

Policy Statement | PS14/18

# Changes to the PRA's large exposures framework

June 2018



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## 1 Overview

1.1 This Prudential Regulation Authority (PRA) Policy Statement (PS) provides feedback to responses to Consultation Paper (CP) 20/17 'Changes to the PRA's large exposures framework'.<sup>1</sup>

1.2 It contains updates to:

- PRA rules on Large Exposures and Regulatory Reporting (Appendix 1);
- Supervisory Statement (SS) 16/13 'Large exposures' (Appendix 2); and
- SS34/15 'Guidelines for completing regulatory reports' (Appendix 3).

1.3 This PS also contains a simplified worked example of the application of the large exposures (LE) limits at the level of the UK consolidated group when the firm has a Non-core large exposures group (NCLEG) permission (Appendix 4).

1.4 This PS is relevant to PRA-authorised UK banks, building societies, PRA-designated UK investment firms and their qualifying parent undertakings, which for this purpose comprise financial holding companies and mixed financial holding companies, as well as credit institutions, investment firms and financial institutions that are subsidiaries of these firms, regardless of their location.

### Background

1.5 In CP20/17, the PRA proposed to:

- provide additional guidance in SS16/13 on how the PRA will assess whether the conditions for granting intragroup permissions have been satisfied;
- limit a firm's exposures to its NCLEG entities to 100% of the firm's own eligible capital. This would replace the current limit for firms with Core UK group (CUG) permissions, which is based on the aggregate eligible capital of all CUG members ('CUG eligible capital');
- amend the LE limit at the UK consolidated level in cases where firms have an NCLEG permission. This change would exempt from the LE limit at the UK consolidated level a firm's exposures to NCLEG entities in the wider group (entities outside the UK consolidated group). All other exposures from the UK consolidated group to group entities outside of the UK consolidated group remain subject to the limit as per CRR Article 395(1) ('LE limits').
- allow firms to apply to the PRA to exempt from the LE limits intragroup exposures that meet the Bank of England's criteria for internal minimum requirement for own funds and eligible liabilities (internal MREL).<sup>2</sup>

### Summary of responses

1.6 The PRA received five responses to CP20/17. Respondents supported the proposals to provide additional guidance in SS16/13. Most respondents agreed with the proposal to change the NCLEG limit for firms with both a CUG and an NCLEG permission and the exemption of

1 October 2017: [www.bankofengland.co.uk/prudential-regulation/publication/2017/changes-to-the-pras-large-exposures-framework](http://www.bankofengland.co.uk/prudential-regulation/publication/2017/changes-to-the-pras-large-exposures-framework).

2 June 2018: [www.bankofengland.co.uk/paper/2016/the-boes-approach-to-setting-mrel-sop](http://www.bankofengland.co.uk/paper/2016/the-boes-approach-to-setting-mrel-sop).

individual NCLEG exposures at the UK consolidated level. Some respondents sought clarity on certain aspects of these proposals.

1.7 Respondents also welcomed the proposal to exempt internal MREL exposures from LE limits to facilitate the orderly resolution of banking groups. However, they questioned the process, scope, and the timing of implementation for this exemption.

### **Changes to draft policy**

1.8 Where final rules differ from the draft in the CP in a way which is, in the opinion of the PRA, significant, the Financial Services and Markets Act 2000 (FSMA)<sup>1</sup> requires the PRA to publish:

- details of the difference together with a cost benefit analysis; and
- a statement setting out whether or not, in the PRA's opinion, the impact of the final rule on mutuals is significantly different to the impact that the draft rule would have had on mutuals; or the impact that the final rule will have on other PRA-authorized firms.

1.9 Chapter 2 sets out the PRA's feedback to responses, including some changes to the original proposals.

1.10 The PRA considers that the changes outlined in this PS make the final policy clearer and reduce the burden on firms relative to the original proposals. The PRA does not consider the changes to be significant and as a result has not updated the assessment of impact on mutuals or the cost benefit analysis from CP20/17.

### **Implementation**

1.11 The changes to the rules and expectations will take effect from Friday 29 June 2018.

1.12 The PRA proposed that firms will no longer be required to submit FSA018. As a consequence, the PRA has removed reference to this requirement from the Regulatory Reporting Part of the PRA Rulebook (Regulatory Reporting 7.1, 7.2 and 7.3, 9.2, 9.3 and 9.4, and 16.10) and updated SS34/15. Firms are still required to report exposures to their own group, which includes exposures to NCLEG entities, on an individual basis in COREP002.

