ISDA® Safe, Efficient Markets

afme/ Finance for Europe

Prudential Banking Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

31 March 2023

Subject: HMT Public consultation: Implementation of the Basel 3.1 standards[1]

The International Swaps and Derivatives Association (ISDA) and the Association for Financial Markets in Europe (AFME) and their members ("the Industry") welcome the opportunity to comment on HM Treasury's consultation on the "Implementation of the Basel 3.1 standards".

The Industry supports the continuation of the Financial Services and Markets Act 2000 (FSMA) model of independent regulators acting to advance objectives set for them by Parliament as the most appropriate legislative framework.

Implementation of the Basel 3.1 standards in the UK provides an opportunity to review the framework ensuring that it is appropriately calibrated in its entirety and to take account of specific UK market circumstances. It is crucial that the UK implementation of the Basel 3.1 framework is done in a risk-sensitive way which results in a robust and effective banking sector.

Overall, the Industry welcomes the proposals from the PRA including the targeted changes that would better capture risk and support the competitiveness of the UK. These include, among other proposals, the application of the output floor at the highest level of application, and the introduction of a reduced 'alpha factor' of one for calculating exposures to non-financial counterparties and pension funds in the standardized approach to counterparty credit risk (SA-CCR) framework. We furthermore support the proposed increased granularity of risk weights in CVA with the introduction of a separate risk weight bucket for pension funds. Greater granularity in the CVA framework has long been an Industry recommendation, as it would bring improved risk sensitivity which is particularly important as the revised framework for CVA does not include advanced approaches for the calculation of CVA capital requirements.

The Basel 3.1 capital framework is a necessary element of preserving financial stability. Equally, it is important that capital requirements are in line with real economic risk incurred by banks. As such, we remain concerned by the significant impact on banks' capital requirements that will result without further changes and urge to improve risk sensitivity in the framework. Disproportionate capital requirements

[1] https://www.gov.uk/government/consultations/implementation-of-the-basel-31-standards

have an impact on banks' ability to provide key financing, liquidity, hedging services and products to end-users.

The PRA's [Aggregated Cost Benefit Analysis] (Appendix 7 to CP16/22) shows the direct costs that it estimates will be placed on the Industry by its proposed rules. The PRA's analysis estimates that firms would raise on average around 3.1% additional Common Equity Tier 1 (CET1) capital, or £14.2 billion in total across all firms, compared with a baseline in which the proposals in CP 16/22 are not implemented in the UK.[2] Total capital, which includes CET1 capital, Additional Tier 1 capital, and Tier 2 capital, would also be expected to rise by 3.1%, or £19.7 billion in total across all firms.

In addition, the total operational compliance costs are estimated to be **£4.9 billion**.[3] The largest share of these costs stem from the changes to the market risk framework, which accounts for £3.8 billion mainly incurred by large banks. The CVA framework account for a further £0.7 billion (or 14% of total costs for all firms), of which £0.6 billion (or 88% of total CVA costs) are incurred almost entirely by large banks.[4]

In its Cost Benefit Analysis, the PRA confirms that it has considered areas where Pillar 2 adjustments may offset some impacts of the proposed package, such as those mentioned above. It is important that there is a comprehensive review of the Pillar 2 framework to mitigate overlap and duplication of capital charges. The PRA has stated the fuller review of P2A methodologies is planned by 2024 and we encourage this review to commence as soon as possible as it is important there is clarity well in advance of the 1 January 2025 implementation timeline, with updates required to the related policy and supervisory statements which firms will also need to embed. This review should be complemented by Industry consultation.

In our response to the PRA's CP16/22 – submitted alongside this response – we include targeted revisions to the output floor, credit risk, credit risk mitigation, CVA, SA-CCR, market risk and operational risk frameworks to improve risk sensitivity in the requirements, help reduce unnecessary burden on firms and ensure that commercial end-users (CEUs), who typically use derivatives to hedge risk, are still able to access them at a reasonable cost.

We cover the following in this consultation response:

- Chapter 2: **HMT's proposed exercise of the section 3 revocation power** – the Industry generally agrees with the articles that HM Treasury proposes to revoke, noting that HM Treasury will revisit this list when the PRA has finalized its rules to confirm that the rules adequately replace the rules being repealed. However, we do have some comments and questions on the way in which this revocation will operate. These cover specific articles, as well as broader recommendations for bringing clarity to the framework, including for guidance published to assist firms in tracking the interactions between PRA rules and the legislation and remaining technical standards.

[2] https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/consultation-paper/2022/november/cp1622app7.pdf, p.19
[3] Ibid.
[4] https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/consultation-paper/2022/november/cp1622app7.pdf, p. 16

- Chapter 3: **Amendments to the CRR** – we propose changes to **the exemption for intragroup transactions from CVA capital requirements**. The Industry welcomes HMT taking a pragmatic approach to retaining the CVA intragroup exemption and ensuring that firms can either rely on existing equivalence or the PRA's firm specific regime to qualify for the exemption in the future. However, the Industry considers that the PRA's proposed rule would not address the concerns of UK institutions that are subsidiaries of non-UK banking groups as to their ability to rely on the exemption for transactions with many of their group companies. Furthermore, the number of existing equivalence decisions made by the UK authorities under UK EMIR Article 13 is limited (it has only been granted to three jurisdictions). The Industry therefore proposes a simpler, single framework, which would recognize the equivalence decisions that have been made for 25 jurisdictions – including the EEA – using the provisions within the UK CRR.

- Chapter 3: **Amendments to the CRR** – we agree with HMT's recommendation to **remove the Article 142(2) equivalence for LFSEs**.

- Chapter 3: **Amendments to the CRR** – we welcome the statements that HM Treasury has made regarding its approach to **ensuring coherence between the UK CRR and the PRA's Basel 3.1 rules** and note that it will be necessary to see the detailed proposals once the PRA has finalized its rules to assess whether or not there may be any concerns regarding coherence. We also highlight areas where we would anticipate potential problems arising, including the scope of the rules and application of specific provisions, defined terms and interaction with the PRA glossary, consequential amendments, and transitional provisions and continuity.

