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Publication

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Consultations by the FPC and PRA on changes to the UK leverage ratio framework

June 2021

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Responses are requested by Tuesday 24 August 2021.

In light of current measures to help prevent the spread of COVID-19, please address any comments or enquiries by email to: CP14_21@bankofengland.co.uk.

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Capital Standards Team
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Threadneedle Street
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1 Overview

1.1 The Financial Policy Committee (FPC) conducted a comprehensive review of the UK leverage ratio framework in light of revised international standards, and its ongoing commitment to review its policy approach. This document outlines the changes that the FPC proposes to make to the framework, and the Prudential Regulation Authority's (PRA) proposed approach to implementing these changes. The PRA has reviewed the leverage ratio framework concurrently, including to reflect international developments, and has coordinated closely with the FPC in relation to its review. The PRA considers that the FPC's proposals would advance the PRA's objectives.

1.2 This document contains two consultation papers (CPs): one from the FPC and one from the PRA. The sections below provide more detail.

FPC consultation

1.3 The FPC's consultation sets out its proposed revisions to the UK leverage ratio framework. In April 2015, secondary legislation was passed giving the FPC powers of direction over leverage ratio requirements and buffers for banks, building societies, and PRA-regulated investment firms.[1] On Monday 14 June 2021 the Government laid secondary legislation (the Bank of England Act 1998 (Macro prudential Measures) (Amendment)) Order 2021, or 'MPM Order 2021') to align the FPC's power of direction with changes made under the Financial Services Act 2021.[2] If Parliament approves the MPM Order 2021, the FPC proposes to use its power of direction (rather than recommendation) for most of the proposed changes to the framework, as set out in this consultation.

1.4 The FPC considers leverage requirements, including the scope of the regime, to be an essential part of the framework of capital requirements for the UK banking system (including banks, building societies, and PRA-regulated investment firms). The leverage ratio is a relatively simple indicator of a firm's solvency that relates a firm's capital resources to the nominal value of its exposures, as opposed to the riskiness of its portfolio. The purpose of the leverage framework is to make the capital framework robust against the inherent errors and uncertainties in assigning risk weights. It can also curtail excessive balance sheet growth or act as a constraint to such excess before it occurs. Without a leverage ratio requirement, a firm with low average risk weights would be able to fund its assets with a substantial amount of debt and only very little equity; a structure that would be particularly susceptible to errors in estimated risk weights.

1.5 Currently, the UK leverage ratio framework requires major banks and building societies to satisfy a minimum Tier 1 leverage ratio of 3.25% on a measure of exposures that excludes qualifying central bank reserves. Mirroring the risk-weighted capital framework, three-quarters of this minimum requirement must be met with Common Equity Tier 1 (CET1) capital instruments. The remaining additional Tier 1 capital instruments must have a conversion trigger of at least 7% of risk-weighted CET1 capital in order to count towards the leverage ratio minimum requirement. The UK leverage ratio framework also includes regulatory buffers that must be met only with CET1: an additional leverage ratio buffer for systemically important banks and a countercyclical leverage ratio buffer.

1 The Bank of England Act 1998 (Macro-prudential Measures) (No.2) Order 2015.
2 Specifically, the MPM Order 2021 would extend the FPC's power to make specifications as to how the leverage ratio exposure measure (which will become the responsibility of the PRA under the Financial Services Act 2021) is defined for the purposes of the FPC's leverage measures. In addition, the MPM Order 2021 would ensure that all macro-prudential measures, as currently set out in secondary legislation, can be applied to holding companies that are approved or designated by the PRA.

1.6 The FPC proposes that the PRA should implement and extend these measures in relation to the following firms (each a 'relevant firm'): each major UK bank, building society, or investment firm; each UK bank, building society, or investment firm with significant non-UK assets; and holding companies approved or designated by the PRA with consolidated situations (including where that holding company is part of a ring-fenced body (RFB) sub-group, the consolidated situation of that sub-group) comparable to any other relevant firm. The PRA's consultation proposes quantitative thresholds which would be used to capture those relevant firms. Subject to Parliament approving the MPM Order 2021, the FPC proposes to direct (rather than recommend) that the PRA implement these measures.

1.7 The FPC's proposed direction would specify at which levels of application the leverage ratio would be applied, while leaving certain aspects of the level of application to the discretion of the PRA. The leverage ratio requirement would apply to UK consolidated groups and RFB sub-groups. In addition, for firms below the top level of those groups, the requirement would also apply on an individual basis, with PRA discretion to apply at a sub-consolidated basis. In continuation of the current approach, the FPC proposes to recommend to the PRA to require that additional Tier 1 capital should have a conversion trigger of at least 7% of risk-weighted CET1 capital in order to count towards the minimum leverage ratio requirement.

1.8 The FPC notes and welcomes the PRA's proposed approach in its concurrent consultation for updating its supervisory expectation for all firms, which helps to prevent excessive system-wide leverage. The FPC also notes and welcomes the PRA's proposed approach to implementing Basel III changes to the leverage exposure measure (LEM).

Summary of the FPC's proposals

1.9 The FPC is consulting on its proposal for the PRA to implement a UK leverage ratio framework that:

(a) maintains: the minimum leverage ratio requirement and its calibration; leverage ratio buffers and their calibration (both subject to the PRA's proposed implementation of changes to the LEM, as set out at Chapter 11 of the PRA's consultation); the capital quality limit; and the approach for calculating the LEM that exempts eligible central bank reserves, as set out in the FPC's current Policy Statement (PS);[3]

(b) extends the scope of application of the framework to capture: major UK banks, building societies, and investment firms; UK banks, building societies and investment firms with significant non-UK assets; and any holding company approved or designated by the PRA whose consolidated situation (including, where that holding company is part of a RFB sub-group, the consolidated situation of that sub-group) is comparable to any other relevant firm. The PRA has set out proposed quantitative thresholds to capture such firms in its concurrent consultation (as set out at Chapter 9 of the PRA's consultation) as £50 billion retail deposits or £10 billion non-UK assets (calculated on an individual, consolidated or sub-consolidated basis as applicable). The FPC agrees that this would capture the types of firms set out in the proposed direction; and

(c) applies: on a consolidated basis in respect of each relevant firm's UK consolidation group; on a RFB sub-consolidated basis in respect of each ring-fenced sub-group that contains a relevant

3 The Financial Policy Committee's powers over leverage ratio tools: https://www.bankofengland.co.uk/statement/2015/the-financial-policy-committees-powers-over-leverage-ratio-tools.

firm; and for all other relevant firms, on an individual basis or, at the PRA's discretion, on a sub-consolidated basis (in respect of the relevant firm and one or more of its subsidiaries), for relevant firms that are not subject to the leverage measures on the basis of their consolidated situation under the preceding limbs.[4]

1.10 Subject to Parliament approving the MPM Order 2021, the FPC proposes to direct (rather than recommend) that the PRA implement those measures.

1.11 In line with its current approach, the FPC also proposes to recommend to the PRA that in implementing the minimum leverage ratio requirement, the PRA specifies that additional Tier 1 capital should only count towards Tier 1 capital for these purposes if the relevant capital instruments specify a trigger event that occurs when the risk-weighted CET1 capital ratio of the institution falls below a figure of not less than 7%.

1.12 The FPC's consultation seeks feedback on its proposed draft amendments to its Leverage Ratio PS (Appendix 4) and its proposed draft direction and recommendation to the PRA (outlined in Chapter 3). This consultation document is the FPC's explanation of the proposed measures, for the purposes of section 9S of the Bank of England Act 1998.

PRA consultation

1.13 The PRA's consultation (PRA CP14/21 below) sets out its proposals for implementing the FPC's proposed changes to the UK leverage ratio framework, should they be adopted by the FPC after consultation. The PRA also proposes changes to implement updated Basel standards relating to the LEM, update reporting and disclosure requirements, and update the PRA's existing expectation for 'firms to consider whether their degree of leverage is appropriate against the internationally agreed measure of leverage on a non-risk weighted basis'.[5]

1.14 This consultation is relevant to all Capital Requirements Regulation (CRR) firms and CRR consolidation entities on an individual, consolidated, and where relevant, sub-consolidated basis. For the purposes of application of the requirements on a consolidated basis, references to 'firms' include CRR consolidation entities.

1.15 The PRA's proposals aim to ensure that the leverage ratio framework is updated to reflect changes in international standards and the evolution of risks to the UK financial system. This helps ensure the leverage ratio continues to complement the risk-weighted capital framework by guarding against the risks of relying on models, or on the standardised approaches to set capital requirements. This promotes the safety and soundness of firms, the distress or failure of which could cause material harm to the UK economy.

1.16 The PRA's CP proposes new rules that would replace the existing CRR in respect of the leverage ratio in the UK. The CP also proposes to amend the PRA's existing rules on the leverage ratio and Supervisory Statement (SS) 45/15 'The UK leverage ratio framework'.[6]

4 For the avoidance of doubt, this may include on the basis of the consolidated or sub-consolidated situation of a holding company approved or designated by the PRA.

5 PRA's approach to supervision of the banking and insurance sectors, October 2018: www.bankofengland.co.uk/prudential-regulation/publication/pras-approach-to-supervision-of-the-banking-and-insurance-sectors.

6 December 2020: www.bankofengland.co.uk/prudential-regulation/publication/2015/the-uk-leverage-ratio-framework-ss.

1.17 Additionally, the PRA proposes to make consequential amendments to the leverage ratio model requirements covering the additional global systemically important institutions (G-SII) and other systemically important institutions (O-SII) leverage ratio buffers, and to other reporting and disclosure requirements referencing the leverage ratio.

Summary of the PRA's proposals

1.18 The PRA proposes to comply with the FPC's direction and recommendation by amending the PRA's existing rules on the leverage ratio:

(a) from 1 January 2022, where the leverage ratio capital requirement is applied on a consolidated basis, to make the CRR consolidation entity responsible for ensuring compliance with the consolidated capital requirement;[7]

(b) from 1 January 2022, to clarify that firms can use permissions granted to firms under Article 9(1) of the CRR, for the purposes of meeting the leverage ratio capital requirement on an individual basis;

(c) from 1 January 2023, to apply a leverage ratio capital requirement not only to all firms with retail deposits equal to or greater than £50 billion, but also to all firms with non-UK assets equal to or greater than £10 billion (calculated on an individual, consolidated, and sub-consolidated basis as applicable); and

(d) from 1 January 2023, to apply the leverage ratio requirement on an individual basis to any firm that is not a CRR consolidation entity or a ring-fenced body (RFB) that is the ultimate parent within an RFB sub-group; on a consolidated basis to CRR consolidation entities; and on an RFB sub-consolidated basis to ring-fenced sub-groups.[8] The PRA proposes to make sub-consolidation available as an alternative to individual application where a firm has subsidiaries that can be consolidated, subject to a firm's application and a firm meeting certain conditions set out in this consultation.

1.19 The PRA considers that the remainder of the existing PRA rules already comply with the FPC's proposed direction.

1.20 Separately, the PRA is also proposing to change PRA rules to:

(a) amend the leverage exposure measure to reflect updated international standards; and

(b) reduce duplicative reporting and disclosure requirements by moving to the same leverage exposure and capital measures for all firms.

1.21 The PRA also proposes to amend its supervisory expectations to:

(a) set out that all firms not in scope of the leverage ratio requirement should manage their leverage risk so that their leverage ratio does not fall below 3.25%; and

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7 This change is consistent with the application of CRR consolidated requirements to holding companies consulted on by the PRA in CP5/21.
8 To the same extent they are required to comply with Parts 2 and 3 of the CRR on a sub-consolidated basis.

(b) set out the criteria for case-by-case sub-consolidation as an alternative to applying the leverage ratio requirements on an individual basis.

1.22 Finally, the PRA proposes to make consequential amendments to the leverage ratio model requirements covering the additional G-SII and O-SII leverage ratio buffers, and to other reporting and disclosure requirements referencing the leverage ratio. For a full list of the policy materials affected by the proposed changes, please see Chapter 8: Overview of PRA consultation.

Background

1.23 A leverage ratio is a simple indicator of a firm's solvency that relates its capital resources to its exposures or assets. The lower a firm's leverage ratio, the more it relies on debt to fund its assets. Unlike the risk-weighted capital framework, a leverage ratio does not seek to estimate the relative riskiness of assets.

1.24 By not making an assessment of exposure riskiness, the leverage ratio can guard against the danger that firms' models or standardised regulatory requirements fail to reflect the true risk of assets. The leverage ratio also limits firms' incentives to reduce estimates of risk weights over time; or to shift assets to those with lower – but potentially incorrectly measured – risk weights. It also protects firms against risks that are effectively unforeseeable.

1.25 The leverage ratio further acts as a broader macroprudential safeguard. High and rising leverage in the system is often associated with credit booms, excessively large balance sheets, and under-pricing of risk – as occurred in the run-up to the global financial crisis. Because buoyant economic conditions tend to coincide with periods of high profits and subdued credit losses, risk weight models based on data from benign periods could tend to underestimate the potential for losses when conditions turn. The leverage ratio curtails this excessive balance sheet growth and model bias in good times, helping to ensure that firms have sufficient capital in a stress to continue supporting the economy.

1.26 Parliament granted the FPC powers of direction to set a minimum leverage ratio requirement and buffers in 2015, following HMT's consultation in 2014. The FPC published a PS to set out how it intended to calibrate and apply these powers on Wednesday 1 July 2015.[9]

1.27 In July 2015, the FPC directed the PRA to introduce a minimum leverage ratio capital requirement and buffers for major UK banks and building societies, which was implemented in January 2016 by PRA rules and SS45/15. This was designed to play a strong complementary role to the risk-weighted framework, introducing a 3% minimum leverage ratio requirement and leverage capital buffers. This framework was implemented before the international approach to the leverage ratio framework was agreed. At the time, the FPC announced it would review the framework in light of developing international standards.

1.28 In July 2016, the FPC recommended that the PRA update the leverage ratio total exposure measure to exclude assets constituting claims on central banks, where they are matched by deposits, denominated in the same currency, and of identical or longer maturity – the PRA implemented that recommendation in 2016. This was intended to ensure that the leverage ratio framework did not act as a barrier to the effective implementation of any monetary policy measures

9 The Financial Policy Committee's powers over leverage ratio tools: https://www.bankofengland.co.uk/statement/2015/the-financial-policy-committees-powers-over-leverage-ratio-tools.

that lead to an increase in claims on central banks, and did not act as a disincentive for firms to use central bank liquidity facilities. The FPC also subsequently recommended that the PRA recalibrate the minimum leverage ratio capital requirement for major UK banks and building societies to 3.25%, in order to avoid an effective easing in the UK leverage ratio framework. The PRA updated the framework so as to comply with that recommendation in 2017.

1.29 Internationally, the leverage ratio is a key element of the post-crisis regulatory reform agenda. The Basel Committee on Banking Supervision (BCBS) finalised the final calibration of the leverage ratio internationally in 2017, which will become a binding minimum requirement on Sunday 1 January 2023. In the European Union, the Capital Requirements Regulation II was finalised in 2019, becoming effective in June 2021. The FPC remains committed to the implementation of robust prudential standards in the UK.

1.30 Given that the Basel and European standards have now been finalised, and there is now more clarity around the future regulatory framework in the context of the UK's withdrawal from the EU, the FPC consultation constitutes the FPC's review of the leverage ratio framework.

Coordination with other UK bodies

1.31 The FPC and PRC coordinated closely in their respective concurrent reviews of the UK leverage ratio framework.

1.32 A change in a firm's leverage ratio requirement could interact with its minimum requirement for own funds and eligible liabilities (MREL) requirements. The FPC and PRC's review of the leverage ratio framework has been aligned with the Bank of England's (the Bank's) concurrent review of its approach to setting MREL, in its role as the UK's resolution authority. By completing the review at a similar time, the Bank is able to take the FPC and PRC's decisions relating to the scope of the leverage ratio requirements into full consideration when reviewing MREL policy for mid-tier banks.

1.33 HM Treasury consulted with the FPC before introducing the MPM Order 2021 to Parliament, as required by section 9(L) of the Bank of England Act 1998. The FPC noted that it agreed with the Government's proposed approach to the changes under the MPM Order 2021. HM Treasury also coordinated closely with officials from the Bank and PRA when drafting the MPM Order 2021. The PRA consulted HM Treasury as required by section 144C(3) of the Financial Services and Markets Act 2000.

1.34 The PRA has consulted with the Financial Conduct Authority (FCA) on the proposals in this consultation. Responses to this CP will be shared with the FCA where they affect FCA objectives.

Implementation

1.35 Should the FPC make its proposed changes to the UK leverage ratio framework, the PRA proposes that the implementation date for the changes to the definition of LEM and reporting and disclosure resulting from this CP would be Saturday 1 January 2022. The changes to scope and level of application of the minimum requirement, buffers, and related additional reporting and disclosure requirements for firms that would be newly brought into scope of the leverage ratio minimum requirement would become effective on Sunday 1 January 2023. The PRA proposes that the measures referred to in paragraph 1.18(a) and 1.18(b) will take effect from Saturday 1 January 2022.

1.36 The PRA's proposals in this consultation are subject to HM Treasury's proposed revocation of the relevant parts of the CRR, which itself is subject to Parliamentary approval. This is currently anticipated to take effect on Saturday 1 January 2022.

Responses and next steps

1.37 This consultation closes on Tuesday 24 August 2021. The FPC and PRA invite feedback on the proposals set out in this consultation.

1.38 Comments on the proposed FPC direction set out in Chapter 3, and on how the PRA would implement the direction set out in Part 2, may be included in a single response. All responses should be emailed to CP14_21@bankofengland.co.uk by Tuesday 24 August 2021.

