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Financial Services Risk and Regulation

FSRR Briefing

PRA leverage ratio on the way

The PRA has proposed requiring large UK banks to meet a new minimum 3% leverage ratio requirement from 1 January 2016

Major UK banks should already be able to meet this 3% minimum. However, the PRA's proposed leverage ratio is layered with additional systemic risk add-ons. This makes the UK requirement more onerous than the EU version of the leverage ratio.

The PRA published a consultation paper on 10 July that proposes that large UK banks (i.e. banks with more than £50 billion in deposits) maintain a leverage ratio of at least 3%. This 3% minimum would be supplemented with additional leverage add-ons for banks that are systemically important or that have exposures to jurisdictions that are subject to a Countercyclical Capital Buffer (CCB).

Because the leverage ratio does not take account of the riskiness of banks' assets in the way the risk-based capital ratio does, some critics have argued that it disproportionately affects banks with predominantly low risk loan books (e.g. mortgage lenders). Banks that fall short of a prescribed minimum leverage ratio will have to raise more eligible capital to meet it or reduce their assets.

When the CRD IV leverage ratio becomes binding in 2018, UK banks will effectively have to comply with two separate, although very similar leverage requirements. The level of the CRD IV leverage ratio has not yet been finalised but is expected to be 3% (i.e. in line with the Basel Committee's provisional leverage requirement). The PRA leverage ratio is likely to be more onerous given its additional leverage buffers, as described below.

The PRA proposal

The leverage ratio is a supervisory tool which allows authorities to assess the risk of excessive leverage in financial institutions. In its simplest form it is the ratio of a bank's capital to its total assets.

On 31 October 2014 the Financial Policy Committee (FPC) of the Bank of England recommended that UK banks and building societies attain a 3% minimum leverage ratio.

Following this the UK Parliament passed legislation in March 2015 to give the PRA the authority to apply these leverage requirements to banks. On 10 July 2015 the PRA published a consultation paper setting out how it would implement its new leverage ratio powers.

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The key differences between the PRA's proposed leverage ratio and the new EU leverage ratio

The CRD IV ratio won't contain a binding minimum requirement until 2018, whereas the PRA leverage ratio will apply to most large banks from 1 January 2016.

The FPC recommended that the UK leverage ratio follow the European leverage ratio definition of 'total assets'; the numerator definition is also broadly similar. There is a slight technical difference between the numerator definition for the CRD IV leverage ratio and the PRA leverage ratio: In the CRD IV leverage ratio, a certain amount of 'Other Tier 1' items can be grandfathered forward from the previous regime into the current Additional Tier 1 bracket and therefore counted within the numerator, whereas these grandfathered instruments cannot be included in the PRA leverage ratio. So banks that have grandfathered Additional Tier 1 (AT1) capital instruments may have a higher CRD IV leverage ratio than their PRA leverage ratio.

The CRD IV leverage ratio requirement will be a constant number, whereas the PRA leverage ratio is more dynamic and sensitive to the systemic risk the firm poses to the UK financial system. It can be increased if the firm is judged to be systemically important and/or if the FPC decides to apply a Countercyclical Leverage Buffer (CCLB) in the UK. For many larger banks this means that in practice the PRA leverage requirement will be higher.

The CRD IV leverage ratio requirements also apply to FCA regulated full-scope investment firms (such as broker/dealers) whereas the PRA leverage ratio will only apply to PRA-regulated banks, building societies and Designated Investment Firms that exceed the £50 billion deposits threshold.

The PRA's proposed Leverage Ratio

The 3% minimum leverage requirement

The PRA leverage ratio will apply to all banks and building societies that have consolidated retail deposits in excess of £50 billion. From 1 January 2016, these banks will be required to hold capital equal to 3% of their total assets.

Determining the exposure value

The PRA propose to use the same exposure definition as the revised exposure definition in the CRR.

For exposures arising from derivative transactions, cash variation margin received can be deducted from the current replacement cost portion of the exposure value.

Cash receivables and payables of securities financing transactions with the same counterparty can be netted, subject to certain criteria.

For credit derivatives, offsetting of protection sold with protection bought is allowed, subject to certain criteria in art 429 (a) and (b) of the 2015/62 Delegated Act.

When converting off-balance sheet items to an exposure value, the usual credit risk conversion factors (0%, 20%, 50% or 100%, depending on the riskiness of the off-balance sheet item) may be used, although the 0% factor will be substituted with a 10% floor.

Banks that are clearing members of a Qualifying Central Counterparty (QCCP) may exempt their derivative trade exposures to that QCCP as long as those trade exposures are cleared with that QCCP.