- Chapter 3: **Amendments to the CRR** – we broadly support the assessment that the **Credit Rating Agencies Regulation (CRAR)** mostly aligns with the Basel 3.1 standards, noting however that additional clarity is sought in relation to how new types of ratings, particularly the mapping of such ratings to credit quality steps, would be envisaged.

- Chapter 4: **CRR equivalence** – the Industry articulates the need for a more transparent, properly and centrally resourced, streamlined and simplified equivalence process in the UK. We support the creation of a single, simplified framework for intragroup exposures to replace the current patchwork of separate waiver applications, firm-specific assessments and equivalence decisions required to enable preferential intercompany treatment across the rulebook. We encourage HM Treasury to develop broader mutual recognition agreements with key jurisdictions. Where those agreements are in place, those jurisdictions should automatically be considered equivalent. In the absence of a broad mutual recognition agreement, a tiered system could be considered, that recognizes jurisdictions that have not yet been assessed as equivalent, but apply the Basel core principles per the financial sector assessment program (FSAP) as assessed jointly by the IMF and World Bank.[5] These jurisdictions should attract a preferential prudential treatment, but less so than equivalent jurisdictions.

- Chapter 4: **Covered bonds** – as a result of onshoring of CRR into the UK, preferential risk weights for covered bonds have been restricted to UK issued covered bonds, thereby putting the UK at a competitive disadvantage internationally with respect to investment in non-UK issued covered bonds. We would request that HMT create a new equivalence regime for third-countries or alternatively

[5] https://www.imf.org/en/Publications/CR/Issues/2022/02/22/United-Kingdom-Financial-Sector-Assessment-Program-Financial-System-Stability-Assessment-513442

amend the definition of covered bonds, in line with Basel, to allow non-UK Issued bonds to be considered for preferential treatment.

- Chapter 4: **Export Credit Agencies (ECAs)** – we ask that ECAs classed as quasi-sovereign public sector entity ECAs are treated the same as those ECAs classed as sovereigns as permitted by the Basel standard.

- Chapter 5: **Credit rating coverage in the UK** – In order to increase credit rating coverage, longer-term solutions could be developed, such as establishing a credit benchmarking platform for banks to pool their company data on or for credit bureaus to be approved as external ECAIs and develop a mechanism to map their assessments to RWs. Any such solution should ultimately be reviewed by Basel and, where possible, incorporated into the international framework.

- Chapter 6: **Overseas exchanges** – we ask that a dedicated list is published by HM Treasury for this purpose that can be subsequently assessed and expanded. The starting point of this list should be exchanges that were recognised at the end of the temporary transition period.

- Chapter 6: **Internal Total Loss Absorbing Capacity** – we support HM Treasury's proposal to delete Article 92b of the CRR as inconsistent with the Bank of England's 2018 MREL Policy Statement (SoP) and the FSB TLAC Term Sheet and Guiding Principles of Internal TLAC which provide for internal TLAC requirements to be set at 75-90%.

We thank you in advance for your consideration and please do not hesitate to contact the undersigned associations with questions or if you would like to discuss our recommendations further. We remain committed to assisting HMT in achieving the objectives of this important consultation.

Gregg Jones
Director, Risk and Capital
International Swaps and Derivatives Association, Inc. (ISDA)
25 Copthall Avenue (3rd floor), London EC2R 7BP
Tel: +44 (0)20 3088 9746
gjones@isda.org

Sahir Akbar
Managing Director
Deputy Head of Prudential Regulation
Association of Financial Markets in Europe (AFME)
25 Canada Square, London E14 5LQ
Tel: +44 (0)20 3828 2732
sahir.akbar@afme.eu

About AFME

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society. AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia. AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76. Information about AFME and its activities is available on the Association's website: www.afme.eu.

About ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 1,000 member institutions from 79 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org.

Follow us on Twitter, LinkedIn, Facebook and YouTube.

Chapter 2. Implementing Basel 3.1: Exercise of the section 3 revocation power

1. Do you have any comments on the list of CRR articles HM Treasury intends to revoke?

2. Are there any further articles which you would advise we should delete (and replace with PRA rules) to materially improve coherence of the regulatory framework?

Response:

The Industry supports the continuation of the Financial Services and Markets Act 2000 (FSMA) model of independent regulators acting to advance objectives set for them by Parliament as the most appropriate legislative framework. As part of this we recognize that, to facilitate the effective implementation of Basel 3.1, HM Treasury needs to amend the UK Capital Requirements Regulation (CRR) in several ways, through targeted revocations and consequential amendments.

Implementation of the international Basel 3.1 standards in the UK provides an opportunity to review the existing framework to ensure that it is appropriately calibrated in its entirety, and to take account of specific UK market circumstances.

As outlined above in the executive summary, the Industry welcome proposals from the PRA for targeted changes that would better capture risk and support the competitiveness of the UK. However, in our response to the PRA's CP16/22 – submitted alongside this response– we include several further targeted revisions to the output floor, credit risk, credit risk mitigation, CVA, SA-CCR, market risk and operational risk frameworks to improve risk sensitivity in the requirements and to reduce unnecessary burdens on firms. In addition, these recommendations would ensure non-financial counterparties / SME corporates are not unduly penalized and can access financing, as well as risk management products such as derivatives to hedge risk, at a reasonable cost.

Where these recommendations are adopted by the PRA, HM Treasury will need to ensure that the appropriate corresponding revocations and consequential amendments are made to the UK CRR.

Specific responses to questions 1 and 2

We note that this is not the final list of articles to be revoked, and that HM Treasury will revisit this list when the PRA has finalized its rules to confirm that the rules adequately replace the rules being repealed. However, based on the PRA's consultation on its proposed changes to its rules, we generally agree with the articles that HM Treasury proposes to revoke.

However, we do have some comments and questions on the way in which this revocation will operate:

Subject Matter, Scope and Definitions

Article 1: The scope of application of requirements will need to be made clear to delineate requirements applicable under the 'strong and simple framework' as proposed by the PRA in CP16/22, and for those institutions that must adhere to the updated Basel 3.1 requirements. Article 1 may be revoked to allow for this articulation.

Level of application of requirements

Article 7: In addition to the deletion of Article 92 to allow for the introduction of the output floor, due consideration should be given to the need to update Article 7, which sets out the derogation from the application of prudential requirements on an individual basis, where the level of application of the floor can be specified.

