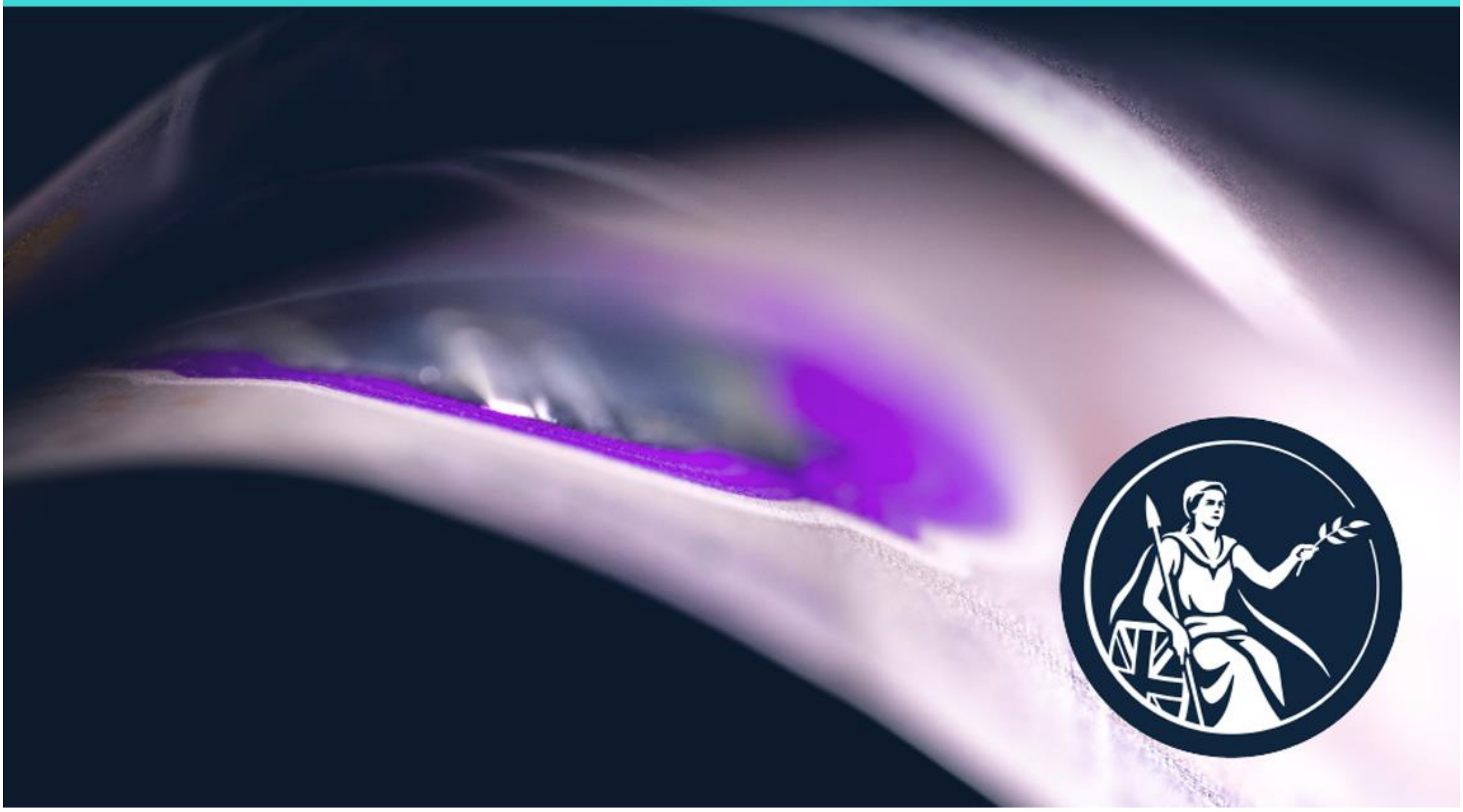
Bank of England

Prudential Regulation Authority

Appendices to CP12/22 Risks from contingent leverage

Consultation Paper | CP12/22

October 2022



Contents

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1. Draft amendments to Supervisory Statement 31/15 'The Internal Capital Adequacy Assessment Process (ICAAP)'

In this appendix, new text is underlined and deleted text is struck through.