1.13 The policy contained in this PS has been designed in the context of the current UK and EU regulatory framework. The PRA will keep the policy under review to assess whether any changes would be required due to changes in the UK regulatory framework, including changes arising once any new arrangements with the European Union take effect.

## **2 Feedback to responses**

2.1 The PRA is required by FSMA to have regard to any representations made to the proposals in a consultation, and to publish an account, in general terms, of those representations.

2.2 The sections below set out the PRA's feedback to responses and final decisions. They have been structured along the same lines as the chapters of the CP, as follows:

- additional guidance for intragroup permissions;

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<sup>1</sup> Section 138J(5) and 138K(4).



- application of NCLEG permissions at a solo and UK consolidated level;
- exemption of resolution exposures from LE limits; and
- other responses.

### **Additional guidance for intragroup permissions**

#### **Attestation by senior management**

2.3 The PRA proposed that firms should submit an attestation from senior management that there are no practical or legal impediments to funds transferability or repayment of liabilities between group entities and the firm.

2.4 Three respondents asked for clarification whether attestations of senior management were necessary in cases where firms already provide capital maintenance agreements.

2.5 One respondent questioned the rationale for focusing on impediments to the transfer of capital, and proposed focusing on transfer of debt and other intragroup exposures instead. This respondent also proposed replacing legally binding capital maintenance agreements (a requirement that is already in place) and the proposed attestations, with attestations of a different form, citing high costs of formalising cross-border arrangements and lower levels of regulatory relief associated with NCLEG status compared to CUG status. The respondent disagreed with the scope of the proposed attestations, on the basis that such requirement was super-equivalent to the Capital Requirements Regulation (575/2013) (CRR). Another respondent proposed modifying the proposed attestation to exclude both Financial Conduct Authority (FCA)-authorised and PRA-regulated firms from this requirement on the basis that they are subject to capital requirements.

2.6 Entities that provide a legally binding agreement as per Section 2 - CRR Article 113 (6): core UK group applications (paragraph 2.8) of SS16/13 do not need to provide an attestation as set out in paragraph 2.11. The PRA has updated paragraph 2.11 to make this clear. The word 'material' has also been included in paragraph 2.11 when referring to 'practical or legal impediments' to align with the language in CRR. The PRA considers that this attestation to transfer funds may be limited to funds in excess of an entity's capital requirements.

2.7 The PRA does not consider requiring NCLEG entities to meet the same conditions as for CUG permissions as super-equivalent to the CRR but necessary to meet the conditions in Article 400(3)(a) in order for the PRA, as the competent authority, to grant these permissions.

#### **Impediment to the prompt transfer of own funds or repayment of liabilities**

2.8 One respondent questioned whether there was policy consistency between (i) the expectations in paragraph 2.11 of SS16/13, that call for an attestation that there are no impediments to the transfer of funds or repayment of liabilities to be provided by the parent undertaking and the relevant group entities; and (ii) the expectations related to reporting inflows under stress in Section 3: Stress testing, scenario analysis and capital planning (paragraph 3.31) of SS31/15 'The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP)'.<sup>1</sup>

2.9 The PRA has not amended the expectations in SS16/13 as it does not consider them to be inconsistent with SS31/15. No impediment to the transfer of funds or repayments of liabilities

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<sup>1</sup> April 2018: [www.bankofengland.co.uk/prudential-regulation/publication/2013/the-internal-capital-adequacy-assessment-process-and-supervisory-review-ss](http://www.bankofengland.co.uk/prudential-regulation/publication/2013/the-internal-capital-adequacy-assessment-process-and-supervisory-review-ss).

is a necessary condition for granting intragroup large exposure permissions. Paragraph 3.31 of SS31/15 sets out the PRA's expectations of management to identify scenarios where capital inflows to the parent undertaking from their subsidiaries may be significantly reduced in times of stress. This may occur without any impediments to the transfer of funds or repayment of liabilities, for example, where the subsidiary is not profitable. The PRA considers that the two expectations on firms address different risks within banking groups. However, the assessment carried out in accordance with paragraph 3.31 of SS 31/15 may point to impediments to the transfer of funds or repayment of liabilities that would need to be considered in relation to intragroup large exposure permissions.

