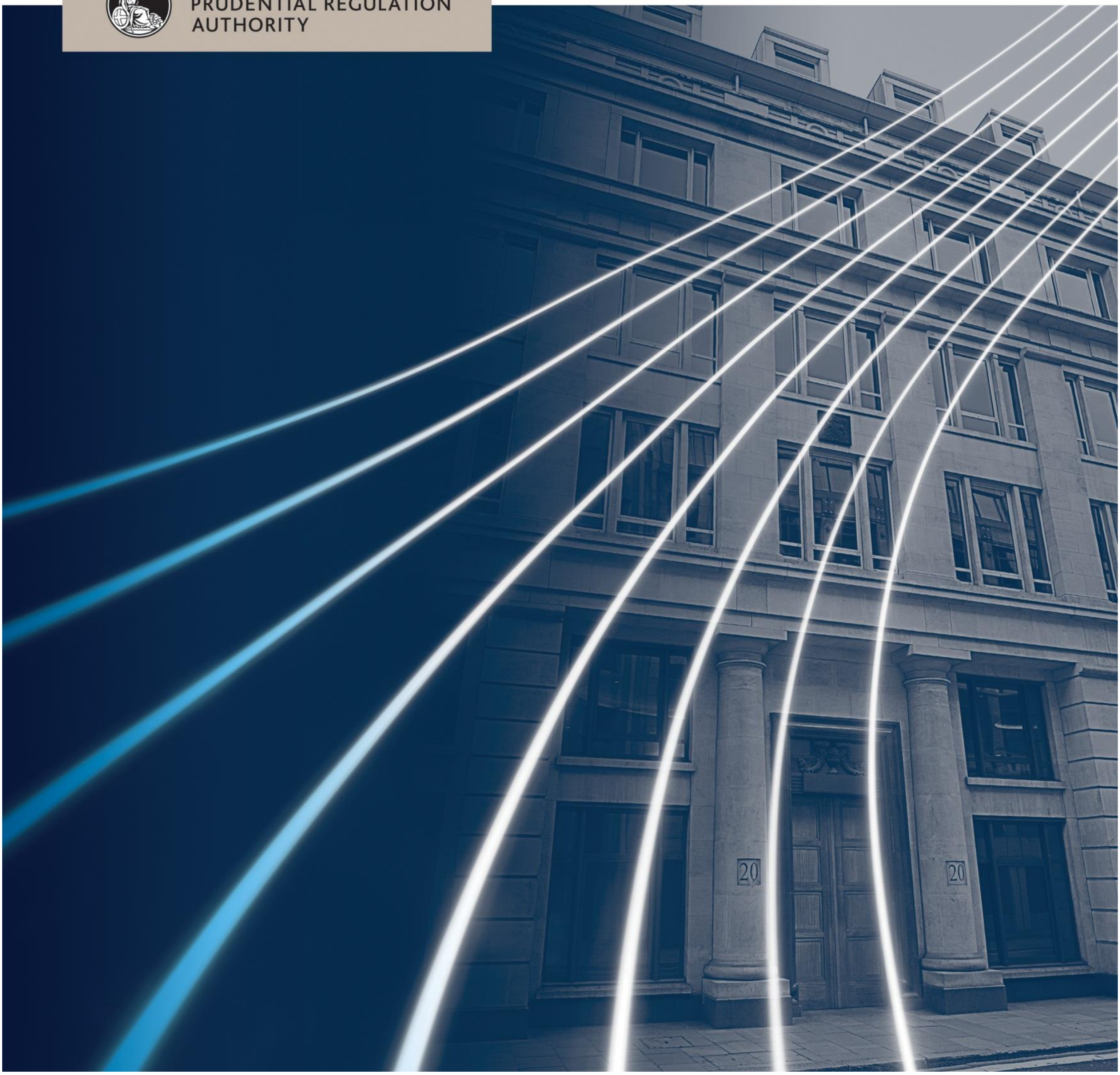
Policy Statement | PS27/15

Implementing a UK leverage ratio framework

December 2015

BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY



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This policy statement contains final rules and supervisory statements for a UK leverage ratio framework.