1.39 The proposals set out in this CP have been designed in the context of the UK having left the European Union and the transition period having come to an end. Unless otherwise stated, any references to EU or EU-derived legislation refer to the version of that legislation which forms part of retained EU law.[10]

10 For further information please see https://www.bankofengland.co.uk/eu-withdrawal/transitioning-to-post-exit-rules-and-standards.

Part 1: FPC consultation

2 Overview of FPC consultation

2.1 The FPC is responsible for protecting and enhancing the resilience of the UK financial system, including identifying, monitoring, and taking action to remove, or reduce, systemic risks. The FPC is not required to achieve resilience at any cost. Its actions must not have a 'significant adverse effect on the capacity of the financial sector to contribute to the growth of the UK economy in the medium or long term'. Subject to achieving its main objective, the FPC is required to support the Government's economic policy, including its objectives for growth and employment.

2.2 The FPC can give directions to the PRA and the FCA to implement a specific measure to further the FPC's objectives. It can also make recommendations to anybody, including the PRA and FCA.

2.3 In April 2015, the FPC was given powers by Parliament to direct the PRA to set minimum leverage ratio requirements and buffers as part of its statutory responsibility for removing and reducing systemic risks.

2.4 The Government has stated its intentions that macro-prudential measures set out in secondary legislation appropriately reflect the enactment of the Financial Services Act 2021 and track the PRA's new powers. In line with this approach, the Government recently laid draft legislation (the MPM Order 2021) that, among other amendments, aims to ensure:

- all macro-prudential measures, as currently set out in secondary legislation, can be applied to holding companies that are approved or designated by the PRA; and
- that within the macro-prudential measures order setting out the FPC's powers of direction over the leverage ratio, the 'total exposure measure' will be defined by reference to PRA rules and, reflecting this change, that the FPC will be able to make specifications over how the total exposure measure is defined for the purpose of implementing a macro-prudential measure.

2.5 If Parliament approves the MPM Order 2021, the FPC proposes to exercise its power of direction (rather than its power of recommendation) over the UK leverage ratio framework, as outlined in this consultation. The FPC is further consulting on an updated PS for its leverage ratio to reflect the changes being made by the MPM Order 2021.

2.6 The effect of the proposed direction is to keep the existing leverage ratio framework, originally based on the 2015 direction, broadly the same for UK consolidation groups of major UK banks, building societies, and sub-consolidation groups of their ring-fenced banks (save for the changes the PRA is consulting on concurrently). The proposed direction would also include firms with significant non-UK assets, consistent with the FPC's commitment to implement robust prudential standards in the UK that maintain a level of resilience that is at least as great as, or exceeds that required by, international baseline standards. The leverage ratio framework would generally apply at individual level, except where a relevant firm is subject to a requirement on the basis of its consolidated situation (including on an RFB sub-consolidated situation). The PRA would also have discretion to allow a sub-consolidated, rather than individual, requirement to be applied.

2.7 For the reasons set out in this consultation, the FPC has decided to keep the rest of the current framework (subject to the PRA's proposed implementation of changes to the LEM, as set out at Chapter 11 of the PRA's consultation, which the FPC welcomes) unchanged. The FPC considers that the existing leverage ratio framework delivers a level of resilience at least as great as that required by international standards. A key aspect is that the vast majority of the UK leverage requirement has to be met with the highest quality of capital. At the same time, the framework has elements the FPC considers of particular benefit to financial stability, such as the additional countercyclical leverage buffer, the leverage buffer for O-SIIs, the exemption of deposit-matched central bank reserves, and the higher buffer usability achieved by relying on the PRA's existing supervisory powers rather than mandatory distribution restrictions.

2.8 The FPC has considered its review with regard to its secondary objective, subject to the achievement of the financial stability objective. The FPC has also had regard to the recommendations sent by the Chancellor of the Exchequer to the Governor on Wednesday 3 March 2021; and conducted a cost-benefit analysis. These considerations are set out in more detail in Chapter 7.

3 Proposed FPC direction and recommendation

3.1 The FPC proposes to direct the PRA to implement the following measures (the 'leverage measures') in relation to the following firms (each a 'relevant firm'):

- each major UK bank, building society, or investment firm;
- each UK bank, building society, or investment firm with significant non-UK assets; and
- any holding company approved or designated by the PRA whose consolidated situation (including, where that holding company is part of a RFB sub-group, the consolidated situation of that sub-group) is comparable to any other relevant firm.

3.2 The leverage measures would be to:

- require each relevant firm to hold sufficient Tier 1 capital to satisfy a minimum leverage ratio of 3.25%;
- secure that each relevant firm ordinarily holds sufficient Tier 1 capital to satisfy a countercyclical leverage ratio buffer rate of 35% of its institution-specific countercyclical capital buffer rate, with the countercyclical leverage ratio buffer rate percentage rounded to the nearest 10 basis points;
- secure that if a relevant firm is a G-SII, it ordinarily holds sufficient Tier 1 capital to satisfy a G-SII additional leverage ratio buffer rate of 35% of its G-SII buffer rate; and
- secure that if the relevant firm is a relevant O-SII, it ordinarily holds sufficient Tier 1 capital to satisfy an O-SII additional leverage ratio buffer rate of 35% of its O-SII buffer rate.

3.3 The leverage measures would be applied:

- on a consolidated basis in respect of the UK consolidation group of the relevant firm;
- on a sub-consolidated basis in respect of any RFB sub-group that contains a relevant firm ('RFB sub-consolidated basis'); and
- on an individual basis or, at the PRA's discretion, on a sub-consolidated basis (in respect of the relevant firm and one or more of its subsidiaries), for relevant firms that are not subject to the leverage measures on the basis of their consolidated situation pursuant to the preceding bullet points.

3.4 Where the leverage measures would be applied on a consolidated or RFB sub-consolidated basis, the FPC proposes that they would be able to be applied to a holding company approved or designated by the PRA, as appropriate.

3.5 In designing its approach to exercising its discretion over the appropriate level of consolidation at which to implement the leverage measures, the FPC proposes that the PRA should have regard to, among other things:

- the desirability of alignment between the levels of application of the leverage measures and measures under the risk-weighted capital framework; and

- the potential for the leverage measures applied on an individual basis to disproportionately impact the capital position of relevant firms driven by their group structure, given the potential consequences for the provision of market liquidity in aggregate for the UK financial system.

3.6 For the purposes of the leverage measures, the FPC proposes to specify the following:

- The total exposure measure shall exclude any assets constituting claims on central banks, where they are matched by deposits accepted by the firm that are denominated in the same currency and of identical or longer maturity.

- The minimum proportion of CET 1 that shall be held is:

    - 75% in respect of the minimum leverage ratio requirement;

    - 100% in respect of the countercyclical leverage ratio buffer; and

    - 100% in respect of the G-SII and O-SII additional leverage ratio buffers.

3.7 The FPC proposes to recommend to the PRA that in implementing the minimum leverage ratio requirement, it specifies that additional Tier 1 capital should only count towards Tier 1 capital for these purposes if the relevant capital instruments specify a trigger event that occurs when the CET1 capital ratio of the institution falls below a figure of not less than 7%.

4 Application of the leverage ratio

Scope of application

4.1 In 2015, the FPC introduced a leverage ratio framework to apply to major UK banks and building societies. At the time, the FPC stated it would expect to broaden the scope to include all PRA-regulated banks, building societies, and designated investment firms, subject to its review. In its 2016 'Framework for the systemic risk buffer' publication, the FPC expressed its intention to apply the leverage ratio to major UK banks and building societies at the level of RFB sub-groups (where applicable). Subsequently, in 2018, the PRA applied the leverage ratio framework to RFBs, within scope of the leverage ratio framework, with FPC support.[11]

4.2 The FPC continues to consider that the leverage ratio should apply to the major UK banks and building societies and their RFBs. These firms account for the majority of UK banking assets, and their provision of critical financial services to the UK economy means that their failure could pose material threats to domestic financial stability. The risks concerning these firms remain in line with the FPC's assessment in its 2015 PS.

4.3 There are a number of other firms that are large, have complex business models, and are inextricably interlinked with the UK financial system. Some of these firms are also important for financial market functioning because of their roles in the provision of liquidity and market making. As such, the FPC considers that their failure could also pose material threats to financial stability.

4.4 These firms are unlikely to be captured by a direction covering major UK banks and building societies (which have large retail deposits) only. While they share a number of qualitative features, the FPC considers that the simplest and most broadly shared feature is these firms' holdings of non-UK assets. The FPC therefore proposes to direct the PRA to extend the criteria for scope to include firms with significant non-UK assets. This is also consistent with the FPC's commitment to the implementation of robust prudential standards in the UK that would maintain a level of resilience that is at least as great as, or exceeds, that required by international baseline standards.

4.5 The FPC recognises that these firms may engage in activities associated with both lower risk weights and lower margins, such as repos, securities lending, and client-clearing services.

4.6 In 2016, the FPC identified specific aspects of the original design of the leverage ratio that may impact incentives to provide liquidity in financial markets. The FPC considers that there are changes in the latest Basel standards that could mitigate the potential adverse impacts on market functioning that extending the leverage ratio to firms with significant non-UK assets might have. Specifically, in its July 2016 Financial Stability Report, the FPC had judged that the treatment of outright purchases and sales of securities in the UK leverage ratio standard might act to discourage market-making activity, and noted that there would be merit in changes to that treatment in any internationally agreed leverage ratio standard. The FPC also noted that there would be merit in any internationally agreed leverage ratio standard allowing initial margin posted by clients to reduce banks' potential exposures to a default of those clients in centrally cleared derivative transactions, provided appropriate safeguards are in place. The BCBS has since adopted changes to this effect, and the FPC

11 PS28/18 'UK leverage ratio: Applying the framework to systemic ring-fenced bodies and reflecting the systemic risk buffer', November 2018: https://www.bankofengland.co.uk/prudential-regulation/publication/2018/uk-leverage-ratio-applying-the-framework-to-systemic-rfbs-and-reflecting-the-srb.

notes and welcomes that the PRA is proposing to implement these. The FPC has also reiterated its intention for the leverage ratio framework not to apply at the level of individual activities.

4.7 The FPC has considered whether to extend the scope of application to other firms than those mentioned at paragraph 3.1. In its considerations, the FPC notes that other smaller, domestic firms are subject to broadly the same risk-weighted and liquidity regulatory requirements as the major UK firms, derived from international standards. The FPC also notes that even where the requirements for these may be simplified, the PRA's objective is to maintain the resilience of those firms.[12]

4.8 The FPC considers that the individual failure of these firms is not likely to represent a systemic risk to UK financial stability. These firms do not significantly contribute to system-wide leverage. Subject to PRA implementation, the firms proposed in the coverage of the leverage ratio framework would already account for at least three-quarters of UK real economy lending and deposit taking. The FPC therefore judges that the systemic risk posed from the disruption to the continuity of the provision of services from these firms in a stress to not be high.

4.9 While the majority of these firms apply standardised regulatory risk weights, a small number of them have permission to use internal models. While these models present risks that could be mitigated by a leverage ratio requirement, the FPC considers that the other mitigants currently under consideration are in proportion to the risk posed by the use of internal models by those firms – in particular, the internationally agreed 'output floor' that limits the risk weights derived from internal models to 72.5% of standardised risk weight when fully phased-in, and the PRA's consultation on a mortgage risk weight floor.[13] The FPC also welcomes the PRA's concurrent consultation on a revised supervisory expectation for all firms not in scope of the FPC's proposed direction.

4.10 Balancing these considerations, and considering its objective for enhancing the resilience of the UK financial system against its secondary objective to promote the growth of the UK economy, the FPC has decided that it would be disproportionate for the PRA to introduce a leverage ratio requirement for firms other than those specified in paragraph 3.1. This is further supported by the FPC's cost benefit analysis, which suggests that a leverage ratio requirement for smaller firms may be proportionately costlier for them than for firms that the FPC proposes should be covered by the leverage ratio requirement.

4.11 In future reviews of the UK leverage ratio framework, the FPC will monitor the extent to which this judgement continues to hold, in light of these firms' future systemic importance and future clarity around the forthcoming regulatory framework, particularly regarding safeguards to internally modelled risk weights (the 'output floor' and the PRA's consultation on a mortgage risk weight floor).

Level of consolidation

4.12 The FPC has the power to direct the PRA to set leverage ratio requirements on a consolidated, sub-consolidated, and individual basis. Consolidated capital requirements determine how much

12 DP1/21 'A strong and simple prudential framework for non-systemic banks and building societies', April 2021: https://www.bankofengland.co.uk/prudential-regulation/publication/2021/april/strong-and-simple-framework-banks.

13 CP14/20 'Internal Ratings Based UK mortgage risk weights: Managing deficiencies in model risk capture', September 2020: https://www.bankofengland.co.uk/prudential-regulation/publication/2020/internal-ratings-based-uk-mortgage-risk-weights-managing-deficiencies-in-model-risk-capture.

capital needs to be held against a group's overall balance sheet. Sub-consolidated capital requirements determine how much capital needs to be held against a sub-group's overall balance sheet. Individual capital requirements determine how much capital an individual firm needs to hold against its own balance sheet, and affect the allocation of capital within the group. Risk-weighted capital requirements are applied on a consolidated, sub-consolidated, and individual basis for different firms.

4.13 In its 2015 implementation of the leverage ratio framework, the FPC applied UK leverage ratio requirements at a consolidated level for UK groups, which the PRA subsequently extended to major ring-fenced banks at a sub-consolidated level, with FPC support. These levels of application would remain unchanged under the FPC's proposed direction.

4.14 With the proposal on increasing the scope of the leverage ratio, the leverage ratio framework would also apply to firms that are not major UK groups or ring-fenced banks, and at an individual level.

4.15 The FPC recognises the benefits in aligning the leverage ratio with the risk-weighted approach, so the leverage ratio can play a strong complementary role. Applying the leverage ratio requirement at an individual level should also be simplest for firms to implement, given it mirrors the existing level at which other regulatory requirements are applied. As such, the FPC recognises the general benefits of applying the leverage ratio at an individual level.[14]

4.16 In some cases, firms' group structure can mean that applying the leverage ratio at an individual level may become disproportionately costly compared to applying it at a sub-consolidated level, where a relevant firm has a number of subsidiaries. The leverage ratio framework has been designed on an aggregate basis without reflecting the impact of group structure; and the FPC has repeatedly stated its intention for it not to apply at the level of individual activities. Where such a cost is disproportionate, and the PRA considers sub-consolidation could prudently apply in light of its own objectives, the FPC considers that there would be a benefit to allowing sub-consolidation – particularly as it may avoid the combination of idiosyncratic group structures and the leverage ratio requirement adversely impacting the provision of liquidity in financial markets, which in turn could adversely impact financial stability.

4.17 Balancing these considerations, the FPC proposes to direct the PRA to apply the leverage ratio to these firms on an individual basis, but to allow the PRA to exercise its judgement in line with its own statutory objectives to allow firms to apply for sub-consolidation where application at individual level may be deemed disproportionate, subject to strict prudential criteria set by the PRA. In exercising its discretion on the appropriate level of consolidation at which to implement the leverage measures, the FPC proposes to direct that the PRA should have regard to, among other things:

(a) the desirability of alignment between the levels of application of the leverage measures and measures under the risk-weighted capital framework; and

(b) the potential for the leverage measures applied on an individual basis to disproportionately impact the capital position of relevant firms driven by their group structure, given the potential consequences for the provision of market liquidity in aggregate for the UK financial system.

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14 Notwithstanding application at an individual level, the FPC continues to be of the view that the leverage ratio should not be applied to individual activities.

Applying the leverage exposure measure

4.18 The FPC continues to consider that the PRA should apply the internationally agreed exposure definition for the purpose of calculating the minimum leverage ratio requirement and buffers. This would include changes made to the international definition in the process of finalising Basel III. The FPC therefore welcomes the PRA's concurrent proposals to this effect, particularly on implementing the changes for which the FPC had previously advocated (see paragraph 4.6).

4.19 Following its 2016 review, the FPC decided to exclude from the calculation of the total exposure measure those assets constituting claims on central banks, where they are matched by deposits accepted by the firm that are denominated in the same currency and of identical or longer maturity.

4.20 The FPC's July 2016 recommendation was intended to ensure that the leverage ratio did not act as a barrier to the effective implementation of any policy measures that lead to an increase in claims on central banks, in particular an increase in central bank reserves.

4.21 The FPC continues to judge that including central bank reserves in the leverage exposure measure could have unintended consequences. In circumstances where firms' balance sheets increase because of an expansion in the central bank's balance sheets, regulatory leverage ratio capital requirements could effectively tighten. This could prompt firms to deleverage by shedding assets, cutting their supply of credit, or withdrawing from other activities. It could also act as a disincentive for firms to use central bank liquidity facilities. This could affect the ability of the banking system to cushion shocks, and to maintain the supply of credit to the real economy and support market functioning.

4.22 As part of its annual review of its proposed direction to the PRA, the FPC would keep under review whether the circumstances that prompted the introduction of the central bank reserves exemption remain applicable.

5 Minimum capital requirement, capital buffers, and capital quality

Setting the minimum capital requirement

5.1 In its 2015 PS, the FPC calibrated the minimum leverage ratio capital requirement to be 3%, given the domestic and international experience of bank losses during past episodes of banking stress. Other things being equal, a 3% minimum leverage ratio requirement would have been sufficient to absorb the average peak losses experienced by major UK banks between 2007 and 2013.

5.2 The FPC continues to consider that this is an appropriate calibration for the baseline minimum, were central bank reserves included in the exposure measure. This is in line with the finalised international standard.