Article 6(1a): Article 6(1a) refers to the application of Article 92b. This will no longer be relevant with the deletion of Article 92b and therefore this paragraph should be revoked.

Credit Risk Mitigation

Article 197(8): This provision allows the PRA to publish lists of main indices and recognised exchanges. However, it also references other CRR articles that are being revoked or amended. As such, this article will need to be revoked to allow for it to be updated to reference the correct articles.

Counterparty Credit Risk

The Industry proposes that Article 271 be removed now as the chapters referenced in the article are now in PRA rules. Similarly, the Industry proposes that Article 272 be transferred to PRA rules given the calculations on counterparty credit risk are now in PRA rules.

Transitional provisions

Transitional provisions that relate to past periods and are no longer relevant should be revoked. For instance, Article 500 relating to adjustments for massive disposals and Article 500c relating to the exclusion of overshootings from the calculation of the back-testing added in view of the COVID-19 pandemic are no longer in effect and should be removed.

The Standardised Approach to Credit Risk

We understand that the intention is to revoke all provisions governing the Standardised Approach and to replace these with the PRA standards. However, outside of the articles that HM Treasury proposes to revoke, there are still a number of references to the Standardised Approach retained in the CRR (e.g., in Article 152(4)(c), which states that for certain exposures institutions shall apply the Standardised Approach laid down in Chapter 2 of this Title). We request that these references are clear within the overall rulebook (e.g. will there be guidance to indicate that firms should look to the PRA rulebook instead of the relevant Chapter of CRR?).

Equivalence

We welcome guidance on the interactions between the PRA rules and the legacy CRR text. For example, Article 114(7) provides the circumstances in which firms may apply a lower risk weight to exposures to a non-UK central government or central bank. We understand that because this involves an equivalence decision, this remains the responsibility of HM Treasury. However, once the remaining parts of Article

114 have been finalized as part of the PRA standards, it will be less clear how this interacts with Article 114(7), or where to find the provisions governing risk weights for non-UK sovereigns.

Furthermore, the CRR makes reference in several instances to equivalence. As the responsibility for equivalence decisions resides with HMT, we believe the existing lists should be transposed into HMT lists and the relevant section of the rulebook updated to refer to the relevant HMT list(s). For example, the list of main indices and recognized exchanges. For alternative tools to the equivalence regime, please see our response to Q.11.

<u>Bringing clarity to the framework</u>

We also note that HM Treasury recognizes that the revocations will leave a complex prudential regulatory framework across legislation, the PRA and remaining technical standards, and that HM Treasury and the PRA will work to complete the repeal and replacement of the remainder of the prudential legislative framework as soon as possible. However, it would be useful to understand whether there will be any guidance published to assist firms in tracking the interactions between PRA rules and the legislation and remaining technical standards. For example, it may be helpful if HM Treasury and the PRA could publish indicative tables showing which articles have been replaced by which PRA rules.

We are aware that, as part of the future regulatory framework (FRF) review, there is a plan to create a comprehensive rulebook, bringing together much of which is currently part of the CRR, supervisory statements and other documents. We support this effort and see no reason why topics such as settlement risk are not transposed directly into the rulebook. As part of this exercise, obsolete references should be removed from the rulebook e.g. Article 456 and 457 make references to articles that have been deleted and should be updated.

Chapter 3. Amendments to the CRR

Amendments and revocations impacting Credit Valuation Adjustment (CVA) risk

3. Do you have any comments on the proposed changes relating to linkages between CVA capital requirements and EMIR?

Response:

The Industry notes that the PRA has opted not to follow the EU in providing an exemption for credit valuation adjustment (CVA) capital requirements for trades with non-financial counterparties, pension funds, central banks, debt management offices, central and local governments. It follows that HM Treasury should therefore remove or amend linkages to the European Market Infrastructure Regulation (EMIR).

The Industry welcomes areas where the PRA can improve risk sensitivity including, among other proposals, introducing a reduced 'alpha factor' of one in the standardized approach to counterparty credit risk (SA-CCR) framework for calculating exposures to non-financial counterparties and pension funds, and increasing the granularity of risk weights in CVA with the introduction of a separate risk weight for pension funds. Greater granularity in the CVA framework has long been an Industry recommendation, as it would bring improved risk sensitivity which is particularly important as the revised framework for CVA does not include advanced approaches for the calculation of CVA capital requirements.

As outlined in our response to question 1, the PRA should consider further revisions to the CVA, SA-CCR, and market risk frameworks to reduce unnecessary burdens on international and UK-based firms.

CVA intragroup exemption

Overview of the consultation proposal

The consultation confirms that HM Treasury's intention is to keep the CVA intragroup exemption. This exemption links to the conditions for the application of the intragroup exemption in Article 3 EMIR. This includes the requirement for an equivalence decision under Article 13 of UK EMIR for transactions with group companies established outside the UK. It also includes the additional conditions specified in Article 3 EMIR, in particular the requirement for affiliated counterparties to qualify as particular types of entity subject to prudential supervision, the requirement for the counterparties to the transaction to be subject to centralised risk evaluation, measurement and control procedures and the requirement for the counterparties to be included in the same UK prudential or accounting consolidation or an equivalent non-UK prudential or accounting consolidation.

The PRA also proposes that, as an additional approach, "following notification to the PRA, both domestic and cross-border intragroup transactions would be exempt from CVA capital requirements if firms meet the following conditions:

(1) the counterparty is included in either: (a) the firm's prudential consolidation group on a full basis; or (b) the same accounting consolidation in accordance with accounting principles;

(2) both the counterparty and the firm are subject to appropriate centralised risk evaluation, measurement and control procedures; and

(3) there are no current or foreseen material practical or legal impediment to the prompt transfer of own funds or repayment of liabilities from the counterparty to the firm."

We note that the legislative proposal to amend EMIR (EMIR 3.0) proposes to remove the requirement for the adoption of an equivalence decision under Article 13 EU EMIR as a condition for EU institutions to benefit from the CVA intragroup exemption under the EU Capital Requirements Regulation (CRR).

Under the EU proposal, the CVA intragroup exemption would be available for transactions with non-EU affiliates in equivalent jurisdictions. For this purpose, it empowers the European Commission to adopt specific equivalence decisions for this purpose determining "whether a third country applies prudential supervisory and regulatory requirements at least equivalent to those applied in the Union". The additional conditions to the application of the intragroup exemption in Article 3 EMIR referred to above would not apply.