Contents

1 Overview

1.1 On 1 July 2015 the Financial Policy Committee (FPC) directed the Prudential Regulation Authority (PRA) to implement a UK leverage ratio framework.[1] On 10 July 2015 the PRA published Consultation Paper (CP) 24/15: 'Implementing a UK leverage ratio framework' setting out how the PRA intended to meet the FPC's direction.[2] This policy statement (PS) provides feedback to responses to the CP. It sets out the changes made to the rules and supervisory statements proposed in the CP. This PS is relevant to PRA-regulated banks and building societies with retail deposits equal to or greater than £50 billion on an individual or a consolidated basis.

1.2 The PRA considers that, in line with its statutory obligations, this framework will address the risk of excessive leverage for the group of firms that are the most systemically important in terms of size and critical services provided to the UK economy, whose individual failure could cause adverse effects on the stability of the UK financial system.

1.3 In the CP, the PRA proposed that:

- firms in scope should include all PRA-regulated banks and building societies with retail deposits equal to or greater than £50 billion, whether on an individual or a consolidated basis, at a firm's financial year end date;
- firms in scope will be required to meet a 3% minimum leverage ratio requirement, and to assess that they hold an amount of Common Equity Tier 1 (CET1) capital that is greater than or equal to their countercyclical leverage ratio buffer (CCLB) and, if the firm is a global systemically important institution (G-SII), its G-SII additional leverage ratio buffer (ALRB);
- firms in scope will be subject to leverage ratio reporting and disclosure requirements.

1.4 The CP further explained that the requirement to calculate the G-SII ALRB, and related reporting and disclosure requirements, would be set by the PRA in respect of specific firms by using the PRA's powers under section 55M of the Financial Services and Markets Act (2000) (FSMA). These firms will be invited to apply for these requirements, following a process that is similar to the Pillar 2 voluntary requirements applications for G-SIIs. [3]

1.5 The PRA is required under FSMA to have regard to any representations made within the specified time to the proposals in a consultation, to publish an account, in general terms, of those representations and its response to them, and to publish details of any significant differences in the rules as made. The PRA received nine written responses to the CP. In light of the responses received the PRA has chosen to extend its proposed transition period for daily averaging disclosure requirements by 12 months.

1 Financial Stability Report, July 2015; www.bankofengland.co.uk/publications/Documents/fsr/2015/fsrfull1507.pdf.
2 PRA CP24/15, 'Implementing a UK leverage ratio', July 2015; www.bankofengland.co.uk/pra/Pages/publications/cp/2015/cp2415.aspx.
3 See 'Capital buffers and Pillar 2 Model Requirements for G-SIIs'; November 2015; www.bankofengland.co.uk/pra/Documents/crdiv/p2gsiimodelreq.pdf.

Structure of the PS

1.6 This PS broadly follows the same chapter structure as the CP. Where relevant, each section includes:

- the approach taken on the most significant issues raised by respondents, in particular noting those areas where the PRA is making changes to the proposals contained in the CP; and

- clarification where the PRA considers it appropriate to use this PS to clarify issues of uncertainty raised in responses to the CP.

2 UK leverage ratio framework

2.1 The CP proposed key components of the leverage ratio framework, as directed and recommended by the FPC. This includes the scope of application, definitions, minimum leverage ratio requirements and buffers. In the CP, the PRA proposed a reporting and disclosure requirement to accompany the minimum requirement and buffers.

Scope of application

2.2 The CP proposed that the leverage framework should apply to PRA-regulated banks and building societies with total retail deposits equal to or greater than £50 billion, whether on an individual or a consolidated basis, on a firm's financial year end date. One respondent explicitly supported the proposed scope while other respondents did not comment on this aspect of the framework. In the final version of the framework some drafting changes have been made to the wording of the provisions on the scope of application. These are intended to clarify that for cross-border groups the framework will apply at the highest level of consolidation in the United Kingdom. These edits do not represent any change in the PRA's intention.