5.3 As a result of its 2016 review, the FPC increased the minimum leverage ratio requirement by 25 basis points, from 3% to 3.25% of total exposures, excluding central bank reserves. This was in order to ensure that excluding central bank reserves from the exposure measure at the time did not reduce the amount of capital needed to meet leverage ratio capital requirements. This calibration was based on major UK firms' balance sheets in 2016. These have evolved since then, with a marginal increase in UK leverage ratio firms' holdings of eligible central bank reserves.

5.4 The FPC considers that this does not warrant a recalibration of the leverage ratio minimum. The resilience achieved continues to be that provided by the 2015 calibration, because of the uniquely risk-free nature of deposit-matched central bank reserves. Recalibrating the minimum now to match this increase would be opposed to the objective of the central bank reserve exemption, which is to avoid a situation in which the leverage ratio framework impeded the transmission of monetary policy.

Setting the capital buffers

5.5 The countercyclical leverage ratio buffer (CCLB) and additional leverage ratio buffer (ALRB) are intended to make the leverage ratio broadly equally binding relative to the risk-weighted framework (i) over the economic cycle and (ii) and for systemic and non-systemic firms.[15]

5.6 The FPC continues to consider that a conversion factor of 35% between these buffers and their risk-weighted equivalents remains appropriate to keep a proportional relationship between the leverage ratio and risk weighted capital frameworks. This reflects the relative calibration of the internationally-agreed minimum leverage ratio of 3% and a risk-weighted capital baseline of 8.5%.[16] Failure to maintain this relationship would mean that the leverage ratio would become relatively less or more binding, not only for systemically important banks, which have to carry additional risk-weighted capital buffers, but also during times of high system-wide risk, when the risk-weighted countercyclical capital buffer (CCyB) would be increased.

5.7 The FPC has considered whether automatic distribution restrictions through a maximum distributable amount (MDA) would be appropriate for leverage ratio buffers. Currently, firms that do not hold an amount of CET1 equal to or greater than their applicable leverage ratio buffers will not

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[15] These apply to G-SII firms, RFBs and relevant O-SIIs.

[16] This includes both the Tier 1 risk-weighted minimum and the 2.5% capital conservation buffer, which the FPC considers to be the appropriate risk-weighted baseline in the absence of a leverage capital conservation buffer.

face automatic restrictions on their distributions. Instead, the PRA could use its existing discretionary powers to restrict distributions when appropriate.

5.8 The FPC considers that MDAs for leverage ratio buffers would lead to a complicated interplay with the existing distribution restrictions for risk-weighted buffers: firms would need to calculate two sets of MDAs and there may be abrupt transitions from one to another. The FPC has also noted that the use of capital buffers allows banks to continue to support the economy in a stress while also weathering losses. The FPC believes that introducing MDAs for leverage ratio buffers could reduce usability of leverage capital buffers, preventing firms from drawing them down in a stress as necessary.

Capital quality

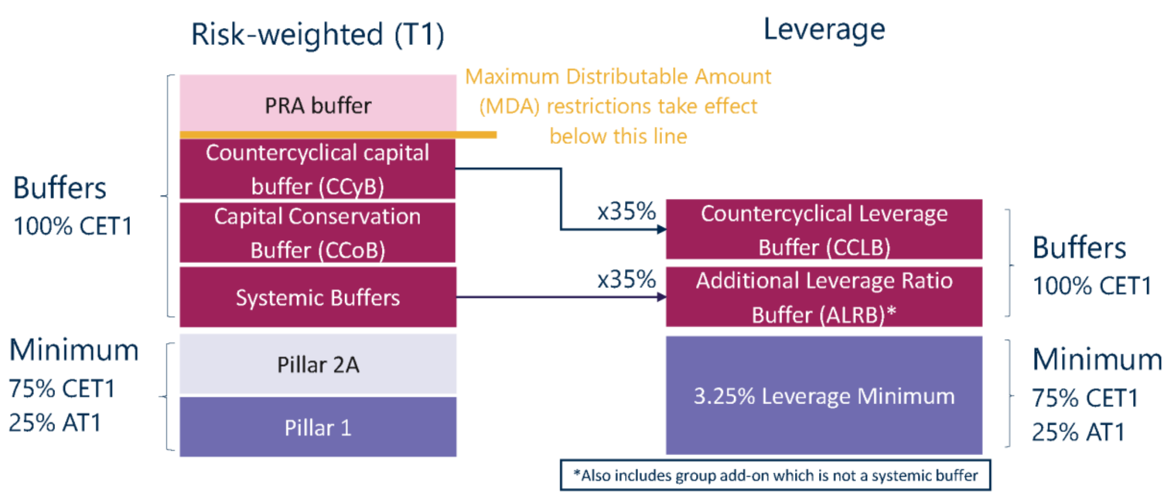
5.9 The FPC considers that capital used to meet the leverage ratio requirement and buffers should be sufficiently loss absorbing while a bank is a going concern.

5.10 In line with the approach taken in the risk-weighted framework, the FPC continues to consider that banks should use CET1 – the highest quality capital – to meet the majority of their leverage ratio requirements, limiting the share of Additional Tier 1 (AT1) instruments eligible to meet the minimum requirement to 25%. All leverage ratio buffers would continue to be required to be met with CET1 only.

5.11 In line with its 2015 approach, the FPC also continues to consider that only ‘high-trigger’ AT1 instruments (ie those that trigger at a risk-based capital ratio of at least 7% CET1) should count towards the leverage ratio, to provide greater assurance that the AT1 would convert to CET1 while the firm is still a going concern. Therefore, the FPC proposes to re-confirm its earlier recommendation in relation to AT1 triggers.

5.12 Figure 1 summarises the relationship between the risk-weighted capital framework and the proposed complementary leverage ratio framework.

Figure 1 The Tier 1 risk-weighted and leverage capital stacks



6 FPC cost benefit analysis

6.1 This section sets out the analysis of the potential costs and benefits of the FPC's proposed changes to the UK leverage ratio framework. All numerical estimates should be treated as indicative, as they are subject to uncertainty and are highly sensitive to the underlying assumptions.

6.2 The FPC expects its leverage ratio framework to continue to benefit the UK economy by enhancing the resilience of the UK financial system to systemic crises, while avoiding potentially negative impacts on competition in the UK financial sector. It expects these benefits to accrue via three main channels:

(a) a minimum leverage ratio requirement that enhances the effectiveness of capital regulation by guarding against model risk, unforeseeable events causing losses, and by limiting unsustainable balance sheet 'stretch' across the system;

(b) supplementary leverage ratio buffers on systemically important banks that complement the supplementary risk-weighted buffers. This enhances the resilience of systemically important institutions, the size and importance of which create the potential for a sharp contraction of lending in a stress that can cause significant damage to the economy; and

(c) operating a CCLB alongside the CCyB, to mitigate unsustainable credit booms which have historically been associated with falling risk weights and heightened financial system fragility, and to allow banks in a stress to recognise and absorb losses without having to restrict lending to meet capital requirements. This helps to ensure that capital accumulated when risks were building up can be used, thus enhancing the ability of the banking system to continue to support the economy in times of stress.

6.3 Extending this framework to firms with significant non-UK assets, which tend to have complex business models, and can be very large participants in UK financial markets, extends these benefits. Particularly, the benefits of the leverage ratio would cover both major firms focused on UK retail lending and those participating and intermediating in financial markets.

6.4 To the extent that the FPC's leverage ratio framework requires some firms to increase their regulatory capital above the levels required by the risk-weighted framework, there may be an economic cost associated with higher funding costs for firms that can be weighed against the resilience that stems purely from higher capital requirements. Although increasing the overall level of capital in the banking system is not the FPC's primary intention in proposing the policy changes set out in this review, FPC considers it important to have regard to this channel to ensure that the introduction of a leverage ratio framework will not have a detrimental impact on UK medium or long-term economic growth.

6.5 The FPC's central forecast is that the changes proposed to its leverage ratio framework will have a small net beneficial impact on the level of GDP.

6.6 In summary, the FPC expects its leverage ratio framework to have a material beneficial impact on UK long-term economic growth by strengthening the resilience of the financial system. It has assessed potential sources of costs and concluded that they will not outweigh these benefits. The remainder of this chapter discusses in detail the analysis that has been undertaken.

Robustness of the capital framework

6.7 The main benefit and primary reason for the proposed policy changes is that they would provide robustness against uncertainties in the existing capital framework. Although the robustness benefits cannot be reliably quantified, they would be expected to operate through a reduction in the probability of future crises. As an indication of the significant impact that even small decreases in the probability of a financial crisis can have for the UK economy, the economic model that the FPC used in this impact analysis estimates that a permanent 1 percentage point reduction in the probability of crises (if starting from a higher probability) would lead to an increase in the net present value of GDP, equivalent to £4.5 billion per annum.[17]

6.8 The FPC considers that the existing leverage ratio framework delivers a level of resilience at least as great as that required by international standards. A key aspect is that the vast majority of the UK leverage requirement has to be met with the highest quality of capital. At the same time, the framework has elements that the FPC considers to be of particular benefit to financial stability, such as the CCLB, the leverage buffer for O-SIIs, the exemption of deposit-matched central bank reserves, and higher buffer usability achieved by relying on the PRA's existing supervisory powers rather than mandatory distribution restrictions.

Macroeconomic impacts

6.9 The leverage ratio framework is part of the package of measures agreed at an international level following the global financial crisis, which raises the level of capital across the UK financial sector (as well as for firms internationally). As such, the benefits of the proposals set out in this CP should be considered in the context of all proposals addressing financial stability following the financial crisis.

6.10 The macroeconomic costs of the leverage ratio are expected to be positive, but are not expected to add significantly to those costs already estimated for all post-crisis reforms, although there is considerable uncertainty about the impact. There are a number of reasons why the FPC does not expect the cost to have a material impact on ongoing UK GDP:

(i) The leverage ratio affects only a proportion of the firms that are subject to the requirements. Consequently, any reduction in lending or other economic activities supported by these firms could, to some extent, be undertaken by other firms.

(ii) The transmission channels for passing through higher costs resulting from the leverage ratio are highly uncertain. The leverage ratio is risk-insensitive and it could be expected that firms may increase overall risks on their balance sheets, as higher risk assets generally provide higher returns. However, as noted in Box A, it is not clear that UK firms subject to the leverage ratio have increased risk as might have been expected.

(iii) While there is empirical evidence of the extent to which deposit-takers pass through any increase in funding costs for increases in risk-based capital requirements, there is currently no similar evidence for the leverage ratio. The transmission channels for increases in risk-based capital requirements show that firms can more efficiently change their capital ratios by adjusting higher-risk assets more than lower-risk assets. However, it is unlikely that firms bound by the

17 Losses from crises in this calculation are based on historical losses of advanced economies and correspond to the best estimate.

leverage ratio would use a similar transmission channel, as the leverage ratio is risk-insensitive.[18]

6.11 In total, the FPC expects the total net benefits of all responses to the global financial crisis, including the leverage ratio, to be around £11.5 billion per annum.[19]

Increases in the level of capital

6.12 The following analysis compares regulatory capital requirements to meet the changes to the FPC's leverage ratio framework with existing capital requirements. Firms that are already subject to the FPC framework will not face any increase in capital requirements.[20] For some of the other firms, the FPC's leverage ratio framework will increase regulatory capital requirements over those set by the risk-weighted framework (Table 2 summarises the impact on firms).

Impact on individual firms

6.13 It is expected that most firms will not need to raise additional capital over and above existing requirements to comply with the FPC's leverage ratio framework. This section focuses on the effect of the leverage ratio framework on these firms and quantifies how much additional capital they would need in order to meet FPC leverage ratio requirements. Table 1 provides information about the number of firms the FPC expects to be in scope, based on its proposed direction, the PRA's proposed thresholds, and regulatory returns.

Table 1 – Population of firms expected to be within scope

	Firms currently in scope[(a)]	Additional firms expected in scope[(b)]	Total
Banks	13	21	34
Building societies	1	0	1
Total	14	21	35

Source: Bank of England
Notes: (a) Firms already in scope of the FPC's leverage ratio
(b) Firms expected to exceed the retail deposits (£50 billion) and non-UK assets thresholds (£10 billion)

6.14 There is little empirical evidence of how firms' balance sheet and capital management practices may respond to a leverage ratio framework. Hence, this analysis uses the size of firms' balance sheets in December 2020 in the FPC's baseline scenario as a starting point. This assumes that firms comply with the leverage ratio requirement by replacing debt funding with eligible regulatory capital instruments, while keeping the asset side of their balance sheet constant. This approach is applied to each firm in the scope of the framework. This allows a derivation of the level of capital that each firm would need to meet its leverage ratio requirements. Comparing this to the firms' projected level of capital in the baseline scenario allows a determination of which of the two requirements would be the binding one, and how much additional capital a firm would require to comply with the leverage ratio framework.

18 For detail of this approach, see de-Ramon, S. and Straughan, M. (2017), 'The economic cost of capital: a VECM approach for estimating and testing the banking sector's response to changes in capital ratios', Bank of England Staff Working Paper No. 663: https://www.bankofengland.co.uk/working-paper/2017/vecm-approach-for-estimating-and-testing-the-banking-sectors-response-to-changes-in-capital-ratios.

19 For detail of this estimate, refer to CP5/21 'Implementation of Basel Standards', February 2021: https://www.bankofengland.co.uk/prudential-regulation/publication/2021/february/implementation-of-basel-standards.

20 These include: Barclays Group, HSBC Holding Group, Lloyds Banking Group, Nationwide Building Society, NatWest Group, Santander UK Group, Standard Chartered Bank, and Virgin Money Group and relevant related ring-fenced banks.

6.15 Following the procedure described in paragraph 6.14 shows that across the firms in scope, the introduction of a leverage ratio framework alongside the capital framework is expected to increase Tier 1 capital by £7.1 billion. In total, 14 of the 35 firms in scope would need to raise additional capital above the capital needed to meet risk-weighted capital requirements, due to the FPC's leverage ratio framework, assuming they elected to maintain their voluntary buffers. The cost of the leverage ratio would be reduced if firms used existing voluntary buffers to meet the higher regulatory requirements.

Table 2 – Summary of expected capital and other balance sheet costs to firms [(a)]

	Additional firms in scope[(b)]	Total
One-off increase in capital (£bn)	4.69-7.14	4.69-7.14
Ongoing costs of capital (£bn per year)[(c)]	0.25-0.54	0.25-0.54

Source: Bank of England

Notes: (a) Firms already in scope of the FPC's leverage ratio face no additional capital increase. The range is to reflect that banks may adjust their assets

(b) Firms exceeding the retail deposits (£50 billion) and non-UK assets thresholds (£10 billion)

(c) This reflects the difference between the cost of equity and debt

Impact on markets and low risk-activities

6.16 The effective functioning of financial markets, including in stress scenarios, ensures supply of finance to the real economy, and can help limit the amplification of shocks. By restricting the build-up of unsustainable leverage in the banking sector, and indirectly the non-bank sector, during credit booms, the leverage ratio helps avoid the destabilising effects of deleveraging during stress scenarios.

6.17 The markets in which the affected firms operate generally covers products most closely associated with the credit intermediation process, including deposit-taking, retail and wholesale lending, and interbank lending. However, some affected firms actively engage in complementary activities such as cash flow management for non-financial corporates, securitisation, repos, securities lending and borrowing, OTC derivatives, and asset management.

6.18 The leverage ratio is a risk insensitive measure, such that the level of capital held is not dependent on the underlying risk of the asset or activity. Hence, the application of the leverage ratio framework to new firms may affect activities in markets that attract a lower regulatory risk weight more strongly. In particular, firms may have incentives to shift from low-risk to more risky activities (risk-shifting).

6.19 The framework may have implications for markets for low-risk, low-margin activities such as repos, securities lending and borrowing, and client-clearing services. These markets are generally dominated by a small number of broker-dealers, which fall within the scope of the framework. Box A presents a summary of research on the possible effects of the leverage ratio on some these markets.

The FPC notes a number of factors mitigating the impact in these markets:

(a) Some of the main participants in these markets are already subject to the leverage framework at group level (others are subject to the PRA's supervisory expectation), and already have to disclose leverage ratios to the market, limiting the potential effect of the expansion of the framework to more firms on these markets.

(b) The leverage ratio framework is not meant to be applied at the level of individual activities, and the FPC's proposals allow discretion to apply the leverage ratio at a sub-consolidated level for certain firms subject to the PRA's approval. The impact on provision of low-risk activities by a firm (and, by extension, the market) is likely to result from the internal application of the framework at the level of business line.

(c) The impact of the leverage ratio on low-risk activities likely results from its applications in a regulatory environment where a risk-based framework exists. Since low-risk activities attract relatively very low risk weights, with constantly evolving market conditions, in the absence of the leverage ratio firms might be incentivised to supply these activities beyond their (economically) optimal levels if risks unexpectedly change or are unknowingly mis-measured, potentially giving rise to vulnerabilities elsewhere in the system (ie including in the non-bank sector). In such cases, the leverage ratio can help correct non-optimality in these markets.

(d) The FPC advocated a number of the changes to the Basel leverage ratio framework that aim to alleviate the impact of leverage ratio on market functioning.[21] These include the treatment of pending settlement of outright sales and purchases of securities, and the treatment of collateral when clearing member banks access derivatives through central counterparties (CCPs) on behalf of clients. The two changes have since been agreed internationally, and the PRA proposes to implement them in the UK.

Box A: The leverage ratio, risk-taking and market functioning

Being a risk-insensitive measure, the leverage ratio increases the capital base required for low-risk activities, compared to the risk-based framework. As such the leverage ratio could create disincentives to engage in activities associated with low risk weights and low returns (eg highly collateralised lending, repo, client-clearing).

