that this is a proportionate approach to addressing such risks, rather than the alternative of automatically applying a sub-consolidation requirement to all firms with third-country subsidiaries.

Chapter 5: Definition of capital

1.20 This chapter sets out the PRA's proposal to require all intangible assets, including software assets classified as intangible assets under International Financial Reporting Standard (IFRS), to be fully deducted from CET1 capital. The proposed approach would advance firms' safety and soundness and align with the Basel III standards on the definition of capital.

1.21 The chapter also proposes to incorporate the list of CET1 deductions that HM Treasury proposes to revoke from the CRR.

Chapter 6: Market risk

1.22 As part of its 'Fundamental Review of the Trading Book', the BCBS amended its standards on requirements for the trading book and on allocating positions to the trading book and the non-trading book. Those changes were intended to ensure greater consistency and transparency in how firms manage that allocation, including introducing a new requirement on valuation of positions to be allocated to the trading book. The PRA proposes to implement these changes in PRA rules.

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9 https://www.fca.org.uk/publication/corporate/regulatory-intitiatives-grid-september-2020.pdf.

10 The Large Exposures (CRR), Liquidity (CRR), Reporting (CRR) and Disclosure (CRR) Parts.

1.23 The PRA proposes to revise the basis on which certain market risk requirements are not applied to firms with limited trading activities. This is intended to enhance the proportionality of the PRA approach.

Chapter 7: Collective investment undertakings

1.24 The Basel standards revise the treatment of exposures to (CIUs) in order to make it more consistent and risk-sensitive.

1.25 The PRA proposes to implement these updated requirements in the PRA Rulebook. This includes specifying the proposed treatment of firms' exposures to CIUs in third countries and the basis on which firms should calculate exposure values for derivative exposures.

Chapter 8: Standardised approach to counterparty credit risk

1.26 The Basel III standards specify that the SA-CCR be implemented by firms that do not use the Internal Models Method (IMM). SA-CCR improves upon the risk sensitivity of the non-modelled approaches to counterparty credit risk currently used by differentiating between margined and unmargined as well as bilateral and cleared trades, addressing known deficiencies of the existing standardised approaches and minimising discretion used by national authorities and firms. The PRA proposes to implement the SA-CCR.

1.27 The Basel III standards also revise the methodology for calculating capital requirements for firms' exposures to a qualifying CCP (QCCP). A QCCP is an authorised CCP, a recognised third country CCP including those that enter the Temporary Recognition Regime (TRR) and any other third country CCP benefiting from the transitional provisions under CRR Article 497. This includes the use of the SA-CCR methodology. The PRA proposes to implement these revised standards in PRA rules.

1.28 In addition, to ensure the counterparty credit risk framework remains proportionate for firms with limited derivatives exposures, the PRA proposes to permit simplified approaches to be used by smaller firms.

Chapter 9: Operational risk

1.29 The PRA has identified an ambiguity in the calculation used for the Business Indicator Approach (BIA) under the CRR. It is unclear whether profit and loss items relating to financial or operating leases, and/or leased assets, may be included in the relevant categories of the relevant indicator (RI). The PRA proposes to amend the methodology used for calculating the RI under the BIA to make explicit the treatment of leasing assets. This would provide greater clarity on the treatment of such assets.

Chapter 10: Large exposures

1.30 The BCBS published its supervisory framework for measuring and controlling large exposures in April 2014. The objective of these standards was to protect firms from traumatic losses as a result of the sudden default of a counterparty or a group of connected counterparties. The framework added to the existing Basel standards for: the scope of application; the value of large exposure limits; the definition of capital on which limits were based; methods for calculating exposure values; and treatment of credit risk mitigation techniques. They also clarified where certain exposures are subject to more lenient treatments. The PRA proposes to implement these standards in PRA rules.

Chapter 11: Liquidity coverage ratio

1.31 The BCBS introduced the LCR in 2013 to ensure that firms have an adequate stock of unencumbered liquid assets that consists of cash, or assets that can be converted into cash at little or no loss of value in private markets, to meet liquidity needs for a 30 calendar day liquidity stress scenario.

1.32 The LCR requirement is currently set out in Part Six of the CRR and Delegated Acts 2015/61 and 2018/1620. The PRA expects that the FS Bill will remove these requirements and empower the PRA to address them in PRA rules. The PRA proposes to replicate the LCR requirements of the CRR and Delegated Acts.

Chapter 12: Net stable funding ratio

1.33 The BCBS introduced the NSFR in 2014 to help ensure that firms maintain a stable funding profile in relation to the composition of their assets and off-balance sheet activities. It seeks to limit overreliance on short-term wholesale funding, encourage better assessment of funding risk across all on- and off-balance sheet items, and to promote funding stability.

1.34 A sustainable funding structure reduces the likelihood that disruptions to a firm's regular sources of funding will erode its liquidity position and increase the risk of its failure. Stability in a firm's longer-term funding enhances the safety and soundness of firms, in line with the PRA's objectives.

1.35 To ensure the framework remains proportionate for smaller firms, the PRA proposes to introduce a simplified NSFR (sNSFR) for small and non-complex institutions.

Chapter 13: Reporting

1.36 Supervisory reporting is fundamental to the supervision of firms against the proposed policies set out in this CP. The proposals would require the submission of new data and, in some areas, may render elements of existing reporting obsolete.

1.37 In order to maintain the continued relevance of the reporting requirements contained in the UK version of COREP and Financial Reporting (FINREP), the PRA proposes to update the UK version of COREP and FINREP, through a combination of new returns, and to make amendments to existing reporting requirements. The PRA also proposes to incorporate the entire body of the UK version of COREP and FINREP requirements into PRA rules to create a single source for reporting requirements for firms.

1.38 These proposed updates are aligned with the reporting changes contained in the European Banking Authority's (EBA's) Taxonomy 3.0 to ensure that firms report to the PRA under a consistent taxonomy, and so that implementation efforts are proportionate to the PRA's new data needs.

Chapter 14: Disclosure

1.39 The BCBS has made a number of changes in recent years to its standards on Pillar 3 disclosure, which reflect many of the changes to prudential requirements proposed in this CP. The PRA considers it important that disclosures made by UK firms are aligned to those standards. Disclosures should also provide users with meaningful insights on the relevant prudential requirements and risk drivers faced by UK firms.

1.40 The PRA therefore proposes to introduce new rules on disclosure that would reflect phases 1 and 2 of the Basel disclosure standards, as well as information relevant to the market transparency of the proposals in this CP. The PRA also proposes to incorporate all Pillar 3 requirements to create a single source of disclosure requirements for UK firms.

Chapter 15: Currency denomination of thresholds and monetary values

1.41 This chapter sets out the PRA's proposal to redenominate currency references from Euros (EUR) to Great British Pounds Sterling (GBP). This would apply to thresholds and monetary values in cases where redenomination may be beneficial at this time. The PRA considers that, in the main, redenominating the currency references would provide greater certainty to firms regarding the value of thresholds and monetary values contained in PRA rules, irrespective of fluctuations in the GBP/EUR exchange rate.

Chapter 16: The temporary transitional power (TTP)

1.42 This chapter sets out the PRA's proposals in relation to the temporary transitional power (TTP). The TTP enables the UK's financial services regulators (the regulators) to delay the application of firms' regulatory obligations where they have changes as a result of an onshoring change made under the EU (Withdrawal) Act 2018.[11] In order to preserve the application of the TTP as far as possible, the PRA has included a mirror provision in the draft PRA Rulebook instrument. This provision extends the PRA's transitional direction to certain rules proposed in this CP.

1.43 The PRA proposes to apply this mirror provision as broadly as possible. However, the PRA does not propose to apply the mirror provision to the proposed LCR rules.

Implementation

The FS Bill

1.44 The FS Bill was introduced into Parliament on Wednesday 21 October 2020. The proposals set out in this CP are based on the version of the FS Bill that was introduced into Parliament. The PRA will provide an update if there are any material changes to the FS Bill that affect the proposals in this CP.

1.45 The FS Bill contains a power that allows HM Treasury to revoke certain provisions from the CRR. HM Treasury is proposing to use this power to revoke provisions so that the PRA can make the rules proposed in this CP.

1.46 Where HM Treasury uses this power to revoke a mandate to make CRR level 2 Regulations, this will have the effect of revoking the CRR level 2 Regulations made under that mandate. The PRA is proposing to make rules to give effect to the content of some of these CRR level 2 Regulations as set out in this CP.

1.47 Firms should read the PRA rules in this CP together with the provisions that remain in the CRR to understand their requirements.

1.48 The FS Bill contains a new rule-making power that allows the PRA to make certain types of rules applying to holding companies that are approved or designated by the PRA.[12] The PRA proposes to use this new rule-making power as set out in this CP.

1.49 The FS Bill introduces a new power for the PRA to include permissions in its CRR rules.[13] This is intended to allow for a continuation of the existing permissions regime in the CRR, whereby firms can apply to the PRA to vary the requirements for the amounts of capital they must hold. The PRA

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11 The European Union (Withdrawal) Act 2018.
12 Section 192XA of FSMA.
13 Sections 144G and 192XC of the Financial Services and Markets Act 2000 (FSMA).

proposes to amend the Permissions Part to direct that an application for permission using this new power must be made in writing to the PRA and be accompanied by necessary information to demonstrate how any relevant conditions have been satisfied. Where a person has applied for or been granted this new type of permission, the changes will require the person to notify the PRA immediately on becoming aware of any matter which could affect the application, permission or any relevant condition.

1.50 The PRA is proposing to use its new permission power as set out in this CP. The PRA has identified these provisions in the draft Rulebook instrument using notes.

1.51 HM Treasury is proposing to use its powers under the FS Bill to make savings provisions in relation to CRR permissions that are replicated in PRA rules so that firms do not need to apply for a new permission to retain their existing capital treatment.

The new accountability framework

1.52 The FS Bill applies a new accountability framework to the making of CRR rules. This requires the PRA to consider certain matters and include certain explanations in addition to the normal requirements for PRA rulemaking.

1.53 When making CRR rules, the PRA must have regard to the following additional matters:

(a) relevant standards recommended by the BCBS from time to time;

(b) the likely effect of the rules on the relative standing of the United Kingdom as a place for internationally active credit institutions and investment firms to be based or to carry on activities; and

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

1.54 The FS Bill also requires that a draft of proposed CRR rules must be accompanied by an explanation of the ways in which having regard to these has informed the proposed rules.

1.55 Chapter 17, Statutory Obligations, and Appendix 12 set out how the PRA has had regard to these additional matters and includes an explanation as to how this has informed the proposed rules.

1.56 In addition, when making CRR rules, the PRA must consider and consult HM Treasury about the likely effect of the rules on ’relevant‘ equivalence decisions, as notified to it by HM Treasury.

1.57 The FS Bill includes an exception from the new accountability framework for PRA rules that reproduce a provision of the CRR or a CRR level 2 Regulation.[14] These provisions are referred to as ‘CRR restatement provisions’.

1.58 The FS Bill also disapplies the normal Financial Services and Markets Act (FSMA) consultation requirements (other than the requirement to consult the Financial Conduct Authority (FCA)) in

[14] Section 144(2) and (3) of FSMA. Section 144E of FSMA is proposed to be inserted by the FS Bill.

relation to CRR restatement provisions. As a result, this CP only contains an explanation of rules that are materially different from the text of the CRR or relevant CRR level 2 Regulation.

1.59 The FS Bill allows the PRA to satisfy its consultation requirements (in relation to rules that are not CRR restatement provisions) in advance of the Bill becoming an Act, including in relation to the new accountability framework in the FS Bill.

Coordination with other UK bodies

1.60 The PRA's proposals in this consultation would take effect at the same time as HM Treasury's proposed revocation of the relevant parts of the CRR. Both of these are currently proposed to take effect on Saturday 1 January 2022.

1.61 The PRA has consulted with the FCA on the proposals in this consultation. Responses to this CP will be shared with the FCA where they affect FCA objectives.

Responses and next steps

1.62 This consultation closes on Monday 3 May 2021. The PRA invites feedback on the proposals set out in this consultation, including on the questions at the end of Chapters 3, 6, 8, 12 and 14. The PRA would also welcome firms' views on whether additional and material costs or impacts not identified in Chapter 17 may arise as a result of the proposals. Please address any comments or enquiries to CP5_21@bankofengland.co.uk.

2 Explanation of interpretative provisions

2.1 This CP proposes to amend the Interpretation Part of the PRA Rulebook to include rules relating to the following:

(a) Rule 2.7(5) would provide that references on EU regulations in the PRA Rulebook are to the UK version of the regulations that were onshored on Thursday 31 December 2020. It ensures that references to these regulations will pick up changes made after Thursday 31 December 2020.

(b) Rule 2.9(1) would set out how to read references to the CRR in PRA rules. It ensures that references to provisions of the CRR are to be read as a reference to the CRR or the relevant PRA rule where that rule is intended to form part of the CRR.

(c) Rule 2.9(2) would use the power in sections 144H and 192XA of FSMA (proposed to be introduced by the FS Bill) to provide that references in CRR rules to provisions of the CRR and CRR level 2 Regulations are references to those provisions as amended from time to time, unless the contrary intention appears. This means that, as a default, any references to those provisions (ie to the UK onshored versions) will automatically update to take account of changes to those provisions.

(d) Rule 2.10 would ensure that the temporary transitional direction continues to apply to CRR restatement provisions (except in the Liquidity (CRR) Part and the Liquidity Coverage Ratio (CRR) Part of the PRA Rulebook) for the intended duration of the temporary transitional direction. This is intended to ensure that firms do not lose the benefit of the temporary transitional relief set out in that direction simply because the provisions are moved from the CRR into PRA rules.

(e) Rule 2.11 would provide that any reference in CRR rules or rules made under section 192XA FSMA to the granting of a waiver, approval, permission or other form of consent by the competent authority is a reference to the giving of a permission by the PRA under the proposed permission powers in section 144G or section 192XC of FSMA. This ensures that rules containing permissions will fall within the provisions set out in those sections, regardless of whether the word ‘permission’ is used or not.

(f) Rule 2.12 would use the power in sections 144H and 192XA (proposed to be introduced by the FS Bill) to modify the CRR and CRR level 2 Regulations, to ensure that the PRA can make the CRR rules set out in this CP and exercise its supervisory and enforcement powers in relation to the matters covered by those rules.

(g) Rule 2.13 would provide that unless the contrary intention appears, CRR rules are to be read as if they formed part of the CRR and that words and expressions used in those rules shall bear the meaning they have in CRR (and not the meaning in the Glossary to the PRA Rulebook). As a result, terms used in the CRR rules that are defined in the CRR are not italicised.

3 Scope of application

CRR Article 1

3.1 This chapter sets out the PRA's proposals in relation to the scope of application for the prudential requirements proposed in this CP.

3.2 The proposals in this chapter would include rules in the following proposed new parts of the PRA Rulebook:

- Own Funds and Eligible Liabilities (CRR);
- Trading Book (CRR);
- Standardised Approach and Internal Ratings Based Approach to Credit Risk (CRR);
- Counterparty Credit Risk (CRR);
- Operational Risk (CRR);
- Credit Valuation Adjustment Risk (CRR);
- Large Exposures (CRR);
- Liquidity (CRR);
- Liquidity Coverage Ratio (CRR);
- Reporting (CRR); and
- Disclosure (CRR).

Proposals

3.3 The CRR applies to banks, building societies, PRA-designated investment firms, and PRA-approved or PRA-designated financial or mixed financial holding companies (firms).

3.4 The PRA proposes, for the measures proposed in this CP, to replicate the scope of application of prudential requirements set out within the CRR. This will ensure that prudential measures are applied to the relevant firms.[15]

Net stable funding ratio

3.5 The Basel standards apply the NSFR to internationally active banks.[16] The CRR applies stable funding requirements for banks, building societies and investment firms to ensure that their long-

15 The PRA proposes to use the new rule making power over holding companies that would be inserted into section 192XA FSMA by the FS Bill to apply requirements to PRA-approved or -designated financial or mixed financial holding companies.

16 Basel standards NSF 10.4.

term obligations are met with diverse stable funding instruments under normal and stressed conditions.[17]

3.6 Consistent with prudential requirements in the CRR, the PRA proposes to apply the NSFR framework to banks, building societies and PRA-designated investment firms.

3.7 The NSFR captures medium-term funding risks that are beyond the scope of the LCR and would not otherwise be sufficiently addressed. The NSFR was not designed specifically to be applied to firms with highly specialised business models, such as PRA-designated investment firms. The NSFR is a relatively simple metric. However, the specific treatment of derivatives, securities financing transactions (SFTs), and certain on-balance sheet securities contained in the proposals in this CP take into account the specific nature of the trading activities in which large banks and PRA-designated investment firms engage by seeking to balance risk sensitivity with the simplicity of the NSFR metric.

3.8 The PRA considers there would be significant prudential benefits in applying an NSFR framework to firms. It would further the safety and safety and soundness of firms, consistent with PRA objectives.

3.9 The activities of PRA-designated investment firms significantly overlap with those of larger banks. Therefore, applying the NSFR to PRA-designated investment firms would help to ensure that PRA rules apply to products with the same risk characteristics in the same way, irrespective of the type of firm using them. This would help to avoid adverse effects on competition between banks and PRA-designated investment firms.

Question

Q1: To what extent do you consider that the application of the NSFR to PRA-designated investment firms is prudentially appropriate and proportionate, given risks faced by such firms and the nature of their activities?

17 CRR Article 413(1).

4 Levels of application

CRR Articles 6 to 24

4.1 This chapter sets out the PRA's proposals in relation to the level of application for the prudential requirements proposed in this CP, the sub-consolidation of third-country subsidiaries and notification requirements relating to the exclusion of subsidiaries from consolidation requirements on the grounds of proportionality.

4.2 Prudential requirements may be applied at the level of an individual firm, its consolidated group or a sub group of which it is a member.

4.3 Provisions specifying the level of application apply prudential requirements to an individual firm and guard against its being adversely affected by its membership of a wider group or sub-group. As a result, they enhance the safety and soundness of firms in line with the PRA's objectives.

4.4 The proposals in this chapter would include rules in the following proposed new parts of the PRA Rulebook:

- the Own Funds and Eligible Liabilities (CRR) Part of the PRA Rulebook;
- the Trading Book (CRR) Part of the PRA Rulebook;
- the Standardised Approach and Internal Ratings Based Approach to Credit Risk (CRR) Part of the PRA rulebook;
- the Counterparty Credit Risk (CRR) Part of the PRA Rulebook;
- the Operational Risk (CRR) Part of the PRA Rulebook;
- the Credit Valuation Adjustment (CRR) Risk Part of the PRA Rulebook;
- the Large Exposures (CRR) Part of the PRA Rulebook;
- the Liquidity (CRR) Part of the PRA Rulebook;
- the Liquidity Coverage Ratio (CRR) Part of the PRA Rulebook;
- the Reporting (CRR) Part of the PRA Rulebook; and
- the Disclosure (CRR) Part of the PRA Rulebook.

4.5 The proposals would also result in a new Statement of Policy:

- Statement of Policy on Liquidity and Funding Permissions.

4.6 They would also make amendments to:

- the Groups Part of the PRA Rulebook;
- the Internal Capital Adequacy Assessment (ICAA) Part of the PRA Rulebook;

- Internal Liquidity Adequacy Assessment Part of the PRA Rulebook;
- the Glossary to the PRA Rulebook; and
- SS 15/13 'Groups'.

Proposals

4.7 The Basel standards apply to internationally active banks on a consolidated basis and on a sub-consolidated basis at every tier within the banking group; or on an individual basis.[18]

4.8 The CRR applies prudential requirements at the following levels:

- to firms on an individual basis;[19]
- to groups of entities containing one or more firm on a consolidated basis, as though they were a single entity;[20] and
- in certain circumstances, to sub-groups containing one or more firms on a sub-consolidated basis.[21]

4.9 HM Treasury is consulting on using its powers under the FS Bill to revoke the level of application provisions in the CRR that relate to large exposures, liquidity, reporting and disclosure. The PRA proposes to make rules specifying the individual, consolidated and sub-consolidated level of application for these areas in the following Parts of the PRA Rulebook – Large Exposures (CRR), Liquidity (CRR), Liquidity Coverage Ratio (CRR)[22], Reporting (CRR) and Disclosure (CRR).

4.10 The PRA proposes also to specify the level of application of the Own Funds and Eligible Liabilities (CRR), Trading Book (CRR), Standardised Approach and Internal Ratings Based Approach to Credit Risk (CRR), Counterparty Credit Risk (CRR), Operational Risk (CRR), Credit Valuation Adjustment Risk (CRR) Parts in a way that cross-references the corresponding level of application provisions that remain in the CRR. This would help to ensure that level of application of these provisions is clear within the PRA Rulebook.

Individual consolidation

4.11 Under the CRR, where certain conditions are met the PRA may grant firms permission to apply certain prudential requirements on the basis of their consolidated situation with their subsidiaries, rather than to the individual firm. This is known as 'individual consolidation'.[23]

4.12 Where a firm has already received permission to apply individual consolidation for the purposes of requirements set out in the CRR, the PRA proposes to extend that permission automatically to the proposed Large Exposures (CRR) and Reporting (CRR) Parts. In combination with changes to the CRR on which HM Treasury is consulting, this would have the effect of maintaining firms' current individual consolidation permissions and avoid their having to reapply for those

18 Basel standards SCO10.1, 10.3, 10.4 and Footnote 2.
19 CRR Articles 6.
20 CRR Articles 11, 13 and 14.
21 CRR Articles 11(6) and 22.
22 The proposed approach in the Liquidity Coverage Ratio (CRR) Part is to cross-refer to the requirements in the Liquidity (CRR) Part to ensure that the requirements are the same in both Parts.
23 CRR Article 9.

permissions because of the changes proposed in this CP. The PRA considers this approach would be prudent and proportionate, as firms would otherwise be required to reapply for a permission that the PRA has granted when there has not been a substantive change in the conditions for obtaining it.

Liquidity: domestic liquidity sub-groups

4.13 Where certain conditions are met on the availability, distribution, management and monitoring of liquidity, the CRR allows the PRA to waive the application of the LCR and associated reporting at individual firm level and instead the firm would be required to meet those requirements at the level of its domestic liquidity sub-group (DoLSub). A DoLSub may comprise the firm and certain other members of its UK consolidation group. Where a DoLSub is formed, the LCR applies to it on the basis of the consolidated situation of its members, rather than applying to member firms individually. This reflects the ability of some firms to manage their liquidity jointly with other entities, as if they were a single entity. HM Treasury has proposed to revoke this provision from the CRR.