Shortcomings in the HMT and PRA proposals

We welcome HMT taking a pragmatic approach to retaining the CVA intragroup exemption and ensuring that firms can either rely on existing equivalence or the PRA's firm specific regime to qualify for the CVA intragroup exemption in the future.

However, the Industry has identified shortcomings in the proposed approach.

The Industry consider that the PRA's proposed rule would not address the concerns of UK institutions that are subsidiaries of non-UK banking groups as to their ability to rely on an exemption from CVA charge for transactions with many of their group companies.

For example, a UK institution that is a subsidiary of a non-UK bank would not be able to rely on the exemption under the PRA's proposed rule for transactions with its non-UK parent bank because the non-UK parent bank would not be included in:

- The UK institution's prudential 'consolidation group' (as defined in PRA rules) because that group would only cover the UK institution, any intermediate UK holding company of the UK institution and the subsidiaries of the UK institution or such a holding company; or
- The same accounting consolidation as the UK institution "in accordance with accounting principles" because the PRA's definition of "accounting principles" is limited to the accounting principles that are applied by the UK institution for the purposes of its own financial reporting (i.e., in most cases, UK accounting principles or IFRS as it applies in the UK) and the only consolidated accounts that include both the UK institution and its non-UK parent bank would be those of the non-UK parent

bank (or any non-UK bank holding company) and those accounts would be prepared under applicable non-UK rules (e.g., US GAAP for US banking groups).

Similar issues would arise for such a UK institution in relation to transactions with other UK or non-UK subsidiaries of its non-UK parent bank or other non-UK holding company (unless those subsidiaries were also subsidiaries of the UK institution or an intermediate UK holding company of the UK institution).

In its current form, the Industry therefore has concerns about relying on the regime proposed by the PRA. For some transactions, the Industry would therefore look to using the link to UK EMIR Article 13 equivalence. However, the number of existing equivalence decisions made by the UK authorities under UK EMIR Article 13 is limited. It has only been granted to three jurisdictions - the USA, Japan and the EEA - and no new determination has been made since the end of the Brexit transition period. For example, Singapore, Hong Kong, Switzerland and Australia have not received UK EMIR Article 13 equivalence despite also receiving the highest classification in implementation progress across OTC derivatives reforms from the Financial Stability Board (FSB). This highlights the challenges posed by reliance on the UK EMIR equivalence framework as the basis for the intragroup CVA exemption.

The Industry proposal

The Industry proposes a simple, single framework. The own funds requirements from CVA risk should not apply to:

- transactions in OTC derivative instruments;
- entered into by an institution with a parent undertaking of the institution, other subsidiaries of such a parent undertaking or its own subsidiaries (i.e. a "group" defined without reference to UK prudential or UK accounting consolidation);
- in so far as those undertakings are covered by the supervision on a consolidated basis to which the firm itself is subject, in accordance with the UK CRR or the PRA rules on the supervision of groups or financial conglomerates;
- <u>or</u> with equivalent standards in force in a country or territory other than the UK. This links the exemption to the UK CRR equivalence decisions, under which the UK already recognises 25 jurisdictions to have equivalent prudential and supervisory requirements.

In the view of Industry, the additional conditions to the application of the intragroup exemption in Article 3 EMIR need not apply as the proposal would only make the exemption available for transactions within a group subject to UK or non-UK equivalent prudential consolidation where the consolidating supervisor is able to assess any risks involved. This proposal could replace both the existing CVA intragroup exemption and the proposed PRA regime.

As per the final bullet above, the Industry expects that the UK authorities would recognise the equivalence of the standards of consolidated supervision that apply in most major jurisdictions whose banks have UK subsidiary institutions that may be subject to own funds requirements for CVA risk. The UK already recognises that **25 jurisdictions** (including the EU) have prudential and supervisory requirements for banks that are at least equivalent to those applied in the United Kingdom for the purposes of the UK CRR, and we would support that the intragroup CVA exemption as based on prudential consolidation and equivalence be made available to firms as soon as possible.

Proposed legal drafting to replace the PRA's proposed rule 3.2 is provided at the bottom of this response.

Benefits of the Industry recommendation:

- The proposal is more consistent with the Basel framework than the current CVA intragroup exemption (or the EU proposal) as it provides an exemption from CVA for transactions within a group which is subject to a UK or equivalent non-UK prudential consolidation. The Basel framework applies on a consolidated basis.
- The proposal would still require a determination, in some cases, of whether non-UK jurisdictions have equivalent standards for consolidated supervision. However, a UK institution that is part of a UK banking group and is subject to consolidated supervision in the UK could rely on the exemption for transactions with its UK and non-UK affiliates if they are covered by the UK prudential consolidation <u>without</u> the need for any equivalence decisions. A UK institution that is a subsidiary of a non-UK banking group and that is subject to consolidated supervision by the non-UK supervisor of that group could rely on the exemption in relation to transactions with affiliates covered by that non-UK prudential consolidation if that consolidation is regarded as equivalent. In contrast, the current CVA intragroup exemption requires equivalence determinations as to the equivalence of the derivatives rules in every jurisdiction in which a UK institution has affiliated counterparties. Similarly, the EU proposal would require an equivalence determination of the prudential rules in relation to every jurisdiction in which a UK institution has affiliated counterparties.
- Unlike the current CVA intragroup exemption (and possibly the EU proposal), the Industry's proposal would clearly cover transactions with unregulated non-UK affiliates (e.g., holding companies) if they are included in the same prudential consolidation. The additional condition specified in Article 3 UK EMIR requiring certain counterparties to be subject to appropriate prudential supervision would not apply.
- In the view of Industry, the proposal need not impose the additional condition specified in Article 3 UK EMIR and the PRA's proposed rule that both counterparties be subject to 'appropriate centralized risk evaluation, measurement, and control procedures'. It would also not need to impose the additional condition specified in the PRA's proposed rule that 'there are no current or foreseen material practical or legal impediments to the prompt transfer of own funds or repayment of liabilities from the counterparty to the firm', which goes beyond Article 3 UK EMIR. This is because the proposal addresses the prudential concerns that underlie the imposition of these additional conditions because the proposal would only make the exemption available for transactions within a group subject to UK or non-UK equivalent prudential consolidation where the consolidating supervisor is able to assess any risks involved.
- Most importantly, the proposal provides a clear rule which would be straightforward for firms and supervisors to apply.