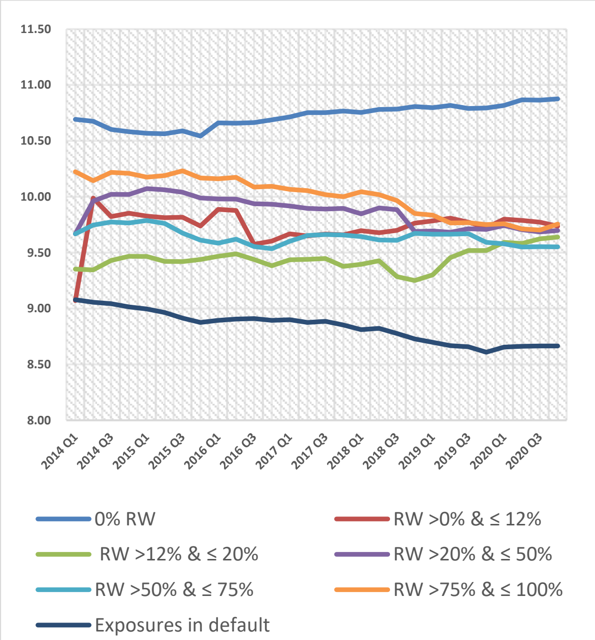
Earlier research had suggested that introducing the leverage ratio might result in 'risk-shifting', where banks substitute parts of their safer assets with more risky assets, when the leverage ratio is the binding constraint.[22]

The FPC's calibration of the leverage ratio framework is designed to play a complementary role to the risk-weighted framework, with risk-weighted requirements forming the binding constraint for the majority of firms most of the time. The framework has been applied to a subgroup of firms since 2016. Hence, one can compare the changes in the composition of the assets of firms subject to the framework with other firms not subject to the framework. Figure 2 shows the average decomposition of total exposures across different risk weight buckets and mean average risk weights, for firms subject to the framework ('LR-firms') and firms not subject to the framework ('other firms'). As the figure shows, there is no indication that LR-firms have changed the risk composition of their assets compared to other firms. Using an econometric model, there is also no evidence of statistically significant differences between the two groups of firms in terms of asset composition.

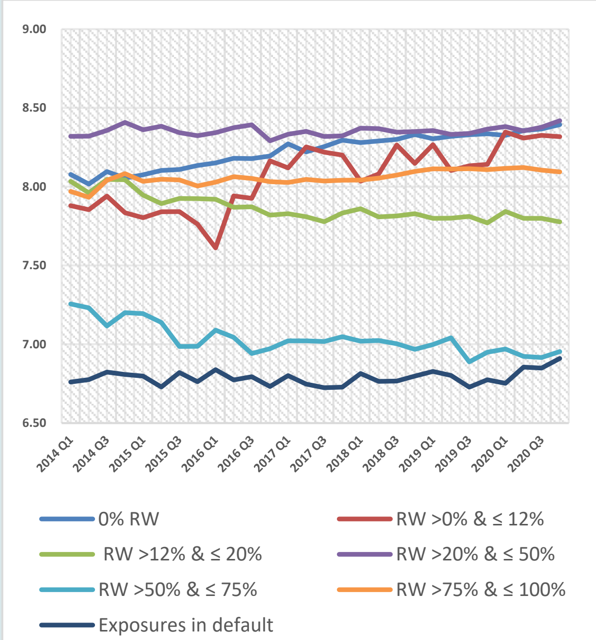
[21] Financial Stability Report; Issue No. 39 (July 2016); p38: https://www.bankofengland.co.uk/financial-stability-report/2016/july-2016.
[22] For example, see Choi et al (2020), and Acosta-Smith et al (2020).

Figure 2: Decomposition of assets per risk weight buckets

Panel (a) – LR-firms



Panel (b) – Other firms



Source: Bank calculations

In addition, since its introduction in 2016, a number of research papers have investigated the impact of the leverage ratio on financial intermediation. The papers have assessed the effects on dealer intermediation in bond markets,[23] liquidity in the gilt and repo markets,[24] repo market functioning,[25] client-clearing in derivatives markets,[26] and currency mispricing in FX markets.[27] The evidence on the impact of the leverage ratio on market liquidity is mixed. The papers generally suggest that the leverage ratio could have a potential impact on the pricing in the markets covered. Dealers that are more restricted by the leverage ratio tended to charge higher premiums when compared to less restricted dealers. However, they provide mixed evidence on the impact of the leverage ratio on the provision of liquidity. Some suggest that the leverage ratio reduced dealers' willingness to intermediate in the markets. Others point out a positive effect on market liquidity, as resilient, better-capitalised dealers are more able to intermediate, even in stress scenarios.

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23 Liu, Z., Baranova, Y. and Shakir, T. (2017), 'Dealer Intermediation, Market Liquidity and the Impact of Regulatory Reform', Bank of England Working Paper No. 665, available at: https://www.bankofengland.co.uk/working-paper/2017/dealer-intermediation-market-liquidity-and-the-impact-of-regulatory-reform.

24 Bicu-Lieb, A., Chen, L. and Elliott, D. (2020), 'The leverage ratio and liquidity in the gilt and gilt repo markets', Journal of Financial Markets, 48, p.100-510.

25 Allahrakha, M., Cetina, J., & Munyan, B. (2018), 'Do higher capital standards always reduce bank risk? The impact of the Basel leverage ratio on the US triparty repo market', Journal of Financial Intermediation, 34, p.3-16, available at: https://www.sciencedirect.com/science/article/pii/S1042957318300147?via%3Dihub; Munyan, B. (2017), 'Regulatory arbitrage in repo markets', Office of Financial Research Working Paper, p15-22, available at http://financialresearch.gov/working-papers/files/OFRwp-2015-22_Repo-Arbitrage.pdf; Kotidis, A., and van Horen, N. (2018), 'Repo market functioning: the role of capital regulation', Bank of England Working Paper No. 746, available at: https://www.bankofengland.co.uk/working-paper/2018/repo-market-functioning-the-role-of-capital-regulation.

26 Acosta-Smith, J., Ferrara, G., and Rodriguez-Tous, F. (2018), 'The impact of the leverage ratio on client clearing', Bank of England Working Paper No. 735, available at: https://www.bankofengland.co.uk/working-paper/2018/the-impact-of-the-leverage-ratio-on-client-clearing.

27 Cenedese, G., Della Corte, P., and Wang, T. (2019), 'Currency mispricing and dealer balance sheets', Bank of England Working Paper No. 779, available at: https://www.bankofengland.co.uk/working-paper/2019/currency-mispricing-and-dealer-balance-sheets.

In the context of the Covid-19 stress, a review by the Financial Stability Board assessed the drivers of market turmoil during the Covid-19 triggered stress in March 2020.28 The review indicates that while dealers expanded their balance sheets, the temporary leverage ratio constraints (as well as other relevant factors, such as the risk appetite of the dealers) may have reduced dealers' incentives to expand balance sheets further. The review, however, acknowledges that the improved resilience of banks following the post-crisis reform helped prevent events similar to those in the global financial crisis happening in funding markets.

28 The Financial Stability Board (FSB) (2020), 'Holistic Review of the March Market Turmoil', available at: https://www.fsb.org/2020/11/holistic-review-of-the-march-market-turmoil/.

7 Remit and recommendations letter from the Chancellor

7.1 On Wednesday 3 March 2021, the Chancellor of the Exchequer wrote to the Governor of the Bank of England setting out specifically what the economic policy of HM Government is taken to be for the purposes of the FPC's secondary objective, and making recommendations about various of the FPC's functions and responsibilities, under sections 9D and 9E of the Bank of England Act 1998.[29] This chapter sets out how these have been taken into account in the course of the FPC's review of the leverage ratio framework.

7.2 The FPC's primary objective is to exercise its functions with a view to contributing to the Bank of England's achievement of the financial stability objective. The Bank of England Act (1998) does not require or authorise the FPC to exercise its functions in a way that would in its opinion be likely to have a significant adverse effect on the capacity of the financial sector to contribute to the growth of the UK economy in the medium or long-term.

7.3 Subject to its primary financial stability objective, the FPC has a secondary objective of supporting the Government's economic policy, including its objectives for growth and employment. The FPC's proposed direction on the leverage ratio is expected to contribute positively to growth over the medium and long-term by increasing the robustness of the regulatory framework. The FPC also expects the additional capital cost to firms from the proposed direction to be low.

7.4 The FPC has carefully designed its proposals in pursuit of its primary objective, in ways that as far as possible are effective in also achieving its secondary objective. Specifically, the FPC considers that the design and calibration of the leverage minimum and buffers provides a strong complementary leverage ratio which does not bind on most firms most of the time. In deciding the scope of the framework, the FPC has considered both the benefits and costs of applying the leverage ratio to certain firm types. In determining the overall framework, and subject to its primary objective, the FPC has also had regard to its secondary objective, as well as the Chancellor's remit and recommendation letter mentioned above, and in particular how its proposed policy would impact competition and competitiveness.

7.5 The proposal to include PRA discretion for sub-consolidation when extending the level of application advances the FPC's primary objective by mitigating potentially adverse impacts the leverage ratio may have on the provision of market liquidity (in addition to the changes identified by the FPC in 2016, which the PRA proposes to introduce).

7.6 The FPC is having regard to the interaction between monetary and macroprudential policy, notably through its proposals to continue excluding central bank reserves, and to not recalibrate the minimum to reflect an increase in reserves since 2016.

7.7 The FPC is also publicly consulting on changes to its PS on the leverage ratio, and will annually review the proposed direction, thereby creating a transparent framework that is responsive to future change, and enhancing the accountability of the FPC.

[29] 'Remit and recommendations for the Financial Policy Committee', March 2021: https://www.bankofengland.co.uk/letter/2021/march/remit-for-the-fpc-2021.

Impact of proposals on the advancement of the PRA's objectives

7.8 The FPC must, so far as it is possible to do so while complying with section 9C(1) of the Act, seek to avoid exercising its functions in a way that would prejudice the advancement by the PRA of any of its objectives. The FPC and PRA have coordinated closely in relation to this review of the UK leverage ratio framework. The PRA considers that the FPC's proposals would advance the PRA's objectives.

Equality and diversity considerations

7.9 The FPC considers that the proposals do not give rise to equality and diversity implications.

Part 2: PRA Consultation

8 Overview of PRA consultation

8.1 Should the FPC make the changes to the UK leverage framework set out in its consultation, the PRA proposes to comply by amending the PRA rules and Supervisory Statements (SS). Separately, the PRA is also proposing to change PRA rules to reflect new international standards, notably in the definition of leverage total exposure measure and in reporting and disclosure requirements; and to transfer Part Seven of CRR, and associated CRR reporting and disclosure requirements, into the PRA Rulebook pursuant to the provisions of the Financial Services Act 2021.

8.2 A summary of the proposals in this CP can be found in Chapter 1. The table below describes the policy material that would change as a result of these proposals:

Table 3 – Amended policy material

Policy material	Proposals
PRA Rulebook	The CP proposes to: • amend the Leverage Ratio Part of the PRA Rulebook, which would be renamed the Leverage Ratio – Capital Requirements and Buffers Part, in order to implement the FPC's proposed direction and to align it to other changes in the leverage ratio framework and changes consulted on in relation to other aspects of the broader prudential framework in CP 5/21; • introduce a new Leverage Ratio (CRR) Part of the PRA Rulebook, corresponding to Part Seven of the CRR, and reflecting updates to the exposure measure set out in Basel III and an exposure measure and capital measure that comply with the FPC's direction and recommendation; • amend the Reporting (CRR) and Disclosure (CRR) Parts of the PRA Rulebook to streamline the reporting and disclosure regimes for the leverage ratio, reflect updates to Basel III, and introduce reporting of foreign assets;[30] • delete the Reporting Leverage Ratio Part and amend the Leverage Ratio Chapter of the Public Disclosure Part of the PRA Rulebook in order to remove duplicative reporting and disclosure requirements; and • amend Chapter 11 of the Internal Capital Adequacy Assessment Part of the PRA Rulebook to align it with the revised leverage ratio.

[30] The Reporting (CRR) and Disclosure (CRR) Parts were consulted on in CP5/21, which was published on 12 February 2021. These two Parts were included as annexes J and K of Appendix 9 to that consultation, and included placeholders for leverage provisions to be inserted. The rule instrument in Appendix 1 shows amendments to the PRA Rulebook as consulted on in CP5/21.

Supervisory Statements (SS)	This CP would amend: • SS45/15 'The UK leverage ratio framework' • SS34/15 'Guidelines for completing regulatory reports' This CP would delete: • SS46/15 'UK leverage ratio: instructions for completing data items FSA083 and FSA084'[31]
Other reporting and disclosure requirements	This CP will amend the instructions on filling in data-points in PRA101, PRA102, and PRA103 – Capital+; and the 'Disclosure - Key Metrics' template.

Remaining content of the FPC's proposed direction

8.3 The PRA considers that the proposals in this CP cover the changes required by the FPC's proposed direction. There are some measures in the proposed direction that are not specifically addressed in the proposals in this CP because the PRA considers that they are already implemented in PRA rules.

31 December 2015: https://www.bankofengland.co.uk/prudential-regulation/publication/2015/uk-leverage-ratio-instructions-for-completing-data-items-ss.

9 Scope of application

9.1 This section sets out the PRA's proposals in relation to the scope of application for the leverage ratio capital requirement and buffers. The proposals would amend the Leverage Ratio Part of the PRA Rulebook, which would be renamed the Leverage Ratio – Capital Requirements and Buffers Part. Reporting of non-UK assets would be introduced by amending the Reporting (CRR) Part of the PRA Rulebook.

9.2 In line with the FPC's proposed direction, the PRA proposes to apply the UK leverage ratio requirement to the following firms:

(i) all firms with retail deposits equal to or greater than £50 billion, or non-UK assets equal to or greater than £10 billion, when calculated on an individual basis, unless they are CRR consolidation entities referred to in (ii) or a ring fenced body identified in (iii) that is the ultimate parent within an RFB sub-group; or

(ii) CRR consolidation entities meeting the threshold referred to in (i) on the basis of their consolidated situation; or

(iii) a RFB that meets either threshold referred to in (i) above on an RFB sub-consolidated basis.[32]

9.3 For this purpose, non-UK assets means financial assets for which the counterparty is resident in a country or territory outside the UK. Most firms currently report this information in Financial Reporting (FINREP) Template F20.4.[33]

9.4 The PRA considers that the proposed criteria comply with the FPC's proposed direction to implement the leverage measures in relation to 'each UK bank, building society, or investment firm with significant non-UK assets'. The £10 billion non-UK assets threshold ensures that the major UK investment firms, as well as an additional small number of the larger and more interconnected firms with significant non-UK assets, are in scope of the requirement, covering 99% of non-UK assets. The criteria would therefore advance the PRA's primary objective of safety and soundness while aligning with international standards. Applying a leverage ratio requirement to these firms would seek to ensure that their business is carried on in a way which avoids any adverse effect on the stability of the UK financial system. It would also minimise the adverse effect that the failure of such firms could be expected to have on the stability of the UK financial system.

9.5 The retail deposits threshold is currently used to identify firms in scope of the leverage ratio requirement, and would ensure that the leverage ratio continues to apply to the most significant deposit-takers, the failure or unsafe risk-taking of which would have the capacity to cause very significant disruption to the UK financial system (and through that, to economic activity more widely).

9.6 The second proposed threshold would be new and would ensure that the leverage ratio applies to additional firms as specified in the FPC's direction, including designated investment firms and large internationally active broker-dealers. Applying a leverage ratio requirement to these firms

32 A ring-fenced body required to comply with Parts Two and Three of the CRR on sub-consolidated basis.

33 This is currently found at Annexes III and IV of Supervisory Reporting Implementing Technical Standards (ITS). The PRA consulted on Annexes III and IV to the Reporting (CRR) Part of the PRA Rulebook in CP5/21 'Implementation of Basel Standards', February 2021: https://www.bankofengland.co.uk/prudential-regulation/publication/2021/february/implementation-of-basel-standards.

would advance the PRA's safety and soundness objective because firms with this level of non-UK assets have the capacity to cause some disruption to the UK financial system in light of their size, interconnectedness, international activity, and/or the complexity of their business models. The PRA considers that this threshold is consistent with international standards.

9.7 The PRA considers that these proposals advance the PRA's secondary competition objective. The application of the leverage ratio to firms below the proposed thresholds would have implications for the secondary competition objective. Smaller firms would be more likely than larger firms to meet any additional requirements (including any MREL requirement) with higher-cost capital, as they tend to have more limited access to cheaper forms of capital. This additional capital funding cost could be a barrier to effective competition. Applying a supervisory expectation provides a more proportionate tool to mitigate the risk of excessive leverage for these firms. MREL is set with reference to regulatory requirements, not supervisory expectations. The Bank, as Resolution Authority, does not intend to propose changing this approach.

9.8 The PRA would keep both thresholds above under review to ensure they remain consistent with the Bank of England's annual concurrent stress testing framework and any simpler prudential regime for small banks and building societies that the PRA develops (as explored in Discussion Paper 1/21 'A strong and simple prudential framework for non-systemic banks and building societies').[34]

9.9 The PRA considers that this set of thresholds captures the type of firms set out in the FPC's proposed direction.

Thresholds measurement and reporting

9.10 The retail deposits threshold above refers to deposits from 'households'.[35] The threshold is measured as at a firm's last accounting reference date.

9.11 The non-UK assets threshold above is determined on the basis of the annual average amount calculated across a rolling period of three years (calculated by reference to the firm's annual accounting date). Where the firm has been in existence for less than three years, the calculation will be made on the basis of the annual average amount for the period during which the firm has been in existence (calculated by reference to the firm's annual accounting date).