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2 Expectations of firms undertaking an ICAAP

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Risk of excessive leverage

2.43 The PRA expects firms to carry out an assessment of the risk of excessive leverage. This is defined as the risk resulting from a firm's vulnerability to leverage or contingent leverage that may require unintended corrective measures to its business plan, including distressed selling of assets which might result in losses or in valuation adjustments to its remaining assets.

2.44 In carrying out their assessment, firms should consider any contingent leverage risk in transactions and trade structures that receive lower leverage ratio exposure measure values than other economically similar transactions. Examples include:

- agency models to transact in security financing transactions (SFTs) or derivatives, SFT netting packages, collateral swaps, and unsecured borrowing or lending of securities;
- internalised derivative positions (including written credit derivatives, equity swaps and total return swaps);
- any other trade structures that have a lower leverage ratio exposure value than economically similar trades.

2.45 The extent to which firms can use these more capital efficient forms of trades may be limited in certain conditions, for example, in the event of the default of counterparties, the movement of certain market parameters, or changes to broader market conditions. For example:

- Netting: a client may withdraw or default from one leg of a transaction that is netted, or one-directional markets in stress could lead to a lack of availability of netting opportunities. If the firm cannot find or replace that transaction, this may result in loss of netting and an increase in the total exposure measure for the purposes of the leverage ratio.

- Internalisation: a client may withdraw or default from one leg of a transaction that is internally offset for hedging purposes. If the firm cannot replace the offsetting leg, the firm may use a cash hedge for the remaining leg of the transaction, increasing its total leverage exposure. In the case of written credit derivatives (in line with 'Article 429d' of the 'Leverage Ratio (CRR)' Part of the PRA Rulebook), the loss of an offsetting leg may result in the loss of conditions that allow the firm to internalise the effective notional amount of the credit derivative, and increase a firm's total exposure.

- Collateral swaps: some lower-quality forms of collateral may become less available in certain market conditions, and firms may have to replace the affected collateral swaps with other forms of financing.

2.46 Firms should consider the extent to which they would need, and be able, to continue to participate in these trades and the extent to which they would instead need to use economically similar transactions or structures that receive higher leverage ratio exposure measure values. Firms should consider the impact this might have on their leverage ratio and other regulatory measures (such as liquidity or risk-weighted metrics) as relevant.

2.47 Continued exposure to transactions or trade structures which receive lower leverage ratio exposure measure values may arise from a variety of reasons, including contractual obligations, franchise considerations, liquidity management, or other commercial reasons. To the extent that firms would not continue to participate in such trades in certain circumstances, firms should consider what implications this might have for their revenues. Examples of risks and assumptions that firms should pay particular consideration to include, but are not limited to:

- Contractual obligations: firms may be contractually obliged to maintain transactions with certain counterparties, even in circumstances where doing so might be detrimental to the firm's leverage ratio position.

- Franchise risk: firms, especially prime brokers, often offer their services to maintain a franchise value with their clients in addition to the revenues generated directly by the business activity. As such, a firm may roll over funding transactions at a client's request even in circumstances where doing so might be detrimental to the firm's leverage ratio position.

- Liquidity management: firms should consider the extent to which they may be able to maintain their funding without having to replace their transactions or trade structures with others that receive higher leverage ratio exposure measure values, such as secured borrowing.

2.48 As part of their ICAAP responses, firms should set out contingent leverage risks by each relevant trade structure that optimises leverage exposure.

2. Draft amendments to the 'Reporting (CRR)' Part of the PRA Rulebook

PRA RULEBOOK: CRR FIRMS: LEVERAGE RATIO INSTRUMENT [2023]

Powers exercised

A. The Prudential Regulation Authority ("PRA") makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 ("the Act"):

(1) section 137G (The PRA's general rules);
(2) section 137T (General supplementary powers);
(3) section 144G(1) (Disapplication or modification of CRR rules);
(4) section 144H(1) and (2) (Relationship with the CRR);
(5) section 192XA (Rules applying to holding companies); and
(6) section 192XC (Disapplication or modification of rules in individual cases).