Implementing leverage ratio requirements and buffers

2.3 Some respondents commented on the elements of the framework that were prescribed in the FPC's Direction and Recommendation, such as the calibration of the leverage ratio buffers and its impact on firms' capital requirements. One respondent raised concerns about unintended consequences of introducing the leverage ratio framework directed by the FPC.

2.4 The PRA notes that the reasoning supporting the FPC's Direction and Recommendation is fully set out in the FPC's Policy Statement accompanying its decision.[1]

Definitions

2.5 One respondent noted that allowing only Additional Tier 1 (AT1) capital with a CET1 trigger ratio of at least 7% on an end-point definition would put UK firms at a disadvantage relative to their peers by potentially reducing the marketability of these AT1 instruments.

2.6 In line with the FPC's response to the feedback received on its leverage ratio consultation paper,[1] the PRA considers that allowing only 'high-trigger' AT1 instruments to count towards

1 The Financial Policy Committee's powers over leverage ratio tools, July 2015: www.bankofengland.co.uk/financialstability/Documents/fpc/policystatement010715ltr.pdf.

the leverage ratio would provide greater assurance that these capital instruments could be fully converted to CET1 while the firm is still a going concern.

Reporting and disclosure

General comments

2.7 The CP proposed key features of the PRA's reporting and disclosure requirements for the leverage ratio, including the averaging calculation, reporting templates and transitional arrangements. These requirements supplement existing requirements under the Capital Requirements Regulation (CRR), and once fully implemented, will require the use of averages of daily balance sheet exposures in producing end quarter returns.

2.8 Some respondents suggested delaying the implementation of the averaging requirements until after the FPC's planned review of its leverage ratio framework in 2017, to avoid any possibility that the changes to their reporting and disclosure systems and processes required by the PRA are superseded at a later date if an internationally-agreed leverage ratio framework is introduced in the European Union.

2.9 As explained in its PS, the FPC saw a strong case for introducing a domestic framework, ahead of an internationally-agreed standard, to manage model risk effectively and to respond consistently to risks to financial stability that might emerge before an international standard is implemented. The PRA considers that the relevant reporting and disclosure requirements, including the daily averaging element, are essential for effective monitoring of this domestic framework. The requirements also promote market discipline by providing comparable and accurate information on firms' leverage ratio positions.

2.10 The PRA is of the view that the introduction of a maximum harmonised CRR Pillar 1 leverage ratio requirement would be unlikely to eliminate flexibility for individual jurisdictions to impose additional reporting and disclosure requirements for leverage, where these are judged necessary to achieve macroprudential or supervisory objectives.

2.11 Furthermore, as firms captured by the framework are required to hold sufficient regulatory capital to meet a minimum leverage ratio requirement at all times, the PRA's view is that developing system capabilities to estimate and report daily balance sheet exposures would help to strengthen their ability to comply with the leverage ratio requirement at all times.

Averaging requirements

2.12 While acknowledging that some of the data required to calculate daily balance sheet exposures are already available in firms' internal systems, respondents noted that a considerable level of resources would be required to implement the reporting and disclosure requirements fully, especially to produce the daily averaged leverage ratio and its components. Some respondents raised a question of whether the proposed averaging requirement is the most cost-effective way to achieve the intended benefit of limiting incentives to engage in short-term balance sheet management to boost leverage ratios at reporting dates. They suggested that the current regulatory reporting framework can provide sufficient data to

1 The Financial Policy Committee's review of the leverage ratio, October 2014; www.bankofengland.co.uk/financialstability/Documents/fpc/fs_lrr.pdf.

enable supervisors to assess whether such activity is taking place. Others argued that concerns around balance sheet management activity could be addressed by only applying the averaging requirement to a limited number of firms where supervisors have particular concerns. A number of respondents proposed to limit daily averaging to the relatively liquid part of balance sheets and potentially allowing rule waivers to be granted to address situations where it could be difficult to obtain daily figures, or leverage exposures are unlikely to fluctuate on a daily basis.