9.12 The PRA proposes that the definition of non-UK assets be aligned with that used for reporting template F20.4 (geographical breakdown by residence of the counterparty). Firms would calculate their non-UK assets from F20.4 by subtracting those assets where the counterparty is resident in the UK from their total assets reported in this form.

9.13 Certain firms with total assets greater than £5 billion already report a geographical breakdown of assets by residence of the counterparty in Template F20.4, but others do not. To ensure that all firms provide this information, the PRA proposes to require all firms with total assets greater than £5 billion to report their non-UK assets in the leverage ratio template LV44, row 0050 (see Chapter 14). The PRA considers that the £5 billion reporting threshold is proportionate to capture firms that may be within the proposed scope of the leverage ratio, without being unduly burdensome to those that are unlikely to be. For all firms reporting in template F20.4, the PRA would expect the total non-UK assets reported in LV44, row 0050, to be consistent with the information provided in F20.4.

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[34] April 2021: https://www.bankofengland.co.uk/prudential-regulation/publication/2021/april/strong-and-simple-framework-banks.
[35] This means deposits from 'households' as defined in paragraph 42(f) of Part 1 of Annex V to the Reporting (CRR) Part.

10 Levels of application

10.1 This section sets out the PRA's proposals in relation to the levels of application for the leverage ratio capital requirement and buffers. These proposals would amend the Leverage Ratio Part of the PRA Rulebook, which would be renamed the Leverage Ratio – Capital Requirements and Buffers Part.

10.2 In line with the FPC's proposed direction, the PRA proposes to apply the leverage ratio capital requirement and buffers to firms in scope – ie those meeting either threshold in the previous section - at the following levels:

(i) on a consolidated basis to CRR consolidation entities, including holding companies for a UK consolidation group;

(ii) on a sub-consolidated basis in respect of a ring-fenced sub-group; or

(iii) in all other cases, to firms on an individual basis.

10.3 In addition, and in line with the FPC proposal and the FPC's considerations around financial stability and market functioning, the PRA proposes that case-by-case sub-consolidation be available as an alternative to individual application where a firm has subsidiaries that can be consolidated, provided that certain conditions are met (proposed criteria for sub-consolidation are below). In such cases, a firm may apply to the PRA for a permission under section 144G of FSMA that (i) dis-applies the requirements on an individual basis; and (ii) provides for the requirements to apply on a sub-consolidated basis in relation to the firm, with such modifications as may be specified in that permission.

10.4 The PRA proposes that if a firm meets the threshold on an individual basis, but it is also a CRR consolidation entity or a RFB which is the ultimate parent within a RFB sub-group, the same firm does not need to also meet the requirement on an individual basis. Where a consolidated or sub-consolidated requirement applies in relation to a group or sub-group, any subsidiary firm in the group or subgroup that individually meets either threshold for being in scope of the requirement would be required to meet the leverage ratio requirement on an individual basis.

10.5 The proposals on levels of application are intended to reinforce the effectiveness of the leverage ratio framework, therefore advancing the PRA's primary objective of safety and soundness while also aligning with international standards. Generally, applying the leverage ratio requirement at individual level ensures that capital can absorb losses where they occur, thereby advancing the PRA's primary objective. It is also consistent with the wider regulatory framework, and the FPC's intention to align the levels of application in the leverage ratio and risk-weighted capital frameworks. However, the PRA notes that case-by-case sub-consolidation has been allowed for in the FPC's proposed direction, to mitigate concerns that the leverage measures applied on an individual basis may disproportionately impact the capital position of relevant firms due to their group structure, potentially constraining the provision of market liquidity.

10.6 Finally, following the coming into force of The Financial Holding Companies (Approval etc.) and Capital Requirements (Capital Buffers and Macro-prudential Measures) (Amendment) (EU Exit) Regulations 2020, approved and designated holding companies will become responsible for ensuring that their group meets consolidated prudential requirements. In keeping with this approach, the PRA therefore proposes that, where the leverage ratio capital requirement is applied on a consolidated basis, the approved or designated holding company will be responsible for ensuring compliance with the consolidated capital requirement. This change would be consistent with the application of CRR consolidated requirements to holding companies consulted on by the PRA in CP5/21 'Implementation of Basel standards'.[36] This change would take effect from Saturday 1 January 2022.

Ring-fenced sub-groups and criteria for case-by-case sub-consolidation

10.7 The PRA already requires application of the leverage ratio requirement on a sub-consolidated basis in respect of the ring-fenced sub-group. The PRA proposes that an RFB which is the ultimate parent entity within a sub-consolidation group will not be subject to an individual requirement, if it meets the threshold on an individual basis.

10.8 A sub-consolidated requirement is available as an alternative to an individual requirement if a firm has subsidiaries that can be consolidated. Firms will need to apply to the PRA for permission to use this treatment. The PRA proposes to introduce a number of conditions to assess whether to grant the application. The following conditions would be introduced by amending SS45/15:

(i) the entities within the proposed sub-consolidation must be subsidiaries (as defined in the CRR) of the firm that is the ultimate parent of the sub-consolidation group. For example, this condition would be fulfilled when the firm at the top of the sub-consolidation group holds the majority of voting rights in the subsidiary undertaking, or is a member of the undertaking and has the right to appoint or remove a majority of the members of the management body of the subsidiary, or otherwise exercises dominant influence over the subsidiary undertaking, or it and the subsidiary undertaking are managed on an unified basis. The same conditions need to apply to all subsidiaries at each level of the sub-consolidation group;

(ii) evidence that leverage ratio risks and capital can be effectively managed and reported at sub-consolidated level: risk evaluation, measurement, and control procedures of the parent undertaking should cover the subsidiary, and the firm should be able to calculate the leverage ratio requirement and buffers (including a sub-consolidated CCyB) at sub-consolidated level;

(iii) evidence that effective governance is in place for the sub-group: the governance structure clearly allocates responsibilities for risk and capital decisions at sub-consolidated level for the firms included in the sub-consolidation; and

(iv) effective supervisory cooperation, including information exchange, in the countries where the subsidiaries are located, and transparent regulation/adherence to Basel standards. This would allow the inclusion of US and EU subsidiaries, for example.

10.9 The PRA would specify the scope of the sub-consolidation group in the permission and may also withdraw this permission when the conditions are not fulfilled anymore.

Individual consolidation

10.10 Under the CRR (Article 9), where certain conditions are met, the PRA may grant firms permission to apply certain prudential requirements on the basis of their consolidated situation with their subsidiaries rather than to the individual firm. This is known as 'individual consolidation'.

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36 February 2021: https://www.bankofengland.co.uk/prudential-regulation/publication/2021/february/implementation-of-basel-standards.

10.11 Where a firm has already received permission to apply individual consolidation for the purposes of requirements set out in the CRR, the PRA proposes to extend that permission automatically to the Capital Requirements and Buffers Part.

10.12 This would allow consolidation of unregulated subsidiaries with only exposures to the parent into the parent's individual regulatory position, and is consistent with the application of the risk-based requirements. This change would take effect from Saturday 1 January 2022.

11 Leverage exposure measure (LEM)

11.1 This chapter sets out the PRA's proposals to: (i) simplify the UK leverage ratio framework by defining a single leverage exposure measure (LEM) that applies for all purposes; and (ii) implement Basel III standards in the LEM. The FPC has welcomed the PRA's proposals to reflect the Basel III changes to the LEM.

11.2 The PRA proposes to introduce a new Leverage Ratio (CRR) Part of the PRA Rulebook, corresponding to Part Seven of the CRR, to define the LEM and reflect updated international standards.

Single definition of the leverage exposure measure

11.3 Currently there are two different LEM definitions, one in PRA rules and one in the CRR. Subject to HM Treasury deleting the on-shored CRR references and granting the PRA rulemaking power as per The Financial Services Act 2021, the PRA proposes to simplify the framework by applying a single LEM for all purposes (ie the leverage ratio capital requirement, the PRA's supervisory expectation, reporting and disclosure). This would align to the current PRA rules definition, which excludes central bank reserves.

11.4 For larger firms, a single definition would simplify gone-concern requirements, and reporting and disclosure requirements. For smaller firms, these changes would imply some initial implementation costs, however firms may benefit in the future from the exemption of central bank reserves.

Implementing updated international standards

11.5 Basel III has made changes to the leverage exposure measure, all of which the PRA proposes to implement. Two of these had been advocated by the FPC to support market functioning: i) netting of pending settlements; and ii) client clearing exemptions.[37] The PRA has already offered the first to firms as part of its Covid-19 response.

11.6 The Basel III LEM changes that the PRA proposes to implement are:

(i) **Netting of pending settlements:** Trade-date accounting allows offsetting between cash receivables for regular-way sales awaiting settlement, and cash payables for regular-way purchases awaiting settlement, but settlement-date accounting does not. Basel III aligns the treatment of pending settlements between accounting frameworks. The PRA offered this change to firms in April 2020 as a modification by consent. Subsequently, the CRR Covid-19 amending regulation brought forward incorporation into the CRR.38 The Financial Services Act 2021 has implemented this permanently in the UK CRR. This is not an effective change for any firm.

(ii) **Standardised approach to counterparty credit risk (SA-CCR)/client clearing:** The Basel III standards specify that SA-CCR should be implemented by firms that do not use the internal models method (IMM). SA-CCR improves upon the risk sensitivity of the non-modelled approaches to counterparty credit risk that are currently used by differentiating between

[37] July 2016 Financial Stability Report: https://www.bankofengland.co.uk/financial-stability-report/2016/july-2016.
[38] Regulation (EU) 2020/873 of the European Parliament and of the Council of 24 June 2020 amending Regulation (EU) No 575/2013 and (EU) 2019/876 as regards certain adjustments in response to the Covid-19 pandemic.

margined and un-margined, as well as bilateral and cleared, trades. It addresses known deficiencies of the existing standardised approaches and minimises discretion used by national authorities and firms. The PRA considers SA-CCR to be prudent, given its higher risk sensitivity, and proposes to also implement it for the leverage ratio in line with Basel III. The PRA consulted in CP5/21 on implementing SA-CCR for the risk-weighted framework. For the purposes of the leverage ratio, the PRA proposes to reference directly to the risk-weighted SA-CCR, once finalised, subject to restrictions on the amount and types of collateral that can reduce the replacement cost of derivatives exposures[39] and potential future exposures (by setting the multiplier at 1).[40]

(iii) **Cash pooling:** Basel III allows banks to net credit and debit balances of participating accounts if the transfer of individual balances occurs according to strict criteria. The PRA considers this approach would be prudent, given qualifying accounts are deemed economically equivalent to a single account, and proposes to implement it in respect of Tier 1 capital that is eligible for the UK leverage ratio's capital measure.

(iv) **Eligible general provisions:** Basel III allows for general loan-loss reserves that have reduced Tier 1 capital to be deducted from LEM. The PRA considers this approach would be prudent, given such exposures will already be reflected in firms' Tier 1 resources, and proposes to implement it.

(v) **Tri-party agents:** In line with the approach for calculating the total value of securities and cash lent to a counterparty, Basel III requires including in the LEM securities deposited at tri-party repo agents in the securities financing transaction (SFT) counterparty credit risk (CCR) add-on. However, Basel III clarifies that excluding from the LEM excess collateral that has been deposited at tri-party agents but not lent out is permitted. The PRA considers this a prudent clarification, and proposes to implement it.

(vi) **Securities financing transactions (SFT) netting conditions:** Basel III provides a clarification of the conditions that allow the netting of cash payables and receivables in SFTs with the same counterparty, setting out what constitutes the functional equivalent of net settlement. The PRA considers these clarifications are informative and prudent and proposes to implement them.

(vii) **Notional exposure of written credit derivatives:** Basel III introduces changes to the criteria for reducing the notional value of written credit derivatives to ensure that a bank may only recognise offsetting from another purchased credit derivative to the extent that the purchased protection is certain to deliver a payment in all potential future states. It also introduces additional criteria, including to limit specific wrong-way risk. The PRA considers these criteria to be prudent and proposes to implement them.

11.7 In addition, the PRA proposes to write into PRA rules the existing modification by consent related to exempting the stock of Bounce Back Loan Schemes loans that were made in 2020. This exemption was made as part of the PRA's Covid-19 response. With the rules changes consulted on, the existing modification by consent would lapse. So to continue its effect the PRA would need to re-offer it, firms would need to re-apply, and the PRA would need to re-grant it. Writing it into rules provides greater certainty for firms and decreases resources required for the PRA and firms.

39 Only eligible cash variation margin that meets certain conditions can be used to reduce the replacement cost. Derivatives collateral can include cash and non-cash initial margin and variation margin.

40 In the risk-based framework, the PFE multiplier under SA-CCR can fall below 1 to partially recognise over-collateralisation (when the total value of collateral exceeds the replacement cost), with a floor of 0.05.

Other changes to the LEM

11.8 In CP5/21, the PRA consulted on, and is in the process of finalising the rules on, implementing simplified approaches for smaller firms as alternatives to SA-CCR in the risk-weighted framework. These alternative approaches are not contained within Basel standards, but are more proportionate, and the calibrations are more conservative in calculating derivatives exposures relative to SA-CCR. To ensure consistency across the frameworks, the PRA proposes to also allow these methods to be used in the leverage ratio framework if a firm uses them in the risk-weighted framework.

Simplified SA-CCR (sSA-CCR)

11.9 In CP5/21, the PRA consulted on implementing a simplified version of SA-CCR in the risk-weighted framework (sSA-CCR). The proposals simplify a number of methodological aspects of SA-CCR, while keeping the structure of the framework unchanged. The calibration of sSA-CCR is more conservative in calculating derivatives exposures than SA-CCR.

11.10 The PRA proposes that sSA-CCR would also be available to be used in the leverage framework by firms below a specific quantitative threshold. sSA-CCR would be available to firms with an on-and-off-balance sheet derivative business that is equal to or less than £260 million and 10% of their total assets, mirroring the risk-weighted framework.

Original Exposure Method (OEM)

11.11 The UK's existing regulatory framework already provides smaller, less complex firms with a simplified alternative to the calculation of derivatives exposures, the OEM, which represents the simplest methodology for calculating the exposure value. In CP5/21, the PRA consulted on retaining and updating the OEM in the risk-weighted framework.

11.12 The PRA proposes that the OEM would also remain available to be used in the leverage ratio framework by firms below a specific quantitative threshold, once updated for the changes being made in the risk-weighted framework. The OEM would be available to firms if the size of their on- and off-balance sheet derivative business is equal to or less than £88 million and 5% of total assets, mirroring the risk-weighted framework.

Basel III Credit Conversion Factors (CCFs)

11.13 Basel III also introduces changes to the credit conversion factors (CCFs) for off-balance sheet items to better reflect the risk of these items coming on balance sheet.

11.14 These factors are also used in the risk-weighted framework, and the PRA will consult on their implementation as part of the implementation of Basel III. Therefore, the PRA is not proposing any changes at this time. The PRA will propose to implement them in the leverage ratio framework at a later date, in line with their implementation as part of the wider remaining risk-weighted Basel III implementation. This would avoid firms having to use different CCFs across the two frameworks.

12 Leverage ratio capital measure

12.1 This chapter sets out the PRA's proposal to simplify the UK leverage ratio framework by defining a single leverage ratio capital measure that applies for all purposes. The leverage ratio capital measure will be defined in the new Leverage Ratio (CRR) Part of the PRA Rulebook, corresponding to Part Seven of the CRR.

Single definition of the capital measure

12.2 Currently there are two different capital measures for leverage ratio purposes, one in PRA rules and one in the CRR. Subject to HM Treasury deleting the on-shored CRR references and granting the PRA rulemaking power as per the Financial Services Act 2021, the PRA proposes to simplify the framework by applying a single capital measure for all purposes (ie the leverage ratio capital requirement, the PRA's supervisory expectation, reporting and disclosure). In accordance with the FPC's direction, this would align to the current PRA rules definition in being based on the CRR definition of Tier 1 capital but excluding AT1 instruments with a conversion trigger below 7%.

12.3 The capital measure in PRA rules currently expressly allows the inclusion of instruments that qualify for the application of transitionals under Article 483 of the CRR. The PRA proposes to remove that provision, as Article 483 has expired. The leverage capital measure is subject to other continuing transitional measures in Part 10 of the CRR insofar as they are relevant to the CRR definition of Tier 1 capital, including the IFRS 9 transitional that the PRA encouraged firms to use as part of the Covid-19 response,[41] and the application of transitionals to certain AT1 instruments issued prior to Tuesday 27 June 2019.[42]

12.4 A single definition of the leverage ratio capital measure will simplify the UK leverage framework and will enhance resilience by applying the 7% trigger to all firms for the purposes of reporting, disclosure, and the PRA's supervisory expectation. A lower trigger could undermine the resilience provided by the leverage ratio, because it is based on risk-weighted CET1 resources. Firms for which leverage ratios bind tend to have very low average risk weights – and therefore a seemingly very high risk-weighted capital ratio. In some cases, AT1 may not be converted well after the leverage minimum has been breached, limiting the usefulness of leverage ratio capital in going concern.

12.5 The PRA has assessed that this change should have a negligible impact as all AT1 issued by UK firms already has a 7% Tier 1 trigger, and most of the smaller firms generally do not issue AT1.

41 Article 473a.
42 Article 494b.

13 Supervisory expectation on risk of excessive leverage for firms not subject to a minimum requirement

13.1 This chapter sets out the PRA's proposals in relation to the risks of excessive leverage. This section applies to all firms and CRR consolidation entities not subject to a minimum requirement.