B. The rule-making powers referred to above are specified for the purpose of section 138G(2) (Rule-making instrument) of the Act.

Pre-conditions to making

C. In accordance with sections 144C(3) and 144E of the Act the PRA consulted the Treasury about the likely effect of the rules on relevant equivalence decisions within the meaning of section 144C(4) of the Act.

D. In accordance with section 138J of the Act (Consultation by the PRA), the PRA consulted the Financial Conduct Authority.

E. The PRA published a draft of the proposed rules in accordance with section 138J(1)(b) of the Act, accompanied by the information listed in section 138J(2) and the explanation referred to in section 144D of the Act insofar as that section is applicable to the rules.

F. After consulting, the PRA published a draft of proposed rules and had regard to representations made.

PRA Rulebook: CRR FIRMS: LEVERAGE RATIO INSTRUMENT [2023]

The PRA makes the rules in the Annex to this instrument.

Commencement

G. This instrument comes into force on [date].

Citation

H. This instrument may be cited as the PRA Rulebook: CRR Firms: Leverage Ratio (CRR) Instrument [2023]

By order of the Prudential Regulation Committee
[DATE]

Annex

Amendments to the Reporting (CRR) Part

In this Annex, new text is underlined and deleted text is struck through.

1. APPLICATION

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1.2 In this Part, the following definitions shall apply:

additional leverage reporting requirements

means the requirements specified in:

(a) paragraphs (2) and (2A) of Article 430 of Chapter 4;~~ and~~

(b) paragraphs 14a and 14b of Part II of Annex XI of Chapter 6~~.~~<u>;and</u>

<u>(c) templates LV49 to LV 52 in Annex X of Chapter 6.</u>

…

5. REPORTING REQUIREMENTS

…

CHAPTER 7 FORMAT AND FREQUENCY OF REPORTING ON THE LEVERAGE RATIO ON AN INDIVIDUAL AND A CONSOLIDATED BASIS

1. In order to report information on the *leverage ratio* and the *countercyclical leverage ratio buffer* in accordance with point (a) of Article 430(1) of ~~the~~ Chapter 4 and, for *LREQ firms*, the information specified in Article 430(2) and (2A) of Chapter 4, institutions shall submit the information specified in Annex X of Chapter 6 ~~i~~n accordance with the instructions in Annex XI of Chapter 6, with a quarterly reporting frequency<u> (except in the case of Templates LV49.00 to LV 52.00 in Annex X of Chapter 6 where the frequency shall be six monthly)</u> and on the basis required by Chapter 2 of this Chapter.

…

6. TEMPLATES AND INSTRUCTIONS

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6.254 Annex X Template LV 47.00 can be found **here.**

<u>6.254A Annex X Template LV49.00 can be found here.</u>

<u>6.254B Annex X Template LV50.00 can be found here.</u>

<u>6.254C Annex X Template LV51.00 can be found here.</u>

<u>6.254D Annex X Template LV52.00 can be found here.</u>

…

7. FORMAT AND FREQUENCY OF REPORTING ON THE LEVERAGE RATIO ON AN INDIVIDUAL AND CONSOLIDATED BASIS

Article 15 Format and Frequency of Reporting on the Leverage Ratio on an Individual and a Consolidated Basis

…

1. In order to report information on the *leverage ratio* and the *countercyclical leverage ratio buffer* in accordance with point (a) of *Article 430(1)* of ~~the~~ *Chapter 4* and, for *LREQ firms*, the information specified in *Article 430(2)* and *(2A)* of *Chapter 4*, institutions shall submit the information specified in *Annex X* of *Chapter 6*~~, with a quarterly frequency and~~ in accordance with the instructions in *Annex XI* of *Chapter 6*~~,~~.and with a quarterly reporting frequency, except in the case of Templates LV49.00 to LV 52.00 in *Annex X* of *Chapter 6* where the frequency shall be six monthly.