The Industry notes that HMT's proposals do address transitional issues by preserving the existing exemption alongside the PRA rules. We would be supportive of transitional mechanisms, ensuring that any existing transactions should be grandfathered, for example.

Proposed legal drafting to replace the PRA's proposed rule 3.2

3.2 A *firm* may exclude from its calculation of own funds requirements for *CVA risk* transactions that meet the following conditions:

(1) the counterparty is:
(a) its *parent undertaking*;
(b) another *subsidiary* of that *parent undertaking*; or
(c) its own *subsidiary*; and

(2) the counterparty is covered by the supervision on a *consolidated basis* to which the *firm* itself is subject [in accordance with the *CRR*, provisions implementing Directive 2002/87/EC]* or with equivalent standards in force in a *third country*.

3.2A For the purposes of 3.2(2), the rules in force in a *third country* shall be considered to be equivalent standards if the *third country* is considered to apply prudential and supervisory requirements that are at least equivalent to those applied in the United Kingdom for the purposes of Article 107(3) of the *CRR*.†

Notes:

*This wording may need to be updated if there are changes to the referenced provisions as part of the implementation of Basel 3.1.

†This wording may need to be updated if HM Treasury decides to alter the existing provisions of CRR referred to as part of the implementation of Basel 3.1.

This legal drafting is designed to be illustrative - the Industry do not wish to propose how HM Treasury and the PRA wish to split such a rule between legislation and the rule book.

Removal of CRR article 142 (2)

4. What are respondents' views on removing or reforming the Article 142(2) equivalence for LFSEs?

Response:

We agree that the current drafting could be interpreted with the counterintuitive outcome that non-prudentially regulated FSEs under equivalent jurisdictions attract lower risk weights than prudentially regulated FSEs under equivalent jurisdictions. The deletion of Article 142(2) will remove this anomaly and ensure clarity in this regard.

Please see response to Q21 of PRA CP16/22 for comments on other aspects of changes to the definition of LFSEs.

Ensuring coherence between CRR and the PRA's Basel 3.1 rules

6. Do you have any comments on HM Treasury's proposed approach to ensuring coherence with the statute book and ensuring continuity for firms?

Response:

We welcome the statements that HM Treasury has made regarding its approach to ensuring coherence between CRR and the PRA's Basel 3.1 rules. However, while these statements are helpful, at this stage it is clearly only possible to make high level statements so it will be necessary to see the detailed proposals once the PRA has finalized its rules to assess whether or not there may be any concerns regarding coherence.

Areas where we would anticipate that potential problems might arise include:

- **Scope of the rules and application of specific provisions** – HM Treasury has addressed this point at high level in the consultation paper, but it will be important for the Industry to be able to confirm that either the scope and application remains unchanged or that it has been intentionally amended.
- **Defined terms and interaction with the PRA Glossary** – this will primarily be an issue for the PRA to resolve in its rulebook, but it will also be important for HM Treasury to ensure that defined terms are not deleted from CRR while they remain relevant and also that provisions that contain definitions or descriptions not otherwise included in the definitions section of CRR are not deleted while they remain relevant.
- **Consequential amendments** – The consultation paper mentions the potential need for consequential amendments required as a result of the revocations, including the need for clarity on operation of equivalence regimes. We welcome this statement and would be happy to discuss this further with HM Treasury at an appropriate time.

- **Transitional provisions and continuity** – The consultation paper mentions the need for ensuring continuity of firms' permissions and we strongly agree that this will be necessary. Depending on the final revocations and PRA rulebook changes, we would also welcome confirmation that HM Treasury will consider any necessary transitional provisions or grandfathering, in conjunction with the PRA where necessary.

As mentioned in our response to questions 1 and 2 above, we would also welcome a guide from HM Treasury and the PRA indicating where provisions formerly located in CRR are now located in the PRA rulebook, along the lines of the transposition tables that were produced to indicate how EU legislation had been transposed into UK law and regulation.

Exercise of section 6: Amendments to the Credit Rating Agencies Regulation (CRAR)

7. Do you agree that the CRAR broadly aligns with the Basel 3.1 standards and further changes are not required?

Response:

We agree that the CRAR broadly aligns with the Basel 3.1 standards, though we seek clarity regarding how new types of ratings e.g. corporate family ratings will be reflected in the framework as the credit quality mapping for these new types of rating is otherwise unclear.

Chapter 4. CRR equivalence

8. What are your views on the operation of the equivalence regimes in the CRR?

Response:

As outlined in Q.3. specific to the CVA intragroup exemption, we urge the removal of the requirements for a UK EMIR Article 13 equivalence determination.

More generally, intragroup exposures should not be subject to equivalence decisions. This would help to preserve the role of the UK as an international financial hub and to support the global connectedness of the banking system.

In terms of the operation of the equivalence regimes in the CRR, we believe there are a number of areas where equivalence decisions are lacking. In part, this is due to a lack of resources to perform assessments. As the responsibility for the assessment of equivalence is with HMT, we believe that the assessment process can be expedited through the creation of a centralized team focusing on equivalence. Additional resources dedicated to assessing equivalence may also be required at the PRA and FCA given the input provided to HM Treasure in an advisory capacity.

In addition, the equivalence assessment process should be transparent; HMT should provide transparency on which jurisdictions are being assessed and provide an indicative timetable for when a decision can be expected. Ideally, HMT would seek to complete all relevant equivalence assessments prior to the go-live of the associated rules.

Furthermore, the current CRR contains many cross references to different articles and to different regulations and directives and is ultimately complex and cumbersome to trace through to the source. This not only adds unnecessary complexity to the CRR but can also lead to unintended consequences when requirements are updated without considering all the interlinkages. We believe that HMT should maintain and publish equivalence lists and these should be referenced directly by the CRR. Direct reference to the relevant HMT maintained list(s) would create clarity in the rulebook and ensure consistent reading and application of the requirements.