#### Current or foreseen regulatory measures or restrictions in other jurisdictions

2.10 The PRA proposed that it will consider whether specific measures or restrictions that will be or have been placed on an NCLEG member by regulatory or other bodies in the relevant jurisdiction will constitute a material impediment to the transfer of funds between group entities.

2.11 One respondent suggested that actions of regulators are difficult to predict and that this condition is overly restrictive. The respondent also requested clarity on the scope of evidence used to assess compliance with this condition.

2.12 The PRA considers that the words 'current or foreseen' used in Section 3: CRR Article 400(2)(c) - non-core large exposures group (trading book and non-trading book) (paragraph 3.2A) of SS16/13 align with the language in the CRR. The PRA expects firms to share the information they have rather than predicting overseas regulators' future actions. This may include informing the PRA if they are in discussion with a regulator that is considering imposing restrictions or whether a change in circumstance is likely to lead to regulatory restrictions.

#### Risk evaluation, measurement and internal control procedures

2.13 The PRA proposed providing firms with a non-exhaustive list of factors the PRA can use to assess compliance with the condition that group entities included in an intragroup permission have to be subject to the same risk evaluation, measurement and internal control processes as the firm.

2.14 One respondent asked for clarification of the scope of evidence used to assess that group entities are subject to similar rather than the same procedures as the firm. Another respondent asked whether the assessment of this condition could be broadened to emphasise the outcomes of these processes rather than the processes themselves. A third respondent also asked for clarity on the PRA's expectations on the scope of evidence required in policy areas which are yet to be finalised, such as ring-fencing (also known as structural reform).

2.15 The PRA is not considering any changes to the non-exhaustive list of factors listed in paragraph 2.5A of SS16/13. The language used in SS16/13 aligns with the language in the CRR. Risk evaluation, measurement and control processes will differ across banking groups and the non-exhaustive list aims to provide a general guideline on how the PRA will assess whether this condition is met. It remains up to the firm to consider its own risk management procedures and provide evidence of how this condition is met.

2.16 The PRA will give due consideration to the fact that firms may be undergoing ring-fencing. Firms should provide the best possible information on the processes that will be put in place to ensure that newly established entities will meet the conditions.

#### The PRA's wider judgement

2.17 The PRA proposed that in exercising its wider judgement when granting CUG or NCLEG permissions even when all CRR conditions are met, it will consider whether group entities are 'strongly incentivised to support each other'. One respondent asked for clarification of what the PRA means by, or expects as evidence to demonstrate, this condition.

2.18 The PRA will consider the group as a whole when granting CUG or NCLEG permissions. This judgement will be based on the specific circumstances of a firm and its group. For instance, the PRA will assess whether granting the intragroup permissions negatively impacts the banking group's recovery and resolution strategy.

### **Application of NCLEG permissions at a solo and UK consolidated level**

2.19 Most respondents were supportive of policy proposals to modify the NCLEG calibration basis for firms that have both CUG and NCLEG permissions.

2.20 Three respondents asked for clarification of the firm to be used for the notification requirement in Large Exposures 2.3 in the PRA Rulebook where there is more than one PRA firm in the CUG.

2.21 PRA firms with NCLEG permissions, at an individual level, will measure and report their exposures to NCLEG entities in relation to their own eligible capital. However, where more than one PRA firm is included in the same CUG permission, the PRA has clarified that the notification requirement in Large Exposures 2.3 in the PRA Rulebook is based on eligible capital of the PRA firm in the CUG with the largest eligible capital base.

2.22 One respondent objected to limiting a firm's exposures to its NCLEG by reference to the firm's individual eligible capital and considered that the NCLEG limits should also apply at the UK consolidated level. They suggested that the reduction in the NCLEG limit would increase the amount of trading book exposures that will be subject to additional capital requirements without a change in its risk profile; and that the policy proposals were not consistent with the principle that capital is fungible within a CUG. Another respondent agreed that, for firms in excess of the new proposed limit, eligible credit risk mitigation techniques could be applied to bring exposures within the new proposed limits.

2.23 The PRA considers that the policy principle that resources should be located close to risks also extends to the LE framework. Accordingly, only the eligible capital base of the individual firm to which the intragroup permission applies should be considered when determining the relevant large exposures limit at the individual level. Firms that exceed the LE limits for exposures in the trading book as per CRR Article 395(6) carry additional risks and the additional own fund requirements are necessary to mitigate these risks.