3. Draft reporting templates (LV49.00-LV52.00)

Table LV49.00: Treatment of collateral swaps

		Column			
		Market value of collateral lent (period end)	Market value of collateral borrowed (period end)	Market value of collateral lent (period average)	Market value of collateral borrowed (period average)
Row		0010	0020	0030	0040
0010	**TOTAL COLLATERAL SWAPS**				
0020	of which client financing				
0030	of which activity for franchise clients				
0040	of which intra-group activity				
0050	**of which: Totals for transactions in which Level 1 HQLAs are lent and the following collateral is borrowed**				
0060	Level 1 assets				
0070	Level 2A assets				
0080	Level 2B assets				
0090	Non-liquid assets				
0100	**of which: Totals for transactions in which Level 2A HQLAs are lent and the following collateral is borrowed**				
0110	Level 1 assets				
0120	Level 2A assets				
0130	Level 2B assets				
0140	Non-liquid assets				
0150	**of which: Totals for transactions in which Level 2B HQLAs are lent and the following collateral is borrowed**				
0160	Level 1 assets				
0170	Level 2A assets				
0180	Level 2B assets				
0190	Non-liquid assets				
0200	**of which: Totals for transactions in which non-liquid assets are lent and the following collateral is borrowed**				
0210	Level 1 assets				
0220	Level 2A assets				
0230	Level 2B assets				
0240	Non-liquid assets				

Table LV50.00: Treatment of repurchase transactions

		Column					
		Gross repo (period end)	Netted amounts (period end)	Net repo (period end)	Gross repo (period average)	Netted amounts (period average)	Net repo (period average)
Row		0010	0020	0030	0040	0050	0060
0010	**Total repo activity**						
0020	of which activity for franchise clients						
0030	of which level 1 HQLA						
0040	of which intra-group activity						

Table LV51.00: Treatment of agency repurchase transactions

		Column					
		Total loan from lender to borrower (period end)	Collateral provided to lender by borrower (period end)	Contribution to Leverage Exposure Measure (period end)	Total loan from lender to borrower (period average)	Collateral provided to lender by borrower (period average)	Contribution to Leverage Exposure Measure (period average)
Row		0010	0020	0030	0040	0050	0060
0010	Agency repo activity in which agent provides a limited guarantee						
0020	Agency repo activity in which agent provides no guarantee						

Table LV52.00: Treatment of internalised trades

		Column					
		Gross market value (period end)	Internalised (period end)	Contribution to Leverage Exposure Measure (period end)	Gross market value (period average)	Internalised (period average)	Contribution to Leverage Exposure Measure (period average)
Row		0010	0020	0030	0040	0050	0060
0010	**Cash prime brokerage**						
0020	of which activity for franchise clients						
0030	of which level 1 HQLA						
0040	of which intra-group activity						
0050	**Synthetic prime brokerage**						
0060	of which activity for franchise clients						
0070	of which level 1 HQLA						
0080	of which intra-group activity						
0090	**Written credit derivatives**						
0100	of which activity for franchise clients						
0110	of which level 1 HQLA						
0120	of which intra-group activity						

4. Draft amendments to the 'Instructions for reporting on leverage'

In this appendix, new text is underlined and deleted text is struck through.

PART I: GENERAL INSTRUCTIONS

…

1.1. Structure

1. This Annex contains additional instructions for the templates (hereinafter "LR") included in Annex X of this Regulation.

2. Overall, the framework consists of ~~five~~ nine templates:

- LV47.00: Leverage Ratio Calculation (LRCalc): Leverage ratio calculation;
- LV40.00: Leverage Ratio Template 1 (LR1): Alternative treatment of the exposure measure;
- LV41.00: Leverage Ratio Template 2 (LR2): On- and off-balance sheet items – additional breakdown of exposures;
- LV43.00 Leverage Ratio Template 4 (LR4): Alternative breakdown of leverage ratio exposure measure components; ~~and~~
- LV44.00: Leverage Ratio Template 5 (LR5): General information.
- LV49.00: Leverage Ratio Template 6 (LR6): Treatment of collateral swaps;
- LV50.00: Leverage Ratio Template 7 (LR7): Treatment of repurchase transactions;
- LV51.00: Leverage Ratio Template 8 (LR8): Treatment of agency repurchase transactions; and
- LV52.00: Leverage Ratio Template 9 (LR9): Treatment of internalised trades.