The UK's departure from the EU is also an opportunity to simplify equivalence provisions.
In this context, we see merit in streamlining and consolidating the current patchwork of available methods to gain preferential treatment for intercompany flows. These currently require separate equivalence decisions, waiver applications and firm-specific assessments. A solution would be to establish a single, simplified framework for intragroup exposures:

A Single, Simplified Framework for Intragroup Exposures

Proposal:

- We support replacing the current patchwork of equivalence decisions, waiver applications and firm-specific assessments facilitating preferential intercompany flows with a "single, simplified" intragroup deference framework which can be automatically unlocked by one prudential equivalence decision for transactions with group entities applying full Basel standards based in a third country (e.g. US, EU, Japan, Australia, Switzerland, Singapore, Hong Kong, etc.).

- Existing permissions and equivalence decisions would be grandfathered, but going forward the regime would override the need for separate individual assessments.
- HMT should perform the relevant equivalence assessments by 1 Jan 2025 for the regime to be live on Day 1. The assessments should take into account existing prudential equivalence decisions under CRR Art. 107(4) and 142(2).
- In terms of the mechanism, the relevant areas of the PRA rules should be amended to refer to the single HMT equivalence decision.
- The PRA retain control, with supervisory tools to review and manage risks, and has the ability to revoke permission for individual firms as a last resort when other tools cannot bring risk within tolerance.

We envisage that the single, simplified deference framework would unlock currently available preferential intergroup treatment covering, but not limited to:

- **Credit risk treatment (CRR Art. 107(4) and 142(2)) – commonly referred to as "CRR prudential equivalence"**: these equivalence decisions currently allow for UK institutions to treat third country institutions as UK institutions under the SA and IRB Approach to Credit Risk, but there is no distinction between intercompany exposures and those with external entities. The UK has given equivalence to most major financial centres (as onshored from the EU), incl. CH, but the coverage is not complete
- **Intragroup large exposures waiver (CRR Art. 400(2))**: intercompany waivers are currently available (e.g. NCLEG subject to PRA permission)
- **Intragroup CVA elimination (EMIR Art. 13, draft PRA rule instrument Annex J, 3.2)**: elimination subject to Art. 13 EMIR equivalence (currently available in the EU and UK, with ongoing reforms to introduce prudential equivalence and a firm-specific regime, respectively – the proposal here is in line with the AFME and ISDA proposal in response to HMT consultation question 3)
- **Output Floor exemption (draft PRA rule instrument Annex A, 2.3)**: the PRA has proposed that international subsidiaries do not need to apply the Output Floor if their home jurisdiction applies it. There is no equivalence decision required, but the PRA can request data on an ad hoc basis and apply the Output Floor at the subsidiary level as a last resort.

Further consideration can be also be given to preferential intragroup liquidity treatment:

- **Intragroup liquidity waivers (CRR Art. 8)**: such waiver allow for the creation of liquidity sub-group across borders (this is currently allowed in the EU with permission).
- **Net Stable Funding Ratio intragroup preferential treatment (CRR Art. 428h)**: institutions belonging to the same group can apply a higher or lower Available Stable Funding / Required Stable Funding respectively (subject to regulatory approval) for the compliance with a minimum NSFR of 100% (available across borders in the EU subject to a waiver, and also within the UK).

Benefits:

- A single simplified framework for intragroup prudential deference would facilitate an open but prudent framework for international and domestic banks to manage, in the UK, their cross-border capital (and liquidity) flows to and from group entities applying full Basel standards elsewhere . The regime would be highly beneficial for UK banks in managing their intragroup exposures with international subsidiaries, and also for international banks active in the UK and many other jurisdictions. The regime also provides more regulatory certainty to banks for the purpose of capital and liquidity management compared to the current framework.

- The regime would promote the UK's regulatory and supervisory cooperation with jurisdictions applying full Basel standards. In this context, the framework champions adherence to internationally agreed standards.
- The treatment of intragroup exposures is not specified by Basel, and therefore UK tailoring in this area is compliant with the internationally agreed standards.
- The regime will ease constraints on HMT and PRA to perform separate and resource-intensive equivalence and firm-specific waiver assessments, respectively.
- There are no additional financial stability risks, given 1) the regime covers existing areas of intragroup preferential treatment (available either on a cross-border basis in the EU, within the UK, or between the EU/UK and third countries), 2) preferential treatment will only be granted to firms applying full Basel standards in jurisdictions with equivalent prudential frameworks in place, and 3) the robust resolution strategies and recovery and resolvability regimes which have been implemented by internationally active banks.

We propose further alternatives to the current equivalence regime under Q11.

Covered Bonds

There is currently no equivalence regime envisaged for covered bonds which appears to be a consequence of the transposition of EU regulations as opposed to the adoption of a UK regime in line with the Basel standards.

Post Brexit the term "CRR covered bonds" was introduced which limits the scope of these to those issued by UK credit institutions. This results in no ability to apply the preferential risk weights under Article 129 except to UK issued covered bonds.

The Basel standards set out in CRE20.33 to 20.39 do not create any jurisdictional distinctions in the ability to apply a preferential approach to covered bonds and as such the UK is at a competitive disadvantage internationally with respect to investment in these bonds.

We would request that HMT create a new equivalence regime for third-countries or alternatively amend the definition of covered bonds, in line with Basel, to allow non-UK Issued bonds to be considered for preferential treatment.

The EU has considered the need to adopt an equivalence regime in the future in Directive 2019/2162 which could further exacerbate the competitive disadvantage for UK firms if the EU progresses with this. As long as the third-country covered bonds meet equivalent standards to those required for UK covered bonds, particularly with respect to ensuring bankruptcy remoteness of the cover pool there is no additional economic risk which warrants a more conservative risk weight treatment for third-country bonds.

Export Credit Agencies (ECAs)

The following request to the PRA relates to possible considerations around the CRR equivalence frameworks, and the PRA removal of UK CRR 116(4):

- **Summary recommendation to PRA:** to treat ECAs classed as quasi-sovereign PSE-ECAs the same as those ECAs classed as sovereigns as per Basel, which also provides for similar treatment to be applied to non-UK exposures where other jurisdictions are also using this Basel discretion.