4.14 Chapter 11 sets out the PRA's proposals to replicate the liquidity requirements that HM Treasury has proposed to revoke from the CRR, including those relating to DoLSubs. The PRA is working with HM Treasury on transitional provisions to ensure that DoLSub permissions in existence before Saturday 1 January 2022 that disapply LCR requirements at an individual level can continue to have effect after that date.

4.15 Chapter 12 sets out the PRA's proposals to implement the NSFR. In addition to proposing to apply the NSFR at the level of individual firms, the PRA proposes to allow firms to apply for a waiver from NSFR requirements at individual level which would instead apply at the level of a DoLSub for the purposes of the NSFR. This would enable the scope of a DoLSub permission to include the NSFR.

4.16 The PRA proposes to introduce a number of conditions that would be specific to the formation of a DoLSub for the NSFR that relate to:

- the management of funding by the proposed sub group;
- the management of funding risk at the sub-group level including the relevant processes and procedures; and
- the funding requirements met by the members of the proposed sub-group immediately prior to the application being made.

4.17 The PRA proposes that firms would need to apply for a DoLSub permission for the NSFR. The PRA proposes to introduce a new Liquidity and Funding Permissions SoP setting out its expectations relating to the use of DoLSubs given the proposed implementation of the NSFR. As a minor consequential change, the PRA also proposes to update reference to the term 'domestic liquidity sub-group' in the Internal Liquidity Adequacy Assessment Part and in the Glossary.

Consolidated application

4.18 The CRR requires parent firms and approved or designated holding companies to meet prudential requirements at a consolidated level. This involves applying requirements to a group containing a firm or entities as if those entities were one entity.

4.19 The PRA proposes to introduce new rules in each of the proposed Large Exposures (CRR), Liquidity (CRR), Liquidity Coverage Ratio (CRR)[24], Reporting (CRR) and Disclosure (CRR) Parts requiring parent firms and approved holding companies to meet those requirements on a consolidated basis. This would have the effect of automatically extending the approach to the application of consolidated requirements, set out in the CRR, to these Parts of the PRA Rulebook.[25] The PRA proposes to mirror the approach of the CRR by applying the requirements on a consolidated basis to 'CRR consolidation entities', a new definition that the PRA proposes to introduce into the PRA Glossary.[26]

Methods of consolidation

4.20 The CRR grants powers to the PRA to determine methods of prudential consolidation.[27] The PRA proposes to continue to make these determinations and make a number of minor changes in the Groups Part to reflect the revised approach as set out in this Chapter.

Organisation structure and control mechanisms

4.21 The CRR requires approved holding companies and institutions to meet appropriate organisational structure and control mechanism requirements on a consolidated basis. The PRA proposes to introduce new rules in each of the proposed Large Exposures (CRR), Liquidity (CRR), Liquidity Coverage Ratio (CRR)[28], Reporting (CRR) and Disclosure (CRR) Parts requiring firms and CRR consolidation entities to meet appropriate organisational structure and control mechanism requirements on a consolidated basis.

Sub-consolidated application

4.22 The PRA proposes to require an institution to comply with the requirements in the Large Exposures (CRR), Liquidity (CRR), Liquidity Coverage Ratio (CRR),[29] Reporting (CRR) and Disclosure (CRR) Parts on a sub-consolidated basis where it is required to comply with Parts Two and Three of the CRR on that basis.[30] This would apply, for example, to the ring-fenced bodies that are required to comply with CRR requirements on a sub-consolidated basis. This would have the effect of requiring firms to continue to comply with those requirements on a sub-consolidated basis. The PRA considers this approach would be prudent and proportionate, as firms that are currently subject to those rules on a sub-consolidated basis would otherwise not be required to apply them on that basis.

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24 The proposed approach in the Liquidity Coverage Ratio (CRR) Part is to cross-refer to the requirements in the Liquidity (CRR) Part to ensure that the requirements are the same in both Parts.

25 The PRA proposes to maintain the exception from CRR Articles 18(3)-(6) and 18(9) for liquidity requirements.

26 CRR consolidation entity means a UK parent institution, a PRA approved parent holding company, a PRA designated parent holding company or a PRA designated institution as those terms are defined in the PRA Glossary.

27 CRR Article 18.

28 The proposed approach in the Liquidity Coverage Ratio (CRR) Part is to cross-refer to the requirements in the Liquidity (CRR) Part to ensure that the requirements are the same in both Parts.

29 The proposed approach in the Liquidity Coverage Ratio (CRR) Part is to cross-refer to the requirements in the Liquidity (CRR) Part to ensure that the requirements are the same in both Parts.

30 Where an institution is required to comply with Parts Two and Three on a sub-consolidated basis, the rules in the Own Funds and Eligible Liabilities (CRR), Trading Book (CRR), Standardised Approach and Internal Ratings Based Approach to Credit Risk (CRR), Counterparty Credit Risk (CRR), Operational Risk (CRR), and Credit Valuation Adjustment Risk (CRR) Parts would also apply on a sub-consolidated basis.

Third country sub-consolidation

4.23 HM Treasury is consulting on revoking the CRR requirement for firms to apply prudential requirements on a sub-consolidated basis to subsidiaries established in third countries that are banks, investment firms or financial institutions (third country sub-consolidation).[31]

4.24 The application of prudential requirements on a consolidated basis can help to ensure that risks that such third country subsidiaries could pose to their parent companies are both clear and addressed through prudential requirements. The PRA considers that it would only be beneficial to apply such requirements where the activities of third country subsidiaries pose significant risks to their UK parent.

4.25 The PRA considers that a prudent and proportionate means of addressing the risks arising specifically from UK firms' third country subsidiaries would be to apply a requirement for a firm to apply third country sub-consolidation in individual cases where it was warranted based on the materiality, activities and risks of those subsidiaries.

4.26 The PRA does not propose to implement a general rule on third country sub-consolidation. Under the CRR, the PRA is empowered to impose requirements on a sub-consolidated basis.[32] The PRA proposes to amend SS13/15 to clarify that one circumstance in which the PRA may use this power to require sub-consolidation is where the risks posed to a firm by a third country subsidiary or subsidiaries warrant such a treatment, and this would be assessed on a case-by-case basis. This would help to enhance the safety and soundness of firms, while also ensuring the application of third country sub-consolidation is proportionate. The PRA also proposes to make a consequential change to the ICAA and Capital Buffers Parts as a result.

Other issues

4.27 The CRR permits firms to exclude a small subsidiary or subsidiaries from consolidation without requiring the permission from, or notification of, the PRA.[33] As a result, the PRA may not have sufficient information on the scope of entities excluded to understand sufficiently the risks they may pose to a group.

4.28 To address this shortcoming, the PRA proposes to introduce a requirement in the Groups Part for firms to notify the PRA of its use of this exemption. This would enhance supervision of firms and reflects the behaviour that the PRA already expects of a firm in ensuring open and transparent dealings with regulators under Fundamental Rule 7.

31 CRR Article 22.
32 CRR Article 11(6).
33 Small in this context means where the balance sheet of a subsidiary or subsidiaries is less than the smaller of €10 million or 1% of the total assets and off-balance sheet items of the parent.

5 Definition of capital

CRR Article 36

5.1 The CRR contains provisions defining the tiers of required capital that firms must hold. This chapter sets out the PRA's proposed rules on deductions from Common Equity Tier 1 (CET1) items that are applicable to PRA-authorised firms and relevant holding companies.

5.2 The proposals in this chapter would enable the PRA to supervise the quality of firms' CET1 capital effectively. This would advance firms' safety and soundness, in line with the PRA's objectives.

5.3 The proposals in this chapter would introduce a new Part of the PRA Rulebook:

- Own Funds and Eligible Liabilities (CRR) Part of the PRA Rulebook.

Proposals

Deduction of software assets from CET1

5.4 The Basel III standards require that intangible assets be deducted fully from CET1, including software assets that qualify as intangible assets under the relevant accounting standards. This approach reflects the concern that intangible assets are not sufficiently loss absorbent on a going concern basis to warrant recognition as CET1 capital.

5.5 The EU CRR II introduced requirements to exclude certain software assets from the requirement for CET1 deduction with effect from Wednesday 23 December 2020. Those requirements were effected by way of a change to Article 36(1)(b) of CRR and by changes to Commission Delegated Regulation (EU) 241/2014.[34] Under the requirements, some software assets that are accounted as intangible assets would not require deduction from CET1, or be subject to a requirement for only partial deduction.

5.6 On Wednesday 30 December 2020, the PRA published a statement on its concern that excluding such software assets from the requirement for CET1 deduction could undermine the safety and soundness of firms.[35] It recommended that firms do not base their distribution or lending decisions on any capital increase from applying the revised EU CRR II deduction requirement.

5.7 To assess the adequacy of the UK's deduction treatment of software assets, the PRA:

- undertook analysis of UK firms' software assets, focusing on their realisable or recoverable values in liquidation or in stress; and
- reviewed relevant information UK banks provided for the BCBS's periodic Basel III monitoring data collection exercises.

5.8 The PRA found no credible evidence that software assets would absorb losses effectively in a stress. Accordingly, the PRA proposes to modify Article 36 of the CRR (as it forms part of retained EU

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34 European Commission Delegated Regulation (2020/2176), 22 December 2020.
35 December 2020: https://www.bankofengland.co.uk/prudential-regulation/publication/2020/statement-prudential-treatment-software-assets.

law) when it is transferred into PRA rules to require the full deduction from CET1 of all intangible assets, with no exception for software assets. The PRA proposes also to make an instrument under section 138P (Technical Standards) of FSMA 2000 to modify Commission Delegated Regulation (EU) 241/2014 in respect of software assets. The PRA proposes to bring this change in as soon as possible (ie before Saturday 1 January 2022), but will confirm the timing in due course. As a result, all software assets that qualify as intangible assets under IFRS or the applicable accounting standards would be required to be deducted from CET1, in line with Basel III standards.

6 Market risk

CRR Articles 94, 102, 103, 104, 104b, 105 and 106

6.1 This chapter sets out the PRA's proposals to update the requirements for the trading book and to amend the eligibility requirements for firms to use the derogation for small trading book business.[36]

6.2 The proposed changes to requirements for the trading book relate mainly to requirements on prudent valuation. They clarify the general requirements for trading book management, implement Basel III standards, and improve the consistency and transparency of requirements applicable across firms. As a result, they would enhance the safety and soundness of firms in line with the PRA's objectives.

6.3 The proposed changes to the derogation for small trading book business would make the derogation available to a broader range of trading book businesses, and to clarify eligibility for its use. This would enhance the proportionality of the PRA approach to applying market risk requirements to firms with limited trading activities.

6.4 The proposals in this chapter would make amendments to Trading Book (CRR) Part of the PRA Rulebook (Appendix 9, Annex B, Chapters 3 and 4).

Proposals

Prudent valuation

6.5 The CRR sets out requirements on prudent valuation for all trading book positions.[37] It applies these requirements to all assets measured at fair value.[38] This helps to ensure the adequacy of valuations of positions, in particular for those without observable market prices and for less liquid positions.

6.6 HM Treasury has proposed to revoke these aspects from the CRR and empower the PRA to address them in PRA rules.

6.7 The PRA proposes to make explicit that in the Trading Book (CRR) Part that prudent valuation requirements apply to trading and non-trading book positions measured at fair value. This will help to advance the safety and soundness of firms, consistent with PRA objectives.[39]

6.8 The FS Bill's deletion of prudent valuation requirements in the CRR will also repeal the UK Technical Standards Instrument covering prudent valuation.[40] The PRA proposes to replicate in in the Trading Book (CRR) Part of the PRA rulebook the requirements of the UK Technical Standards Instrument. The UK Technical Standards Instrument provides additional, more specific, requirements relative to the Basel standards on prudent valuation.[41] The PRA considers that this additional

[36] The PRA's implementation of Basel III's revised Pillar 1 requirements for market risk is not addressed in this consultation and will be covered by a future consultation.
[37] CRR Articles 105.
[38] CRR Article 34.
[39] Basel standards CAP50.1.
[40] CRR Article 105 and Onshored Delegated Regulation (EU) No 101/2016 of 26 October 2015, supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council with regard to regulatory technical standards for prudent valuation under Article 105(14) of Regulation (EU) No 575/2013.
[41] Basel standards CAP50.

prescription remains necessary to support consistent and transparent implementation of prudent valuation requirements across firms.

Revaluation of positions

6.9 The Basel III standards require that, to be included in the trading book, a position must be revalued at fair value on at least a daily basis and the changes in the value of those positions must be reported in the profit and loss account of the firm.[42] The PRA proposes to implement this requirement, which, given the volatile nature of trading book activities, would support the safety and soundness of firms by ensuring that market risk capital requirements are calculated based on the actual positions and valuations that firms have.

Management of the trading book and internal hedges

6.10 The CRR sets requirements for the management of the trading book, including requirements on inclusion in the trading book and on internal hedges between the trading book and non-trading book.[43] HM Treasury has proposed to revoke these requirements and empower the PRA to address them in PRA rules.

6.11 The PRA proposes to incorporate these requirements, replicating their substance but amending their presentation in order to improve their clarity.[44]

Limited trading activities

Derogation and proportionality thresholds

6.12 The CRR provides a derogation for small trading book business. It allows a firm to use the credit risk framework to calculate the own funds requirements for their trading book business, rather than also being required to calculate market risk capital requirements for interest rate and equity position risk.[45] The derogation is available to firms with on- and off-balance sheet trading book business that:

- is normally less than €15 million and less than 5% of their total assets; and
- never exceeds €20 million or 6% of total assets.

6.13 The CRR requires firms using the derogation to notify supervisors if their trading book size exceeds either 6% of total assets or €20 million. It requires the PRA to assess whether a notifying firm should cease to use the derogation if it considers the firm does not 'normally' meet the minimum threshold requirements that trading book size is less than 5% of total assets or €15 million. The CRR does not elaborate on what this could entail in practice.

6.14 HM Treasury has proposed to provoke the derogation from the CRR and empower the PRA to address it in PRA rules.

6.15 Given the relatively limited traded activities undertaken by smaller firms, the PRA considers that it would be prudentially appropriate, and would enhance the proportionality of the PRA's approach, to increase the proportionality thresholds for limited trading activity. Accordingly, the PRA

42 Basel standards RBC25.4.
43 CRR Articles 102 to 104b, and Article 106.
44 CRR Articles 102 to 104.
45 CRR Article 94.

proposes to specify in the Trading Book (CRR) Part a revised derogation for firms with limited trading activities.[46] This would replace the current thresholds in the CRR with:

- a threshold of 5% of a firm's total assets; and
- an absolute threshold of £44 million.

6.16 The PRA proposes that firms wishing to apply the derogation should calculate the revised thresholds on a monthly basis.

Calculation of trading book size

6.17 The CRR does not allow firms to exclude any positions in their calculation of trading book size for the purposes of the determining eligibility for the derogation for small trading book business.

6.18 The derogation allows firms to apply credit risk framework to calculate capital requirements for their trading book business, rather than calculating market risk capital requirements for interest rate and equity position risk. The derogation does not exempt firms from calculating market risk capital requirements for foreign exchange and commodities risks (whether those risks arise from trading book or banking book positions). The PRA therefore proposes that firms should exclude from the calculation of trading book size all foreign exchange positions and commodities positions, as these positions are not in the scope of derogation for small trading book business.

6.19 The PRA proposes that firms should exclude from the calculation of trading book size all internal and external credit derivative positions recognised between the trading book and non-trading book, as firms that do not apply the derogation may also exclude such positions from market risk capital requirements.

6.20 The PRA considers that these changes would facilitate effective competition by more precisely aligning the calculation of trading book size (and thus, eligibility to use the derogation) with the scope of positions that the derogation may apply to.

Conditions for ceasing to use the derogation

6.21 The PRA proposes to specify in the Trading Book (CRR) Part of the PRA rulebook the quantitative conditions under which a firm must cease to apply the derogation.[47] The PRA proposes a firm would no longer be permitted to apply the derogation within three months of ceasing to meet the thresholds for applying the derogation for either:

- the past three consecutive months; or
- more than 6 of the last 12 months.

6.22 This approach would enhance firms' safety and soundness by clarifying the circumstances in which the derogation would no longer apply, while also remaining proportionate.

Questions

[46] Article 94.1 of the Trading Book (CRR) Part of the PRA Rulebook, Annex B, Chapter 3.
[47] Article 94.7 of the Trading Book (CRR) Part of the PRA Rulebook, Annex B, Chapter 3.

Q2: To what extent do you consider the proposed approach to improve the proportionality of the derogation from market risk requirements for firms with limited trading activity?

7 Collective investment undertakings

CRR Articles 128, 132, 132a, 152 and 158

7.1 This chapter sets out the PRA's proposed implementation of the Basel III capital requirements for firms' equity exposures to collective investment undertakings (CIUs) in the non-trading book.

7.2 Pillar 1 capital requirements are applied to firms' CIU exposures to ensure firms have sufficient minimum capital to withstand losses from such exposures. The proposed implementation of the BCBS revised requirements would enhance the consistency and risk sensitivity of Pillar 1 requirements for CIU exposures. As a result, it would enhance firms' safety and soundness, consistent with PRA objectives.

7.3 The proposals in this chapter would introduce a new Part of the PRA Rulebook:

- Standardised Approach and Internal Ratings Based Approach to Credit Risk (CRR) Part.

Proposals

7.4 The Basel III standards introduce a revised hierarchy of approaches to determine capital requirements for CIU exposures under the standardised approach (SA) to credit risk and the internal ratings-based (IRB) approach to credit risk:[48]

- a revised look-through approach (LTA) that can be used where a firm has sufficient information on the underlying exposures of the CIU, and the information is verified by a third party;
- a mandate based approach (MBA) that can be used when the conditions for using the LTA are not met and is based on the information contained in a CIU's mandate; and
- a fall-back approach (FBA) to be used when the LTA and MBA are not feasible.

7.5 Under the LTA, the capital requirements are those that would apply if the firm had a direct exposure to the underlying assets. Under the MBA, capital requirements would apply assuming the CIU invests in different assets to the maximum extent permitted under its mandate, starting with the assets subject to the highest capital requirements. Under the FBA, a 1,250% risk weight would apply.

7.6 HM Treasury is proposing to use its powers under the FS Bill to remove from the CRR the provisions on the Pillar 1 requirements for firms' exposures to CIUs, and empower the PRA to address those requirements in PRA rules. Accordingly, the PRA proposes to make rules in the new standardised approach and internal ratings based approach to credit risk (CRR) Part to revise the prudential requirements applicable to CIU exposures.

Hierarchy of approaches

7.7 The CRR permits various approaches to be applied to CIU exposures depending on whether the CIU meets certain criteria and depending on whether the firm applies SA or IRB for credit risk.

48 Basel standards CRE60.1 – 60.20.

7.8 In implementing a revised framework for CIU exposures in the Standardised Approach and Internal Ratings Based approach to credit risk (CRR) Part, the PRA proposes to specify the revised LTA, MBA and FBA under SA and IRB. The PRA recognises that a firm may meet the conditions to apply the LTA for some of its CIU exposures, the MBA for others, and have to apply the FTB for its remaining exposures. Therefore, the PRA proposes to permit firms to apply a combination of the LTA, MBA and FBA to its CIU exposures, provided the relevant conditions for their use are met.

7.9 The PRA's proposed implementation of the new hierarchy of approaches would enhance the prudential approach to CIU exposures, and better reflect the information available on a CIU's underlying exposures and the leverage risks to which it is subject. As a result, it would enhance the safety and soundness of firms, in line with the PRA's objectives.

Additional criteria for using the LTA and the MBA

7.10 The CRR applies eligibility criteria for the use of a LTA or an average risk weight approach based on the mandate of the CIU. Those eligibility criteria require the manager of the CIU to be subject to FCA supervision - or equivalent for companies supervised in a third country; cover the information provided on the CIU's investment mandate; and cover reporting on the CIU's performance.

7.11 In implementing the revised framework in PRA rules, the PRA proposes to permit firms to use the LTA and the MBA subject to certain conditions:

- the CIU satisfies one of the following conditions:
  - the CIU is a UK undertaking for the collective investment in transferable securities (UCITS) or an alternative investment fund (AIF) managed by a UK alternative investment fund manager (AIFM);
  - the CIU is an AIF managed by a full-scope Gibraltar AIFM and marketed in the UK under regulation 57 of The Alternative Investment Fund Managers Regulations 2013; [49]
  - the CIU is an AIF managed by a third country AIFM and marketed in the UK under regulation 59 of The Alternative Investment Fund Managers Regulations 2013; or
  - the company managing the CIU is established in a third country and is subject to supervisory and regulatory arrangements that have been determined by HM Treasury to be equivalent to that of the UK;[50]
- the CIU's prospectus provides specific information on its investment mandate; and
- there is sufficiently frequent and granular information by the CIU or its management company.[51]

49 HM Treasury have set out their intention to introduce a Gibraltar Authorisation Regime (GAR). The PRA will consider in due course whether any changes are required to the proposed new PRA rules to reflect the introduction of GAR.

50 This is consistent with the proposals made by HM Treasury in to retain the jurisdictional equivalence provision set out Article 132(3)(a) of the CRR.

51 Where the LTA is used, this includes verification of the information on the underlying exposures by an independent third party. For the MBA, this is limited to information relating to the investment mandate for the CIU.

7.12 Where these requirements are not met, the PRA proposes that the FBA would apply, meaning a 1,250% risk weight. These criteria would enhance the safety and soundness of firms by ensuring that the LTA and MBA apply only where there is adequate supervision of the management, marketing and supervisory oversight of a CIU. Whilst the criteria regarding supervisory oversight are not required under the Basel standard, the PRA considers that these are important to mitigate risks that come from exposures to CIU themselves, in addition to the risks associated with the underlying investments.

7.13 The PRA does not propose to apply eligibility requirements relating to supervisory oversight for relevant CIU exposures of firms that co-invest in a CIU with a bilateral or multi-lateral development bank, provided the assets in which the CIU is able to invest are limited to those that promote sustainable development in developing countries. The PRA proposes to require a firm to notify the PRA of the CIUs to which it applies this treatment.