…

2a. Additional reporting requirements for *LREQ firms*

14.a In order to reduce the reporting burden for institutions not in scope of the UK leverage ratio capital requirement, only *LREQ firms* shall report templates LV49.00, LV50.00, LV51.00 and LV52.00, on a six-monthly basis at the applicable reporting reference dates (30 June and 31 December). ~~in template LV47.00 only *LREQ firms* shall report averages over the reporting quarter in column 0020, quarter lows in column 0030 and quarter highs in column 0040. All other institutions shall leave these columns blank.~~

14.b In addition, in template LV47.00 only *LREQ firms* shall report rows 0530-0570, and averages over the reporting quarter in column 0020, quarter lows in column 0030 and quarter highs in column 0040. All other institutions shall leave these rows blank.

14.c In templates LV49.00, LV50.00, LV51.00 and LV52.00, the following definitions apply.

- *Period end*: The relevant data elements as calculated at the reporting reference date.
- *Period average*: For on-balance sheet assets and securities financing transactions, the arithmetic mean of the relevant data element on each day in the half-year period ending on the relevant reporting reference date. For off-balance sheet items, the arithmetic mean of the relevant data element on the last day of each month in the half-year period ending on the relevant reporting reference date.
- *Total exposure measure*: The meaning provided in Article 429(4) of Chapter 3 of the Leverage Ratio (CRR) Part of the PRA Rulebook.
- *Franchise clients:* those clients to whom funding extensions are granted at a client's request even in circumstances where doing so might be detrimental to the firm's leverage ratio position.

…

7. LV 49.00 – Treatment of collateral swaps

29. Collateral swaps are transactions in which non-cash assets are swapped for other non-cash assets.

30. In this table, the following column definitions apply:

- *0010 / 0030 - Market value of collateral lent (period end / period average)* – The period end or period average, as applicable to each column, current market value of collateral lent, gross of any haircut.
- *0020 / 0040 - Market value of collateral borrowed (period end / period average)* – The period end or period average, as applicable to each column, current market value of collateral borrowed, gross of any haircut.

31. In this table, the following row definitions apply:

- *0010 - Total collateral swaps* – Calculates the aggregate collateral lent and borrowed in all collateral swap transactions.
- *0020 - of which client financing* – Report the collateral swaps activity that is used for client focused purposes, such as: (i) sourcing collateral to meet firm obligations to clients, or (ii) sourcing collateral to cover client and firm shorts. This should not include collateral swaps entered into for the firm's own liquidity needs.
- *0030 – of which activity for franchise clients* – Report the collateral swaps activity done with franchise clients.
- *0040 - of which intra-group activity* – Report the collateral swaps activity done with other entities within the group, which do not fall within the consolidated situation relevant to the firm specified in rule 2.8 of the Reporting (CRR) Part of the PRA Rulebook.
- *0050 to 0240 - of which: Totals for transactions in which [asset quality type] are lent and the following collateral is borrowed* – Report the aggregate collateral borrowed for each category of collateral lent.

32. For rows 0060-0090, 0110-0140, 0160-0190 and 0210-0240, apply the asset class categories as defined in Article 3 of Chapter 1 of the Liquidity Coverage Ratio (CRR) Part of the PRA Rulebook: Level 1 assets, Level 2A assets, Level 2B assets, and non-liquid assets.

8. LV 50.00 – Treatment of repurchase transactions

33. Repurchase transactions are transactions governed by a repurchase agreement or a reverse repurchase agreement involving the exchange of cash.

34. In this table, the following column definitions apply:

- *0010 / 0040 - Gross repo (period end / period average):* Report period end or period average, as applicable to each column, total gross value of repurchase transactions (with no recognition of netting).
- *0020 / 0050 - Netted amounts (period end / period average)*: Report the period end or period average, as applicable to each column, amounts of cash payables and cash receivables of repurchase transactions that have been measured on a net basis for the purposes of calculating the leverage ratio total exposure measure.
- *0030 / 0060 Net repo (period end / period average):* Calculates the period end or period average repo activity, as applicable to each column, recognising netted amounts.