2.13 The PRA maintains that the application of the averaging requirement to all firms in a uniform manner would provide significant long term benefits. The primary benefit is to ensure that the leverage ratios disclosed by all firms captured by the framework are comparable and fully representative of their leverage ratio position over the quarter. The PRA does not consider that representative disclosures can be achieved by relying solely on supervisory monitoring and bilateral agreements with individual firms. It sees considerable benefits in requiring the disclosure of an averaged leverage ratio as a means of promoting market discipline and in aligning the approach to UK leverage ratio disclosures with those required of US firms.

2.14 The PRA recognises that there are cost implications when developing systems and processes to report and disclose the averaged leverage ratio. However, the PRA does not consider this cost disproportionate to the size and systemic importance of the firms in scope. Firms may apply for a rule modification if they consider that the statutory tests for such a modification are satisfied with respect to all or parts of their activities. In considering any such application, the PRA expects to receive robust evidence to demonstrate that compliance with daily averaged reporting and disclosure rules would, in respect of a specified element of the balance sheet, a business line or a group entity, be unduly burdensome or would not achieve the purpose for which the rules were made. In considering applications, the PRA expects to take into account, among other factors, the likelihood of short term balance sheet management activity and the cost of calculating daily averages.

Disclosing the averaged leverage ratio

2.15 Respondents expressed their concerns about disclosing the daily averaged leverage ratio from 2017. They also asked for high-level guidance on the averaging calculation. One respondent suggested that the requirement be removed. Firms raised the point that the use of a ‘best estimate’ averaging calculation could potentially hinder comparability across firms and create market confusion. Respondents identified elements of the averaging calculation that may rely on assumptions that could be applied in a divergent way across firms. These included the treatment of banking associates, unverified profits, derivatives and whether regulatory adjustments should be calculated on a daily basis.

2.16 Furthermore, respondents explained that the proposed 12 month transitional period is challenging for making appropriate system changes to produce daily averaged figures that are sufficiently accurate and comparable to provide useful disclosures.

2.17 The PRA recognises that the ‘best estimate’ approach does present challenges to the comparability of the averaged leverage ratios across firms and there are difficulties in implementing, in a consistent manner, the disclosure requirement following a 12 month transitional period. The PRA intends to adopt a pragmatic approach to the averaging calculation, so as to reduce the operational burden on firms. As specified in Supervisory

Statement SS45/15,[1] 'best estimates' are acceptable so long as they are measured consistently and prudently.

2.18 Based on the above, the PRA considers it appropriate to extend the transitional period for daily averaged disclosures from 12 months (ie ending on 31 December 2016) to 24 months (ie ending on 31 December 2017), while maintaining the 12 month transitional period for implementing the daily averaging reporting requirement. This would mean that there is a period where the daily averaged number is being reported to the PRA but not publicly disclosed, which would allow firms additional time to improve the accuracy and comparability of the averaged numbers without compromising the effective monitoring of the UK leverage ratio framework.

2.19 Furthermore, the PRA agrees that there are benefits in working with the industry to develop common approaches to the 'best estimate' elements of the averaging calculation and to help firms achieve greater consistency of their disclosures. The PRA is willing to engage with industry where they identify technical hurdles for developing a 'best estimate' calculation and to seek common solutions that could be implemented consistently across firms.

2.20 A few respondents expressed their concerns that disclosing the averaged leverage ratio may risk investors and market participants misinterpreting balance sheet flexibility and movements reflecting business cycles as structural weakness or window dressing.

2.21 The PRA considers that it is essential to have a credible disclosure regime, which will promote market discipline and mitigate risks associated with short-term balance sheet management activities. It will be important for firms to convey their risk profile comprehensively to market participants and ensure that any differences between the averaged and end-quarter leverage ratios are clearly explained to facilitate understanding of their disclosures.

Links with other policy initiatives

2.22 Respondents asked for clarification on the PRA's approach to domestic systemically important banks (D-SIBs), especially on the calibration of the leverage ratio buffers. One respondent asked whether the proposed G-SII ALRB would apply to banks and building societies with UK D-SIB designations.