13.2 The PRA has previously stated that all firms are expected to consider whether their degree of leverage is appropriate against the internationally agreed measure of leverage.[43] Chapter 11 of the Internal Capital Adequacy Assessment (ICAA) Part of the PRA Rulebook requires firms to monitor and address the risks of excessive leverage. Rule 11.2 requires firms to use the CRR's definition of the leverage ratio as an indicator of the level of risk. The PRA proposes to update this rule and to refer to the revised single definition of the leverage ratio as set out in this consultation, rather than the CRR definition. In addition, the PRA proposes to update SS45/15 to set out that the PRA expects that the firms' leverage ratio in most circumstances will be greater than 3.25%.

13.3 The PRA proposes to expect that firms not in scope of the leverage ratio minimum capital requirement and buffers should manage their leverage risk so that their leverage ratio, as calculated in accordance with the Leverage Ratio (CRR) Part of the Rulebook, does not ordinarily fall below 3.25%.

13.4 As set out in Chapter 12, the PRA proposes to align the leverage exposure measure disclosed by such firms and used to monitor their risk of excessive leverage with the measure used for the minimum capital requirement for firms in scope of a minimum requirement. The PRA considers that a consistent approach across firms is beneficial in terms of simplifying the framework, is in line with the FPC's Direction on the leverage ratio, and avoids unintended consequences of including central bank reserves in the exposure measure.

13.5 The PRA proposes that firms not in scope of the leverage ratio requirement and buffers should meet the expectation with at least 75% CET1 (ie the highest quality of capital). This approach ensures that capital used to meet the leverage ratio expectation is sufficiently loss-absorbing in going concern.

13.6 Overall, the PRA has assessed that an expectation of a leverage ratio – mirroring the calculation of the minimum leverage ratio requirement – should provide a strong framework to mitigate excessive leverage for smaller firms. Not applying a minimum requirement to these firms would preserve proportionality between the increases in their cost of capital and in their resilience. Additionally, this approach will create a single leverage ratio that is used to define a minimum capital requirement and buffers for firms in scope of the leverage ratio requirement, and will ensure that it is reported, disclosed, and used to monitor leverage risk by all firms. The PRA considers that setting this expectation clearly will aid transparency and create incentives for firms to manage the risk effectively.

13.7 The PRA does not propose to include any equivalents to the regulatory leverage buffers in its expectations for firms not in scope of a minimum requirement. However, in line with ICAA 11.3,

[43] 'The PRA's Approach to Banking Supervision', paragraph 87.

firms should take a forward-looking view of leverage risk in order to withstand stress events. This expectation should not conflict with the PRA's approach to buffer usability.[44]

13.8 The PRA proposes to expect that for a firm not in scope of the leverage ratio minimum capital requirement and buffers, the leverage ratio will not fall below 3.25% in the normal course of business or as part of its base business plan. The PRA acknowledges, however, that for such firms there may be occasions, such as in a systemic stress or immediately following an idiosyncratic stress, where firms may not meet this expectation. Failure to meet the expectation does not create a presumption that a firm is breaching Chapter 11 of the ICAA Part or not meeting Threshold Conditions. The PRA proposes that the leverage ratio expectation would not need to be met immediately following resolution.

13.9 The PRA proposes that firms should notify their supervisors as soon as practical if they do not meet or expect not to meet the PRA's expectation. There would be no automatic consequences, but a firm which does not meet the expectation can expect enhanced supervisory action, and should prepare a credible plan to reduce excessive leverage. If the PRA is satisfied with the rationale presented for not meeting the expectation, the PRA would allow a firm to manage its excessive leverage by restoring compliance with the expectation over a reasonable period of time. In exercising its judgement on what constitutes a reasonable time to manage excessive leverage and other potential supervisory action, the PRA would take into account the firm's leverage ratio, the firms' rationale for not meeting the expectation, the expected period over which the firm would not meet the expectation, the drivers of the excessive leverage, the context of the excessive leverage (whether firm-specific or systemic), and macroeconomic and financial conditions. If the PRA is not satisfied with the firm's plan to reduce excessive leverage or with the firm's reasons for not meeting the expectation, it may consider using its powers under section 55M of FSMA to resolve the issue, including by requiring the firm to raise sufficient capital to meet the expectation within an appropriate timeframe.

13.10 Having regard to its secondary competition objective, the PRA considers that this expectation is a proportionate approach to advance the safety and soundness of firms not in scope of the leverage ratio minimum requirement. It mitigates excessive leverage for these firms and provides capital against unforeseeable risks, while allowing flexibility in the assessment of individual firms' circumstances. The PRA has assessed that firms not in scope of the leverage ratio requirement have a low leverage footprint, and the impact of their failure on the provision of critical services would be limited.

[44] Q&A on the use of Liquidity and Capital Buffers: https://www.bankofengland.co.uk/prudential-regulation/publication/2020/buffer-usability-qanda.

14 Reporting

14.1 This chapter sets out the PRA's proposals to update PRA supervisory reporting requirements for the leverage ratio and buffers, reflecting the proposals set out elsewhere in this CP to implement Basel standards and to simplify the UK's leverage ratio framework.

14.2 These proposals would amend the Reporting (CRR) Part of the PRA Rulebook and delete the Reporting Leverage Ratio Part of the PRA Rulebook in order to remove duplicative reporting requirements.

14.3 The PRA has considered how to update the leverage reporting framework in line with international standards in a proportionate manner that best serves financial stability, is consistent with the existing reporting requirements, and that firms can implement efficiently. The PRA has been mindful of the need to do so in a way that also maintains precision in the requirements and control over the quality of submitted data, including the direct relationships between data points and regulatory definitions, and validation rules to enforce these relationships.

14.4 In line with the PRA's proposal to create a single definition of the LEM that applies for all purposes, the PRA proposes to create a single, harmonised set of leverage reporting templates that will be reported by all firms.

14.5 Appendix 1 sets out the PRA's proposed leverage ratio reporting rules. Appendix 6 sets out the proposed reporting templates and instructions.

14.6 The PRA proposes to continue to require all firms and CRR consolidation entities to report their leverage ratios to the PRA. This should be at individual, consolidated and, for ring-fenced banks, sub-consolidated levels of application in line with wider CRR reporting requirements. The PRA also proposes to require all firms to report their leverage ratios both inclusive and exclusive of central bank reserves, and inclusive and exclusive of transitional measures. Firms subject to the leverage ratio minimum capital requirement would continue to be subject to additional reporting requirements, at the same level of application as the minimum capital requirement applies, including the calculation of the leverage ratio on an averaged basis, the countercyclical leverage ratio buffer, and capital surpluses/shortfalls to the requirement.

14.7 The PRA proposes to require firms to report all leverage reporting templates to the PRA on a quarterly basis, with a remittance of 42 calendar days, in line with the proposed timelines for quarterly reporting of non-leverage information.[45] Reporting and remittance dates for each quarter of the year are outlined in the table below. Where the remittance day is a public holiday or falls on a Saturday or Sunday, the data should be submitted on the following working day.

Table 4 – Reporting and remittance dates for leverage reporting templates

Quarter	Reporting date	Remittance date
1	31 March	12 May
2	30 June	11 August
3	30 September	11 November
4	31 December	11 February

45 Article 2 of Chapter 5 of the Reporting (CRR) Part.

Templates

14.8 The PRA proposes to create a single set of leverage reporting templates to replace existing templates (FSA083 and COREP templates C40–C48), and to ensure consistency with the UK's updated leverage ratio framework. The PRA considers these changes to be prudent and proportionate, as they will avoid duplication and reduce the number of data points that need to be reported. Specifically, the PRA proposes:

(a) to align the templates with revised Basel III standards on the exposure measure. To do so, the PRA proposes to largely base its new leverage reporting templates on the European Banking Authority's (EBA) Taxonomy 3.0 version of the COREP leverage reporting templates (C40–C48), which have recently been updated in line with Basel standards;

(b) to make line-by-line edits to the EBA's Taxonomy 3.0 version of the COREP leverage reporting templates (C40–C48) to ensure that the templates remain operational in the UK's new leverage ratio framework; and

(c) to simplify reporting by removing duplicative or unnecessary templates such that there is a single set of leverage reporting templates that applies for all purposes.

14.9 The PRA also proposes to create a single source of leverage reporting requirements for UK firms, by incorporating requirements from the Reporting Leverage Ratio Part of the PRA Rulebook into the proposed Reporting (CRR) Part of the PRA Rulebook, to achieve a single, consolidated regime and to simplify current leverage reporting. The PRA proposes to incorporate all leverage reporting templates and instructions in the PRA Rulebook.

14.10 The following mapping table sets out the names of the new leverage reporting templates that the PRA is proposing to implement, alongside the existing template(s) that they would be replacing, and the content of each:

Table 5 – Proposed new leverage reporting templates

Current template(s)	New template	Content
C47, FSA083	LV47	Reporting on the calculation of the leverage ratio, including the calculation of the leverage ratio on an average basis for firms in scope of the UK's leverage ratio requirement.
C40	LV40	Reporting on an alternative treatment of the exposure measure.
C41	LV41	Reporting on an additional breakdown of on- and off-balance sheet exposures in accordance with the risk weight.[46]
C42	[none]	[n/a]
C43	LV43	Reporting on an alternative breakdown of leverage exposure measure components.
C44	LV44	Reporting on general information.

46 This template is based on COREP template C41. Although the EBA is removing this template as part of the Taxonomy 3.0 changes, the PRA proposes to retain this template. The data helps in monitoring the risk composition of leverage ratio exposures, supports the PRA's supervisory activities, and provides useful information for future reviews of the leverage ratio framework.

14.11 The PRA proposes to add a row in template LV44 to collect data on non-UK assets, as described in paragraph 9.13. The PRA also proposes to require all firms to report as a memorandum item in template LV47 both LEM and Tier 1 capital on a fully-phased in basis, except for the inclusion of IFRS9 transitionals.[47] This will allow for the calculation of the leverage ratio on a fully-phased in basis but including the benefit of IFRS9 transitionals. This is one of the FPC's published core indicators.

14.12 The PRA proposes to make consequential amendments to references to leverage elsewhere in wider regulatory reporting (namely, to update the instructions for Capital+ templates PRA101, PRA102, and PRA103, such that they refer to the updated leverage exposure measure outlined elsewhere in this CP). Appendix 5 sets out the PRA's proposals for updated instructions for these templates via amendments to SS34/15.[48]

Averaging requirements

14.13 The PRA proposes to update its reporting requirement for the calculation of the leverage ratio on an averaging basis, to align with new international disclosure standards. The BCBS published a statement in June 2019 indicating that the disclosure of daily averages of SFT exposures would be necessary.[49] The PRA therefore proposes to update its calculation of the averaged leverage ratio to include a daily average, rather than a month-end average, for SFT exposures. The PRA proposes to update guidance in SS45/15 on the new calculation for an averaged leverage ratio over a quarter, which will be based on:

- Daily on-balance sheet assets and SFT exposures averaged over the quarter; and
- End-of-month exposures averaged over the quarter for the remaining off-balance sheet items, the capital measure, and relevant deductions and adjustments.

14.14 The PRA proposes to continue to require only firms in scope of the leverage ratio capital requirement to report the calculation of the leverage ratio on an averaging basis.

14.15 The PRA proposes to reflect this update in reporting requirements to align the information that firms report to the PRA with their Pillar 3 disclosures. The PRA considers that this proposal appropriately balances the advancement of the PRA general objective, costs to firms, and Basel equivalence.

14.16 The PRA proposes to introduce a transitional for reporting of the new method of calculation for averaged leverage exposures described above. The PRA proposes that firms subject to a requirement to do so must report their averaged leverage exposures based on this new calculation from Sunday 1 January 2023, while retaining the existing calculation until this date. During the transitional period, the calculation for an averaged leverage ratio over a quarter will be based on:

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47 Article 473a.
48 The PRA has consulted on changes to templates PRA101, PRA102, and PRA103 as part of CP5/21. The changes to these templates outlined in this CP are subject to any changes that may be made to the templates as a result of that consultation.
49 https://www. bis.org/press/p190626.htm.

- Daily on-balance sheet assets averaged over the quarter; and
- End-of-month averages for off-balance sheet exposures, the capital measure, and relevant deductions and adjustments over the quarter.

14.17 The PRA proposes not to adopt COREP template C48, which was introduced by the EBA in its Taxonomy 3.0 to incorporate reporting of mean SFT exposures. Instead, the PRA proposes to incorporate averaging reporting requirements into template LV47, to be consistent with the existing approach to averaging of leverage ratio components.

Currency denomination of thresholds and monetary values

14.18 The PRA proposes to specify in GBP the thresholds and monetary values included in the proposed PRA rules for the leverage reporting proposed in this chapter.

14.19 In transposing Capital Requirements Directive V (CRD V), the PRA already redenominated EUR thresholds in PRA rules for certain remuneration purposes. Similarly, in CP5/21, the PRA consulted on taking a consistent approach in respect of the implementation of international standards.

14.20 The PRA proposes to take a consistent approach in specifying thresholds and monetary values in PRA rules covered by this CP. The PRA proposes to use the same average daily GBP/EUR spot exchange rate as that used in CP5/21, covering the 12-month period prior to Friday 10 July 2020, rounded to the nearest integer: £1 = €1.14. The PRA proposes also to round the redenominated GBP values to two significant figures.

Table 6 – Proposed GBP thresholds and monetary values

Relevant PRA rule	Summary	EUR (€ billion)	Proposed GBP (£ billion)
Article 15 (5) of Chapter 5 of the Reporting (CRR) Part	Materiality threshold for the total notional value of derivatives above which firms must report additional breakdowns of derivatives exposures	10	8.8
Relevant PRA rule	Summary	EUR (€ million)	Proposed GBP (£ million)
Article 15 (6) (a) of Chapter 5 of the Reporting (CRR) Part	Materiality threshold for the credit derivatives volume above which firms must report additional breakdowns of derivatives exposures	300	260
Article 15 (6) (b) of Chapter 5 of the Reporting (CRR) Part	Materiality threshold for the credit derivatives volume above which firms must report additional breakdowns of derivatives exposures	500	440

15 Disclosure

15.1 This chapter sets out the PRA's proposals to update the UK Pillar 3 disclosure requirements for the leverage ratio, and key metrics, which aim to align to the new Basel Pillar 3 leverage disclosure requirements and reflect the proposals set out elsewhere in this CP to simplify the UK's leverage ratio framework.

15.2 These proposals would amend the Disclosure (CRR) Part of the PRA Rulebook and the Public Disclosure Part of the PRA Rulebook, in order to remove duplicative disclosure requirements.

15.3 BCBS has made changes in recent years to its standards on Pillar 3 disclosure for the leverage ratio, which reflect many of the changes to the definition of the leverage exposure measure proposed in this CP. The PRA considers that it is important for the UK to be aligned to international standards on disclosure, in the form prescribed by the BCBS disclosure framework. This ensures that UK firms show the same level of transparency as their peers in other jurisdictions, and ensures that they will be subject to the same forces of market discipline. Investors would therefore have consistent and comparable information on which to judge firms.

15.4 The PRA proposes to continue to require firms and CRR consolidation entities to disclose their leverage ratios. The level of application of the leverage ratio disclosure regime should align with the wider CRR disclosure regime as consulted on in CP5/21. The PRA proposes to require firms to disclose their leverage ratios, both inclusive and exclusive of central bank reserves, and inclusive and exclusive of certain transitional measures, in line with its wider commitment to implement international disclosure standards. Firms subject to the leverage ratio minimum capital requirement would be subject to additional disclosures, at the same level of application as the minimum capital requirement applies, in relation to averaging and the countercyclical leverage ratio buffer.

15.5 The PRA proposes to replace existing leverage-specific disclosure templates with a revised set of templates, and related instructions, which are consistent with the Basel disclosure framework and the PRA's proposed requirements for the leverage ratio. The PRA proposes to also make consequential amendments to references to leverage elsewhere in wider regulatory disclosure templates, including in template UK KM1 in Annex I of UK Pillar 3 disclosure data items. All firms are to continue to disclose the leverage ratio and leverage exposure measure, both exclusive and inclusive of central bank claims, as key metrics in UK KM1. The PRA proposes to amend template UK KM1 such that it includes a section for additional disclosure requirements for firms in scope of the leverage ratio capital requirement, including the leverage ratio inclusive of central bank claims, the average leverage ratio inclusive and exclusive of central bank claims, and the leverage ratio exclusive of central bank claims on a fully loaded ECL accounting model basis, in line with new Basel disclosure requirements.[50]

15.6 All relevant proposed disclosure templates, and the proposed frequency of disclosure for various types of firms, are outlined in the following table:

50 The PRA is has consulted on changes to templates UK KM1 as part of CP5/21. The changes to these templates outlined in this CP are subject to any changes that may be made to the templates as a result of that consultation.

Table 7 – Disclosure frequencies for leverage disclosure templates

Template	Frequency large institutions (listed)	Frequency large institutions (not listed)	Frequency other institutions (listed)
UK LR1 - LRSum: Summary reconciliation of accounting assets and leverage ratio exposures	Semi-annual	Annual	Annual
UK LR2 - LRCom: Leverage ratio common disclosure	Annual (for rows 28 to UK-34); Semi-annual (for rows up to row 28)(1)	Annual(2)	Annual(3)
UK LR3 - LRSpl: Split-up of on balance sheet exposures (excluding derivatives, SFTs, and exempted exposures)	Semi-annual	Annual	Annual
UK LRA – Free format text boxes for disclosure on qualitative items	Annual	Annual	Annual
UK KM1 – Key metrics template; rows 13 to 14e	Quarterly(4)	Semi-annual(5)	Semi-annual(6)

Footnotes:

(1), (2), (3) Institutions that are in scope of the leverage ratio minimum requirement shall disclose values in UKL2 – LRCom; UK-24b, UKL2 – LRCom; 25, UKL2 – LRCom; UK-25a, UKL2 – LRCom; UK-25c, UKL2 – LRCom; 27, UKL2 – LRCom; UK-27b, UKL2 – LRCom; UK-33 and UKL2 – LRCom; UK-34 with a quarterly frequency.