Application of LTA by firms applying IRB for credit risk

7.14 Where a firm has permission to use the IRB for credit risk but the conditions for using an IRB are not met for all or part of the underlying exposures of a CIU (including where the CIU exposure would meet the conditions for permanent partial use of IRB-CR under the CRR), the PRA proposals would, for:

- equity exposures, apply the IRB for credit risk simple risk weight approach of the CRR to calculate capital requirements;[52]
- securitisation positions, apply the securitisation requirements of the CRR to calculate capital requirements as if the firm had a direct exposure to those positions;[53] and
- all other exposures, apply the SA for credit risk.

7.15 The proposed treatment to securitisation positions would ensure consistency with the framework applied to such exposures in the CRR.

Leverage adjustment

7.16 The CRR does not apply requirements in relation to the extent of leverage of a CIU when using the look-through approach or the average risk weight approach.

7.17 The Basel standards specify that a firm should apply a leverage adjustment to the average risk weight of a CIU exposure under the LTA and the MBA.[54] Its purpose is to address the risk from the underlying leverage of a CIU. The adjustment is based on the ratio of total assets to total equity, subject to a cap of 1,250% on the resulting risk weight.

7.18 The PRA proposes that firms should take leverage into account when calculating capital requirements for CIU exposures. Except where stated otherwise, this would be done by multiplying the risk-weighted exposure amount of the CIU's exposures by the percentage of shares held. The PRA also proposes an alternative calculation that can be used for off-balance sheet exposures and in cases where the accounting treatment specified in Article 132(7) of the Standardised Approach and Internal Ratings Based Approach to Credit Risk (CRR) Part applies.

52 CRR Article 155(2).
53 CRR Article 254.
54 Basel standards CRE60.13 – 60.16.

Reliance on third party calculations

7.19 The CRR allows firms to rely on certain third parties, such as the depository institution of the CIU, to calculate and report the capital requirements for an exposure to a CIU, provided the calculation is confirmed to be correct by an external auditor.[55]

7.20 The Basel III standards permit firms to rely on third party calculations if they do not have adequate data to perform the calculations themselves. In such cases, a 1.2 scalar is applied to the applicable risk weight. In the case of firms with permission to use IRB-SA that rely on third party calculations for the purposes of applying the LTA, the Basel III standards specify that the third party must use:

- the simple risk weight method for equity exposures;
- the Securitisation External Ratings Based Approach (SEC-ERBA) or a 1,250% risk weight where the requirements for using SEC-ERBA are not met; and
- SA-CR for all other exposures.

7.21 In implementing PRA rules on CIU exposures, where a firm does not have access to sufficient data to apply the LTA or the MBA, the PRA proposes to allow it to rely on the calculations of certain third parties. This would be subject to specific conditions including a requirement for an external auditor to have confirmed the calculation is correct. In order to ensure the capital requirements applied are sufficiently conservative in such cases, the PRA proposes to:

- apply a scalar of 1.2 to the risk weighted exposure amounts of CIU exposures using the LTA and MBA where a firm relies on third party calculations but does not have unrestricted access to the third party's detailed calculations; or
- not apply a scalar where a firm has unrestricted access to the third party's detailed calculations.

CIUs that invest in other CIUs

7.22 When an exposure of a CIU is an exposure to another CIU, the CRR permits an LTA to be applied to the underlying assets provided the eligibility criteria are met.[56]

7.23 The Basel III standards define the approach that may be applied based on how many layers of investments in other CIUs a CIU exposure entails. The first layer of investment by one CIU in another may be subject to the LTA, MBA or FBA. The LTA may be applied to subsequent layers of investment in other CIUs if used in the previous layer; otherwise the FBA applies.

7.24 The PRA proposes to implement restrictions on the approaches that can be applied to subsequent layers of investment in other CIUs. This approach seeks to ensure that the capital requirements for multiple level of CIU investment are prudent given the information a firm has about the underlying assets.

55 CRR Articles 132 and 152.
56 CRR 132 and 152.

Exclusions

7.25 The PRA proposes for its rules, together with the CRR, to specify requirements for firms' holdings of CET1, Additional Tier 1 and Tier 2 instruments and eligible liabilities to be deducted from the corresponding element of a firm's own funds or eligible liabilities. The CRR does not currently specify how exposures to CIUs that invest in such instruments should be treated.

7.26 The Basel III standards permit equity holding in entities whose debt obligations qualify for a zero risk weight to be excluded from the LTA, MBA and FBA approaches at the discretion of the national supervisor.[57] The PRA proposes to exclude from the LTA, MBA and FBA equity exposures that receive a 0% risk weight under SA for credit risk.

7.27 In order to promote specified sectors of the economy, the Basel III standards afford national discretion to exclude from capital requirements equity holdings made under legislated programmes that provide significant subsidies or investment to a firm and involve some form of government oversight and restrictions on the equity investments. The PRA proposes to exclude from the LTA, MBA and FBA exposures to CIUs for underlying exposures to legislated programmes.[58]

Derivative exposures

7.28 CIUs' underlying assets can include derivative exposures.

7.29 The PRA proposes a methodology for calculating counterparty credit risk (CCR) exposure values under the MBA in the event that certain inputs needed for the calculation are unknown. In particular, where one or more of the inputs required for the calculation of replacement cost and/or the potential future exposure are not available, firms should set these using a calculation based on derivative notional amounts. This methodology would apply under all CCR methods available under the MBA.

Credit Valuation Adjustment risk for derivatives exposures

7.30 The Basel III standards and the CRR apply capital requirements for Credit Valuation Adjustment (CVA) risk.[59]

7.31 The PRA proposes to apply the requirements for CVA risk also to a CIU's derivative exposures. Where the LTA or the MBA approach is applied, the PRA proposes on proportionality grounds to permit firms to calculate the CVA requirement for such exposures based on 50% of the applicable counterparty credit risk capital requirement for those derivatives exposures.

7.32 To ensure consistency with the CRR, the PRA also proposes to permit firms to exclude from a CVA capital requirement derivatives exposures to a CIU that would be excluded from the CVA requirement if the firm had a direct exposure to the relevant underlying assets.

Definitions

7.33 The PRA proposes to use within its rules several terms set out in the Alternative Investment Fund Managers Regulations 2013, and these terms will be defined to have the same meaning as set out in those regulations. The PRA also proposes to introduce a definition of the term UK UCITS, based on the FSMA definition of this term. The PRA considers that using terms that are defined elsewhere, with clear references to those definitions, will make these rules easier to understand.

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57 Basel standards CRE60.11.
58 Basel standards CRE60.12.
59 CRR Article 382.

Other consequential changes

7.34 The PRA proposes that exposures to CIUs will not qualify as items associated with particular high risk.[60]

60 CRR Article 128.

8 Counterparty credit risk

CRR Articles 272 to 282 and 300 to 311

8.1 This chapter sets out the PRA's proposals to implement the Basel III standards on counterparty credit risk. These comprise the introduction of a new standardised approach for measuring counterparty credit risk exposures (SA-CCR) for firms that do not have permission to use the internal model method (IMM) for counterparty risk,[61] and a revised framework for capital requirements for firms' exposures to central counterparties (CCPs).[62] The chapter does not cover their potential application for the purposes of the UK leverage ratio framework. That will be considered as part of the review of the UK leverage ratio framework by the FPC and PRC. The review is expected to be completed in Summer 2021.

8.2 The BCBS's new SA-CCR framework is intended to:

- be applied to a wide variety of derivatives transactions;
- be capable of being implemented simply and easily;
- address known deficiencies of the existing standardised approaches;
- draw on prudential approaches already available in the Basel framework;
- minimise discretion used by national authorities and firms; and
- improve the risk sensitivity of the capital framework without creating undue complexity.

8.3 The SA-CCR framework applies to over-the-counter (OTC) derivatives, exchange traded derivatives and long settlement transactions.

8.4 The implementation of a simple, more consistent, and risk sensitive framework for counterparty credit risk would enhance the safety and soundness of firms, in line with the PRA's objectives.

8.5 The Basel standards for exposures to CCPs introduce; the use of SA-CCR in measuring exposures to CCPs, a cap on capital charges on a firm's exposures to a qualifying CCPs (QCCP), and specify further the treatment of multi-level client structures. These improvements in the framework would enhance the safety and soundness of firms and help to ensure that capital requirements for CCP exposures are proportionate.

8.6 The proposals in this chapter would:

- delete the Counterparty Credit Risk Part of the PRA Rulebook;
- introduce a new Counterparty Credit Risk (CRR) Part of the PRA Rulebook;

61 https://www.bis.org/publ/bcbs279.pdf.
62 https://www.bis.org/publ/bcbs282.pdf.

- amend SS12/13 'Counterparty credit risk';[63] and
- amend SoP 'The PRA's methodologies for setting Pillar 2 capital'.[64]

Proposals

SA-CCR

8.7 The PRA proposes to delete the Counterparty Credit Risk Part of the PRA Rulebook and implement SA-CCR in the Counterparty Credit Risk (CRR) Part of the PRA Rulebook, which would introduce new rules requiring firms without IMM permission to use the SA-CCR approach to:

- calculate the exposure value, the replacement cost and the potential future exposure (PFE) of transactions using the SA-CCR approach, including for the recognition of collateral;
- map transactions to the relevant risk categories and to identify hedging sets that are relevant for each risk category of a netting set, when calculating potential future exposure; and
- calculate PFE using the SA-CCR methodology. This includes specifying:
    - the methodology for firms to calculate the risk position for each transaction in a netting set;
    - adjustments for trade direction and non-linearity (application of the so-called 'supervisory delta'), notional amount, and risk horizons (maturity factor); and
    - methodologies for aggregating risks within and across asset classes.

Mapping transactions to risk categories and asset classes

8.8 The Basel III standards require firms to assign a derivative transaction to an asset class based on its primary risk driver. This is necessary in order to determine an aggregate capital add-on to be applied as part of the PFE for each netting set.

8.9 The Basel III standards note that most derivatives transactions would have only one risk driver, defined by its reference underlying instruments, and that transactions that are more complex may have more than one driver. The Basel III standards do not prescribe methodologies according to which firms must identify the risk driver, or drivers, of a transaction and map them to asset classes.[65] Once the primary risk driver has been identified, it must be allocated to one or more asset classes in order to calculate the relevant PFE add-on.

8.10 The PRA considers it would be prudent and proportionate for firms to identify a transaction's risk drivers and to map those drivers to the relevant asset classes. Accordingly, in implementing this aspect of the SA-CCR framework, the PRA proposes not to prescribe a methodology for identifying risk drivers and mapping them to asset classes. The PRA intends to consider whether further prescription may be necessary and appropriate in light of the experience of firms' implementation of the SA-CCR framework.

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63 October 2020 https://www.bankofengland.co.uk/prudential-regulation/publication/2013/counterparty-credit-risk-ss.
64 December 2020: https://www.bankofengland.co.uk/prudential-regulation/publication/2015/the-pras-methodologies-for-setting-pillar-2-capital.
65 Basel standards CRE 52.26 to 52.29.

Additional risk category and hedging set

8.11 In addition to the five asset classes[66] prescribed by the Basel III standards to which transactions must be mapped, the PRA proposes to add an 'other risks' category.[67] This is intended to provide flexibility for the future in the event that transactions are developed that cannot be readily mapped to one of the five categories.

8.12 The Basel III standards define the hedging sets in different asset classes.[68] The PRA proposes to add a 'climatic conditions' hedging set under the commodity risk category. This is intended to provide greater scope to ensure that transactions aimed at addressing climate risks are specifically identified and addressed.

Supervisory delta

8.13 The Basel III standards note there may be cases in which the underlying price of an option (P) divided by the strike price (K) may be zero or negative, for example in a negative interest rate environment.[69] In such cases, it is not possible to calculate the value of the term $ln(P/K)$ when calculating supervisory delta adjustments. The supervisory delta ensures the effective notional of a trade reflects the trade direction and non-linearity.

8.14 The Basel III standards require firms to incorporate a shift in the price value and strike value representing the presumed lowest possible extent to which interest rates in the respective currency can become negative to calculate the supervisory delta for interest rates in a particular currency (λ). They also encourage supervisors to specify the value of λ.[70]

8.15 The PRA proposes to implement a λ adjustment to the supervisory delta equation for the interest rate risk category.[71] This will help to promote the safety and soundness of firms, ensuring the supervisory delta can be calculated in low interest rate environments.

Definition of commodities

8.16 The Basel III standards note the operational difficulty of defining all individual commodity types when calculating the add-on for the commodity derivative asset class within a netting set.[72] The Basel III standards note that supervisors may require firms to use more refined definitions of commodities when firms are significantly exposed to the basis risk of different products within those commodity types.

8.17 The PRA proposes not to refine further the definitions of commodities at this stage. The PRA intends to address such definitional risks on a case-by-case basis, and to consider whether further prescription in PRA rules is warranted in light of the experience of implementation of the framework.

Proportionality

8.18 In order to enhance the proportionality of the proposed framework for counterparty credit risk, the PRA proposes to make the framework more proportionate by providing two additional methodologies for firms with limited derivatives exposures: the simplified SA-CCR (sSA-CCR) and the

66 Interest rate, foreign exchange, commodity, equity and credit.
67 In the Counterparty Credit Risk (CRR) Part of the PRA Rulebook (Annex D, Chapter 3, Article 277).
68 Basel standards CRE 52.45 – 52.47.
69 Basel standards CRE 52.40, FAQ2.
70 Basel standards CRE 52.40, FAQ2.
71 In the Counterparty Credit Risk (CRR) Part of the PRA Rulebook (Annex D, Chapter 3, Article 279a).
72 Basel standards CRE 52.71.

original exposures method (OEM). These additional methodologies are designed to be less complex, with lower operational cost for firms to implement and maintain. In line with their lower risk sensitivity, the calibration of these methods is more conservative than for SA-CCR.

8.19 The PRA proposes that sSA-CCR and the OEM would be available to firms below specific quantitative thresholds. The PRA proposes that firms would be able to use the sSA-CCR if the size of their total on- and off-balance sheet derivative business is equal to or less than £263 million and 10% of their total assets. OEM would be available to firms if the size of their derivative business is equal to or less than £88 million and 5% of total assets.

8.20 The Basel SA-CCR standard was designed to be applied to internationally active banks. In accordance with the scope of application of prudential requirements in the CRR, the PRA proposes to apply SA-CCR generally to all firms that do not have permission to use IMM.

8.21 In order to ensure the PRA approach is proportionate for smaller, less complex firms, the PRA proposes to allow certain firms to choose to implement a simplified sSA-CCR or the OEM in order to determine capital requirements for counterparty credit risk as an alternative to applying SA-CCR. Firms would be required to notify the PRA if they use either of the methods (and therefore meet the appropriate threshold requirements) and if they cease to meet the conditions. These approaches are simpler than but at least as conservative as SA-CCR. As a result, they offer a robust but proportionate alternative to implementing SA-CCR. The PRA proposes a further consequential change, restating CRR Article 385 with amendments to update the cross-referencing to OEM and minor typographical changes.

8.22 The PRA is thinking broadly about ways prudential regulation in the UK could be made more proportionate towards small firms by considering ways to make prudential regulation simpler for those firms while maintaining resilience.[73]

Simplified SA-CCR (sSA-CCR)

8.23 The PRA proposes to implement a simplified version of SA-CCR.[74] This methodology is available to firms with on- and off-balance sheet derivative business that is equal to or less than both of the following:

- 10% of the firm’s total assets; and
- £263 million.

8.24 The proposals for sSA-CCR simplify a number of methodological aspects of SA-CCR, while keeping the structure of the framework unchanged. The sSA-CCR would represent a simpler but more conservative methodology for calculating the exposure value for counterparty credit risk compared to SA-CCR. The PRA proposes that sSA-CCR would differ from SA-CCR in the following ways:

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73 November 2020: https://www.bankofengland.co.uk/speech/2020/sam-woods-city-banquet.
74 In the Counterparty Credit Risk (CRR) Part of the PRA Rulebook (Annex D, Chapter 3, Article 281).

- the calculation of replacement cost would be adjusted in a range of scenarios, including:
  - the recognition of net independent collateral amounts would be removed in the calculation of replacement cost for netting sets not subject to a margining agreement;
  - for netting sets of traded and cleared transactions, the replacement cost would be equal to the margin threshold plus the minimum transfer amount; and
  - for multiple netting sets covered by a margin agreement, replacement costs would be calculated as the sum of each netting set, calculated as if the netting set were not margined.
- firms would not be permitted to establish separate individual hedging sets in each risk category for the following transactions:
  - transactions for which the primary risk driver, or the most material risk driver in the given risk category, would be either the market implied volatility, the realised volatility of a risk driver, or the correlation between two risk drivers; and
  - transactions for which the primary risk driver, or the most material risk driver in the given risk category, would be the difference between two risk drivers mapped to the same risk category, or transactions that consist of two payment legs denominated in the same currency and for which a risk driver from the same risk category of the primary risk driver is contained in the payment leg that does not contain the primary risk driver.
- the calculation of the PFE multiplier would be simplified and set to 1, such that overcollateralisation is not recognised; and
- the calculation of the supervisory delta would be simplified, such that it no longer captures non-linearity in the risk profile of transactions, as follows:
  - the calculation of the supervisory duration factor would be simplified to be the difference between the end date and start date of a transaction;
  - the calculation of the maturity factor would be removed, and replaced by a value of 1 for unmargined netting sets, and to 0.42 for margined netting sets;
  - the calculation of the effective notional of a hedging set would be simplified to remove diversification across hedging buckets within a hedging set; and
  - the calculations for the credit, equity and commodity risk category add-ons would be simplified to remove the correlation factor calculations.

Original exposures method (OEM)

8.25 The PRA proposes to implement the OEM.[75] This methodology is available to firms with on- and off-balance sheet derivative business that is equal to or less than both of the following:

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75 In the Counterparty Credit Risk (CRR) Part of the PRA Rulebook (Annex D, Chapter 3, Article 282).

- 5% of the firm's total assets; and
- £88m.

8.26 The PRA proposes to retain and update the OEM as a very simplified approach for those firms with very small or non-complex counterparty credit risks. OEM represents the simplest but least risk-sensitive methodology for calculating the exposure value. The PRA proposes to update the OEM to ensure consistency with newer methods as well as market developments. These changes include:

- the expansion of the list of asset classes to which the OEM can be applied;
- the introduction of a replacement cost component, and updating the regulatory percentages to better reflect the risks associated with these different asset classes. The alpha factor of 1.4, used in other CCR measures, would also be introduced; and
- the adjustment of the PFE of netting sets consisting of exchange traded, cleared, or subject to regulatory bilateral margin obligations to reflect lower risk.

Capital requirements for exposures to central counterparties

8.27 The Basel standards on capital requirements for exposures to CCPs revise the following aspects of the Basel approach:

- the methodologies used to calculate the clearing members' exposures to clients to reflect SA-CCR, and clarify the treatment of multi-level client structures;
- the methodology used to calculate the own funds requirements for pre-funded contributions to the default fund of a QCCP; and
- the alternative calculation for own funds requirements for exposures to a QCCP, which is removed.

8.28 The PRA proposes that firms acting as clearing members report and disclose unfunded contributions to the default fund of a QCCP in their capital requirements and apply a 0% risk weight. The PRA considers that this would promote transparency regarding contingent liabilities to CCPs.

Consequential amendments to SS 12/13 'Counterparty credit risk' and SoP 'The PRA's methodologies for setting Pillar 2 capital'

8.29 The PRA proposes to amend SS12/13 to reflect the CCP authorisation and recognition framework in the UK. This would include the list of CCPs that could be treated as QCCPs for the purpose of calculating firms' exposures to CCPs.

8.30 The PRA proposes to update Chapter 5 of the SoP to remove references to existing standardised approaches to measure counterparty credit risk exposures.

Implementation date and transitional arrangements

8.31 The PRA proposes to implement the requirements in this chapter with an effective date of Saturday 1 January 2022, in order to avoid requiring banking groups with both EU and UK entities to apply two different applications of the Basel III standards. As a result, the PRA considers that transitional provisions replicating the effect of TTP is not necessary.

Questions

Q3: To what extent do you consider that the proposed simplified SA-CCR and OEM would be useful measures to enhance the proportionality of the counterparty credit risk framework?

9 Operational risk

CRR Article 316

9.1 This chapter sets out the PRA's proposals to amend requirements for operational risk.

9.2 The PRA has identified an ambiguity in the calculation used for the basic indicator approach (BIA) under the CRR. It is unclear whether profit and loss items relating to financial or operational leases, and / or leased assets, may be included within the 'interest receivable and similar income' and 'interest payable and similar charges' categories of the Relevant Indicator (RI).

9.3 Under the BIA, the own funds requirement for operational risk is equal to 15% of the three-year average of the RI. The RI is the sum of these categories:

- interest receivable and similar income;
- interest payable and similar charges;
- income from shares and other variable/fixed-yield securities;
- commissions/fees receivable;
- commissions/fees payable;
- net profit or net loss on financial operations; and
- other operating income.

9.4 HM Treasury has proposed to revoke the parts of the CRR that cover the BIA. The PRA proposes to reintroduce those requirements as PRA rules in order to provide greater transparency around the calculation of the BIA, ensure consistency of the application of requirements, and to avoid unnecessary regulatory burden for firms in interpreting the current requirements.

Proposals

9.5 For the purposes of mapping profit and loss account items to the relevant categories, firms applying accounting standards that implemented Directive 86/635/EEC in the UK, must apply the accounting categories for profit and loss under Article 27 of that Directive. The accounting categories do not specify the inclusion of:

(a) interest income from financial and operating leases, and profits from leased assets; and

(b) interest expense from financial and operating leases, and losses, depreciation and impairment of operating leased assets.

9.6 The PRA proposes to allow firms to choose not to apply the current accounting categories for the profit and loss account, and instead include items under [9.5(a)] within 'interest receivable and similar income', and items under [9.5(b)] within 'interest payable and similar charges' in the calculation of the RI. The use of this option would be at individual firms' discretion.

10 Large exposures

CRR Articles 389 to 403

10.1 This chapter sets out the PRA's proposals to transfer (a) the large exposure requirements as set out in Part Four of the CRR, and (b) Regulation No. 1187/2014 for determining the overall exposure to a client or a group of connected clients in respect of transactions with underlying assets into PRA rules. It also sets out the PRA's proposal to implement new Basel III standards on large exposures.