2.23 The UK leverage ratio framework does not currently include an ALRB for D-SIBs. The FPC has indicated that, in due course, it expects to direct the PRA to apply an ALRB to any D-SIBs that are subject to a systemic risk buffer (SRB).[2] At this stage, subject to the outcome of the PRA consultation on O-SIIs[3] and the FPC consultation on SRB buffers for SRB institutions, the PRA expects to apply an ALRB to SRB institutions which represent a subset of UK D-SIBs.

2.24 One respondent asked for further clarification of the interaction between the minimum requirement for own funds and eligible liabilities (MREL) and the leverage ratio. As explained in the CP, MREL must be set by the Bank of England as the UK resolution authority for individual firms in consultation with the PRA as the UK competent authority. The Bank will

1 SS45/15 'The UK leverage ratio framework', December 2015;
www.bankofengland.co.uk/pra/Pages/publications/ss/2015/ss4515.aspx.
2 The Financial Policy Committee's power over leverage ratio tools, July 2015;
www.bankofengland.co.uk/financialstability/Documents/fpc/policystatement010715ltr.pdf.
3 CP39/15 'The PRA's approach to identifying other systemically important institutions (O-SIIs)', October 2015;
www.bankofengland.co.uk/pra/Pages/publications/cp/2015/cp3915.aspx.

consult soon on its approach to MREL, including how it relates to the leverage ratio framework.

3 Cost benefit analysis

Benefits

3.1 As explained in the FPC's leverage ratio review, the UK leverage ratio framework will provide robustness against uncertainties in the existing capital framework and provide substantive benefits to the financial system.[1] The PRA supports the FPC's analysis on the benefits of introducing this framework.

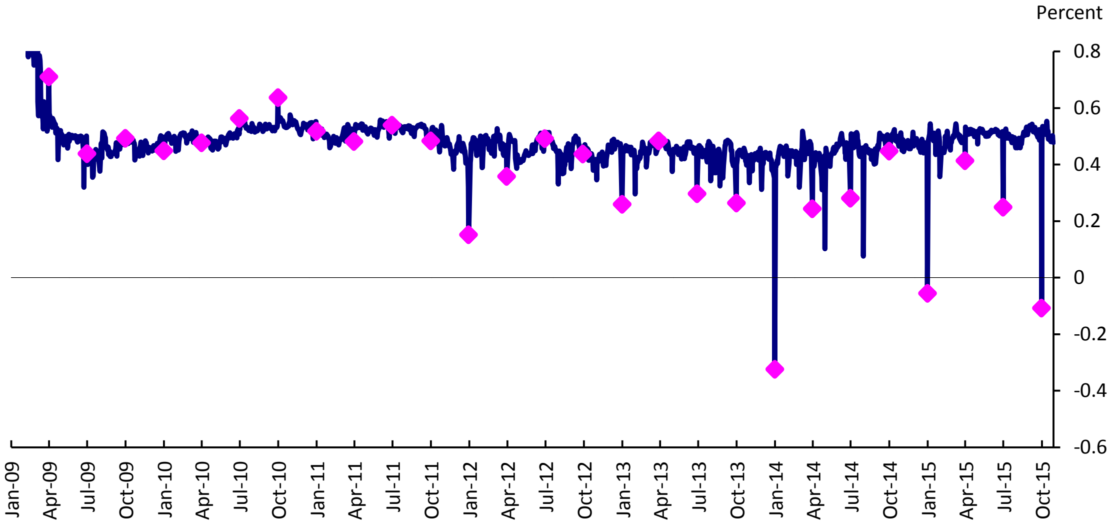
3.2 In the CP, the PRA explained that the requirement to report and disclose an averaged leverage ratio will significantly enhance the comparability and representativeness of the leverage ratio information shared with regulators and the public. This would increase the effectiveness of supervision and market discipline, reducing incentives to engage in short-term balance sheet management activity that may cause disruption to financial markets.