(4), (5), (6) Institutions that are in scope of the leverage ratio minimum requirement shall disclose values in rows 13 to 14e of template UK KM1 with a quarterly frequency.

15.7 As set out in section 12 above, the leverage ratio is subject to certain capital transitional measures in Part 10 of the CRR. In addition, the PRA proposes that firms should continue to be required to disclose what their leverage ratios would have been if they were instead to exclude the effect of the transitional measures in Articles 468 and 473a.[51] In light of those specific requirements, and the expiry of other transitional measures in Part 10, the PRA considers that the option in Article 499(2), of choosing between transitional and end-state leverage ratio disclosure, is not necessary after 31 December, and proposes to remove that option.

15.8 The PRA also proposes to create a single source of leverage disclosure requirements for UK firms, by incorporating additional requirements from Chapter 3 of the Public Disclosure Part of the PRA Rulebook into the proposed Disclosure (CRR) Part of the PRA Rulebook, to achieve a single, consolidated regime and simplify current leverage disclosure.

15.9 Appendix 6 sets out the PRA's proposed leverage disclosure requirements, including templates and instructions. Appendix 1 sets out the disclosure rule instrument.

Averaging requirements

15.10 The PRA proposes to update its disclosure requirements for the calculation of the leverage ratio on an averaging basis. As outlined elsewhere in this CP, the PRA proposes to update the calculation of the averaged leverage ratio to include a daily average, rather than a month-end

51 See Article 468(5) and 473a(8).

average, for SFT exposures, while keeping the remainder of the calculation the same, to align with new Basel disclosure requirements. The PRA proposes to reflect this update in disclosure requirements for firms' averaged leverage exposure measures and leverage ratios, and to introduce a disclosure requirement for a daily average of SFT exposures, in line with the wider commitment to implement international standards. The PRA proposes to update SS45/15 to set out the new calculation for an averaged leverage ratio over a quarter. The new methodology is described in paragraph 14.13 above (Reporting).

15.11 The PRA proposes to continue to require only firms in scope of the UK leverage ratio requirement to disclose the calculation of the leverage ratio on an averaging basis. The PRA considers that this appropriately balances the advancement of the PRA objectives, costs to firms, and Basel equivalence.

15.12 The PRA proposes to introduce a transitional for disclosure of the new method of calculation for averaged leverage exposures described above. The PRA proposes that firms would be required to disclose their averaged leverage exposures based on this new calculation from Sunday 1 January 2023, while retaining the existing calculation until this date.

16 The PRA's statutory obligations

16.1 In carrying out its policy making functions, the PRA is required to comply with several legal obligations. The PRA has a statutory duty to consult when introducing new rules (FSMA s138J), or new standards instruments (FSMA s138S). When not making rules, the PRA has a public law duty to consult widely where it would be fair to do so.

16.2 The PRA fulfils its statutory obligations and public law duties by providing the following in relation to the proposed policy:

(i) **a cost benefit analysis**;

(ii) **compatibility with the PRA's objectives:** an explanation of the PRA's reasons for considering that making the proposed rules is compatible with the PRA's duty to act in a way that advances its general objective,[52] insurance objective[53] (if applicable), and secondary competition objective;[54]

(iii) **FSMA regulatory principles**: an explanation of the ways in which having regard to the regulatory principles has affected the proposed rules;[55]

(iv) **CRR rules**: in addition to the above, FSMA requires the PRA to 'have regard' to several further matters when making CRR rules.[56] It also requires the PRA to explain how the new 'have regards' have affected its proposed rules.[57] The FS Act further requires the PRA to 'consider, and consult the Treasury about, the likely effect of the rules on relevant equivalence decisions';[58]

(v) **impact on mutuals**: a statement as to whether the impact of the proposed rules will be significantly different to mutuals than to other persons;[59]

(vi) **HM Treasury recommendation letter**: the Prudential Regulation Committee (PRC) should have regard to aspects of the Government's economic policy as recommended by HM Treasury; [60] and

(vii) **equality and diversity**: the PRA is also required by the Equality Act 2010[61] to have due regard to the need to eliminate discrimination and to promote equality of opportunity in carrying out its policies, services, and functions.

52 Section 2B of FSMA.
53 Section 2C of FSMA.
54 Section 2H(1) of FSMA.
55 Sections 2H(2) and 3B of FSMA.
56 Section 144C(1) of FSMA.
57 Section 144D of FSMA.
58 Section 144C(3) of FSMA.
59 Section 138K of FSMA.
60 Section 30B of the Bank of England Act 1998.
61 Section 149.

Impact on mutuals

16.3 The PRA considers that the impact of the proposed rule changes and expectations on mutuals would not differ from the impact on other smaller firms, generally unable to issue forms of capital cheaper than CET1. The proposal to use a supervisory expectation, rather than a binding requirement, may limit this effect provided these firms maintain (or potentially reduce) current capital surpluses over requirements.

Equality and diversity

16.4 The PRA considers that the proposals do not give rise to equality and diversity implications.

Objectives and have regards

16.5 Appendix 7 lists the statutory obligations applicable to the PRA's policy development process. Where have regards have not been explicitly considered in this chapter, it is because the PRA has considered them not to be relevant to the proposals.

16.6 The analysis in this rest of this chapter explains how each set of proposals have had regard to the most relevant matters listed in paragraph 16.2, including an explanation of the ways in which having regard to these matters has affected the proposals.

The leverage ratio stack

Scope of application

16.7 In line with the FPC's proposal, the PRA proposes to extend the leverage ratio capital requirement to include firms with significant non-UK assets. The PRA proposes using a simple threshold to identify firms with significant non-UK assets, based on foreign assets equal to or greater than £10 billion (calculated on an individual, consolidated, and sub-consolidated basis as applicable). Firms currently subject to a leverage ratio requirement based on the £50 billion deposits threshold, (ie the large UK groups and their RFB subsidiaries), will continue to be in scope. The PRA does not propose to set a leverage ratio requirement on other not systemically important firms; however, the PRA proposes to strengthen the existing supervisory expectation on these firms.

16.8 The proposals are intended to ensure that the leverage ratio framework is in place for the largest and most interconnected firms and groups, therefore advancing the PRA's primary objective of safety and soundness while also aligning with international standards. The PRA has considered the less material prudential and financial stability benefits of including smaller firms in scope of a requirement, the impact on cost of capital and the proportionality of such costs to the increase in resilience, and the contribution of the leverage ratio requirement vis-à-vis other planned policy changes. These considerations support not applying a minimum leverage ratio requirement to smaller firms.

16.9 In terms of identifying the largest and most interconnected firms, a dual threshold is considered appropriate: a retail deposit threshold to capture domestic importance, and a foreign assets threshold to capture banks in scope because of significant international activity. The thresholds are based on financial information and are simple and transparent.

PRA objectives

16.10 Given their size, financial interconnectedness and complexity, the PRA considers that applying a leverage ratio requirement to firms and groups with significant non-UK assets would advance the PRA's primary objective. Other, not systemically important, firms have a lower leverage footprint, and the impact of their failure on the provision of critical services would be more limited; the PRA is proposing setting a supervisory expectation for a minimum leverage ratio in order to reduce excessive leverage for these firms.

16.11 The proposals aim to achieve simplicity, proportionality between burden and benefits, and transparency in how the PRA exercises its functions, thereby advancing the PRA's secondary competition objective.

16.12 The application of the leverage ratio to smaller firms would have implications for the secondary competition objective. Smaller firms would be more likely to meet any additional requirements with CET1 capital, as they tend to have more limited access to cheaper forms of capital. This additional capital funding cost could be a barrier to effective competition. Applying a supervisory expectation provides a more proportionate tool to mitigate the risk of excessive leverage for these firms.

Have regards

16.13 **International standards**: firms with significant non-UK assets conduct a considerable amount of cross-border activity. The Basel standards require the leverage framework to apply to all internationally active banks at consolidated and either sub-consolidated or solo level. The PRA proposals are consistent with these international standards. The proposed UK framework is stronger, compared to international standards, in two key areas: (i) the requirement and supervisory expectation are to be met with at least 75% CET1 instead of 100% Tier 1 capital; any AT1 instruments need to have a minimum 7% trigger; and (ii) additional leverage buffers apply, mirroring the RWA CCyB and O-SII buffer. The UK framework applies a 35% conversion factor to the G-SII buffer instead of 50% and there are no automatic MDA restrictions when firms breach their buffers. On the former, the PRA assesses that overall, taking into account the additional leverage buffers and higher quality of capital, the UK framework delivers at least as much resilience as required by international standards. On the latter, the PRA notes that it can use its discretionary powers as appropriate to restrict distributions (s.55M FSMA), and that in practice the risk-weighted buffers, which have automatic distribution restrictions, exceed the leverage buffer for global systemically important institutions. The PRA considers that the design of its framework enhances UK firms' resilience and contributes towards ensuring the quality of firms' capital resources, which is important for maintaining creditor confidence in UK firms.

16.14 **Efficient and economic use of resources**: the proposals support the efficient and economic use of the PRA's resources, by setting a requirement where it matters the most (ie the largest domestic and internationally focussed firms) and reducing the capital burden on smaller, less systemic firms.

16.15 **Proportionality and different business models**: the proposals are proportionate to firms' size and complexity. In particular, by applying a strengthened supervisory expectation instead of a minimum requirement to smaller firms, the PRA allows some flexibility and reduces those firms' implementation costs.

16.16 **Relative standing of the UK and competitiveness:** The proposals to apply a leverage ratio requirement to firms with significant non-UK assets are in line with the approach taken in peer jurisdictions. Implementing international standards is important to ensure that the UK remains a safe and attractive domicile for internationally active financial institutions. The proposals have been tailored to be proportionate and only impose a further constraint on firms where this is necessary to meet FPC and PRA objectives.

16.17 **Finance for the real economy, growth, and sustainable growth:** Few of the firms with significant non-UK assets are expected to become leverage ratio-bound, and few lend to the real economy. The FPC has in the past raised concerns on market functioning due to the potential impact of the leverage ratio requirement on low margin/low risk businesses, such as specialised broker-dealers. The relatively low expected additional cost for these firms somewhat mitigates such concerns. Additionally, the PRA is proposing to introduce an option for sub-consolidation, which may create extra headroom to the leverage requirement for firms with large subsidiaries and intragroup activities.

16.18 The proposals have been designed to prevent a disproportionate increase in the cost of capital for smaller firms, therefore indirectly supporting sustainable lending and economic growth. Overall, the proposals are not expected to have a material impact on lending.

Minimum requirement

16.19 The PRA considers it to be appropriate, in line with the FPC's proposed Direction, to require firms in scope of the leverage ratio requirement to meet a 3.25% minimum capital requirement, excluding central bank reserves.

16.20 The PRA has considered the leverage ratio's strong complementary role to the risk-weighted framework in advancing its primary objective; the PRA has also considered its secondary objective in its proposal to not apply a minimum requirement to smaller firms. The PRA has had regard to international standards and relative standing of the UK in setting the leverage ratio minimum requirement.

PRA objectives

16.21 Setting a leverage ratio minimum requirement in line with Basel standards advances the PRA's primary objective. Recalibrating upward the requirement (from 3% to 3.25%) to reflect the exemption of central bank exposures helps avoid the leverage ratio undermining the effectiveness of monetary policy, while providing sufficient resilience. While playing a strong complementary role in support of the risk-based requirements, the leverage ratio is calibrated to not be the binding constraint for the majority of UK banks, most of the time. This mitigates risk-shifting incentives, whereby firms bound by the leverage ratio may seek to increase returns by investing in riskier assets with no impact on their capital requirements.

16.22 The PRA's secondary objective comes into play in the decision to set an expectation, rather than a requirement, for other not systemically important firms (see 'scope of application' and 'supervisory expectation').

Have regards

16.23 **International standards**: The international standard for calibration is 3%, but national authorities are able to exempt central bank reserves subject to recalibration of the requirement. The UK exposure measure excludes central bank claims as long as they are matched by deposits in the same currency, and of identical or longer maturity. To provide equivalent resilience, the leverage ratio minimum has been increased from 3% to 3.25%. The exemption and recalibration are consistent with discretions allowed in Basel.

16.24 **Relative standing of the UK and competitiveness:** The proposals are in line with international standards. This ensures that the UK remains a safe and attractive domicile for internationally active financial institutions

Buffers and buffer scalar

16.25 The PRA considers it appropriate, in line with the FPC's proposed Direction, to require firms in scope of the leverage ratio requirement to meet systemic leverage buffers (G-SII and O-SII) and a countercyclical leverage buffer. These are scaled at 35% of their risk-weighted equivalents. These buffers do not apply to smaller firms subject to a supervisory expectation.

16.26 The FPC has proposed leverage buffers to strengthen the leverage ratio framework for systemically important firms and to provide extra resilience and capital availability through the cycle. In implementing this, the PRA has considered the interaction between its primary and secondary objectives and the 'have regards', including in relation to international standards and relative standing of the UK, and proposes to not apply the buffers to smaller firms not in scope of the leverage ratio requirement.

PRA objectives

16.27 By including both systemic buffers (G-SII and O-SII) and a countercyclical leverage buffer, the leverage ratio aims to provide the same relative binding-ness across all firms and through the cycle as the risk weighted regime. Absent leverage buffers, leverage-bound firms would not face higher capital requirements if they became systemic or if the risk environment increased. In the absence of these leverage buffers, firms would have more scope to 'optimise' downward their risk weights to counteract the impact of risk-weighted buffers. The PRA considers this would go against lessons learned in the financial crisis.

16.28 Scaling leverage buffers at 35% keeps the proportion of leverage to risk-weighted requirements the same for all firms, regardless of whether they are systemic or not, and as the CCyB changes. This reflects the baseline relative calibration between the two ratios for non-systemic firms with a zero CCyB: the original 3% Tier 1 minimum leverage ratio on the one side, and a 6% Tier 1 minimum + 2.5% Capital Conservation Buffer = 8.5% on the risk-weighted side.

16.29 These additional buffers do not apply to the supervisory expectation. This allows some flexibility and reduces firms' implementation costs, facilitating effective competition.

Have regards

16.30 **International standards**: All the leverage ratio buffers are scaled at 35% of their risk-weighted equivalents. The UK framework applies a 35% conversion factor to the G-SII buffer instead of 50% specified in the Basel standard; but it also applies additional buffers to capture domestic systemic importance and heightened cyclical risks. The PRA assesses that overall, taking into account the additional leverage buffers and higher quality of capital (see below), the UK framework delivers at least as much resilience as required by international standards. The PRA considers that the design of its framework enhances UK firms' resilience and contributes towards ensuring the quality of firms' capital resources, which is important for maintaining creditor confidence in UK firms. Scaling leverage buffers at 35% also has the benefit of keeping the proportion of leverage to risk-weighted requirements broadly the same.

16.31 **Relative standing of the UK and competitiveness:** The proposals deliver at least as much resilience as required by international standards. This ensures that the UK remains a safe and attractive domicile for internationally active financial institutions.

Capital quality

16.32 The PRA considers it appropriate, in line with the FPC's proposed Direction, to require firms in scope of the leverage ratio requirement to meet the minimum with at least 75% CET1 and all buffers with 100% CET1 – mirroring the risk-weighted framework.

16.33 The PRA considers it appropriate, in line with the FPC recommendation, that AT1 instruments contributing to meeting the minimum requirement need to have a 7% CET1 capital ratio trigger to be eligible. Similar standards apply to the smaller firms' supervisory expectation (see below).

PRA objectives

16.34 A capital quality standard that mirrors the risk-weighted framework ensures that the leverage ratio is met with equally credible and loss-absorbing capital and reinforces the effectiveness of the leverage ratio framework, ultimately advancing the PRA's primary objective of safety and soundness.

16.35 The PRA has considered that allowing non-systemically important firms to meet the supervisory expectation with lower capital quality would compromise its primary objective.

Have regards

16.36 **International standards:** The high standards on capital quality advance the PRA's primary objective as they provide better loss absorbency. This enhances the UK firms' resilience, and contributes towards maintaining creditor confidence in UK firms. The leverage ratio approach is aligned to the risk-based approach where the PRA has set a similar requirement on capital quality.

16.37 **Relative standing of the UK and competitiveness:** Overall, the proposals deliver at least as much resilience as required by international standards. This ensures that the UK remains a safe and attractive domicile for internationally active financial institutions

16.38 **Proportionality and different business models:** the PRA has achieved proportionality via different means, (ie through a strengthened supervisory expectation instead of a minimum requirement), which allows some flexibility and reduces firms' implementation costs overall.

16.39 **Finance for the real economy, growth, and sustainable growth:** A stronger capital quality enhances firms' resilience, which is important for maintaining creditor confidence in UK firms and support growth and finance for the real economy in the medium-long term.

Maximum distributable amounts (MDA) restrictions

16.40 The PRA proposes to continue without imposing mandatory capital distribution restrictions for firms that breach their leverage ratio buffers.

16.41 The PRA has considered its primary and secondary objectives and 'have regards', including in relation to international standards, relative standing of the UK, finance for the real economy, growth and sustainable growth, and proposes to not impose automatic MDA restrictions to firms that breach their leverage ratio requirements.

PRA objectives

16.42 The Covid-19 crisis has emphasised that firms perceive mandatory distribution restrictions as an obstacle to using their regulatory buffers; and as a result during challenging periods firms may restrict the provision of financial services, including the supply of credit and support for market functioning, to avoid triggering the restrictions. As such, there is a financial stability argument for not having automatic restrictions in the leverage ratio, and instead using the PRA's discretionary powers when appropriate (s.55M FSMA).