10.2 A prudential framework for large exposures requires firms to identify, manage and control the risk of significant losses that could result from a firm's large exposures to single counterparties or groups of connected counterparties. A large exposures framework is an important complement to risk-weighted capital requirements. Its objective is to ensure that the maximum possible loss a bank could incur if a single counterparty or group of connected counterparties were to suddenly fail would not threaten a firm's ability to continue as a going concern. As a result, it helps to enhance the safety and soundness of firms.

10.3 The Basel supervisory framework for measuring and controlling large exposures introduces enhancements compared to the framework set out in the CRR.[76] These include defining a large exposure and large exposure limits using Tier 1 capital, revising the calculation of exposure values, introducing lower limits for exposures between globally systemically important institutions (G-SIIs) and revising the recognition of credit risk mitigation.

10.4 The proposals in this chapter would:

- amend the Large Exposures Part of the PRA Rulebook;
- amend SS16/13 'Large exposures';
- introduce a new Large Exposures (CRR) Part of the PRA Rulebook (Appendix 9, Annex G); and
- amend the Glossary Part of the PRA Rulebook.

Proposals

Incorporation of large exposures requirements from the CRR

10.5 The FS Bill will remove the Large Exposures part of the CRR and empower the PRA to address large exposures requirements in PRA rules.

10.6 The PRA proposes to introduce a new part into the PRA Rulebook that will implement the large exposures requirements currently set out in Part Four of the CRR as well as the provisions of Regulation No. 1187/2014 for determining the overall exposure to a client or a group of connected clients in respect of transactions with underlying assets.

10.7 As a result, the following requirements will be transferred into the new Large Exposures (CRR) Part of the PRA Rulebook:

76 BCBS - Supervisory framework for measuring and controlling large exposures - April 2014.

- CRR: Articles 387, 389, 390, 391[77], 392, 393, 394, 395, 396, 397, 398, 399, 400, 401, 402 and 403; and
- Regulation No. 1187/2014: Articles 1 to 7.

10.8 The PRA does not propose to replicate certain requirements of the CRR.[78] This is because they relate to investment firms that will no longer be within the scope of the CRR or relate to discretions that the PRA has not exercised.

10.9 In implementing these aspects, the PRA proposes to make a number of significant amendments to align with the updated Basel III standards.[79] The details of these proposed changes are set out below. The PRA also proposes to make a number of minor amendments to clarify the framing and ordering of requirements compared to the CRR.

Definition of capital

10.10 The CRR defines large exposures and large exposures limits by reference to 'eligible capital.' Eligible capital comprises Tier 1 capital and a limited amount of Tier 2 capital.[80] The Basel framework specifies the definition of capital used for large exposures purposes should be Tier 1 capital. This focus on Tier 1 capital is consistent with the objective of the large exposures framework: to protect firms from sudden unexpected losses from a counterparty or groups of connected counterparties and remain a going concern. It would also enhance the safety and soundness of firms.

10.11 The PRA proposes to amend the existing Large Exposures Part,[81] and introduce a new Large Exposures (CRR) Part,[82] to implement a Tier 1 definition of capital that will cover the definition of a large exposure and the limits applied. The PRA also proposes to amend all references to 'eligible capital' within the SS16/13 'Large Exposures'[83] to refer instead to Tier 1 capital.

Calculation of the exposure value

Retained provisions

10.12 The PRA proposes to retain the substance of CRR requirements that are not being amended for covering the calculation of the exposure value although the paragraph order of some of these provisions will be amended.[84]

Exposures deducted from Capital

10.13 Under the CRR, exposures deducted from eligible capital are not included in the definition of exposures for large exposures purposes.[85] Given the PRA's proposal to limit eligible capital only to Tier 1 capital, the PRA proposes that amounts deducted from Tier 2 capital would be included in the definition of exposures for large exposure purposes.

77 The second subparagraph of Article 391 remains in the CRR.
78 CRR Articles 388, 390(8), 395(6), 395(7), 400(2)(a)-(b),(d)-(f) and (i)-(l).
79 These relate to CRR Articles 390, 391, 394, 395, 399, 401 and 403.
80 CRR Article 392, 394, 395,396 and 397.
81 Large Exposure Part of PRA Rulebook: Rule 2.1(2), 2.2(2), 2.3(1)(b) and (c), 5.6(3) and 5.7.
82 Large Exposures (Part Four CRR) Part of the PRA Rulebook: Rule 1.2, Article 394, 395, 396 and 397.
83 June 2018: https://www.bankofengland.co.uk/prudential-regulation/publication/2013/large-exposures-ss.
84 CRR Article 390.
85 Article 390(6)(e).

Calculation of the exposure value for derivatives

10.14 The CRR requires that firms assess exposures to clients through transactions where there is an exposure to underlying assets to determine if they constitute an additional exposure.[86]

10.15 The BCBS framework requires firms to include indirect exposures to clients referenced in derivatives transactions to the overall exposure to that client.[87] This is necessary to ensure that all possible losses that a firm can suffer as a result of a client defaulting is taken into account and limited.

10.16 The PRA proposes that total exposures to a client must include the exposures arising from derivatives contracts listed in Annex II of the CRR and credit derivative contracts, where the contract was not directly entered into with that client, but the underlying debt or equity instrument was issued by that client.

10.17 The CRR permits firms to use the same method they use for calculating derivative exposure values for capital requirement purposes, for large exposure purposes. This includes the mark-to market method, the original exposure method, the standardised method and the internal model method (IMM). The BCBS framework requires that SA-CCR be used to calculate the exposure value for derivative transactions.

10.18 The PRA proposes that firms may continue to use the method for determining the exposure value for derivatives that they are using for risk-based capital requirements, but will not be permitted to use the IMM for large exposures purposes. The BCBS considered that internal models were not designed to capture the maximum loss that the large exposure framework was designed to capture.

Calculation of the exposure value for securities financing transactions (SFTs)

10.19 The CRR permits firms to use for large exposure purposes the method they use for calculating derivative exposure values for capital requirement purposes. This includes the use of IMM. The PRA is proposing that firms can continue to use the method that they are currently using for calculating risk based capital requirements against SFTs.

Netting long and short positions

10.20 The CRR permits firms to offset long and short positions in all financial instruments issued by a client (eg firms can offset a long equity position with a short debt position issued by the same client).

10.21 A core assumption of the large exposures framework is that a default would lead to a 100% loss given default (LGD). The risk of loss on a short position in a more senior instrument may not be offset fully by a long position in a more junior instrument. Accordingly, the BCBS framework requires that positions in different issues from the same counterparty may be offset only when the short position is junior to the long position, or if the positions are of the same seniority.

10.22 The PRA proposes that firms are still permitted to offset long and short positions in the same financial instrument (ie two issues are defined as the same if the issuer, coupon, currency and maturity are identical) but that long and short positions in different instruments issued by a given

86 CRR Article 390(7).
87 Basel standards LEX30.18 to LEX30.21.

client should only be allowed provided the short position is junior or equal in seniority to the long position. This would align with the Basel III standards. The PRA also proposes that firms be permitted to allocate finance instruments into buckets on the basis of different degrees of seniority in order to determine the relative seniority of positions (for example, 'equity', 'subordinated debt' and 'senior debt').

Definition of an institution

10.23 The CRR defines an institution to include a private or public undertaking including its branches which, were it established in the UK, would fulfil the definition of the term 'institution' and has been authorised in a third country that applies prudential supervisory and regulatory requirements at least equivalent to those applied in the UK.[88] The sub-paragraph of this Article states that HM Treasury may by regulation determine whether a third country applies supervisory and regulatory requirements at least equivalent to those applied in the UK. HM Treasury is not consulting on revoking this sub-paragraph and as such the PRA does not propose to restate it in PRA rules. The PRA proposes to clarify in PRA rules that any equivalence decision must be made by HM Treasury.

Reporting requirements

10.24 The CRR requires firms to report all large exposures, including the identity of the client or group of connected counterparty, the exposure value before taking into account the effect of the credit risk mitigation, the type of funded or unfunded credit protection and the net exposure value.[89] Firms are also required to report their 20 largest exposures on a consolidated basis.

10.25 The CRR does not include additional reporting requirements on firms' exposures to firms that engage in non-bank financial intermediation. Non-bank financial intermediation can pose bank-like risks to financial stability, or result in regulatory arbitrage. EBA set out Guidelines (GLs) that prescribe limits on exposures to shadow banking entities that carry out banking activities outside a regulated framework. Those GLs applied to PRA authorised firms prior to the end of the Transition Period and the PRA continues to expect firms to make every effort to comply with them.[90] The PRA proposes to introduce a requirement for firms to report to the PRA their 10 largest exposures on a consolidated basis to shadow banking entities that carry out banking activities outside the regulated framework. This would help to ensure the PRA has sufficient information about firms' exposures to shadow banking entities to be able to monitor the risks that such exposures may pose.

Exposures to G-SIIs

10.26 The CRR does not set specific large exposure limits on a G-SII's exposure to another G-SII. The BCBS framework requires that G-SIIs should limit any exposures to other G-SIIs to 15% of their Tier 1 capital.

10.27 In line with Basel, the PRA proposes to limit to 15% of Tier 1 capital any exposure of a G-SII for which the PRA is the lead supervisor to another G-SII. This would enhance the safety and soundness of PRA-supervised G-SIIs and help to limit their interconnectedness. The PRA proposes this requirement would apply only on a consolidated basis.[91] The PRA also proposes to include a definition for G-SIIs and non-G-SIIs in the Glossary Part of the PRA Rulebook.

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88 CRR Article 391.
89 CRR Article 394(1).
90 December 2020: https://www.bankofengland.co.uk/paper/2019/interpretation-of-eu-guidelines-and-recommendations-boe-and-pra-approach-sop..
91 Rule 2.1 and 2.3 of the Large Exposures (CRR) Part of PRA Rulebook.

Credit Risk Mitigation

Eligible credit mitigation techniques

10.28 The CRR permits firms to recognise funded or unfunded credit protection that complies with the eligibility requirements as per the risk based capital requirements. This includes techniques used in the internal ratings based approach (IRB).

10.29 The Basel III standards apply the same minimum requirements and eligibility criteria for the recognition of unfunded credit protection and financial collateral as under the SA for risk-based capital requirement purposes.

10.30 The PRA proposes that credit risk mitigation techniques that are available only to firms using one of the IRB approaches should not be used to reduce exposure values for large exposure purposes, except for certain exposures secured by immovable property.[92] These are prudent assumptions and are consistent with the objectives of a large exposures framework to limit the maximum loss that a bank could suffer in the event of a default. As a result, they would help to enhance firms' safety and soundness.

Calculating the effect of the use of credit risk mitigation techniques

10.31 The CRR allows firms to use the fully adjusted exposure value as calculated under the risk-based capital requirements to calculate exposure values for large exposure purposes. This includes the use of the IRB approach subject to the PRA's permission. Collateral that is eligible only under the IRB approach is not eligible to reduce exposure values for large exposure purposes under the BCBS framework.

10.32 For calculating the effect of using credit risk mitigation, with the exception of institutions using the Financial Collateral Simple Method (per CRR Article 222), the PRA proposes that firms use the Financial Collateral Comprehensive Method (per CRR Article 223), regardless of the method used for calculating the own funds requirements for credit risk. This approach is both prudent and consistent with the objectives of the large exposures regime. The PRA proposes that firms may still use the methods that they use currently for calculating the risk-based capital requirements for calculating exposure values for SFTs.

Substitution approach

10.33 The CRR allows firms to choose whether to assign an exposure to the underlying borrower or to a provider of credit protection or collateral; to use a 'substitution approach'. The BCBS framework requires the substitution approach to be used mandatorily for credit protection and collateral providers.

10.34 The PRA proposes the substitution approach to be applied. This would help to limit high concentrations to issuers of collateral and credit protection providers that could have a material impact on a firm if they were to fail. As a result, it would enhance firms' safety and soundness.

10.35 The calculations involved in applying the substitution approach could be unduly burdensome for firms with exposures to a collateral issuer due to tri-party repurchase agreements facilitated by a tri-party agent. The PRA proposes that firms may choose to either report the exposure to such a collateral issuer or the full amount of the limit that the firm has instructed its tri-party agent to apply

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92 CRR Article 402.

to securities issued by the collateral issuer. The PRA proposes that firms would only be permitted to report based on the instructed limit if a firm has verified that:

- the tri-party agent has appropriate safeguards in place to prevent breaches of these limits;
- the PRA has not restricted this in a requirement imposed under FSMA; and
- these limits aggregated with any other exposure the firm has to the collateral issuer do not exceed the large exposure limit.

10.36 The PRA considers this approach would be prudent and proportionate given the operational issues that could arise with triparty repo.

Exemptions

Central counterparties

10.37 The CRR currently exempts firms' trade exposures and default fund contributions to central counterparties from large exposure limits. The Basel framework permits exposures to qualifying central counterparties (Q-CCPs) to be exempt from large exposure limits, but not exposures to non-qualifying CCPs. The Basel standards provide that when a transaction of a client with a clearing member is treated as an exposure to a Q-CCP under the risk-based capital requirements regime, the client may also treat that exposure as to the Q-CCP for large exposures purposes, rather than to the clearing member.

10.38 The PRA proposes that clearing members' trade exposures and default fund contribution to Q-CCPs will be exempt from large exposure limits. The PRA also proposes that clients' trade exposures that are effectively treated as exposures to a Q-CCP are exempt from large exposure limits.[93]

Intragroup exposures

10.39 The CRR provides discretion for the PRA to exempt certain intragroup exposures from the large exposure limit.[94] The PRA has applied this discretion to exposures to parent undertakings, subsidiaries of that parent undertaking, or its own subsidiaries that meet certain conditions. The BCBS framework does not specify requirements for intragroup exposures but considers that jurisdictions should consider potential concentrations risks that might arise as a result of such exposures.

10.40 In incorporating large exposures requirements, the PRA proposes to include an option to also extend this discretion to qualifying holdings, although the PRA's current approach to intragroup permissions are not changing. The PRA's current approach, as set out in SS16/13 'Large exposures', is that only entities that are 100% owned by the group would be considered for inclusion in these permissions.

Application of exemptions

10.41 The PRA proposes to clarify that the simultaneous application of more than one exemption to the same exposure is not allowed. Where more than one exemption could be relevant to a transaction, firms may in each case determine which exemption they wish to rely on.

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93 Article 305(2) and 305(3) of the Counterparty Credit Risk (CRR) part of the PRA Rulebook.
94 CRR Article 400(2)(c).

11 Liquidity coverage ratio

CRR Articles 411, 412, 414 to 416 and the LCR Delegated Act

11.1 This chapter sets out the PRA's proposals to implement the prudential requirements for liquidity set out in Part Six of the CRR and the onshored European Commission Delegated Act 2015/61 on the liquidity coverage requirement (LCR) for credit institutions ('LCR Delegated Act').

11.2 The LCR furthers the PRA's statutory objective of safety and soundness by promoting firms' short-term liquidity resilience. It does this by requiring firms to hold sufficient high-quality liquid assets (HQLA) to survive a significant stress scenario lasting 30 calendar days. Together with Rule 2.1 of the Internal Liquidity Adequacy Assessment Part of the PRA Rulebook, the LCR ensures that the PRA has an appropriate regime for ensuring that firms have adequate short-term liquidity.

11.3 The proposals in this chapter would replicate in PRA rules the LCR requirements of the CRR and Delegated Acts, and result in the introduction of:

- a new Liquidity (CRR) Part of the PRA Rulebook (Appendix 9, Annex H); and
- a new Liquidity Coverage Ratio (CRR) Part of the PRA Rulebook (Appendix 9, Annex I);
- a new 'Liquidity and Funding Permissions' Statement of Policy (SoP).

Proposals

Implementation of the LCR in PRA rules

11.4 The LCR requirement is currently set out in Part Six of the CRR and Delegated Acts 2015/61 and 2018/1620. The PRA expects that the FS Bill will remove these requirements and empower the PRA to address them in PRA rules.

11.5 The PRA proposes to replicate the LCR requirements of the CRR and Delegated Acts. In doing so, the PRA proposes to make the following amendments to ensure the requirements work in the context of PRA rules:

- to re-state the definitions from the CRR in the Liquidity (CRR) Part of the PRA Rulebook and to introduce and clarify a number of definitions that apply to the LCR requirements.[95] This includes the proposed definition of 'reporting currency' (see below) and a proposed clarification of the definition of 'financial customer' to include financial customers belonging to a non-financial corporate group. This would make explicit whether such customers are 'financial customers,' and so ensure outflow rates are applied correctly;
- to replicate LCR permissions, and set out the factors to which the PRA proposes to have regard when considering permission applications, in a new proposed SoP on liquidity and funding permissions. The proposed SoP is intended to ensure a consistent approach to the granting of such permissions, and to ensure that the different conditions for each permission are clear and easy to understand;

95 CRR Article 411.

- not to prescribe the outflow rates for certain products and services.[96] The PRA considers that it would be prudent and proportionate instead to require firms to determine the appropriate outflow rates for themselves, subject to supervisory review. The PRA proposes to assess the appropriateness of the outflow rates that firms apply to these products and services as part of supervision, including as part of the Liquidity Supervisory Review and Evaluation Process; and

- to re-state CRR Part Six in the proposed Liquidity (CRR) Part of the PRA Rulebook and include, with minor amendments, a number of CRR Articles to which the LCR refers ensure consistency between PRA rules and the CRR.[97]

Reporting currency

11.6 The CRR currently does not define reporting currency. The PRA proposes to introduce a definition of the term 'reporting currency' in the Liquidity (CRR) Part that is applicable to liquidity reporting requirements.

11.7 To maintain a flexible and proportionate approach to reporting while improving clarity, the PRA proposes to restate the relevant requirements of the CRR in the Liquidity (CRR) Part and define 'reporting currency' as pounds sterling (GBP), unless a firm's annual accounts are prepared in a different currency, in which case a firm may use that currency as its reporting currency. The PRA considers this would not result in any change in approach for most firms.

Compliance with the LCR and NSFR

11.8 The Basel III standards specify that a firm's NSFR and LCR be at least equal to 100% on an ongoing basis. For the NSFR, this seeks to ensure that an institution holds sufficient stable funding to meet its funding needs over a one-year horizon under both normal and stressed conditions. For the LCR, this serves to ensure that firms maintain a stock of HQLA that is sufficient to act as a defence against the potential onset of a liquidity stress over a 30-day period.

11.9 To ensure consistency with the principle that firms may let either ratio fall below 100% in a stress, the PRA proposes to re-state the relevant part of the CRR with an amendment to state that firms must provide a notification of any LCR or NSFR shortfall (or expected shortfall) 'without delay' rather than 'immediately', as is currently required.[98]

11.10 The PRA also considers that this principle would be enhanced by amending Article 414 to state that in the event of any shortfall or expected shortfall, firms should submit a plan for the restoration of their LCR or NSFR in a timeframe that is consistent with the anticipated duration of any associated stress, rather than 'immediately', as Article 414 currently states.

11.11 The PRA considers it appropriate to re-state CRR Article 414 and amend it to include LCR reporting expectations that are currently set out in the reporting chapter of SS24/15. The PRA considers that it would not be proportionate to require firms to provide or be capable of providing daily NSFR reporting, as the data provided by this return is unlikely to change with a frequency that justifies its provision on a daily basis.

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96 LCR Delegated Act Articles 23, 24, and 25.
97 This includes CRR Articles 412, and 416–426.
98 CRR Article 414.

12 Net stable funding ratio

CRR Articles 413 and 417 to 428

12.1 This chapter sets out the PRA's proposals to implement the net stable funding ratio (NSFR).

12.2 The NSFR is intended to help to ensure that firms maintain a stable funding profile in relation to the composition of their assets and off-balance sheet activities. It seeks to limit overreliance on short-term wholesale funding, encourage better assessment of funding risk across all on- and off-balance sheet items, and to promote funding stability. A sustainable funding structure reduces the likelihood that disruptions to a firm's regular sources of funding will erode its liquidity position and increase the risk of its failure. Stability in a firm's longer-term funding enhances the safety and soundness of firms, in line with the PRA's objectives.

12.3 The proposals in this chapter would result in the introduction of:

- a new Liquidity (CRR) Part of the PRA Rulebook (Appendix 9, Annex H); and
- a new 'Liquidity and Funding Permissions' Statement of Policy (SoP) (Appendix 8).

12.4 The PRA also proposes to make consequential changes to SS24/15 'The PRA's approach to supervising liquidity and funding risk' to reflect the introduction of the NSFR. The proposed updates to SS24/15 are set out in Appendix 5 to this consultation.

Proposals

12.5 The CRR requires firms to ensure they have sufficient diverse stable funding under normal and stressed conditions. It does not specify an NSFR.

12.6 The PRA proposes to introduce an NSFR framework in the proposed Liquidity (CRR) Part. The NSFR would limit overreliance on short-term wholesale funding, encourage better assessment of funding risk across all on- and off-balance sheet items, and promote funding stability. This would enhance firms' safety and soundness, in line with the PRA's objectives.

Available stable funding and required stable funding

12.7 The Basel III standards define the concepts of 'available stable funding' (ASF) and 'required stable funding' (RSF). ASF is the portion of capital and liabilities that can be relied on to provide funding over the one-year time horizon considered by the NSFR. RSF reflects the liquidity characteristics and residual maturities of the various assets held by a firm as well as those of its off balance sheet exposures.

12.8 The Basel standards calibrate the amounts of RSF and ASF to reflect the liquidity of assets, and the stability of capital items and liabilities. This is done by assigning assets, capital items, and liabilities to categories to which an RSF or ASF factor is applied. The amount of RSF is determined based on the broad characteristics of the liquidity risk profile of an institution's assets and off-balance-sheet exposures. The amount of ASF is measured based on the broad characteristics of an institution's funding sources, including their relative stability, their contractual maturity, and the differences in the propensity of different types of funding providers to withdraw funding.

12.9 The PRA proposes to specify in the proposed Liquidity (CRR) Part of the PRA Rulebook:

- the amount of ASF as the carrying value of various categories or types of capital items and liabilities, multiplied by the available stable funding factors;
- the amount of required stable funding as the carrying value[99] of various categories or types of assets and off-balance-sheet items, multiplied by the required stable funding factors;
- the ASF factors for different categories of item; and
- the RSF factors for different categories of item.