The UK-proposed mandatory standardised approach for sovereigns under CP16/22 allows direct access to a zero-risk weight for ECAs classed as sovereigns. However, those classed as quasi-sovereigns (ie PSE-ECAs) will not be able to directly access the same treatment under the proposals (CP16/22, 3.66[6]).

Therefore, we are requesting that the PRA avails itself of the Basel discretion under CRE 20.12[7] to allow certain quasi sovereigns (ie those ECAs classed as PSEs) to be treated as sovereigns under the proposed mandatory standardised approach (SA).

While UK CRR Article 116(4) currently reflects, in part, the discretion set out in Basel 20.12 for the UK, it does not include the ability also set out in the Basel for firms to treat non-UK PSE exposures as sovereign where these third countries also allow the PSEs in that jurisdiction to be risk-weighted in the same manner.

This could be achieved via a clause in Article 116 to cover this subset to potentially access zero RW treatment under the CRR 114 standardised routes, and rely on the 'supervisory and regulatory arrangements' equivalence requirements for non-UK exposures under 114(7). We consider a PSE-specific equivalence framework under HMT remit, or a standalone-assessment and framework devolved to the PRA, likely to be less operationally preferred by authorities, given this is a small subset of exposures. Alternatively, we would also welcome a UK designated list for eligible global PSE-ECAs by HMT/PRA.

We request direct access for this non-significant class of quasi sovereigns to be treated as sovereigns and suggest potential drafting to address this:

> *[Article 116 insert:] Exposures to public-sector entities may be treated under Article 114 as exposures to the central government and central bank in whose jurisdiction they are established where there is no difference in risk between such exposures because of the existence of specific public arrangements.*
>
> *[Article 147A(1)(a) insert:] In addition, for point (b)(i) of Article 147(2), exposures of a quasi-sovereign institutions classed as a public sector entity under Article 116 where there is the existence of specific public arrangements and no difference in risk between such exposures and those by the central government and central bank.*

---

[6] CP16/22, 3.66: For PSEs, the PRA proposes not to treat any exposures to UK PSEs as exposures to the UK central government, a regional government, or a local authority in the UK. This aligns with the Basel 3.1 standards, as the PRA proposes to not implement the Basel 3.1 [ie Final Basel 3] national discretion to treat PSEs as exposures to the sovereign in certain circumstances.

[7] CRE20.12: Subject to national discretion, exposures to certain domestic PSEs[7] may also be treated as exposures to the sovereigns in whose jurisdictions the PSEs are established. Where this discretion is exercised, other national supervisors may allow their banks to risk-weight exposures to such PSEs in the same manner.

Given no difference in risk and national discretion under Basel, this would enable application of the same consistent treatment for sovereign ECAs and quasi-sovereign ECAs.

Operational consideration around indirect access

- The PRA have confirmed in industry discussions the expectation that banks can indirectly apply a zero risk weight using the credit risk mitigation framework given the allowance for indirect counter-guarantees by sovereign entities (CP6/22, 5.101; Appendix 4, Article 214).
- This means that instead of applying unfunded credit protection conditions to a PSE-ECA issued guarantee in respect of the transaction, the bank will look through to the public arrangements/guarantee for the PSE-ECA. While in theory, we agree that this may achieve the same treatment indirectly for many export finance exposures in the form of cover/guarantees, it adds some complexity, uncertainty and potential compliance/operational costs. In addition, in the separate potential business scenario, for example, where a bank is lending to a PSE-ECA and UFCP is not in use then there remains no direct or indirect access.
- Given ECA exposures – due to an organisational/institutional structural difference – can be designated in either the sovereigns or quasi sovereigns classes, we believe this access should be direct and automatic for PSE-ECAs given the proposed application of a mandatory standardised approach for government ECAs with the same risks.]

International competitiveness analysis

- It is important to maintain an equivalence with EU and other jurisdictions where the financial institutions (banks) can treat exposures to PSE as central government when such PSE benefits from the central government financial support. For example, where the central government will assume the entire liability of the PSE-ECA in the event of insolvency and such arrangement is confirmed in their relevant national legislation.
- Some official ECAs from certain jurisdictions (Denmark, Switzerland, Belgium, US, Korea, Japan etc) take an organisational or institutional form of a PSE as opposed to being an integral part of central government itself. EEA banks may treat the PSE-type of ECA exposures (typically an 'unfunded guarantee') as a central government exposure as these PSEs have financial support from the central government under the specific legislative arrangement as per CRR 116(4) and/or CRR 150(1)(d)(i).
- It is important to point out that, in the ECA business, UK banks globally compete with non-UK banks in pricing the non-UK PSE's exposures, not on the pricing of UK-PSE exposure.
- The PRA proposed Article 116(3A), corresponding to the UK CRR 116(5) equivalence regime, leads to a 20% RW at best (Credit Quality Step 1) for non-UK PSEs. As such, UK banks will not be able to compete with, for instance, EEA banks which may apply 0% RW for exposures to PSE ECAs who are treated as central government. This as, in most EU member states, the competent authorities chose to allow the direct use of the SA. UK banks will be disadvantaged compared to banks in the EU or other jurisdictions in running a global ECA business. UK banks will be uncompetitive in this segment (PSE type) of ECA exposure.
- **Pre-Brexit**: IRB banks were able to access SA and the zero RW via the EU CRR Article 150(1) for, at least, EEA ECA exposures under Article 114(4) and 116(4). However, this access was removed post Brexit given restriction of Article 114(4) and 116(4) to the UK.

- **UK Basel 3.1 proposal on PPU:** The PRA proposes to remove Article 150(1)(d)[8] given the introduction of a new PPU framework for application of the SA for IRB banks for certain asset classes (ex quasi sovereigns), and mandatory standardised for sovereigns.

Please see responses to credit risk standardised and IRB sections of PRA CP16/22 for detailed comments on other aspects of changes to the treatment of sovereigns and quasi sovereigns.

11. Are there any alternative tools that you would recommend the government consider regarding the prudential treatment of overseas assets?

<u>Response:</u>

Whilst we believe the equivalence regime, excluding intragroup exposures as previously outlined (see response to Q3. and Q8.), will be a mainstay of the CRR and assessments should be expedited, we believe there are alternate tools that can operate alongside the equivalence regime.