2.24 The PRA granted NCLEG permission to individual firms and these permissions did not apply at the consolidated level. The PRA has, on a case-by-case basis allowed NCLEG exposures from firms to their NCLEG entities to be exempt from the LE limit which applies to these aggregate exposures at the consolidated level. The proposals in CP20/17 were intended to extend the ability to exempt these exposures at the consolidated level to all firms.

2.25 One respondent also suggested that incentives to apply eligible credit risk mitigation for firms impacted by the proposals could increase opacity of group structures as well as increase operational risk.

2.26 Eligible credit risk mitigation is allowed in accordance with CRR Article 399 to 403 for all exposures. The PRA considers that the proposals simplify the intragroup large exposure framework while promoting the safety and soundness of PRA authorised firms.

2.27 One respondent asked for worked examples of calculations for the NCLEG exemptions at the individual level and at the UK consolidated group level for firms with and without a CUG permission. The policy proposals mean that firms will calculate their total exposure to their NCLEG regardless of whether they have a CUG permission. A simplified worked example of how this applies at the consolidated level is provided in Appendix 4.

### **Exemption of resolution exposures from LE limits**

2.28 Respondents welcomed the exemption of intragroup exposures arising from internal MREL from LE limits. However, some questioned the process, scope and implementation timeline for this exemption.

#### **Application process and scope**

2.29 The PRA proposed that firms can apply to the PRA to exempt from LE limits intragroup exposures, identified and reported as internal MREL. This would be similar to the process for allowing CUG and NCLEG permissions.

2.30 One respondent asked for an automatic exemption of internal MREL from LE limits and questioned the rationale for a formal application process.

2.31 After further consideration of the PRA rules and SS16/13, the PRA has modified Large Exposures 1.2 and 2.4 in the PRA Rulebook to exclude exposures defined as 'Resolution exposures' from LE limits. This removes the need for a formal application process. The PRA has also set out its expectations of firms for the resolution exemption in Section 6 of SS16/13.

2.32 The PRA proposed defining an internal MREL exposure as an exposure that meets the eligibility criteria for internal MREL set out in the Bank of England's Statement of Policy.<sup>1</sup>

2.33 One respondent asked the PRA to expand the definition of exempt exposures beyond the Bank of England's eligibility criteria to include similar instruments issued by foreign subsidiaries. Another respondent asked that this exemption apply to all senior exposures to material subsidiaries, not only internal MREL exposures.

2.34 The PRA has changed the definition of resolution exposures as specified in Large Exposures 1.2. Any exposures that meet the same eligibility criteria will be excluded from the LE limit.

2.35 Intragroup exposures remain subject to LE reporting requirements, whether or not they are exempted from CRR Article 395(1). As set out in SS16/13, firms are expected to notify the PRA if exposures excluded pursuant to the resolution exemption in the Large Exposures Part of the PRA Rulebook are not included in the firm's MREL reporting templates as specified in SS19/13 'Resolution Planning'.<sup>2</sup>

2.36 The PRA has also clarified in Section 6 - Resolution exposures of SS16/13 that when assessing whether exposures are resolution exposures as defined in the Large Exposures Part of the PRA Rulebook, a firm should give due consideration to whether resolution liabilities

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1 June 2018: [www.bankofengland.co.uk/paper/2018/boes-approach-to-setting-mrel-2018](http://www.bankofengland.co.uk/paper/2018/boes-approach-to-setting-mrel-2018).

2 June 2018: [www.bankofengland.co.uk/prudential-regulation/publication/2018/resolution-planning-mrel-reporting](http://www.bankofengland.co.uk/prudential-regulation/publication/2018/resolution-planning-mrel-reporting).

have been recognised by relevant resolution authorities. This could have an impact on whether resolution liabilities ensure that losses can be absorbed and passed from the firm to its resolution authority. Where firms have exposures to liabilities that are recognised by the relevant resolution authorities but do not meet the criteria in the PRA Rules to qualify for a resolution exemption, firms may wish to get in touch with their usual supervisory contact.

### **Other responses**

#### **Cost benefit analysis**

2.37 Two respondents questioned the interaction of policy proposals with upcoming changes in 'Capital Requirements Regulation II' (CRR II). One respondent questioned the ease of using guaranteed exposures as eligible credit risk mitigation with minimal costs, given that this could add to capital requirements under CRR II. Another respondent questioned the impact of the Internal Model Method (IMM) not being allowed for large exposure measures, and of the restriction of eligible capital for large exposures to Tier 1 capital only.