NSFR definition

12.10 Consistent with the Basel standards, the PRA proposes that the NSFR should be the ratio of an institution's amount of ASF to its amount of RSF over a one-year horizon:

$$\frac{Available\ Amount\ of\ Stable\ Funding}{Required\ Amount\ of\ Stable\ Funding} = Net\ Stable\ Funding\ Ratio\ (\%)$$

NSFR requirement

12.11 The Basel III standards specify that the NSFR must be at least equal to 100% on an ongoing basis. This seeks to ensure that a firm holds sufficient stable funding to meet its funding needs over a one-year horizon under both normal and stressed conditions.

12.12 The PRA proposes firms maintain an NSFR of at least 100%. Chapter 11 on LCR sets out the PRA's proposed approach in the event a firm's NSFR falls below 100%.

Regulatory permissions

12.13 The PRA proposes to codify the conditions for regulatory permission relating to the NSFR in SoP 'Liquidity and Funding Permissions'. This is intended to ensure a consistent approach to the granting of such permissions and ensure that the different conditions for each permission are clear and easy to understand. The draft text of this SoP is set out in Appendix 8.

12.14 The PRA considers that it would be inconsistent with the goal of ring-fencing to grant a permission that would result in an increased degree of financial, operational, or organisational dependence between ring-fenced and non-ring-fenced entities.

Categories of ASF and RSF factors

12.15 The PRA proposes to specify the ASF and RSF levels for categories of item in the Liquidity (CRR) Part of the PRA Rulebook. In defining its proposed approach, the interactions with the CRR framework the liquidity coverage ratio (LCR), the potential impacts on certain aspects of market liquidity and the UK real economy were among the factors the PRA considered.

Secured financing transactions (SFTs)

12.16 The Basel III standards apply asymmetric ASF and RSF factors to different legs of short term SFTs secured by Level 1 Assets.[100] This reflects the fact that matched SFT books could unwind

[99] Generally recorded by following the asset's accounting value, ie net of specific provisions.
[100] Basel standards NSF 30.27 – 30.28 and 30.14.

asymmetrically, with transactions that generate funding rolling off before or in greater proportion than transactions that require funding.

12.17 In view of the use of securities, including sovereign bonds, as collateral in short-term transactions, and the market-making activities that SFTs help to support, the PRA proposes to set in line with Basel requirements:

- the RSF and ASF at 0% for SFTs with < 6 months' maturity that are collateralised by Level 1 HQLA with rehypothecation rights; and
- the RSF at 5% and the ASF at 0% for SFTs with < 6 months' maturity that are not collateralised by Level 1 HQLA with rehypothecation rights.

12.18 The PRA considers these RSFs would appropriately reflect the stable funding risk of such transactions, while also having regard to the potential effects on market liquidity.

Holdings of Level 1 Assets

12.19 The Basel III standards apply a 5% RSF factor to certain unencumbered Level 1 assets. This includes marketable securities representing claims on, or guaranteed by, central governments and certain other public authorities that are assigned a 0% risk weight under the Basel III standard's approach to Credit Risk.[101]

12.20 In order to ensure consistency with the CRR's approach to the LCR, the PRA proposes to apply a 0% RSF factor to such marketable securities. The PRA considers this approach to be prudent and proportionate, given the liquidity characteristics of such marketable securities.

Holdings of high-quality covered bonds

12.21 The Basel III standards apply a 15% RSF[102] factor to holdings of high-quality covered bonds,[103] consistent with their classification as Level 2A assets under the Basel LCR.

12.22 Under the CRR, certain high quality covered bonds can qualify as level 1 HQLA in the LCR, rather than level 2A HQLA. In order to apply a treatment consistent with the LCR, the PRA proposes to apply a 7% RSF factor to holdings of covered bonds that qualify as level 1 HQLA, rather than a 15% RSF. The PRA considers this would be appropriately prudent and proportionate, given the nature of such assets.

Variation margin

12.23 The Basel III standards specify that only variation margin received in the form of cash can be used to calculate the funding available or required for a net derivatives position.[104]

12.24 The PRA proposes that both cash and Level 1 assets received as variation margin, excluding extremely high-quality covered bonds, may be used to calculate a net derivatives position. The PRA considers this would be consistent with the risk characteristics of Level 1 assets. It would also help to ensure the approach taken to such assets is consistent with that taken in the CRR for the LCR.

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[101] Basel standards CRE 20.
[102] Basel standards NSF 30.28.
[103] Comprising covered bonds with a credit rating equal or equivalent to at least AA-.
[104] Basel standards NSF 30.24.

On-balance sheet trade finance

12.25 The Basel III standards do not specify a distinct treatment of on-balance sheet trade finance assets. Such assets are treated as loans and attract the RSF factor applicable to loans, depending on their counterparty and their collateralisation.

12.26 The PRA proposes to apply the same approach as the Basel III standards, as it would be prudent. However, given that the nature and risk characteristics of trade finance exposures could differ significantly from other types of unsecured exposure, the PRA intends, during the consultation period to discuss further with firms the nature of their on-balance sheet trade-finance exposures. This will also inform the PRA's consideration of consultation responses on the RSF treatment of on-balance sheet trade finance assets.

RSF factors

Gross derivatives liabilities

12.27 The Basel standards provide discretion for jurisdictions to set the RSF factor for derivative liabilities at a point between 5% and 20%.[105] The BCBS is considering whether any further changes to the treatment of derivatives liabilities are warranted.

12.28 The PRA proposes to introduce a rule applying a 5% RSF factor to gross derivatives liabilities. Pending the BCBS's further consideration, PRA considers this level to be prudent and to avoid unintended consequences for the smooth function of derivatives markets and hedging activities.

Off-balance sheet exposures

12.29 The Basel III standards provide a national discretion that allows supervisors to set an RSF factor for off-balance sheet assets for which there is no prescribed RSF factor in the BCBS NSFR.[106]

12.30 For off-balance sheet trade finance assets, the PRA's approach is set out below in paragraphs 12.31 – 12.32.

12.31 For any other off-balance sheet asset, the PRA proposes that firms regularly assess the amount of RSF they hold, in line with the high-level principles set out in paragraph 12.8, and determine the RSF levels to apply. The PRA proposes to assess the appropriateness of the RSF factors firms apply as part of its supervision of firms, including as part of the L-SREP process.

Off-balance sheet trade finance and factoring

12.32 The Basel standards provide for a national discretion allowing supervisors to set an RSF factor for off-balance sheet assets, including off-balance sheet trade finance-related assets.[107]

12.33 The PRA proposes to apply RSF factors that depend on the residual maturity of the off-balance sheet trade finance-related product. This would ensure firms took a consistent approach while also introducing a degree of risk sensitivity. The PRA proposes to apply the following RSF factors:

- 5% where the residual maturity of an asset is less than 6 months;
- 7.5% where the residual maturity of an asset is between 6 and 12 months; and

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105 Basel standards NSF 30.32.
106 Basel standards NSF 30.34.
107 Basel standards NSF 30.34.

- 10% if the residual maturity of an asset is greater than 12 months.

12.34 The PRA considers that this approach would be prudent. Given that the nature and risk characteristics of trade finance exposures can differ significantly from other types of unsecured exposure. The PRA intends during the consultation period to discuss further with firms the nature of their trade finance and factoring exposures. This will help to inform further consideration of the potential effects of the PRA's proposed approach.

12.35 To clarify the nature of the factoring that that can be treated as trade finance, the PRA proposes to restate the CRR Article 411(16) definition of factoring, to state that only off balance-sheet factoring should be treated as trade finance for the NSFR. This is to maintain consistency with the proposed approach to trade finance outlined above.

Interdependent assets and liabilities

12.36 The Basel III standards provide a jurisdictional discretion for certain asset and liability items, in limited circumstances, to be treated as interdependent assets and liabilities (IA&L).[108] It is intended to provide a concessionary stable funding treatment of contractual arrangements that ensure that a liability cannot fall due while the asset remains on a firm's balance sheet. Where certain conditions are met, supervisors may set RSF and ASF factors for IA&L to zero. The Basel III standards also require supervisors to consider whether perverse incentives or unintended consequences are created in cases in which the discretion is used.

12.37 The PRA considers there could be circumstances in which strict criteria are met that ensure IA&L do not present a stable funding risk. In such cases, it may be appropriate to set RSF and ASF factors to zero. In practice the PRA has not identified circumstances in which this treatment would be warranted.

12.38 The PRA proposes that firms should only apply for this permission in respect of a liquidity consolidation group where the entities that hold the asset and record the liability respectively are either both ring-fenced bodies or both not ring-fenced bodies (or their subsidiaries). In order to ensure the treatment of IA&L is granted only where it is prudentially warranted, and does not give rise to perverse incentives or unintended consequences, the PRA proposes firms provide information to help the PRA determine whether there might be perverse or unintended consequences where the asset and/or liability in question is a derivative.

Required reserves

12.39 The Basel III standards provide a national discretion allowing supervisors to apply an RSF factor that is higher than 0% to central bank reserves that are held because of requirements for them to be maintained at all times: 'required reserves.'[109] It may be inappropriate to apply a 0% RSF to reserves as it may not adequately reflect the stable funding required in practice.

12.40 The Bank does not currently operate a required reserves regime. Therefore, this discretion is not relevant for reserves placed with the Bank. However, other jurisdictions do operate such regimes. To ensure an appropriate RSF is applied in such cases, the PRA proposes to introduce a requirement in the proposed Liquidity (CRR) Part that firms apply any locally applicable RSF factor to required reserves.

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[108] Basel standards NSF 30.35.
[109] Basel standards NSF 30.25 (Footnote 14).

Temporary central bank operations

12.41 The Basel III standards include a discretion for supervisors to discuss and agree with the relevant central bank to apply a lower RSF factor to assets encumbered in non-standard, temporary operations conducted by a central bank in order for it to achieve its mandate in a period of market-wide financial stress and/or exceptional macroeconomic challenges.[110] This is intended to ensure that the NSFR standard does not have the unintended consequence of inhibiting the effectiveness of those operations.

12.42 Should it be necessary to ensure the consistency of its NSFR requirements with any such temporary central bank operations, the PRA would agree an approach with the Bank and consider granting rule modifications to apply a lower RSF.[111] This would enable firms to apply to the PRA for permission to modify the RSF factor applied to such facilities if the PRA found that the applicable RSF factor was unduly burdensome or failing to achieve its intended purpose, and where doing so would not adversely affect PRA objectives.

Derivative transactions with central banks

12.43 The Basel III standards include a limited national discretion allowing derivatives transactions with central banks arising from short-term monetary policy and liquidity operations to be excluded from the computation of the NSFR and to offset unrealised capital gains and losses related to these derivative transactions from ASF.[112] These transactions include foreign exchange derivatives such as foreign exchange swaps, and must have a maturity of six months or less at inception. This is intended to ensure that the NSFR standard does not have the unintended consequences for the application of monetary policy.

12.44 In order to ensure that the NSFR requirements are consistent with such central bank operations, the PRA would consider granting rule modifications to exempt such transactions from the NSFR should that be necessary.[113] That would enable firms to apply to the PRA for permission to exclude such transactions if the PRA found that the applicable treatment was unduly burdensome or did not achieve its intended purpose, and where doing so would not adversely affect PRA objectives.

Intragroup treatment

12.45 The PRA proposes that firms could apply for permission to apply a lower RSF factor for intragroup assets, and/or a higher ASF factor for intragroup liabilities, where the firm and its group counterparty apply a reciprocal NSFR treatment. This permission is intended to facilitate the centralised management of liquidity within groups. The PRA would consider applications on a case-by-case basis having regard to the conditions set out in the SoP ‘Liquidity and Funding Permissions’.

12.46 The PRA’s preliminary view is that it would not be appropriate to apply a lower RSF/higher ASF factor for intragroup assets or liabilities that cross the ring fence established for ring fenced bodies, as that would be inconsistent with the intention of ring-fencing, which is to financially, operationally and organisationally separate ring-fenced bodies and non ring-fenced bodies.

12.47 The PRA also considers that it would be inappropriate to apply a lower ASF / higher ASF factor for intragroup assets or liabilities where the group counterparty is not supervised by the PRA, as in such cases the PRA cannot guarantee that a reciprocal stable funding factor will be applied.

[110] Basel standards NSF 30.20 and Footnote 12.
[111] Section 138A of FSMA.
[112] Basel standards NSF 10.6.
[113] Section 138A of FSMA.

RSF factor applied to exchange traded common equity shares

12.48 The Basel III standard specifies an RSF factor of 50% for assets classified as Level 2B HQLA, a category that includes exchange traded common equity shares. To be classified as Level 2B, such shares must not have fallen in value by more than 40% in any 30-day period. This is in line with the classification criteria for HQLA as set out in the Basel LCR standard.[114] Shares that have fallen in value by greater than 40% over a 30-day period are no longer classified as HQLA, and attract the higher RSF factor assigned to non-HQLA.

12.49 The PRA considers that this approach is prudent, because it results in a higher RSF factor for shares that may be less liquid. However, the PRA acknowledges that this approach could result in a pro-cyclical increase in RSF requirements during periods of market stress. The PRA would welcome firms' views on whether a different treatment could be warranted during times of market stress.

Definitions

12.50 The PRA proposes to incorporate in the proposed Liquidity (CRR) Part the liquidity definitions set out in the CRR.[115]

12.51 The PRA proposes to introduce a definition of the term 'reporting currency' that is applicable to NSFR reporting as well as the LCR.[116] To maintain a flexible and prudent approach to reporting while ensuring clarity, the PRA considers it would be appropriate to define 'reporting currency' as being denominated in pounds sterling, unless a firm's annual report and accounts are prepared in a different currency, in which case a firm may use that currency. This approach would ensure that the majority of firms could use the same reporting currency that they do for the current LCR returns.

12.52 The PRA proposes that the definition of 'financial customer' would include financial customers belonging to a non-financial corporate group.[117] The PRA considers that it is currently unclear whether such customers are 'financial customers,' which could lead to the application of incorrect funding factors.

Netting conditions for derivatives and SFTs

12.53 The PRA proposes to specify in the Liquidity (CRR) Part the conditions according to which derivatives and securities financing transactions may be netted for the purposes of determining the stable funding requirement for such transactions.[118] This would ensure a prudent and proportionate stable funding treatment of such transactions, recognising netting only where prudentially warranted. It is also necessary to ensure that the PRA's proposed treatment of such transactions in the NSFR is clear.

12.54 The PRA also proposes to introduce an additional netting condition for the purpose of the NSFR not specific in the Basel standards, which states that transactions using level 1 HQLA cannot be netted against transactions using non level 1 HQLA. The PRA considers this approach to be prudent as it reflects the risk that transactions netted in this way generate a funding requirement when they

114 Basel standards LCR 54(c).
115 CRR Article 411.
116 CRR Article 411(15).
117 CRR Article 411(1).
118 The proposed conditions implement those specific in Basel standards NF 30.22 and 30.24 on recognition of netting under the leverage ratio (LEV 30). The proposed approach to netting in the NSFR is without prejudice to the conditions applied for the recognition of the netting of such transactions in the leverage ratio, which will be considered as part of the FPC-PRC review of leverage.

mature or are unwound, and the proposal thereby enhances firms' safety and soundness in line with PRA objectives.

Proportionality: the simplified NSFR

12.55 In order to enhance the proportionality of the NSFR framework, the PRA proposes to introduce a version of the NSFR that small and non-complex firms could choose to use that would be simpler than and at least as conservative as the NSFR: the simplified NSFR (sNSFR).

12.56 The sNSFR would be calculated based on a limited number of data points, which would reduce the complexity, and cost, of an approach that small and non-complex firms could choose to use. The sNSFR would ensure that such institutions maintained sufficient stable funding by means of a calibration that is at least as conservative as the full NSFR.

12.57 The PRA proposes to allow firms that qualify as small and non-complex to pre-notify the PRA of their intention to apply the sNSFR. As part of this pre-notification, as set out in the proposed SoP 'Liquidity and Funding Permissions', the PRA would expect firms to provide the following information:

- evidence that the firm meets the definition of 'small and non-complex' in the CRR and expects to continue to meet this definition for the foreseeable future;[119]
- evidence that the firm's sNSFR is at least 100%, and the basis on which the firm expects that it will continue to be at least 100% for the foreseeable future; and
- an assessment which shows that that the complexity of the firm's funding profile is such that the sNSFR is not an inappropriately simple methodology for the calculation of funding risks.

12.58 The PRA is thinking broadly about ways prudential regulation in the UK could be made more proportionate towards small firms by considering ways to make prudential regulation simpler for those firms while maintaining resilience.[120] In this context, we intend to keep under review whether this approach remains appropriate.

CRR Part Six

12.59 The PRA expects the FS Bill will remove Part Six from the CRR and empower the PRA to address those requirements in PRA rules.

12.60 The PRA proposes to incorporate Part Six of the CRR in Liquidity (CRR) Part. In doing so, the PRA proposes to make a number of minor amendments, to ensure consistency between PRA rules and other aspects the CRR.

Questions

Q4: To what extent do you consider that the proposed approach to RSF and ASF factors adequately reflects the underlying risks of, or has any material unintended consequences for, particular business lines?

[119] CRR Article 145.
[120] November 2020: https://www.bankofengland.co.uk/speech/2020/sam-woods-city-banquet.

Q5: To what extent do you consider that the proposed sNSFR would enhance the proportionality of liquidity requirements?

13 Reporting

CRR Articles 99-101, 394, 415 and 428

Supervisory reporting

13.1 This chapter sets out the PRA's proposals to update PRA supervisory reporting requirements. These changes reflect the proposals set out elsewhere in this CP to update the prudential risk methodologies applicable to UK credit institutions, and also seek to align the information that firms report to the PRA with their Pillar 3 disclosures.

13.2 The Basel standard reforms on prudential regulation since the financial crisis have necessitated new regulatory reporting. The PRA intends to implement significant changes to prudential risk methodologies. As a result the PRA will need granular data to understand their effects.

13.3 Many elements of the prudential requirements that the PRA proposes to introduce are also relevant to Pillar 3 disclosure. The PRA proposes to apply the new Basel disclosure framework in the UK and considers there is benefit to both supervisors and firms in ensuring that these requirements form, as much as possible, a single dataset (see Chapter 14 for more details). The PRA also proposes to make amendments to reporting to increase the alignment of data requirements and definitions between the reporting and disclosure.

13.4 The existing versions of many of the prudential requirements that the PRA proposes to update are subject to reporting requirements in the COREP and FINREP reporting templates. The PRA therefore sees updating reporting via the UK COREP, UK FINREP and PRA UK-specific frameworks as the most efficient way to achieve this, using formats firms are already familiar with, and leveraging the benefits of work previously undertaken to implement that framework.

13.5 The PRA has considered how to update the reporting framework in a proportionate manner that best serves financial stability; is consistent with the existing reporting requirements; and that firms can implement efficiently. The PRA has been mindful of the need to do so in a way that also maintains precision in the requirements and control over the quality of submitted data, including the direct relationships between data points and regulatory definitions, and validation rules to enforce these relationships.

13.6 The PRA considers that the most efficient way to implement the proposed updates to UK COREP and UK FINREP by the time the proposed new prudential requirements could come into effect is to use version 3.0 of the European Banking Authority's (EBA) reporting taxonomy, which has also been recently updated for changes to the Basel III standards. These reports contain sufficiently granular data to enable the PRA to supervise the proposed prudential requirements sent out in this CP.

13.7 The proposals in this chapter aim to apply reporting changes proportionately, seeking to limit the proposed requirements for certain new reporting to firms that will publish equivalent data, and avoiding the introduction of new reporting where suitable existing PRA reporting exists. Where prudential methodologies vary in their application to the size and activity of firms, the proposed reporting templates also vary reflecting simplifications in methodology and request less granular data. The PRA will further consider how the reporting requirements can be made proportionate to firms' size and business model as part of future work on the 'Strong and Simple' review.[121]

13.8 The PRA will maintain the existing UK leverage ratio capital requirements, as well as the existing leverage ratio reporting requirements until the completion of the FPC and PRC review of the UK leverage ratio framework. Further reporting and disclosure amendments may be necessary to reflect any changes to the leverage framework following this review. References to leverage reporting and disclosures in the supporting draft rule instruments to this CP have been excluded, and will be consulted on in due course.

13.9 The PRA's proposed reporting requirements are attached to this CP, including draft templates, instructions, amended SSs and the reporting rule instrument. The PRA proposes to include all supervisory reporting templates and instructions into the PRA rulebook.

13.10 The proposals in this chapter will amend:

- the Regulatory Reporting Part of the PRA Rulebook; and
- SS34/15 Guidelines for completing regulatory reports.

Proposals

IRB Credit Risk

13.11 Firms currently report to the PRA and disclose to the public different information on IRB credit risk. Consistent with the proposal in this chapter to ensure that the data requirements and definitions used in reporting are aligned to those used in Pillar 3 disclosures, the PRA proposes to introduce new reporting templates and update existing reporting on IRB credit risk.

13.12 The PRA proposes to introduce new reporting templates, and make minor changes to existing IRB credit risk reporting. These proposals include:

- amendment of existing templates to reflect the proposed credit risk treatment of collective investment undertakings set out in this CP, as well as the impact of the infrastructure and revised SME supporting factors that came into effect in 2020 (templates C08.01, C08.02, C09.01 and C09.02);
- reporting on probability of default ranges by firms that make equivalent disclosures (template C08.03);
- reporting on credit RWA flows that provides a breakdown on the key elements of credit RWA change between reporting periods by firms that make equivalent disclosures (templates C08.04);
- reporting on probability of default backtesting by firms that make equivalent disclosures (C08.05);

121 November 2020: https://www.bankofengland.co.uk/speech/2020/sam-woods-city-banquet.

- reporting on the calculation of credit risk capital requirements under the specialised lending slotting approach by firms that make equivalent disclosures (C08.06); and

- reporting on the allocation of exposures subject to the standardised approach and IRB approach to credit risk by firms that make equivalent disclosures (template C34.06).

Counterparty Credit Risk

13.13 This CP proposes to implement Basel III standards on counterparty credit risk which includes the new SA-CCR methodology to replace the existing standardised methodologies, a revised methodology for calculating exposures to CCPs, and the addition of two new simplified standardised methods. The existing reporting on credit and counterparty credit risk and free deliveries does not contain the necessary information to supervise firms applying the new approaches. Therefore the PRA considers that it is necessary to introduce new reporting reflecting the proposed counterparty credit risk requirements, the thresholds at which these requirements apply, and the exposure of firms to relevant activities and counterparties driving counterparty credit risk.