Firstly, we encourage HMT to develop broader mutual recognition agreements with key jurisdictions. Where those agreements are in place, those jurisdictions should automatically be considered equivalent.

In the absence of a broad mutual recognition agreement, a tiered system could be considered:

- **Tier 1: Jurisdictions** that have been **assessed as equivalent** as part of the onshoring of CRR and any subsequent HMT assessments. Equivalent jurisdictions will benefit from preferential prudential treatment as they currently do;
- **Tier 2: Jurisdictions that** have not yet been assessed as equivalent but **apply the Basel core principles** per the financial sector assessment program (FSAP) as assessed jointly by the IMF and World Bank. These jurisdictions should attract a preferential prudential treatment, but less so than equivalent jurisdictions; and
- **Tier 3: Non-equivalent jurisdictions**, which will continue to attract the prudential treatment relevant to 3rd countries.

With respect to the FSAP assessments, it would be helpful for these to be consolidated in a single public list for ease of reference.

[8] CP 16/22 4.106: The PRA has also considered whether to retain other existing CRR permanent partial use exemptions. The PRA considers that the majority of the existing exemptions are either no longer relevant, due to other changes in the framework such as restrictions on the scope of modelling; or no longer necessary, due to the proposed introduction of a more general exemption for immateriality as set out in (b) above. The PRA therefore proposes to remove these exemptions. The PRA proposes; however, to retain the exemptions currently in the CRR relating to intragroup exposures and exposures in the form of minimum reserves required by the Bank of England.

Chapter 5. Credit rating coverage in the UK

12. Will the PRA's proposed approach to Basel 3.1 – and the impact this has on funding costs for unrated corporates – provide sufficient additional incentive for firms who would previously not have taken out a credit rating to now do so?

13. If not, are there alternative models that HM Treasury should consider to mitigate industry concerns regarding unrated corporates?

Response:

Please see response to Q8. of PRA CP16/22 for Industry's comments on the PRA's proposed approach for exposures to unrated corporates.

With respect to ratings coverage, ultimately, corporates that wish to lower their cost of funding will need to get a rating which comes at an additional cost that may be passed onto customers. This runs contrary to the regulatory drive since the financial crisis to move away from reliance on mechanistic application of ratings within the prudential framework. There are other longer-term solutions that could be developed. For instance, one solution could be to establish a credit benchmarking platform for banks to pool their company data on or for credit bureaus to be approved as external ECAIs and develop a mechanism to map their assessments to RWs. Should the UK pursue these solutions – which may take time to develop – these should ultimately be reviewed by Basel and, where possible, incorporated into the international framework. The Industry supports investigation of these alternatives; however, it should be noted that they also pose implementation challenges.

Chapter 6. Miscellaneous

Overseas exchanges

14. Do you agree with the approach linking the ROIEs regime to the definition of "recognised exchange"?

Response:

HMT's proposals seek to address the issues arising from the amended definition of "recognised exchanges" under the onshored CRR which resulted in increased capital requirements for firms trading on these exchanges.

The suggestion to amend the link to equivalence provided under paragraph 8 of Schedule 3 to Regulation (EU) No 600/2014 (Markets in Financial Instruments Directive (MiFIR)) to the ROIEs regime in the UK CRR definition of recognised exchanges, will provide some benefit versus the current arrangements, but still leaves a significant gap versus the list of recognized exchanges pre onshoring the CRR into the UK.

As outlined in our response to Q8. we believe that lists relating to equivalence should be maintained and published by HMT, and that these should be referenced directly by the CRR. Direct reference to the relevant HMT maintained list(s) would create clarity in the rulebook and ensure consistent reading and application of the requirements. This also enables HMT to manage and update such lists more readily than otherwise.

As such, in the case of recognized exchanges, rather than create a cross reference to MIFIR or the ROIEs regime, a new list published by HMT that can be assessed and expanded would be welcome. The starting point of this list should be the exchanges that were recognized at the end of the temporary transition period.

Internal Total Loss Absorbing Capacity requirements for UK based material sub-groups of non-UK Global Systemically Important Banks – Deleting Article 92b of the CRR

15. Do respondents agree with the government's intention to legislate to remove the fixed 90% iTLAC requirement for UK based material sub-groups of non-UK G-SIBs?

Response:

We support HMT's proposal to delete Article 92b of the CRR for the reasons set out below:

We view Article 92b of the CRR as inconsistent with the Bank of England's 2018 MREL Policy Statement (SoP) and the FSB TLAC Term Sheet and Guiding Principles of Internal TLAC which provide for internal TLAC requirements to be set at 75-90%[9].

Prior to the onshored Article 92b of the CRR, internal MREL was calibrated by the Bank of England in accordance with the SoP in line with the TLAC standard and we view this as an appropriate area where the Bank of England is best placed to establish internal MREL requirements as part of the UK resolution framework. The Bank of England's SoP states that "By setting internal MREL, the Bank will also implement the Financial Stability Board (FSB) Total Loss Absorbing Capacity (TLAC) standard" (see para 1.7).

Article 92b CRR2 is unduly prescriptive, reducing the Bank of England's flexibility to achieve its policy outcomes in consultation with home authorities. With respect to calibration, the Bank of England sets internal MREL requirements in the 75 to 90% range of the full amount of external MREL requirement, as agreed at international level. This provides an important mechanism to authorities and incentive to firms to encourage coordination and progress across jurisdictions. In contrast, Article 92b sets a fixed scalar at the upper bound of the range. In addition, prescriptive restrictions with regards to issuance paths in Article 92b(2) are unnecessary and redundant. Different paths should be able to be considered by firms and by the resolution authority, as long as losses can effectively be absorbed and passed up to the resolution entity. The Bank of England's existing approach is consistent with this principle (see SoP, para 8.4). It should also be noted that the Bank of England already has powers to issue directions to firms if it considers that the issuance path of MREL/TLAC constitutes an impediment to resolvability.

Finally, the Associations note that inconsistencies in requirements creates confusion among investors and stakeholders, rather than supporting the Bank of England's objective to increase transparency in the resolution process, as set out in the Resolvability Assessment Framework.

[9] https://www.fsb.org/wp-content/uploads/TLAC-Principles-and-Term-Sheet-for-publication-final.pdf ; https://www.fsb.org/wpcontent/uploads/P060717-1.pdf