When banks calculate their leverage ratio on a solo basis intra-group exposures may be discounted, subject to regulatory approval.

However, in the case of Securities Financing Transactions collateral received may not be used to reduce the exposure value. Some banks had been using collateral in this way as they argued that the original European text was ambiguous on this point.

Frequency of calculation

There will be a transitional period during the calendar year 2016, where firms will be allowed to calculate their leverage ratio on the basis of exposure values at the end of each month during the quarter. From 1 January 2017, however, firms will have to calculate their leverage ratio on the basis of their exposure values at the end of each working day during the relevant quarter.

The Countercyclical Leverage Buffer (CCLB)

UK banks and building societies may also be subject to a CCLB which the FPC (and other national regulators) can activate if it fears overheating or unsustainable growth in particular sectors of an economy. The CCLB will be set at 35% of the level of any CCB in effect. For example, if the FPC applies a 1% CCB to certain UK exposures then a CCLB rate of 0.35% will apply to those UK exposures The CCLB applies in addition to the minimum of 3% and any Additional Leverage Ratio Buffer that applies (see below).

Similarly, where regulators in another EU member state or third country decide to apply a CCB in respect of exposures in that country, UK banks will have to hold a CCB and a CCLB in respect of their exposures in that country. As above the CCLB will be calibrated as 35% of the CCB. Currently only Norway, Sweden and Hong Kong have decided to apply a CCB to their exposures[1].

Additional Leverage Ratio Buffer (ALRB) for systemically important firms

A further requirement, the ALRB, will apply to globally systemically important banks (G-SIBs) and other major domestic UK banks and building societies, including banks that are subject to ring-fencing requirements. The ALRB will be calibrated as 35% of the combined systemic risk buffers that apply to the bank in question.

For example, if a bank is subject to a combined systemic risk buffer of 2% its ALRB will be 0.7%, in addition to the minimum of 3% and any CCLB in effect.

[1]http://www.bankofengland.co.uk/financialstability/Pages/fpc/ccbrates.aspx

Reporting and disclosure

In addition to the minimum leverage requirements, the PRA is also proposing to introduce a new reporting form (the FSA083) which banks will be required to complete and submit quarterly from 2017. During 2016 the affected banks will be required to complete and submit a transitional form (the FSA084). The new forms will collect data on the banks' breakdown of assets.

The PRA proposes that banks disclose data on their leverage ratio and the exposure measure on a quarterly basis. Where there are differences between a bank's PRA leverage ratio and its CRR leverage ratio (e.g. because the PRA leverage ratio does not recognise grandfathered AT1 capital instruments) the bank must explain why this is so.

This presents an additional burden for UK banks compared to their European peers, as they are required to complete two sets of regulatory reports on leverage (i.e. COREP and PRA reporting) and two sets of leverage ratio disclosures (i.e. CRR Pillar 3 leverage data and the PRA quarterly leverage disclosure)

Implementation timeline

The PRA leverage ratio requirements will apply to the affected banks (i.e. those with more than £50 billion in deposits) from 1 January 2016. As noted above, however, during 2016 it will be calculated on a month end basis rather than a daily basis

The FPC will review the implementation of the UK leverage ratio in 2017. At that stage, the FPC expects to direct the PRA to extend leverage ratio requirements to all other PRA regulated banks and building societies.

What's next?

The PRA's consultation will run until 12 October 2015. They will then finalise the proposed new rules and policy and publish these before the end of 2015. The new leverage ratio and reporting requirements will then begin to apply from 1 January 2016.

What do I need to do?

This will be the first time that a binding leverage requirement applies to UK banks so it will be important to implement it accurately. The PRA leverage ratio requirement will be considerably more onerous than the CRD IV leverage ratio in many ways. The timeline for compliance is also very compressed with the requirement applying from 1 January 2016.

Our teams can help you with implementation, ensuring in particular that you calculate and report the ratio properly. You will need to review the PRA's proposed leverage reporting forms in order to determine if you will be able to complete these in an accurate and complete way. You need to ensure that you have access to up-to-date data that will enable you to comply with the daily calculation requirement from 2017. Your systems will also need to consider if any of your assets are based in jurisdictions that are subject to a countercyclical capital buffer, which would also trigger an additional countercyclical leverage requirement.

Finally, as this is a consultation, you may wish to respond to the PRA before the 12 October deadline if you have views on the reporting and disclosure requirements. However, the PRA's ability to relax the leverage requirement itself is very limited because it arises from a Direction of the Bank of England's FPC and UK legislation.

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