13.14 The PRA proposes to introduce new reporting templates, and make minor changes to existing credit and counterparty risk reporting. These proposals include:

(i) reporting on the size of a firm's derivative business to enable the PRA to monitor the conditions underlying the use of different counterparty credit risk standardised methodologies (template C34.01);

(ii) reporting on the calculation of the counterparty credit risk exposure values and the impact on risk weighted exposure amounts under the different methodologies available to firms (templates C34.02 to C34.05 and C34.07);

(iii) reporting on the composition of collateral, breakdown of credit derivative exposures and exposures to central counterparties respectively (templates C34.08 to C34.10); and

(iv) reporting on the top twenty counterparties with whom firms have highest counterparty credit risk exposures (template C34.06).

Net stable funding ratio (NSFR)

13.15 Firms currently submit the C60 and C61 templates to the PRA on their required stable funding and available stable funding. In Chapter 12 of this CP the PRA proposes to introduce a definition for the NSFR into PRA rules, consistent with the Basel III standards, as well as a simplified version of this for smaller firms. As the existing C60 and C61 templates are not aligned to the Basel standards, the PRA considers that it is necessary to update its reporting requirements in order to operationalise the new methodology and monitor firms' funding position against it.

13.16 The PRA proposes to delete the C60 and C61 templates and replace these with new templates aligned to the Basel III standards. These proposals include:

(i) a summary of the required and available funding, and the resulting NSFR to provide an overall picture to supervisors of the firm's funding position (template C84); and

(ii) reporting on the revised methodology relating to required stable funding and available stable funding respectively, and aim to provide supervisors with more detailed data that can be used to analyse movements in the ratio (templates C80 and C81).

13.17 Smaller firms subject to the simplified NSFR will submit streamlined versions of NSFR reporting. For these firms the PRA proposes to introduce new reporting that will enable the PRA to assess their firms' funding requirements and sources of funding at an appropriate level of detail. This proposed reporting includes:

(i) a simplified report for required stable funding (template C82); and

(ii) a simplified report for available stable funding (template C83).

Liquidity

13.18 Firms currently submit several liquidity reports to the PRA, including the PRA's template on the maturity ladder, PRA110, which is aligned to the PRA's own methodology.

13.19 The PRA proposes to maintain all liquidity reporting templates apart from the C66 maturity ladder template. As PRA 110 reports sufficient information on cash-flow mismatch, the PRA considers that it would be appropriate to remove the C66 requirement, in order to relieve the burden on firms producing this information.

Total Loss Absorbing Capital

13.20 The PRA already collects supervisory reporting from firms on Minimum Requirements for Own Funds and Eligible Liabilities ('MREL') and Total Loss Absorbing Capital (TLAC), as laid out in SS19/13.

13.21 The PRA proposes to introduce a requirement for Globally Systemic Important Institutions (G-SIIs) to report information relating to their TLAC, so that it is a binding requirement for firms to report TLAC, a key element of the Basel standards that is designed to prevent contagion in the financial system in the event of a G-SII going into resolution.

13.22 The PRA considers that it already has sufficient information to monitor firms' TLAC from existing reporting, and so it would be disproportionate to impose an additional reporting burden for TLAC. The PRA therefore does not propose to introduce any additional reporting templates regarding TLAC beyond those which firms already report to the PRA.

Market Risk

13.23 In 2019 the Basel standards revised market risk methodology was published, completing the reforms that resulted from the Fundamental Review of the Trading Book (FRTB). The PRA intends to implement the new methodology for the capital requirements at a future time, in accordance with internationally agreed timelines for implementation. In advance, the PRA considers that there is significant benefit to supervision from updating reporting to include new international standards for market risk, so that supervisors have access to data that quantifies market risk according to the new standards, showing the effect of the FRTB framework on their firms prior to its application in capital requirements and so enabling a smoother transition.

13.24 In the interim, the PRA proposes to introduce a reporting requirement on the FRTB methodology. The PRA proposes to begin collecting information on firms' position against the eligibility thresholds of the FRTB framework and on firms' calculations of their capital requirements using the new FRTB alternative standardised approach for market risk. The PRA proposes to implement this new reporting using the reporting templates and instructions contained in the EBA's final draft Implementing Technical Standards (ITS) on supervisory reporting requirements for market risk.

13.25 The new reporting requirements will only apply after HM Treasury has finalised proposed legislation explaining how firms should calculate market risk capital requirements under the FRTB framework. The implementation date of the FRTB reporting requirements will be defined in this legislation. However the PRA considers that alignment of the effective date with the other reporting proposals in this chapter would be appropriate.

Impact of COREP and FINREP changes on existing UK-specific reporting

13.26 A number of the PRA's UK-specific reporting templates are based on the format of COREP and FINREP templates, following similar data definitions and template structures, albeit with different level of granularity or reporting coverage period. As the PRA is proposing to make updates to UK COREP and UK FINREP templates that are relevant to the PRA's UK-specific reporting, the PRA has considered whether it is also necessary for supervisory purposes to update the UK-specific templates to capture these changes. The PRA has identified some areas where it believes such updates are necessary to ensure that firms are reporting current methodologies and to minimise the operational burden for firms of preparing reporting on differing bases.

Capital +

13.27 The PRA's Capital + templates, PRA101 to PRA103, report forecasts of regulatory capital over a two year period. The PRA proposes to amend these templates to align with the row structure and labelling of the revised COREP templates on which these templates are based and to ensure that capital forecasts contain data items relevant to the new prudential methodologies the PRA proposes to adopt.

13.28 The PRA proposes to make the following changes to PRA101 and PRA102 to:

- add rows to report the deductions from capital that both reflect changes in the definition of capital and increase the reported granularity of existing deductions;
- add rows reporting the break down any surplus/deficit of CET1;
- add memorandum items on the accounting classification of AT1 instruments and exceptions from CET1 deduction;
- add row for institutions with significant investments in financial sector entities;
- delete rows relating to the Basel 1 floor and other transitional arrangements;
- delete a row relating to a threshold for CET1 deductions; and
- make other minor changes to row labels and numbering.

13.29 The PRA also proposes to change the row title for the leverage ratio exposure measure in PRA103.:

13.30 The proportionate application of Capital + may mean that certain proposed row additions may only apply to some firms on a presentational basis. Where this is the case, the rows in question have been added to Capital + for presentational consistency and will be marked grey for non-completion in the templates.

Financial Statement forecasts

13.31 PRA105 and PRA107 report firms' forecasts of balance sheet liabilities and profit/loss respectively and are based on FINREP templates. The PRA proposes to update the reporting instructions for PRA105 and the template for PRA107 to reflect minor changes in references and to add an additional row on the gains or losses on derecognition of investments in subsidiaries, joint ventures and associates. These proposed changes will enable firms to prepare their FINREP templates and financial forecasts on the same basis.

Reporting for ring-fenced banks

13.32 The PRA collects several templates for firms that are subject to the ring-fencing rules to monitor activities relevant to the operation of the ring-fence. Changes in this consultation proposed for both FINREP and COREP are relevant to the design of the ring-fence bank templates. The PRA proposes to make changes to the ring-fencing templates to ensure that these templates are prepared consistently with other reporting. These include:

- updates to definitions of data items in the RFB001 template for intragroup exposures;
- deletion of a column from the RFB001 on intra-group counterparties relating to 'Type of connection';
- additional columns for purchased or originated credit-impaired assets in the RFB004a and RFB004c tables in the RFB004 template for intragroup financial reporting (detailed breakdown); and
- updates to row codes for RFB002.

Reporting on internal ratings based (IRB) portfolio risk

13.33 The Capital Requirements Directive V (CRD V) introduces a limitation on the collection of information that is duplicative with existing reporting. The PRA proposed in CP12/20 'Capital Requirements Directive V (CRD V)' to amend existing PRA reporting to remove the existing duplicative reporting requirements identified. The proposed COREP IRB credit risk template C08.03 on the breakdown by Probability of Default (PD) ranges has the potential to be duplicative as it contains information very similar in nature to the PRA's FSA 045 template on IRB portfolio risk. Accordingly, the PRA proposes to retire FSA045 from the date that C08.03 reporting comes into effect to eliminate any potential future duplication in reporting.

14 Disclosure

CRR Articles 13, 431-455, 492

14.1 This chapter sets out the PRA's proposals to update the UK Pillar 3 disclosure requirements. These proposals aim to align the Pillar 3 disclosures of UK firms to the new Basel Pillar 3 disclosure requirements (the Basel disclosure framework), as well as enhance the market transparency in additional areas, including remuneration policy.

14.2 The BCBS has made a number of changes in recent years to international standards on Pillar 3 disclosure, agreeing a first set of disclosure reforms in 2015 and a second in 2017. The PRA considers that it is important for the UK to be aligned to international standards on disclosure, in the form prescribed by the Basel disclosure framework. This ensures that UK firms show the same level of transparency as their peers in other jurisdictions and ensures that they will be subject to the same forces of market discipline as investors will have consistent and comparable information on which to judge firms.

14.3 The PRA proposes to introduce new rules for disclosure to consolidate the first and second phases of the Basel disclosure framework into one set of requirements and formats and which would be aligned to the new prudential requirements proposed in this CP. The PRA has considered how to update disclosure requirements in a proportionate and efficient manner that will result in firm disclosures that are comparable with firms' international peers.

14.4 The ITS on public disclosure include templates and instructions that implement the first two phases of the Basel disclosure framework, and directly reflect the updates to prudential requirements proposed elsewhere in this CP. The PRA considers that the most efficient way to ensure the UK is aligned to the Basel disclosure framework is to implement disclosures in the same form as those contained in the ITS in most cases. This approach seeks to ensure that firms continue to disclose using consistent templates and definitions, which may beneficial in particular to significant subsidiaries of UK firms that based in the EU.

14.5 The PRA's proposed disclosure requirements are attached to this CP, including draft templates, instructions, amended SSs, and the disclosure rule instrument. The PRA proposes to include all disclosure templates and instructions in the PRA Rulebook. The PRA proposes to apply the requirements of the updated reporting framework from January 2022 unless stated otherwise. The proposals in this chapter would introduce a new disclosure chapter in the PRA Rulebook, and amend SS2/19 PRA approach to interpreting reporting and disclosure requirements and regulatory transactions forms after the UK's withdrawal from the EU.

14.6 The PRA proposes to introduce the threshold set out in paragraph 14.12 of this chapter to limit the requirement to disclose the composition of collateral to certain firms. The PRA also proposes to repeal its SS6/17 'Compliance with the EBA Guidelines on Disclosure' that explains the current waiver policy for this disclosure.[122]

[122] PRA Supervisory Statement 6/17 'Compliance with the EBA Guidelines on Disclosure' September 2017: https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/supervisory-statement/2017/ss617.pdf.

Proportionality

14.7 Proportionality is a key element of the PRA's approach to setting new requirements and ensuring that the new disclosure requirements only result in an operational burden that is proportionate to the size of the firm. The PRA proposes to vary the application of the proposed disclosures by the 'large', 'small and non-complex', and 'other firms' categories. The PRA proposes that disclosures made by 'small, and non-complex firms' will primarily centre on key-metrics, whilst 'large' firms will disclose a greater number of more granular templates. Given the need for more detailed disclosure in cases where firms have listed securities, the PRA also proposes that listed firms in each size category should make more detailed and more frequent disclosure than non-listed firms.

Proposals

Counterparty credit risk

14.8 The PRA considers it necessary to introduce revised disclosure templates on counterparty credit risk in order to align it with the proposed methodology proposed in this CP, as well as the exposures and activities that are relevant to firms' exposure to counterparty credit risk. The PRA proposes to introduce new disclosure templates on counterparty credit risk contained in the ITS on public disclosure, that also reflect the revised Basel disclosure framework on counterparty credit risk.

14.9 The existing counterparty credit risk disclosure template CCR5 on the composition of collateral discloses the amount of collateral received and posted by type of collateral, broken down into collateral for derivatives (in turn split into segregated and unsegregated collateral) and for securities financing transactions. This disclosure format has the potential to reveal the receipt of emergency liquidity assistance (ELA) through the separate disclosure of collateral posted and received for securities financing transactions (SFTs), metrics that could significantly rise in the event of a collateral swap transaction for ELA purposes.

14.10 The Bank has a policy of keeping its liquidity assistance to firms confidential in order to avoid firms being unfairly stigmatised by receipt of emergency liquidity assistance (ELA), which could then have a negative impact on the financial stability of the firm and the wider financial system.

14.11 SS6/17 sets out the PRA's expectation that CCR5 is only disclosed by firms for which the risk of disclosing ELA is lowest. Currently the PRA waives this disclosure if the fair value of their collateral received or fair value of their collateral posted in the form of debt securities is below £100 billion.[123]

14.12 The PRA has analysed reporting data regarding the levels of collateral posted and received in the years since the waiver was granted and identified an increase in the average levels of collateral reported by firms. Recognising this increase, the PRA propose to increase the application threshold for the disclosure to £125 billion, to reduce the risk of firms making this disclosure where there is substantial risk of ELA visibility.

14.13 Under this proposal, firms would be required to disclose CCR5 only when the fair value of total collateral posted and total collateral received respectively both exceed £125 billion. Furthermore, firms would not make this disclosure if either the collateral posted or collateral received is less than £125 billion. The PRA proposes to introduce the application threshold for the disclosure in PRA rules, and retire SS6/17 at the same time.

[123] September 2017: https://www.bankofengland.co.uk/prudential-regulation/publication/2017/compliance-with-the-ebas-guidelines-on-disclosure.

14.14 In addition, the PRA proposes to use the flexibility granted by the Basel disclosure framework regarding the row breakdown to simplify its design and reduce the level of granularity, further reducing the risk of ELA visibility. The PRA proposes to require a summary breakdown of collateral types, requiring a split across four broad collateral types (cash, debt, equity and other collateral).

Interest Rate Risk in the Banking Book

14.15 Phase two of the Basel disclosure framework introduced qualitative and quantitative disclosures for firms to make in relation to their risk exposure to Interest Rate Risk in the Banking Book (IRRBB) and their management of this risk. The PRA proposes firms make these disclosures, in line with its wider commitment to implement international disclosure standards.

14.16 The PRA has designed qualitative and quantitative templates to serve as the required format for the disclosures and has drafted additional guidance for firms to use when preparing the disclosures. The templates and guidance are consistent with the Basel disclosure framework and the PRA's prudential requirements for IRRBB.

Net stable funding ratio

14.17 The proposed introduction of the net stable funding ratio (NSFR) into PRA rules necessitates the PRA introducing the new disclosure template, LIQ2, to provide information on the NSFR ratio and the main sub- components. Consistent with the proportionate approach applied to NSFR supervisory reporting, the PRA proposes that only large institutions and listed institutions will disclose this new template. Small, non-complex firms will disclose the NSFR as part of the revised key metrics template.

14.18 The Basel NSF standard specifies a disclosure regime for the NSFR that includes the spot disclosure of firms' NSFR position and NSFR components on a quarterly Basis.

14.19 The PRA's preliminary view is that such a disclosure regime is appropriate given the nature of the risks captured by the NSFR. However, the PRA recognises that the existing disclosure regime for other metrics, including the LCR, requires disclosures of a 12-month average. This is intended to mitigate the risk of adverse signalling during a market stress. The PRA would welcome views from firms on whether spot disclosure of the NSFR and its components could lead to adverse market signalling during a stress.

14.20 The PRA proposes that firms commence NSFR disclosure when the NSFR standard comes into force on Saturday 1 January 2022. The PRA considers that this implementation date, and the ensuing lag in the first disclosure reference date, should allow firms sufficient time to operationalise NSFR disclosures and close any NSFR compliance gaps that may exist. However the PRA acknowledges that the public disclosure of regulatory information soon after the introduction of a new standard may present challenges, and would welcome firms' views on their preparedness for NSFR disclosures.

Securitisation

14.21 Phase one of the Basel disclosure framework included templates for firms to make disclosures relating to their securitisation exposures, followed by subsequent Basel standards on the regulatory treatment of securitisations. The PRA proposes firms make disclosures about their securitisations, using new templates that are consistent with the Basel disclosure framework in this area and the securitisations prudential requirements that came into effect in 2019.

Total loss absorbing capacity ('TLAC')

14.22 Phase two of the Basel disclosure framework included templates for firms to make disclosures relating to their total loss absorbing capacity (TLAC), which some firms are disclosing on a voluntarily basis. The PRA proposes that firms make TLAC disclosures as it considers that it is important for investors to have consistent and comparable information about G-SIIs' loss-absorbing capacity, so they can more accurately assess firms' resilience to stress and enforce market discipline on firms.

14.23 At this stage, the PRA does not propose that firms make this disclosure in a specific format. As set out in its MREL Statement of Policy, the Bank will review the calibration of MREL, and the final compliance date, prior to setting end-state MRELs.[124] The PRA considers that it is appropriate to wait until that review has been completed so that the PRA can draft templates and instructions that are fully aligned both to the Basel disclosure framework and the Bank's approach to MREL. This would ensure that firms' implementation costs are limited to implementation of a more lasting disclosure requirement than would otherwise be the case. The PRA is supportive of UK G-SII firms using the Basel disclosure templates for TLAC in the interim as a way of meeting the PRA's proposed requirement.

Interpreting EU-based references in reporting and disclosure requirements

14.24 SS2/19 sets out the PRA's expectations on firms' approach when interpreting EU-based references in reporting and disclosure requirements.[125] The PRA's approach to updating reporting and disclosure requirements in this CP includes the use of templates or instructions from EBA ITS which in some cases includes new EU-based references. The PRA proposes to amend SS2/19 in order to add additional guidance on the interpretation of these EU-based references. The draft amendments to SS2/19 are attached to this CP.

Questions

Q6: To what extent do you consider that the disclosure of the NSFR on a spot basis is unlikely to lead to adverse signalling in a stress, or that disclosing on an average basis would materially reduce adverse signalling?

[124] May 2020: https://www.bankofengland.co.uk/paper/2018/boes-approach-to-setting-mrel-2018.
[125] December 2020: https://www.bankofengland.co.uk/prudential-regulation/publication/2019/pra-approach-to-interpreting-reporting-and-disclosure-reqs-and-reg-trans-forms-ss.

15 Currency denomination of thresholds and monetary values

15.1 This chapter sets out the PRA's proposals to redenominate certain references to Euros (EUR) into Pound Sterling (GBP) in the PRA rules proposed in this CP.

15.2 The CRR and the Basel III standards contain a number of thresholds and monetary values set in EUR.[126] These determine, for example, whether firms qualify for more proportionate prudential treatments, or define limits on certain types of exposure. The specification of thresholds and monetary values in GBP would help to reduce the extent of change in the requirements applicable to firms that result from variations in the GBP/EUR exchange rate. As a result, it would help to enhance firms' safety and soundness, and the proportionality of the prudential framework.

15.3 The proposals in this chapter would include rules in the following new parts of the PRA Rulebook that are proposed to be inserted by this CP:

(iii) Own Funds and Eligible Liabilities (CRR);

(iv) Trading Book (CRR);

(v) Counterparty Credit Risk (CRR);

(vi) Large Exposures (CRR);

(vii) Liquidity (CRR);

(viii) Liquidity Coverage Ratio (CRR); and

(ix) Reporting (CRR)

Proposals

15.4 The PRA proposes generally to specify in GBP the thresholds and monetary values included in the proposed PRA rules included in this CP. An exception to this proposed approach is the thresholds for disclosure in the CRR of the number individuals that receive remuneration of €1 million or more per financial year.[127] The PRA proposes not to redenominate those EUR references as part of this consultation owing to interdependencies with the Remuneration Part of the PRA Rulebook.[128] The PRA intends to consider this further in reviewing the relevant template.

Methodology

15.5 In transposing CRD V, the PRA already redenominated EUR thresholds in PRA rules relating to the identification of Material Risk Takers (MRTs) for remuneration purposes.[129] The PRA proposes to take a consistent approach in specifying thresholds and monetary values in PRA rules covered by this CP. The PRA proposes to use the same average daily GBP/EUR spot exchange rate as that used when

126 This is also the case for the EU CRR II requirements that the PRA used as a basis for developing proposed PRA rules.

127 CRR Article 450(1)(i) requires firms to disclose this information in payment bands of €500,000 for individuals earning between €1 million and €5 million, broken down into pay bands of €500,000, and broken down into pay banks of €1 million for remuneration of €5 million and above. The PRA's proposed rules are in Article 450(1)(i) of the Disclosure (CRR) Part.

128 Chapter 18 of the Remuneration Part of the PRA Rulebook requires firms to report the same information to the PRA as this disclosure requirement. Both use the same template, which is denominated in EUR.

129 December 2020: https://www.bankofengland.co.uk/prudential-regulation/publication/2020/capital-requirements-directive-v-further-implementation.

transposing CRD V, covering the 12-month period prior to Friday 10 July 2020, rounded to the nearest integer: £1 = €1.14.[130] The PRA proposes also to round the redenominated GBP values to 2 significant figures.

15.6 For ease of reference, the table below lists the PRA rules for which the PRA proposes to set thresholds and monetary values in GBP, together with the proposed GBP value.