3.3 One respondent noted that no quantitative evidence was provided in support of the benefits of the averaging requirement. Chart 1 shows consistent evidence of increased volatility in the sterling secured overnight interest rate (RONIA) at quarter-end dates from the end of 2011 onwards. Market intelligence collected by the Bank of England suggests that it is highly likely that an important contributory factor to this observed volatility is short-term balance sheet management activity aimed at boosting leverage ratios on reporting dates. [2]

3.4 A recent study of the US repo market has demonstrated that a requirement to disclose daily averaged leverage ratio figures can be effective in disincentivising short-term balance sheet management activity and hence could provide significant benefits in terms of reduced market volatility.[3] The study examined volatility in short-term market rates in the United States and, by examining the identities of transacting firms, showed that non-US firms subject to end period reporting were engaging in significant balance sheet deleveraging at quarter-end reporting dates, while the US firms who are required to disclose daily average leverage figures, did not show such behaviour.

[1] The Financial Policy Committee's review of the leverage ratio, October 2014; www.bankofengland.co.uk/financialstability/Documents/fpc/fs_lrr.pdf.
[2] In November 2011 the FPC recommended that major UK banks start to disclose their Basel III leverage ratios. See www.bankofengland.co.uk/publications/Pages/Records/fpc/2011/record1112.aspx.
[3] Benjamin, M (2015), 'Regulatory Arbitrage in Repo Markets', *Office of Financial Research and Vanderbilt University Working Paper*, October.

Chart 1: Secured overnight interest rates movements [(a)]



(a) The secured overnight interest rate is measured by RONIA. This index is provided by the Wholesale Markets Brokers' Association. For further details, see www.wmba.org.uk. Data are for the period from 1 January 2009 to 28 October 2015.

Costs to firms in scope

3.5 The CP estimated that the incremental cost of the reporting and disclosure requirement will be driven largely by the increased frequency of valuing firms' balance sheet positions, which in turn is likely be driven by banking book portfolios that are revalued less frequently. The CP encouraged firms to provide detailed quantitative assessments of their incremental costs of complying with the averaging requirement to assist the PRA perform a more comprehensive cost benefit analysis, however such evidence was not received.

3.6 Some respondents argued that the cost of the proposed framework would be substantially more than the PRA's estimates and questioned whether all associated costs had been identified.

3.7 The PRA acknowledges that although these different categories of costs have been taken into account when estimating firms' overall compliance cost to the reporting and disclosure requirement, these were not explicitly discussed in the CP. The PRA considers that the 'best estimate' approach to daily averaging will help to contain costs. The extended transitional period for the disclosure of the averaged leverage ratio and the PRA's commitment to support industry efforts to develop common approaches to daily averaged calculations may further reduce costs. As explained in paragraph 2.14 above, the cost of reporting and disclosing daily averaged leverage ratios will be taken into account when considering any rule modification applications, including those in relation to business lines or group entities.

Appendices

1	**PRA Rulebook CRR Firms: Leverage Ratio (PRA2015/89), available at www.bankofengland.co.uk/pra/Pages/publications/ps/2015/ps2715.aspx**
2	**PRA Rulebook CRR Firms: Reporting Leverage Ratio (PRA2015/90), available at www.bankofengland.co.uk/pra/Pages/publications/ps/2015/ps2715.aspx**
3	**PRA Rulebook CRR Firms: Public Disclosure (Leverage Ratio Amendment) (PRA2015/91), available at www.bankofengland.co.uk/pra/Pages/publications/ps/2015/ps2715.aspx**
4	**Supervisory statement 45/15: The UK leverage ratio framework (see SS45/15 landing page: www.bankofengland.co.uk/pra/Pages/publications/ss/2015/ss4515.aspx)**
5	**Supervisory statement 46/15: UK leverage ratio: instructions for completing data items FSA083 and FSA084 (see SS46/15 landing page: www.bankofengland.co.uk/pra/Pages/publications/ss/2015/ss4615.aspx)**
6	**FSA083 leverage ratio template available at www.bankofengland.co.uk/pra/Pages/regulatorydata/formscrdfirms.aspx**
7	**FSA084 leverage ratio – transitional template available at www.bankofengland.co.uk/pra/Pages/regulatorydata/formscrdfirms.aspx**
8	**Supervisory statement 3/13: Capital requirements for major UK banks and building societies (see SS3/13 landing page: www.bankofengland.co.uk/pra/Pages/publications/ss/2015/ss313update.aspx)**