2.38 The PRA conducted its impact assessment accounting for possible future developments in the international regulatory framework. The estimated impact on trading-book exposures using the Standardised Approach for Counterparty Credit Risk (SA-CRR) method versus the IMM as well as limiting the eligible capital is relevant for all exposures and not just limited to intragroup exposures. As with all international policy changes, the PRA will monitor its current policy and make adjustments where appropriate.

#### **Sovereign large exposures exemption**

2.39 One respondent suggested removing reference to the PRA's expectations relating to intragroup support arrangements and the firm's business model that were listed under the conditions assessed for granting sovereign large exposures exemptions.

2.40 The PRA has removed this reference in Section 4: CRR Article 400 (2)(g) and (h) - sovereign large exposures exemption (paragraph 4.4) of SS16/13 as it was not relevant for exposures to central banks and central governments.

## Appendices

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- 1** PRA RULEBOOK: CRR FIRMS: LARGE EXPOSURES AMENDMENT INSTRUMENT 2018, available at: [www.bankofengland.co.uk/prudential-regulation/publication/2017/changes-to-the-pras-large-exposures-framework](http://www.bankofengland.co.uk/prudential-regulation/publication/2017/changes-to-the-pras-large-exposures-framework)

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  - 2** SS16/13 UPDATE 'Large Exposures', available at: [www.bankofengland.co.uk/prudential-regulation/publication/2013/large-exposures-ss](http://www.bankofengland.co.uk/prudential-regulation/publication/2013/large-exposures-ss)

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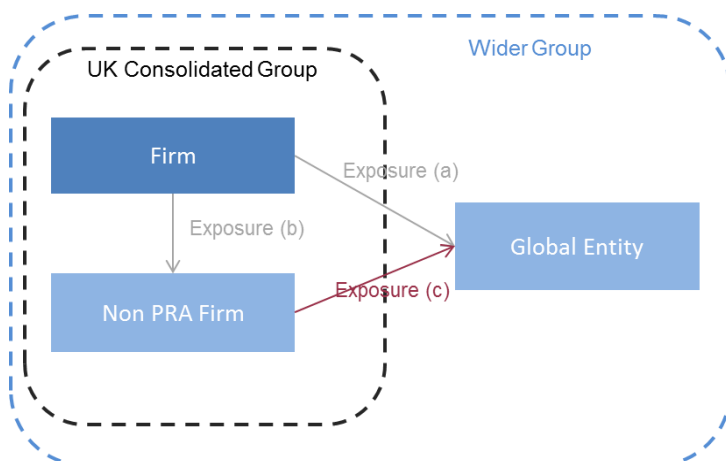
  - 3** SS34/15 UPDATE 'Guidelines for completing regulatory reports', available at: [www.bankofengland.co.uk/prudential-regulation/publication/2015/guidelines-for-completing-regulatory-reports-ss](http://www.bankofengland.co.uk/prudential-regulation/publication/2015/guidelines-for-completing-regulatory-reports-ss)

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  - 4** Example of application of the LE limit at the level of the UK consolidated group when the firm has an NCLEG permission

## Appendix 4: Application of the LE limit at the level of the UK consolidated group when the firm has an NCLEG permission

Figure 1: The firm has an NCLEG non-trading book permission that includes the non-PRA firm in the UK consolidation group and the Global entity in its wider group



1. At the level of the UK consolidated group, the aggregate exposures of all entities in the UK consolidated group to all entities in its wider group are limited to 25% of the UK consolidated group's eligible capital ("UK Group LE limit").
2. If a firm has an NCLEG permission, the exposures from the firm to NCLEG entities in its wider group are exempt from the UK Group LE limit. This refers to exposure (a) in the example above.
3. This means that at the UK consolidated group level, only exposure (c) will be subject to the UK Group LE limit.
4. In this example, it is assumed that 25% of the UK Group's eligible capital is higher than EUR 150 million and hence, does not take into account scenarios where some firms may have a higher LE limit to institutions as set out in Article 395 (1).
5. The application of LE limits to trading book exposures has not been depicted in this example. If the firm does not have an NCLEG trading book permission, trading book exposures to the Global entity remains subject to the UK Group limit provided conditions in CRR Article 395 are met. Where a firm does have an NCLEG trading book permission, exposures in excess of its trading book exposure allocation also remain subject to additional own funds requirements in CRR Article 395(5)(b).
6. Firms should consider their individual circumstances and group structures when ensuring they comply with the relevant LE limits at the solo and UK consolidated level.