Table 1 – Proposed GBP thresholds and monetary values

Relevant PRA rule	Summary	EUR (€ million)	Proposed GBP (£ million)
Article 15e (8)(b) of Chapter 4 of the Own Funds and Eligible Liabilities (CRR) Part	Threshold for the amount of funding that a firm holds in an intermediate entity below which it may be eligible to be treated as a non-significant indirect investment and deducted from CET1 capital	10	8.8
Article 94 (1)(b) of Chapter 3 of the Trading Book (CRR) Part	Threshold for the size of trading book below which firms can qualify to apply the derogation for small trading book businesses	50	44
Article 273a (1)(b) of Chapter 3 of the Counterparty Credit Risk (CRR) Part	Threshold for the size of derivative business below which firms can calculate their counterparty credit risk exposure value under the simplified SA-CCR	300	260
Article 273a (2)(b) of Chapter 3 of the Counterparty Credit Risk (CRR) Part	Threshold for the size of derivative business below which firms can calculate their counterparty credit risk exposure value under the Original Exposure Method (OEM)	100	88
Article 394 (1) of Chapter 4 of the Large Exposures (CRR) Part and Article 14 (3) of Chapter 5 of the Reporting (CRR) Part	Threshold at which firms should report exposures to the competent authority	300	260

130 The average daily GBP/EUR spot exchange rate for the year ending Thursday 31 December 2020 would be £1 = €1.13.

Relevant PRA rule	Summary	EUR (€ million)	Proposed GBP (£ million)
Article 395 (1) and 396 (1) of Chapter 4 of the Large Exposures (CRR) Part	Limit on exposures to a client or group of connected clients	150	130
Article 411 (2) of Chapter 4 of the Liquidity (CRR) Part	Limit on the aggregate deposit by an SME or company on a group basis for it to be treated as a retail deposit	1	0.88
Article 416 (5) of Chapter 4 of the Liquidity (CRR) Part	Limit on the absolute amount of exposure to a CIU that can be treated as a liquid asset	500	440
Article 428 (1)(g)(ii) of Chapter 4 of the Liquidity (CRR) Part	Limit on the aggregate deposit by an SME or company on a group basis, as part of a definition of retail loans to be reported as items requiring stable funding	1	0.88
Article 10 (1)(f)(iv) of Chapter 2 of the Liquidity Coverage Ratio (CRR) Part	Minimum issue size for extremely high quality covered bonds to be recognised as Level 1 HQLA	500	440
Article 11 (1)(c)(iv) of Chapter 2 of the Liquidity Coverage Ratio (CRR) Part	Minimum issue size for high quality covered bonds to be recognised as Level 2A HQLA	250	220
Article 11 (1)(d)(vii) of Chapter 2 of the Liquidity Coverage Ratio (CRR) Part	Minimum issue size to determine the asset coverage requirement for third country issued covered bonds to be recognised as Level 2A HQLA	500	440
Article 11 (e)(ii) of Chapter 2 of the Liquidity Coverage Ratio (CRR) Part	Minimum issue size to determine whether corporate debt securities should be recognised as Level 2A HQLA	250	220
Article 12 (1)(b)(ii) of Chapter 2 of the Liquidity Coverage Ratio (CRR) Part	Minimum issue size to determine whether corporate debt securities should be recognised as Level 2B HQLA	250	220

Relevant PRA rule	Summary	EUR (€ million)	Proposed GBP (£ million)
Article 12 (1)(e)(iv) of Chapter 2 of the Liquidity Coverage Ratio (CRR) Part	Minimum issue size to determine whether high quality covered bonds should be recognised as Level 2B HQLA	250	220
Article 13 (11) of Chapter 2 of the Liquidity Coverage Ratio (CRR) Part	Minimum issue size to determine which securitisations should be eligible as Level 2B HQLA	100	88
Article 15 (1) of Chapter 2 of the Liquidity Coverage Ratio (CRR) Part	Limit on the absolute amount of exposure to a CIU that can be treated as a liquid asset	500	440
Article 25 (2)(a) of Chapter 2 of the Liquidity Coverage Ratio (CRR) Part	Size of total deposit balance above which higher LCR outflow rates apply	0.5	0.44
Relevant PRA rule	**Summary**	**EUR (€ billion)**	**Proposed GBP (£ billion)**
Article 4 (1) of the Trading Book (CRR) Part	Threshold for the size of fair valued assets and liabilities below which firms may use the simplified approach to determine Additional Valuation Adjustments (AVAs)	15	13
Article 20 (2)(a) of Chapter 5 of the Reporting (CRR) Part	Threshold specifying which firms report the G-SII template	200	170

16 The temporary transitional power

16.1 This chapter sets out the PRA's proposals in relation to the temporary transitional power (TTP).

16.2 The TTP enables the UK's financial services regulators (the regulators) to delay the application of firms' regulatory obligations where they have changed as a result of an onshoring change made under the EU (Withdrawal) Act 2018.[131] This includes onshoring changes that the PRA has made to rules and Binding Technical Standards. It also includes such changes made by HM Government to onshored EU legislation, for example the CRR.

16.3 The TTP is available for use by the regulators for a maximum period of two years after the end of the transition period. The PRA is using the TTP to provide broad transitional relief to firms until Thursday 31 March 2022, with key exceptions expressly provided for in the PRA's transitional direction.[132]

16.4 The proposals in this chapter would make amendments to:

- the Interpretation Part of the PRA Rulebook.

Proposals

16.5 The TTP can only apply to onshoring changes in scope of the PRA's transitional direction. It cannot apply to new rules, or changes to rules, made by the PRA under FSMA, and the powers proposed by the FS Bill. This means that the TTP will cease to apply to CRR Articles and CRR level 2 Regulations restated as PRA rules.

16.6 In order to preserve the application of the TTP, the PRA has included a mirror provision in the draft CRR 2 (Revocations and Other Amendments) Instrument 2021. This mirror provision replicates the effect of the PRA's transitional direction for CRR restatement provisions. The mirror provision can only apply to CRR restatement provisions. It cannot apply to new rules, or rules which the PRA is proposing to materially change in this CP.

16.7 The effect of the mirror provision is to retain the effect of the PRA's transitional direction for CRR restatement provisions between Saturday 1 January 2022, when the PRA's proposed rules would take effect, and Thursday 31 March 2022, when the PRA's transitional direction is due to expire.

16.8 The PRA considers that the mirror provision can mitigate any potential inconsistencies generated with other parts of the PRA Rulebook, and the CRR where the PRA's transitional direction will continue to apply until Thursday 31 March 2022. It is therefore the PRA's intention to apply the mirror provision as broadly as possible.

16.9 The proposed Liquidity (CRR) and the Liquidity Coverage Ratio (CRR) Parts of the PRA Rulebook are the only exceptions identified where the PRA considers it would not be appropriate to apply the mirror provision. The PRA expects that applying the mirror provision in these areas could create

131 The UK's withdrawal from the EU required changes to be made to UK legislation to ensure that it remained functional after the end of the transition period. These changes are referred to as onshoring changes.

132 December 2020, Appendix 2: https://www.bankofengland.co.uk/prudential-regulation/publication/2020/uk-withdrawal-from-the-eu-changes-before-the-end-of-the-transition-period.

inconsistencies between the PRA's proposed LCR rules, which are CRR restatement provisions to which the mirror provision can apply, and the PRA's proposed NSFR rules. The mirror provision cannot apply to the PRA's proposed NSFR rules, because these are not CRR restatement provisions. The PRA therefore proposes to carve-out the Liquidity (CRR) Part, the Liquidity Coverage Ratio (CRR) Part, and the related liquidity reporting or disclosure rules in the Reporting or Disclosure Parts of the PRA Rulebook from the application of the mirror provision.

16.10 The PRA's transitional direction would continue to apply to existing PRA rules. These include the related Designated Investment Firms (DIF) and Individual Liquidity Adequacy Assessment (ILAA) Parts of the PRA Rulebook, as well as the PRA110 report in the PRA Regulatory Reporting rule. The DIF Part of the PRA Rulebook references the onshored European Commission Delegated Act 2015/61, as does PRA 110. In both cases, as of Saturday 1 January 2022, this would refer to the new Liquidity Coverage Ratio (CRR) Part of the PRA Rulebook.

16.11 Under the proposals the PRA's transitional direction would not apply to the Liquidity (CRR) Part, the Liquidity Coverage Ratio (CRR) Part, and the related liquidity reporting or disclosure rules in the Reporting or Disclosure Parts of the PRA Rulebook from Saturday 1 January 2022. The PRA considers that this would still provide firms with sufficient time to adjust to any onshoring changes to LCR requirements that are currently in scope of the PRA transitional direction.

17 Statutory obligations

The PRA's statutory obligations

17.1 In carrying out its policy making functions, the PRA is required to comply with several legal obligations. Before making any rules, the Financial Services and Markets Act 2000 (FSMA)[133] requires the PRA to publish a draft of the proposed rules accompanied by:

- a cost benefit analysis;
- an explanation of the PRA's reasons for considering that making the proposed rules is compatible with the PRA's duty to act in a way that advances its general objective[134] and secondary competition objective;[135]
- an explanation of the PRA's reasons for believing that making the proposed rules are compatible with its duty to have regard to the regulatory principles;[136] and
- a statement as to whether the impact of the proposed rules will be significantly different to mutuals than to other persons.[137]

17.2 The PRC should have regard to aspects of the Government's economic policy as recommended by HM Treasury.[138]

17.3 The PRA is also required by the Equality Act 2010 to have due regard to the need to eliminate discrimination and to promote equality of opportunity in carrying out its policies, services, and functions.[139]

17.4 The requirements summarised above also apply to the PRA when exercising its power to make a standards instrument under section 138P of FSMA. A standards instrument must also be approved by HM Treasury

17.5 In addition to the above, the Financial Services Bill (FS Bill), if passed into law, would require the PRA to 'have regard' to three further matters when making CRR rules.[140] The FS Bill would also require the PRA to explain the ways that the new 'have regards' have affected its proposed rules.[141]

17.6 Under the FS Bill the PRA would also be required to 'consider, and consult the Treasury about, the likely effect of the rules on relevant equivalence decisions'.[142]

[133] Section 138J.
[134] Section 2B of FSMA.
[135] Section 2H(1) of FSMA.
[136] Sections 2H(2) and 3B of FSMA.
[137] Section 138K of FSMA.
[138] Section 30B of the Bank of England Act 1998.
[139] Section 149.
[140] Schedule 3 of the FS Bill, proposed section 144C(1) of FSMA.
[141] Schedule 3 of the FS Bill, proposed section 144D of FSMA.
[142] Schedule 3 of the FS Bill, proposed section 144C(3) of FSMA.

The PRA's objectives

17.7 The PRA has a general objective to promote the safety and soundness of the firms that we regulate.[143] When discharging its general functions in a way that advances its objectives, the PRA has a secondary objective to act, as far as reasonably possible, in a way that facilitates effective competition in the markets for services provided by the firms we regulate, when they carry on regulated activities.[144]

17.8 The PRA considers that each of its proposals enhance the safety and soundness of firms and, where appropriate, facilitate effective competition. While advancing these objectives the PRA has had regard to the FSMA regulatory principles, the HM Treasury recommendation letter and the additional matters which the PRA must have regard to under the Equalities Act 2010 and the proposed FS Bill.

17.9 The PRA considers that the impact of the proposed rule changes and expectations on mutuals would not differ from the impact on other firms.

17.10 The PRA considers that the proposals do not give rise to equality and diversity implications.

17.11 Appendix 12 explains in detail the ways that the PRA's primary and secondary objectives, along with the have regards, have affected the proposed rules for each policy area set out in this CP. This is in line with the new requirements introduced under the FS Bill. The PRA has chosen to apply this requirement also to all the existing 'have regards', setting out which of these have had the greatest effect for each policy proposals, in order to help stakeholders better understand the overall rationale for each of its proposals.

FSMA regulatory principles

17.12 In developing proposed rules, the PRA has a duty to have regard to the following regulatory principles:

- **efficient and economic use of resources**: the need to use the resources of the PRA in the most efficient and economic way;
- **proportionality**: burden/restriction should be proportionate to benefits;
- **sustainable growth**: the desirability of sustainable growth in the economy of the UK in the medium or long term;
- **consumer responsibility**: the general principle that consumers should take responsibility for their decisions;
- **senior management responsibility**: the responsibilities of the senior management of persons subject to requirements imposed by or under FSMA, including those affecting consumers, in relation to compliance with those requirements;

143 Section 2B of Chapter 2 of FSMA.
144 Section 2H of Chapter 2 of FSMA.

- **different business models**: the desirability where appropriate of the PRA exercising its functions in a way that recognises differences in the nature and objectives of businesses carried on by different persons (including different kinds of persons such as mutual societies and other kinds of business organisation), subject to requirements imposed by or under FSMA;

- **publishing information**: the desirability in appropriate cases of the PRA publishing information relating to persons on whom requirements are imposed by or under FSMA, or requiring such persons to publish information, as a means of contributing to the advancement by the PRA of its objectives; and

- **transparency**: the principle that the PRA should exercise its functions as transparently as possible.

HM Treasury recommendation letter

17.13 HM Treasury has made recommendations to the PRC about aspects of the Government's economic policy to which the PRC should have regard when considering how to advance the PRA's objectives and apply the regulatory principles. Those recommendations relate to:

- **competition**: the government is keen to see more competition in all sectors of the industry, particularly retail banking. This includes minimising barriers to entry and ensuring a diversity of business models within the industry;

- **growth**: the government wishes to ensure financial services markets make a positive contribution to sustainable economic growth in the UK economy in the medium and long term, through the facilitation of finance for productive investment and as a productive sector of the UK economy;

- **competitiveness:** the government wishes to ensure that the UK remains an attractive domicile for internationally active financial institutions, and that London retains its position as the leading international financial centre. The government considers that achieving this aim in a manner that is consistent with robust institutions and a resilient system will support its aims for sustainable economic growth;

- **innovation:** the government is keen to see innovation in the financial services sector and how this can support the wider economy, through new methods of engaging with consumers of financial services and new ways of raising capital. This includes recognising differences in the nature and objectives of business models and ensuring burdens are proportionate;

- **trade:** the government aims to encourage trade and inward investment to the UK that can help boost productivity and growth across our economy. This can be supported by improved competition opening the UK to new ways of doing things and being seen as a good place to do business; and

- **better outcomes for consumers:** the government wants to see financial services work in the best interests of the consumers and businesses they serve. This is supported by improved competition in financial services and the securing of an appropriate degree of protection for consumers, including policyholders.

Financial Services Bill have regards

17.14 The Financial Services Bill will require the PRA to have regard to three additional matters when making CRR rules:

- **international standards:** the 'relevant standards' recommended by the BCBS from time to time;
- **relative standing of the UK**: the likely effect of the rules on the relative standing of the UK as a place for internationally active credit institutions and investment firms to be based or carry on activities; and
- **finance for the real economy:** the likely effect of the rules on the ability of CRR firms to continue to provide finance to businesses and consumers in the UK on a sustainable basis in the medium and long term.

Cost Benefit Analysis

17.15 This section sets out an analysis of the costs and benefits of introducing the proposals discussed in this CP. The PRA has provided quantitative estimates of those proposals that are expected to have the most material impact on firms and for which the PRA has sufficiently granular information on firms' likely responses. These estimates should be treated as indicative, subject to substantial uncertainty and sensitive to the underlying assumptions.

17.16 Quantitative estimates for some proposals in this analysis have not been included where the PRA anticipates that the aggregate cost to all firms will not be material or available data are insufficient to provide estimates. That is not to say that no firm will experience changes in costs as a result of those proposals for which the PRA has not provided estimates. Some proposals are expected to both raise and lower costs for different firms (to a limited extent) leaving the aggregate impact unchanged, while for other proposals the PRA has only anecdotal data from which the PRA cannot publish quantitative estimates for confidentiality reasons.The demands on both the PRA's and firms' resources in the current economic environment mean that data collection to support additional quantitative analysis would not be proportionate. A qualitative analysis has been included where proposals represent potentially material changes for firms, but cannot be quantified.

17.17 The proposals in this CP are part of the package of measures to implement in the UK the Basel reforms agreed at an international level following the 2007-2008 financial crisis, as with the implementation of the CRD V measures set out in recent CPs.[145] As such, the costs and benefits of the proposals set out in this CP should be considered in the context of all proposals addressing financial stability following the financial crisis.A number of these proposals are intended to ensure that the benefits of proposals already introduced will be realised. In 2012, the PRA estimated that the net benefits of all prudential reforms introduced in response to the financial crisis at the time of the CRD IV package,[146] which implemented many of the Basel III standards within the EU, was

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[145] July 2020: https://www.bankofengland.co.uk/prudential-regulation/publication/2020/capital-requirements-directive-v; and October 2020: https://www.bankofengland.co.uk/prudential-regulation/publication/2020/capital-requirements-directive-v-further-implementation.

[146] August 2013: https://www.bankofengland.co.uk/prudential-regulation/publication/2013/strengthening-capital-standards-implementing-crd-4.

approximately £8¼ billion per annum.[147] Adjusting for changes to GDP since 2012, the net benefits were expected to be approximately £11¾ billion per annum. The PRA's assessment of the impact of the proposals in this CP is that the net benefits of all proposals addressing financial stability remains highly net beneficial at approximately £11½ billion per annum.

Outline of the analysis

17.18 The analysis in this chapter considers both the impacts on individual firms and the macroeconomic implications of the proposals set out in this CP. The analysis proceeds by:

(a) discussing the affected firms and the markets in which they operate, and the baseline from which the impact of the proposals is calculated;

(b) setting out the specific benefits expected from the proposals in this CP;

(c) estimating direct costs to firms, which includes operational costs and capital and balance sheet costs that are imposed directly on firms, and discussing those proposals that are expected to have non-material costs or represent no substantial change in the PRA's approach; and

(d) estimating the macroeconomic impacts of the change that may occur as a result of changes to firms' capital positions.

Affected firms and markets

Firms

17.19 The proposals in this CP apply to all CRR firms regulated by the PRA. There are 403 PRA-authorised CRR firms in total,[148] comprising 352 banks, 43 building societies, and eight designated investment firms, at the time of the PRA Business Plan 2020/21.[149] PRA-approved or -designated financial or mixed financial holding companies would also be affected.[150] Not all the proposals would be relevant for all firms. Some proposals would only have a direct impact on those firms with particular business models. Other proposals are intended to move existing provisions of the CRR into the PRA Rulebook without changing materially their substance or effect on firms. Nevertheless, where firms are not currently subject to the proposals set out in this CP, changes to their business models could bring them within scope of the new requirements in future. The proposals do not directly affect other PRA-regulated firms (ie insurers and credit unions).

Markets

17.20 The markets in which the population of relevant firms regulated by the PRA operates cover products most closely associated with the credit intermediation process, including deposit-taking, retail and wholesale lending, and interbank lending. However, some affected firms (including the PRA's designated investment firms) operate in a number of other markets for similar or

147 Annualised net present value of the chain-volume measure (2012) of GDP.
148 The exact number of these firms and groups changes as new firms enter, other firms close or vary their permission, and entities within groups restructure.
149 April 2020: https://www.bankofengland.co.uk/prudential-regulation/publication/2020/pra-business-plan-2020-21.
150
October and December 2020: https://www.bankofengland.co.uk/prudential-regulation/publication/2020/capital-requirements-directive-v-further-implementation.

complementary products such as cash flow management for non-financial corporates, securitisation, repos, securities lending and borrowing, OTC derivatives, and asset management. The impact of the proposals on the broader economy will depend on the type of firms, and therefore which markets, are affected.

17.21 As many banks have the capacity to cross-subsidise operations across business lines, it is possible that the proposals could also affect other markets indirectly, such as in the provision of liquidity to corporate bond markets. The PRA has not considered a strict definition of markets in this discussion. A more complete definition would include products that perform very similar functions whether used for this purpose or not ('imperfect substitutes'), and consider those firms not currently in the market that could supply these products (potential entry to the market). The PRA expects that any indirect effects will be limited and that a high level description of markets is sufficient for the analysis as the proposals are not expected to disrupt the business models of existing firms given their relatively small impact, or to change the balance of costs and benefits of the overall regulatory response to the crisis.

Baseline for calculations

17.22 Firms have been planning on the basis of the proposals in this CP for some time. Firms are likely to have already responded and will be broadly compliant with most of these proposals. It is not possible to disentangle any actions that firms may have taken in anticipation of these proposals from other actions that they take in response to either changes in business strategy or market developments in recent years.

17.23 FSMA requires that the cost benefit analysis provides 'an analysis of the costs together with an analysis of the benefits that will arise … if the proposed rules are made'.[151] The relevant costs and benefits in this analysis therefore reflect those changes that we anticipate affected firms will make in response to the proposals, and not simply the mechanical change in nominal regulatory requirements. For example, where the proposals involve the transfer of existing CRR requirements into the PRA rulebook, the PRA has not assessed the impact from a baseline that assumes there was no regulation in place. Rather, the baseline considers firms existing business strategies, which includes their response to existing requirements. The subsequent analysis only considers any changes arising where the proposals substantially alter the regulations currently facing firms.

Costs and benefits of proposals

Benefits

17.24 Overall, the proposals implement in the UK many of the remaining elements of the Basel III standards, address risks identified as banks have responded to the existing regulations, and address unintended consequences of the existing rules. The proposals therefore would help to ensure that the benefits identified of all reforms undertaken in response to the crisis, and set out in CP5/13 will be realised.[152] These aggregate benefits are set out in the section on the macroeconomic impacts of the proposals. The PRA has identified material benefits from the following measures in addition to helping realise the net benefits expected from all measures promoting financial stability.

[151] Section 138J(7) of FSMA.
[152] August 2013: https://www.bankofengland.co.uk/prudential-regulation/publication/2013/strengthening-capital-standards-implementing-crd-4.

Collective investment undertakings (CIUs)

17.25 The benefits of the proposals on CIUs arise from appropriately managing the risks of these assets based on the information available about the CIU, with more prudent treatment required when less information is available. The new fall back approach, with its corresponding 1.250% risk weight, will apply in cases where there is not sufficient information available about the CIU or when supervisory oversight criteria are not met. The new CIU requirements also take into account the leverage of the CIU. The PRA's approach reflects the fact that issues related to the structure and governance of a fund could have an impact on risk over and above the credit risk of the underlying assets. The PRA aims to ensure sufficient recognition of the quality of supervision of funds as well as the nature of the funds themselves.

Net stable funding ratio

17.26 The benefits of the NSFR arise from ensuring that banks and investment firms take into account the costs that their funding instability can impose on the wider economy when choosing their funding structures. Such firms serve the economy in several ways, one of which is through liquidity transformation. They invest in illiquid long-term assets while offering liabilities that act as a store of liquidity for end users. This mismatch can make them vulnerable to shocks to the stability of their liabilities, as well as shocks limiting their ability to liquidate some of their assets. These shocks can have self-fulfilling features (eg depositor loss of confidence or expectations of government support).

17.27 Such fragilities can have adverse impacts that go beyond the firm itself. For example, banks' asset illiquidity and their funding troubles are known to feed one another and can propagate to the financial system more broadly through fire sales or through loss of confidence at other similar institutions. This fragility can also cause damage to wider economic activity to the extent that it means that the economy suffers from a reduction in credit every time significant parts of the financial system have difficulty refinancing their own liabilities. Thus, the NSFR can improve outcomes (from society's viewpoint) by increasing firms' resilience to these shocks as well as reducing the risk of damaging runs or liquidity stress and the incidence of 'fire sales'.[153]

Direct costs

17.28 The direct costs of the proposals are those costs that firms face directly to operationalise the new rules within their business or to alter their business models by adjusting their balance sheet. The direct costs of the proposals fall into three categories: (i) operational costs; (ii) capital and other balance sheet costs; and (iii) non-material costs.