35. In this table, the following row definitions apply:

- *0010 - Total repo activity:* Report the total gross and netted activity of repurchase transactions.
- *0020 – of which activity for franchise clients* – Report repurchase transactions activity done with franchise clients.
- *0030 - of which level 1 HQLA* – Report repo activity in which the collateral lent or borrowed is classified as level 1 HQLA.
- *0040 - of which intra-group activity* – Report the repurchase transaction activity done with other entities within the group, which do not fall within the consolidated situation relevant to the firm specified in rule 2.8 of the Reporting (CRR) Part of the PRA Rulebook.

9. LV 51.00 – Treatment of agency repurchase transactions

36. Agency repurchase transactions are transactions where a firm acts as an agent between two parties in a repurchase agreement or a reverse repurchase agreement involving the exchange of cash.

37. In this table, the following column definitions apply:

- *0010 / 0040 - Total loan from lender to borrower (period end / period average):* Report the period end or period average, as applicable to each column, total amount lent in any agency repurchase transactions.

- *0020 / 0050 - Collateral provided by borrower to lender (period end / period average):* Report the period end or period average, as applicable to each column, total amount of collateral provided in return for the amount lent. The value of securities should be calculated as the current market value of collateral lent, gross of any haircut.
- *0030 / 0060 - Contribution to agent's leverage exposure measure (LEM) (period end / period average):* Calculates the period end or period average, as applicable to each column, counterparty credit risk add-on for the transaction, which will be reflected in the agent's total leverage exposure measure. This should be the difference between the total loan and the amount of collateral provided in return, as defined above (and floored at zero).

38. In this table, the following row definitions apply:

- *0010 - Agency repo activity in which agent provides a limited guarantee* – Report the total agency repurchase transaction activity in which the firm is acting as an agent and providing a guarantee to the lender limited to any difference between the value of the security and the value of collateral, in line with part (a) of Article 429e(7) of Chapter 3 of the Leverage Ratio (CRR) Part of the PRA Rulebook.
- *0020 - Agency repo activity in which agent provides no guarantee* – Report the total agency repurchase transaction activity in which the firm is acting as an agent and providing no guarantee to the lender limited to any difference between the value of the security and the value of collateral, in line with part (b) of Article 429e(7) of Chapter 3 of the Leverage Ratio (CRR) Part of the PRA Rulebook.

10. LV 52.00 – Treatment of internalised trades

39. For the purpose of this reporting table, internalised trades captures any trades carried out in a firm's prime brokerage business or defined as a written credit derivative.

40. In this table, the following column definitions apply:

- *0010 / 0040 - Gross market value (period end / period average):* Report the period end or period average, as applicable to each column, gross amounts of financing provided under each financing type. Where a firm has financed the assets of one client by internally netting them against the short sale proceeds of another client and where different financing transactions have been used for the respective legs, firms should list the two legs broken out into their constituent parts. For written credit derivatives, firms should not include any purchases of credit protection.
- *0020 / 0050 - Internalised (period end / period average):* Report the period end or period average, as applicable to each column, *value* of internalised amounts achieved by offsetting opposing client positions, whether the same form of financing is used on both legs (e.g. margin loan) or two different forms of financing are used (e.g. long margin loan, short total return swap). This should include client-to-client and client-to-dealer

forms of internalisation, as well as indirect internalisation utilising any off-balance sheet form of hedging or financing.

  - For cash prime brokerage, *value* should be interpreted as the market value of the securities pledged in clients' prime brokerage accounts, which are financed by long margin loans that are internalised;
  - For synthetic prime brokerage, *value* should be interpreted as the notional value of derivatives representing client long positions (i.e. the market value of the underlying reference asset/s of the derivatives) that are internalised;
  - For written credit derivatives, *value* should be interpreted as the effective notional of sold credit protection referenced as per Article 429d of Chapter 3 of the PRA Rulebook that is internalised.