17.29 Quantitative estimates of operational costs and capital and other balance sheet costs are set out where the PRA expects the direct costs to be material. For these estimates, the PRA gathered information directly from the industry. The PRA has not systematically gathered data from firms where it is anticipated that the costs to firms would not be material. The compressed timetable for transposition of the proposals, and the demands on both the PRA's and firms' resources in the current economic environment, meant that such a data collection to support further quantitative analysis would not be proportionate.

153 There is econometric evidence supporting the idea that stable funding requirements would have helped predict those banks most at risk of failure or in need of government assistance during the 2007-09 financial crisis. Lallour and Mia (2016), for example, find that structural funding ratios, including a proxy for the NSFR, are key determinants of future failure in times of crisis, even after accounting for measures of capital adequacy. See Lallour, A. and Mio, H. (2016), "Do we need a stable funding ratio? Banks' funding in the global financial crisis", Bank of England Staff Working Paper No. 602.

Operational costs

17.30 The PRA expects that the reporting and disclosure proposals will have material operational costs for firms.

17.31 The PRA conducted a survey of firms to estimate the costs of all reporting and disclosure requirements. The survey asked firms to provide estimates of the incremental cost of recent updates to regulatory reporting and disclosure requirements, including the implementation of EBA Taxonomy 2.7 and FINREP reporting, and the EBA Taxonomy 2.9 and reporting and disclosure requirements for non-performing and forborne exposures that were required at the end of 2019. To calculate the size of the changes needed for this analysis, the scope of these recent updates was compared to the changes in reporting set out in this CP (see Chapters 13 and 14). The cost per firms was calculated using this comparison and the survey estimates, separated into small and large firms. The cost per firm was then matched to the population of affected firms to estimate the total cost to all firms.

Table 2: Estimated costs of reporting and disclosure

	Small[(a)]	Large[(b)]	Total
		(£ million)	
Cost per firm (based on survey responses)			
One-off	0.4	4.3	0.7
Ongoing	0.0	0.4	0.1
Estimated total cost to all affected firms			
One-off costs	64.8	73.7	138.5
Ongoing costs	6.2	6.2	12.4

Source: PRA survey of firms and calculations
Notes (a) Firms with total assets less than £100 billion
(b) Firms with total assets greater than £100 billion

17.32 Table 2 above sets out the expected costs of implementing the reporting and disclosure proposals. The cost per firm, based on the survey responses, is estimated to be approximately £1 million and £100,000 for large and small firms, respectively. The estimated one-off and annual ongoing costs to the industry in total are estimated to be approximately £138.5 million and £12.4 million, respectively.

17.33 There is considerable uncertainty around these estimates, which reflect the limited sample available to the PRA to estimate the costs and the difficulty in separating the incremental costs of the changes from the normal ongoing costs of reporting regulatory data. Nevertheless, the PRA would be unable to monitor compliance with new rules in the absence of these proposals, which means the benefits of the regulatory regime would be unlikely to be realised.

Capital and other balance sheet costs

17.34 The proposals on counterparty credit risk and the net stable funding ratio (NSFR) are expected to have the most material impact on affected firms' regulatory requirements, and subsequently their capital resources and balance sheet structure. Below, we discuss the general approach to calculating capital and balance sheet costs, before setting out estimates of the costs of the policy proposals.

17.35 The PRA developed an empirical analysis of UK bank behaviour to create a firm-level model that approximates the different responses expected from individual firms.[154] It is assumed that firms target a particular level for their capital-resources-to-risk-weighted-assets ratios determined

154 The model was originally discussed and used in CP 5/13 (see footnote 145). The model has been updated to reflect the post-crisis period. See de-Ramon, S., Francis, W. and Harris, Q. (2016), "Bank capital requirements and balance sheet management practices: has the relationship changed after the crisis?", Bank of England Staff Working Paper No.635.

by each firm's overall business strategy, and that they will seek to restore their target capital ratios following any change brought about by changes to the measurement of their risk weighted assets (RWA).[155] The model is applied to each affected firm considered in the analysis, and provides an estimate of the likely change in capital resources and RWA. The individual responses are then aggregated to derive an industry-wide response to the policy changes which can be used in a macroeconomic model to determine the wider impact on the UK economy.

17.36 A key limitation of this model is that it applies directly to UK banks and building societies, but not investment firms. The PRA has no clear empirical basis for how investment firms might change their balance sheets in response to changes in their capital resources ratios. Nevertheless, as profit making entities, investment firms are expected to pass through the costs of adjustment in the most efficient way possible. For completeness, the PRA has calculated changes to investment firms' capital and risk-weighted assets using the same model as for banks. These provide only a broad indication of the responses that investment firms will make to their balance sheets.

17.37 While the PRA's model allows it to provide an estimate of the changes to firms' capital, it has not been possible to model other changes to firms' balance sheets, such as changes to the debt structure. A qualitative analysis of these other changes to firms' balance sheets has been provided, including indicative estimates were possible of the likely scale of the costs, noting where these calculations may overstate the actual costs to firms.

Standard approach to counterparty credit risk (SA-CCR)

17.38 All CRR firms will be subject to the new SA-CCR proposals, while some smaller firms with limited derivatives business will have the option of using the simplified SA-CCR or the original exposure method (OEM). However, only 55 firms will be directly affected by the proposals and the impact is expected to be mixed across these affected firms. The size and direction of the impact will depend on the characteristics of firms' portfolios (such as asset class, proportion margined and not-margined, direction and netting arrangements), the proportion of those portfolios subject to the standardised approach rather than the internal model method (IMM) and the proportion of trades subject to central clearing via a QCCP.[156]

17.39 Two different types of firms affected by these requirements have been identified. The first are firms that are predominantly involved in lending to the real economy and are funded by deposits. The second are firms that have significant trading activity, but have a significantly smaller role in lending. The second firm type predominantly includes the PRA's designated investment firms.

17.40 For those firms predominantly involved in lending, the proportion of RWA affected by counterparty credit risk is relatively small, accounting for around 1% of affected firms' RWA. This proportion is significantly higher for those firms with significant trading activities, accounting for around 25% of affected firms' RWA. Firms with a significantly higher proportion of centrally cleared trades, which are subject to 2% risk weights, will also be less impacted by any changes brought about by the proposals.

17.41 The PRA has been able to identify all firms with exposures that make use of the standardised approach to counterparty credit, although estimates of the likely impact of the changes were available for only a small number of firms. The data for those firms with significant trading activity

155 In its analysis, the PRA assumes that firms target the same capital resources ratios they held before the change to RWAs.
156 The proposals in this CP will not change counterparty credit risk calculations under the IMM.

varies materially. Within the sample, some large firms with significant trading activity are expected to experience reductions and others increases in RWA, with the overall change as a percentage of total RWA varying within a 30 percentage point range. Consequently, a consistent estimate of the impact on firms with significant trading activity cannot be provided.

17.42 The data for lending firms is sufficient to estimate the effect across both large and small firms. The data has been used to estimate the expected change in capital, although the estimates are subject to significant uncertainty. Table 3 below sets out the expected impact on affected firms of the SA-CCR proposals in isolation to any other changes. The analysis shows that large and small firms predominantly undertaking lending are expected to see an increase in RWA of around £12.3 billion and £0.9 billion, respectively. In response, these firms are expected to raise total capital resources of £1.9 billion and £0.2 billion, respectively.

17.43 The ongoing costs of changes to affected firms' balance sheets reflect the different funding costs to the firms of any change in their funding mix. Where firms raise (lower) capital to meet requirements, they will lower (raise) debt funding given their existing balance sheet size. To estimate the ongoing costs, the average cost of capital and average cost of debt for the sector as a whole has been used. That said, the potential change in asset returns that may arise as banks adjust their RWA, which may also affect the net ongoing cost to firms, has not been estimated. Nevertheless, the PRA considers that this calculation provides a reasonable indication of the likely size of the ongoing costs.

Table 3: Estimated change in capital requirements and resources

	Initial impact on risk weighted assets [a]	Expected change in firm:			
		Capital resources [b]			Risk weighted assets [c]
		CET1	Tier 1	Total	
	(£ billion)	(£ billion)			
One-off cost[d]					
Firms predominantly lending					
Large[e]	12.3	1.4	1.7	1.9	-2.6
Small[f]	0.9	0.2	0.2	0.2	0.1
Total	13.2	1.6	1.9	2.1	-2.5
Ongoing cost (£billion per annum) [g]					
Affected firms predominantly lending		0.1			

Source: Firm regulatory returns, QIS data and PRA calculations
Notes: (a) Change in firms' calculated risk-weighted assets as a result of the introduction of the SA-CCR proposals without any other actions from firms; (b) Expected change in firms' capital resources in response to the initial impact, Calculated assuming firms maintain the ratio of existing capital resources to RWAs; (c) Expected change in risk weighted assets as firms' adjust their capital resources in response to the initial impact. Calculated as the difference between the total RWA after firms have adjusted their balance sheets as calculated in the model, and the total RWA including the initial impact resulting from the introduction of the SA-CCR proposals and before firms make any changes; (d) Change in capital resulting from the SA-CCR proposals taking into account adjustments made to the composition of firms' balance sheets; (e) Firms with total assets greater than £100 billion; (f) Firms with total assets less than £100 billion; (g) Additional annual cost to firms of remunerating additional capital on balance sheets. Calculation does not assume any change to equity or debt prices as a result of the changes to firms' balance sheet structure

Net stable funding ratio

17.44 All PRA-regulated firms that currently apply the Basel standards will be subject to the NSFR requirements. Our analysis suggests that, with the exception of the eight PRA-designated investment firms, all in-scope firms are currently compliant with the NSFR requirements. Therefore, it is not expected that banks and building societies will incur any additional direct costs from the NSFR proposals.

17.45 An aggregate shortfall in available stable funding amounting to around £50 billion has been identified for designated investment firms involved in supporting the economy through broker-dealer and market-making activities. The additional direct costs to these firms will depend on the strategies each undertakes to close the shortfall (eg by adjusting available stable funding and required stable funding). The PRA expects that profit-maximizing firms will take the least costly course of action to comply with the NSFR. This will likely depend on firms' existing business models, balance sheet and funding structures.

17.46 The PRA has no direct empirical evidence for the UK on how designated investment firms may respond to close their shortfalls. There is evidence indicating that the increase in the NSFR of European banks since the 2007-2008 crisis was mainly driven by an increase in available stable funding rather than by a reduction in required stable funding. This result suggests that banks have focused on adjusting the liability (maturity structure) side of the balance, rather than the asset side to satisfy higher NSFR.

17.47 Designated investment firms could close the estimated NSFR shortfall by substituting more-stable, longer-term (and higher cost) funding for less-stable, shorter-term (and lower-cost) funding in debt markets. In taking this action, the aggregate cost to these firms is estimated to be between £150 million and £420 million. The lower estimate is based on the recent differential between long- and short-term dollar LIBOR rates,[157] while the upper estimate is based on the average differential for the year to October 2020. It should be pointed out, however, that the actions (and resulting compliance costs) are estimated in isolation from other requirements, specifically, related to the SA-CCR discussed above, under which designated investment firms may be expected to see a reduction in compliance costs.

17.48 This potential for interaction between the impact of the NSFR and the SA-CCR changes is a further complication in understanding the response of investment firms. While the NSFR implies substantial costs for investment firms, the SA-CCR proposal is expected to reduce significantly the amount of capital that some investment firms need to hold, which would provide significant opportunity for these firms to expand their balance sheets by increasing RWA.

Non-material costs or no substantial change in approach

17.49 This section sets out the costs to firms of those proposals that: the PRA does not expect to have material aggregate costs for affected firms; generally reflect consequential changes to PRA rules that reflect existing practice; or would have incremental costs only where firms choose to make use of provisions (but would not face additional costs otherwise). Consequently, the PRA does not expect these proposals to influence the overall scope of costs and benefits of all proposals set out in this CP.

Level of application

17.50 The PRA does not expect that the proposals on level of application would have a material effect on firms. The costs for some firms may be reduced by the PRA's proposal not to implement an automatic requirement to apply prudential requirements on a sub-consolidated basis where a firm has a subsidiary in a third country, as set out in Chapter 4.

Currency redenomination

17.51 The proposals on currency redenomination are not expected to have material consequences for firms. It is expected that no UK firm will be affected by stating thresholds and monetary values in GBP that are currently set out in EUR.

[157] September, 2020.

Temporary transitional power

17.52 The PRA does not expect the proposals on the TTP to have a significant effect on firms. The proposals will help avoid any costs that firms might incur where there is confusion over the date at which CRR restatement provisions and the PRA transitional direction apply.

Own Funds

17.53 The proposals on own funds will, in effect, maintain the status quo with respect to the deductibility of software assets that prevailed before Wednesday 23 December 2020. Since this date, changes to EU requirements now allow UK firms to partially deduct intangible software assets. The PRA considers that, if UK firms were to take full advantage of the partial deduction, there would be an average increase in CET1 ratio of around 30 basis points and 39 basis points for large and small firms respectively. The PRA recommends that firms do not base their distribution or lending decisions on any capital increase from applying the deduction.[158] Consequently the practical impact of the change is likely to be less than expected.

Market Risk

17.54 The proposals on market risk are not expected to have material consequences for firms. The proposals on prudent valuation and clarification on valuation adjustment for less liquid positions do not change firms' current requirements. Moreover, increasing the threshold for derogation rules is not expected to directly affect existing firms.

Collective investment undertakings (CIUs)

17.55 The proposals for implementing CIUs are not expected to have a material impact on firms in aggregate, although the proposals may have capital impacts for firms with exposures that are not eligible for the LTA or MBA (eg where firms hold exposures to CIUs managed in third countries where supervisory oversight criteria are not met).

17.56 The PRA has identified a small number of PRA regulated firms who have exposures to CIUs under the standardised approach to credit risk (approximately 11 firms in total). From the regulatory data, the PRA notes that CIUs make up at least 2.9% of affected firms' RWA, but only 0.7% of total RWA across all relevant firms. The PRA expects that some firms may see an increase in their calculation of RWA as a result of the proposals on the third country treatment of CIUs, but would expect this increase to represent only a small fraction of overall RWA for these firms. It is unclear at this point which jurisdictions will be considered equivalent for the purposes of these proposals as any equivalence assessment will be carried out in future. There is additional uncertainty over the likely size of any impact.

17.57 Given the small number of affected firms and the limited exposure of affected firms' overall RWA to affected assets, the PRA does not expect that the cost to firms in terms of additional capital will be material to the industry overall.

Operational Risk

17.58 The proposals on operational risk do not reflect a substantial change in the PRA's current approach, but provide clarity on the calculation of relevant indicators which is available at the discretion of the firm. The PRA therefore does not expect that the proposals on operation risk would have any incremental costs for firms.

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[158] December 2020: https://www.bankofengland.co.uk/prudential-regulation/publication/2020/statement-prudential-treatment-software-assets.

Large Exposures

17.59 The proposals on large exposures do not reflect a substantial change in the PRA's current approach. The proposals implement the Basel standards on large exposures which were published in April 2014, and it is expected that firms are already compliant with the requirements. The costs of changes to reporting requirements for large exposures are included in the estimates for reporting and disclosure (see section on operational costs above).

Liquidity coverage ratio

17.60 The proposals on the liquidity coverage ratio are intended to ensure that existing requirements are transposed into PRA rules. The PRA does not expect that the proposals will have any incremental impact on firms.

Macroeconomic impacts of proposals

17.61 In this section, the macroeconomic impacts of the proposals are discussed and some indicative estimates of the likely impact on real economic activity, using UK GDP as a measure, are provided. Only the SA-CCR and NSFR proposals are expected to have a sufficiently large impact on firm behaviour to have an influence on macroeconomic activity and so have been included in this analysis.

17.62 In summary, the PRA expects the net benefits of the responses to the financial crisis, of which the proposals in this CP contribute, to be approximately £11½ billion per annum, while the incremental costs of the proposals are expected to be approximately £130 million per annum, to the extent that the PRA is able to provide quantitative estimates. As noted in paragraph 17.15 above, the quantitative estimates in this section are subject to considerable uncertainty and should only be considered indicative of the impacts that the PRA expects to arise.

17.63 The PRA set out techniques and models for estimating the macroeconomic costs and benefits of responses to the 2007-2008 financial crisis in CP 5/13. The techniques are limited to estimating the impact of changes in total capital held in those UK firms that lend money to households and non-financial firms in the economy and fund those loans significantly through deposits (ie banks and building societies). The PRA has updated the models used in that analysis to provide estimates of the costs and consider whether there are any additional macroeconomic benefits to the proposals set out in this CP. However, these techniques are limited and cannot provide quantitative estimates of all policy proposals.

17.64 The key benefits of the Basel III standards are to reduce the likelihood that a financial crisis occurs, and thereby avoid any disruption to real economic activity that may result. Increases in the proportion of capital held in the financial system help reduce the likelihood of crisis by ensuring that there is sufficient 'skin in the game' on the part of banks to appropriately consider the risk of failure and manage their risks accordingly. By setting a stable funding requirement, the transmission of liquidity shocks to the real economy is also expected to be limited in the future. Insulating banks from liquidity shocks thus brings important benefits in terms of lending during times of liquidity stress.

17.65 While the PRA can assign changes to capital and liquid asset ratios to specific policy measures, it is not possible to allocate the associated benefits to any particular policy proposal as the impact on the likelihood of crisis changes depending on the amount of capital and liquid assets in the system (ie there are diminishing returns from tighter capital and liquidity policy).[159]it has not been possible to estimate consistently additional benefits of both increases in capital ratios and the NSFR as there is insufficient data to date that can be used to form an estimate.

17.66 As noted in paragraph 17.15, the macroeconomic benefits of the proposals in this CP need to be considered in the context of all measures taken in response to the 2007-2008 financial crisis. Consequently, to the extent that the PRA is able to provide quantitative estimates, the proposals in this CP are expected to contribute to the total benefits of £22 billion per annum previously estimated for all responses to the financial crisis.[160]

17.67 In contrast to the estimation of benefits, the estimated opportunity costs to GDP of additional capital in the financial system increase linearly and can therefore be calculated for individual policy proposals. These costs arise as higher capital resources raise funding costs for deposit takers, and they recover (at least partially) the costs incurred by increasing the spread between lending and deposit rates to customers. Households and non-financial corporates face higher borrowing charges and lower deposit returns which, in turn, affects real economic activity.

17.68 The macroeconomic costs are estimated using outputs from the National Institute Global Econometric Model (NiGEM).[161] The cost estimates should be treated with caution as they represent the net-present value of the reduction in GDP over the long run, and are influenced by assumptions made in this analysis.[162]

17.69 As noted in paragraph 17.40, firms that are predominantly engaged in lending activity are expected to raise additional capital in response to the SA-CCR proposals, and the NiGEM macroeconomic model has been used to estimate the change in real economic activity. These changes are expected to reduce annual UK GDP marginally, by approximately £130 million per annum, increasing the estimate of the cost of all responses to the financial crisis to £10½ billion per annum.[163] This additional cost does not alter the PRA's judgement that the responses to the financial crisis that raise aggregate capital in the banking system generate net benefits in terms of additional GDP of around £11½ billion per annum.

17.70 For the impact on investment firms, any increase in costs they face is likely to be recovered by increased fees to their customers, reducing the returns to those entities that lend cash and security and reducing the demand for these services in the economy. It is possible that these firms, could seek to relocate their activities outside the UK to avoid the costs of the NSFR. However, the PRA expects that similar policies will be implemented in all jurisdictions in which investment firms compete to provide these services, and firms will face the costs of adjusting to the NSFR regardless of which jurisdiction the activity is located. Any increase in costs for these services reflects the

159 For an explanation, see de-Ramon, S, Iscenko, Z, Osborne, M, Straughan, M and Andrews, P (2012), "Measuring the impact of prudential policy on the macroeconomy: a practical application to Basel III and other responses to the financial crisis" FSA Occasional Paper 42.

160 Table 15D of CP 5/13 reports net benefits of £8¼ billion per annum in 2013. Given growth in the UK economy since then, the benefits are £22 billion per annum when converted to 2019 GDP.

161 https://nimodel.niesr.ac.uk/index.php?t=0.

162 For detail of this approach, see de-Ramon, S. and Straughan, M. (2017), "The economic cost of capital: a VECM approach for estimating and testing the banking sector's response to changes in capital ratios", Bank of England Staff Working Paper No. 663 https://www.bankofengland.co.uk/-/media/boe/files/working-paper/2017/vecm-approach-for-estimating-and-testing-the-banking-sectors-response-to-changes-in-capital-ratios.pdf.

163 The impact is calculated as a percentage of nominal GDP. These figures are calibrated for comparison to UK 2019 nominal GDP of £2.2 trillion.

pricing in of risks that otherwise would not be addressed, so should improve risk management practice more generally in the economy.

17.71 It has not been possible to estimate the opportunity costs to the broader economy of changes affecting investment firms. In addition to uncertainty over the net effect of both the SA-CCR and NSFR proposals, the likely pass-through of any costs from investment firms to non-financial firms in the economy is difficult to measure.

Appendices

1 Draft amendments to SS15/13 'Groups

2 Draft amendments to SS12/13 'Counterparty Credit Risk'

3 Draft amendments to Statement of Policy 'The PRA's methodologies for setting Pillar 2 capital'

4 Draft amendments to SS16/13 'Large exposures'

5 Draft amendments to Supervisory Statement 24/15 'The PRA's approach to supervising liquidity and funding risks'

6 Draft amendments to SS2/19 'PRA approach to interpreting reporting and disclosure requirements and regulatory transactions forms after the UK's withdrawal from the EU'

7 Draft amendments to SS34/15 'Guidelines for completing regulatory reports'

8 Draft Statement of Policy 'Liquidity and funding permissions'

9 Draft PRA Rulebook (CRR) Instrument 2021

10 Draft PRA Rulebook: CRR Firms: (CRR 2 Revocations and other amendments) Instrument 2021

11 Draft PRA Standards Instrument: The Technical Standards (Definition of Capital) Instrument 2021

12 Detailed analysis of objectives and 'have regards'

13 Draft updates to reporting templates and instructions