- *0030 / 0060 - Contribution to leverage exposures (period end / period average):* Report the period end or period average, as applicable to each column, net contribution to the firm's total leverage exposure measure. This should reflect both the amount of financing provided and any hedging assets purchased / collateral management activity.

41. In this table, the following row definitions apply:

- *0010 - Cash prime brokerage:* The financing of client positions through cash margin loans and other cash-based products.
- *0050 - Synthetic prime brokerage:* The financing of client positions via total return swaps or all other (non-credit) derivatives.
- *0090 – Written credit derivatives:* The credit protection purchased or sold via a credit derivative that creates a notional credit exposure related to the creditworthiness of a reference entity.
- *0020, 0060, 0100 – of which activity for franchise clients* – Report activity done with franchise clients.
- *0030, 0070, 0110 - of which level 1 HQLA* – Report activity in which the underlying asset is classified as level 1 HQLA.
- *0040, 0080, 0120 - of which intra-group activity* – Report activity done with other entities within the group, which do not fall within the consolidated situation relevant to the firm specified in rule 2.8 of the Reporting (CRR) Part of the PRA Rulebook.

5. PRA statutory obligations

The statutory obligations applicable to the PRA's policy development process are set out below. This CP explains the policy assessment of relevant considerations.

- **For rules instruments and UK Technical Standards Instruments**: Purpose of the policy proposals (FSMA s138J(2)(b)).
- **For rules instruments and UK Technical Standards Instruments:** Cost benefit analysis (FSMA s138J(2)(a) and (7)(a)); and an estimate of those costs and benefits (if reasonable) (FSMA s138J(8)).
- **For rules instruments and UK Technical Standards Instruments:** Analysis of whether the impact on mutuals is significantly different to the impact on other authorised firms (FSMA s138J(2)(c) and 138K).
- Compatibility with the PRA's primary objectives (FSMA s138J(2)(d)(i), 2B and 2C).
- Compatibility with the PRA's secondary competition objective (FSMA s138J(2)(d)(ii) and 2H(1)).
- Compatibility with the regulatory principles (FSMA s138J(2)(d)(ii), 2H(2) and 3B).
- Have regard to the HMT recommendation letters (BoE Act s30B).
- Have due regard to the public sector equality duty (Equality Act s149).
- Have regard, subject to any other requirement affecting the exercise of the regulatory function, to the principles of good regulation and when determining general policy or principles to the Regulators Code (Legislative and Regulatory Reform Act 2006 s21 & 22).
- Have regard, so far as consistent with the proper exercise of those functions, to the purpose of conserving biodiversity. Conserving biodiversity includes, in relation to a living organism or type of habitat, restoring or enhancing a population or habitat (Natural Environment and Rural Communities Act 2006, s40).
- **For rules instruments and UK Technical Standards Instruments:** Consultation of the FCA (FSMA s138J(1)(a)).
- **For UK Technical Standards Instruments only:** FSMA s138J(1)(a) is replaced with: consultation of the FCA and/or Bank, where that Regulator has an interest in the technical standards (FSMA s138P(4) and (5)).
- **For UK Technical Standards Instruments only:** notice given to HMT of the consultation on the UKTS ('best efforts' basis).
- For CRR rules only: subject to certain exceptions, have regard to:
    - relevant standards recommended by the Basel Committee on Banking Supervision from time to time
    - 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. For these purposes, the PRA must consider the United Kingdom's standing in relation to the other countries and territories in which, in its opinion, internationally active credit institutions and investment firms are most likely to choose to be based or carry on activities
  - 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
  - the target in section 1 of the Climate Change Act 2008 (carbon target for 2050)
  - (s144C (1) & (2) FSMA – exceptions in s144E FSMA).
- **For CRR rules only –** explanation of the ways in which having regard to the matters specified above has affected the proposed rules (s144D FSMA).
- **For CRR rules only –** publication of a summary of the proposed CRR rules.
- **For CRR rules only –** consideration and consultation with the Treasury about the likely effect of the rules on relevant equivalence decisions (s144C (3) & (4) FSMA)