16.43 The PRA has considered that the MDAs would add complexity as firms would need to calculate two sets of MDAs and there may be abrupt transitions from one to another. Together with the PRA's discretionary powers, overall the proposals aim to achieve simplicity and proportionality between burden and benefits, thereby advancing the PRA's secondary competition objective.

Have regards

16.44 **International standards**: Having considered Basel's MDA restrictions the PRA proposes not to implement them as rules. The PRA notes that it can use its discretionary powers when appropriate (s.55M FSMA), and that in practice the risk-weighted buffers, which have automatic distribution restrictions, exceed the leverage buffer for global systemically important institutions. The PRA considers that these deviations enhance the UK firms' resilience and contribute towards ensuring the quality of firms' capital resources, which is important for maintaining creditor confidence in UK firms.

16.45 **Relative standing of the UK and competitiveness:** Overall, the proposals deliver at least as much resilience as required by international standards. This ensures that the UK remains a safe and attractive domicile for internationally active financial institutions.

16.46 **Finance for the real economy, growth, and sustainable growth:** Usable buffers provide capital flexibility, help prevent deleveraging, and preserve firms' ability to continue to lend in stress.

Levels of application

Consolidated, sub-consolidated and individual application with case-by-case sub-consolidation

16.47 In line with the FPC proposal, the PRA proposes that the leverage ratio requirement should apply on a consolidated basis in respect of each relevant firm's UK consolidation group; on a RFB sub-consolidated basis in respect of each ring-fenced sub-group; or on an individual (solo) basis in all the other cases. The PRA proposes that individual consolidation available in risk-based space be also available for the leverage ratio.

16.48 The FPC has granted PRA discretion to allow case-by-case sub-consolidation to mitigate concerns that firms specialised in low risk/low margin business become constrained by a leverage ratio requirement and therefore adopt behaviours that impact effective market functioning. Therefore the PRA proposes to allow firms to apply for permission to sub-consolidate, as an alternative to being subject to an individual requirement. The PRA has set out the criteria it would consider when assessing applications for case-by-case sub-consolidation in a way that advances its safety and soundness objectives.

PRA objectives

16.49 When a firm is not at the top of a group or RFB sub-group, applying the leverage ratio requirement at solo level ensures that capital is located where the risks are, therefore advancing the PRA's primary objective of safety and soundness of firms. It is also consistent with the wider regulatory framework. Not applying an individual requirement to firms subject to the leverage ratio requirement at consolidated or sub-consolidated level, when they are the ultimate parent within a sub-consolidation group, is proportionate and consistent with the leverage ratio's role as a guardrail. Case-by-case sub-consolidation as an alternative to solo application, where firms have subsidiaries they can consolidate and under certain prudential criteria, aims to mitigate concerns of a disproportionate impact of the leverage ratio on the capital position of firms due to their group structure, given the potential consequences for the provision of market liquidity.

16.50 The proposals aim to achieve simplicity, proportionality between burden and benefits, and transparency on how the PRA exercises its functions, thereby advancing the PRA's secondary competition objective.

Have regards

16.51 **International standards**: The proposals are consistent with international standards. Basel explicitly applies the leverage ratio framework to all internationally active banks at consolidated and either sub-consolidated or individual (solo) level.

16.52 **Relative standing of the UK and competitiveness:** Case-by-case sub-consolidation could improve the 'relative standing of the UK' and 'competitiveness' as it would offer some flexibility to firms that are disproportionally constrained by the leverage ratio due to their group structure.

16.53 **Efficient and economic use of resources**: the proposals on level of application of the leverage ratio requirement are broadly consistent with the risk-based approach, facilitating implementation. Case-by-case sub-consolidation ensures efficient use of resources by the PRA, and reduces the burden on firms.

16.54 **Proportionality and different business models**: The proposals are proportionate to firms' size and complexity and allow some flexibility in groups' capital allocation.

Leverage exposure measure

Central bank reserves (CBR)

16.55 The PRA proposes to reflect the FPC Direction by continuing to exclude CBR from the leverage exposure measure and recalibrate the requirement accordingly.

16.56 Excluding CBR and recalibrating the leverage ratio requirement (from 3% to 3.25%) helps avoid the leverage ratio undermining the effectiveness of monetary policy, while providing sufficient resilience.

PRA objectives

16.57 If matched by liabilities in the same currency, CBR typically do not represent an 'exposure' to risk. Recalibrating upward the requirement (from 3% to 3.25%) provides sufficient resilience to compensate for the exclusion. On the other hand, not excluding CBR could have unintended consequences. In circumstances where firms' balance sheets increase because of an expansion in central bank balance sheets, regulatory leverage ratio capital requirements could effectively tighten. This could prompt firms to deleverage by shedding assets, cutting their supply of credit, or withdrawing from other activities. It could also act as a disincentive for firms to use central bank liquidity facilities. This could affect the ability of the banking system to cushion shocks, and to maintain the supply of credit to the real economy and support market functioning.

16.58 The exemption and recalibration are also applied to the minimum requirement in the supervisory expectation, which applies to all firms. This achieves simplicity and transparency.

Have regards

16.59 **International standards**: The UK approach is consistent with Basel standards which allow the exclusion of CBR subject to recalibration and disclosure. The PRA and FPC will keep this under review; however the change is not time-limited as this could result in potentially harmful uncertainty over its extension even where circumstances still justified it. The PRA therefore considers it more appropriate to draft the rule without time limitation.

16.60 **Relative standing of the UK and competitiveness:** Other countries have used the exemption during the Covid-19 period. Overall, the proposals deliver at least as much resilience as required by international standards. This ensures that the UK remains a safe and attractive domicile for internationally active financial institution.

16.61 **Finance for the real economy, growth, and sustainable growth:** This exemption supports finance for the real economy and growth, in particular during stress. See 'PRA's primary objective' above.

Basel III changes including netting of pending settlements

16.62 The PRA proposes incorporating a number of changes made by Basel III into the leverage exposure measure. These cover the treatment of pending settlements, netting of cash pooling transactions, exemption of excess collateral deposited at tri-party agents, netting of cash receivables and payables in securities financing transactions (SFTs), deduction from LEM of general provisions or general loan-loss reserves that have reduced Tier 1 capital, and conditions for reducing the notional exposure of written credit derivatives, including protection against specific wrong-way risk.

16.63 The proposals are intended to reinforce the effectiveness of the leverage ratio framework by improving the measurement of leverage exposures, and align to international standards.

PRA objectives

16.64 These proposed updates improve the measurement of leverage exposures and therefore the effectiveness of the leverage ratio tool in advancing the PRA's primary objective of safety and soundness.

16.65 These changes apply to the calculation of the leverage ratio requirement and expectation and are neutral on the PRA's competition objective.

Have regards

16.66 **International standards**: Adoption of the proposal is consistent with international standards.

SA-CCR / client clearing

16.67 The PRA proposes to adopt the SA-CCR methodology as the standardised approach to measure derivatives exposures.

16.68 The proposals are intended to reinforce the effectiveness of the leverage ratio framework by improving the measurement of leverage exposures, and aligning to international standards.

PRA objectives

16.69 The PRA considers SA-CCR is prudent given its higher risk sensitivity, and proposes to implement it for the leverage ratio, aligning to the risk-based approach. SA-CCR reflects better the levels of netting/hedging in a derivative portfolio, and provides a more favourable treatment for client clearing, therefore supporting market functioning.

16.70 By aligning the approach to the risk-based framework, the proposal achieves simplicity and minimises implementation costs to firms.

Have regards

16.71 **International Standards:** The Basel III standards specify that SA-CCR should be implemented by firms that do not use the Internal Models Method (IMM). The PRA's proposal aligns to the international standard.

16.72 **Proportionality and different business models**: SA-CCR provides a more risk-sensitive measurement of derivatives for firms that don't have an internal model.

Credit conversion factors

16.73 The PRA proposes to postpone adopting Basel III changes to credit conversion factors (CCFs).

16.74 The PRA has considered the interaction between its primary and secondary objectives, and proposes to postpone this change to align to the risk-weighted framework and reduce complexity and implementation costs.

PRA objectives

16.75 The proposed update would advance the PRA's primary objective, as the new CCFs better reflect the probability of an off-balance-sheet item becoming on-balance sheet (eg a commitment being drawn). The impact of this change can be negative or positive dependent on a firm's business model. The PRA proposes to implement these CCFs in the leverage ratio framework at a later date, when they are introduced in the risk-weighted framework as part of the wider remaining risk-weighted Basel III implementation. This would avoid firms having to use different CCFs across the two frameworks.

16.76 To avoid the complexity and costs of firms having to use different CCFs across the two frameworks, the PRA proposes to align the proposals for the leverage ratio framework to the risk-weighted framework.

CRR2 alternatives to SA-CCR and EU-specific exemptions

16.77 The PRA proposes to maintain simpler alternatives to SA-CCR for the calculation of derivatives exposures of smaller firms. The Original Exposure Method (OEM) is already part of the UK framework and would be retained for firms with insignificant derivatives business. The second is a simplified SA-CCR.

16.78 The PRA proposes not to implement certain EU-specific CRR II changes to the exposure measure. These include: (i) pre-financing loans; (ii) government guaranteed export credit; (iii) exposures of public development banks; (iv) promotional loans granted by public development banks or by central/regional governments to promote public policy objectives; and (v) banking exposures of central securities depositories (CSD).

16.79 The PRA proposes to introduce simpler, cost-effective alternatives to measure counterparty credit risk to smaller firms; and to not implement the other CRR changes to preserve adherence to Basel standards.

PRA objectives

16.80 The simpler methodologies to measure derivatives are at least as conservative as the Basel SA-CCR and do not hamper the PRA's primary objective. The strength and integrity of the UK leverage ratio framework is preserved by not adopting the CRR II EU-specific exemptions.

16.81 The simpler methodologies to measure derivatives introduce proportionality and maintain the leverage ratio framework aligned to the risk-weighted framework, which benefits simplicity. Not adopting the CRR II EU-specific exemptions has no implications for the secondary objective.

Have regards

16.82 **International standards**: The simpler methodologies to measure derivatives are at least as conservative as Basel SA-CCR and introduce proportionality into the derivatives part of the framework, aligning to the risk-weighted framework. Implementing these would also ensure consistency between leverage ratio and RWA frameworks.

16.83 None of the CRR II specific exemptions discussed here currently exist in the UK or Basel frameworks. The PRA estimates that implementing these exemptions would have a negligible macro-economic benefit, as the relevant activities are either very small compared to total leverage (therefore less likely to affect firms' lending decisions), or because there are a sufficiently large number of providers who would not be subject or bound by to proposed leverage requirements. The exemptions would, on the contrary, not further the PRA's objectives as there is no benefit to firm's safety and soundness directly, or indirectly via financial stability benefits. The last three are not relevant to the UK: (iii) regarding exposures of public development banks such as the British Business Bank, the PRA does not regulate such institutions; (iv) regarding promotional loans, the PRA is not aware of any such schemes currently in existence in the UK; and (v) regarding banking exposures of central securities depositories (CSD), in the UK no CSD has a banking licence. These exemptions go against the fundamental philosophy of the leverage ratio to capture all assets regardless of risk and without netting; and there would be no benefit for financial stability or market functioning. Importantly, they would also be Basel sub-equivalent on a line by line basis.

Supervisory expectation

Supervisory expectation for firms not in scope of a minimum requirement

16.84 The PRA proposes to implement a strengthened supervisory expectation that firms not in scope for the leverage ratio requirement should manage their leverage risk so that their leverage ratio does not fall below 3.25%. The calculation follows the same approach as the leverage ratio of the firms in scope of a minimum requirement. This includes an expectation of 75% minimum CET1 and a 7% additional Tier 1 trigger.

16.85 The PRA has considered the interaction between its primary and secondary objectives and the 'have regards', including in relation to international standards, proportionality, different business models, finance for the real economy, growth, sustainable growth, and transparency. It has concluded that an expectation of a minimum leverage ratio – mirroring the calculation of the minimum leverage ratio requirement – should apply to all firms not in scope of the leverage ratio requirement. This should provide a strong framework to mitigate excessive leverage for smaller firms, while preserving proportionality between the increases in their cost of capital and in their resilience. Overall the PRA considers that the proposed change remains justified.

PRA objectives

16.86 The proposals on the supervisory expectation are intended to mitigate excessive leverage for non-systemically important firms, thereby advancing the PRA's primary objective of safety and soundness of firms.

16.87 The calculation of the leverage ratio expectation mirrors that of the leverage ratio requirement. Overall, the proposals aim to achieve simplicity, proportionality between burden and benefits, and transparency on how the PRA exercises its functions, thereby advancing the PRA's secondary competition objective.

Have regards

16.88 **Proportionality and different business models**: The proposals are proportionate to firms' size and complexity. In particular, the PRA proposes to apply an expectation rather than a requirement to smaller firms. All firms currently report and disclose the leverage ratio and are expected to consider whether their degree of leverage is appropriate against the internationally agreed measure of leverage. This should minimise implementation costs.

16.89 **Finance for the real economy, growth, and sustainable growth:** The proposals have been designed to prevent a disproportionate increase in the cost of capital for the smaller firms, therefore indirectly supporting sustainable lending and economic growth. This is not expected to have a material impact on lending. The increase in resilience could support sustainable bank lending, which in turn could contribute both to 'growth' and 'sustainable growth', and finance for the real economy in the medium to long term.

16.90 **Transparency:** The proposal improves transparency because firms will be clearer on what the expectation is and the consequences of failing to meet it.

16.91 **Relative standing of the UK**: While not applying a minimum requirement to small firms is a different approach to the EU, it is not material in terms of relative standing as it applies to UK domestic institutions.

Reporting

Reporting of leverage ratio

16.92 The PRA proposes having a single, harmonised set of leverage reporting templates for all firms. These will reflect changes to the LEM to align to international standards. Firms would continue to report LEM, both including and excluding central bank reserves, to allow compliance with the Basel standards.

16.93 The PRA has considered how to update and simplify the leverage reporting framework in line with international standards, in a proportionate manner that best serves its primary and secondary objectives, is consistent with the existing reporting requirements, and that firms can implement efficiently.

PRA objectives

16.94 The proposals reflect updated definitions and measurements, therefore supporting the monitoring and managing of leverage risks by firms and the PRA, and advancing the PRA's safety and soundness objective. Reporting average leverage ratio information prevents gaming.

16.95 The proposals aim to achieve simplicity, proportionality between burden and benefits, and transparency on how the PRA exercises its functions, thereby advancing the PRA's secondary competition objective.

Have regards

16.96 **International standards**: The proposals are consistent with international reporting standards.

16.97 **Proportionality and different business models**: The proposals reflect the adoption of a single definition of the LEM and the leverage ratio that applies for all purposes, so that firms can implement it efficiently. The proposals also simplify the templates where possible by removing duplication. The proposals are proportionate as they do not require smaller firms not in scope of the minimum requirement to provide more granular and average-based information.

Disclosure

Disclosure of leverage ratio

16.98 The PRA proposes to update the disclosure requirements to reflect changes to the LEM from Saturday 1 January 2022.

16.99 The PRA has considered how to update and simplify the leverage disclosure requirements in line with international standards in a proportionate manner that best serves its primary and secondary objectives, is consistent with the existing reporting requirements, and that firms can implement efficiently.

PRA objectives

16.100 The proposals reflect updated definitions and measurements and are intended to give investors, analysts, and the PRA greater confidence in the quality of the disclosure. Investors may need this information to make informed investment decisions, which should contribute to market discipline and the PRA's objectives of promoting the safety and soundness of firms.

16.101 The proposals on disclosure are aligned to firms' reporting and aim to achieve simplicity, proportionality between burden and benefits, and transparency on how the PRA exercises its functions, thereby advancing the PRA's secondary competition objective.

Have regards

16.102 **International standards:** The PRA considers that it is important for the UK to be aligned to international standards on disclosure, in the form prescribed by the Basel disclosure framework. This ensures that UK firms show the same level of transparency as their peers in other jurisdictions, and ensures that they will be subject to the same forces of market discipline. Investors would therefore have consistent and comparable information on which to judge firms.

16.103 **Proportionality and different business models**: The proposals are proportionate, as they do not require smaller firms not in scope of the minimum requirement to disclose more granular and average-based information, to prevent gaming.

16.104 **Disclosure (publicity)**: The PRA has considered that it is appropriate to require firms to publish the leverage ratio information, as a means of contributing to the advancement through market discipline of safety and soundness.

17 PRA cost benefit analysis

Summary of estimates

17.1 This section sets out an analysis of the costs and benefits of introducing the measures set out in this CP in the UK. The PRA has provided quantitative estimates of the proposals that are expected to have the most material impact on firms. All numerical estimates should be treated as indicative, subject to substantial uncertainty and highly sensitive to the underlying assumptions.

17.2 The proposals in this CP form part of a broader package of measures to implement in the UK the reforms to international standards agreed subsequent to the global financial crisis, as with the implementation of the CRD V measures set out in recent CPs.[62] As such, the costs and benefits of the proposals set out in this CP should be considered in the context of all proposals addressing financial stability following the financial crisis. A number of these proposals are intended to ensure that the benefits of reforms already introduced will be realised.

17.3 In 2012, the PRA estimated that the net benefits of all prudential reforms introduced in response to the financial crisis at the time of the CRD IV package, which implemented many of the Basel III standards within the EU, was approximately £8.25 billion per annum.[63] Adjusting for changes to GDP since 2012, the net benefits were expected to be approximately £11.75 billion per annum. The PRA's assessment of the impact of the proposals in this CP is that the net benefits of all proposals addressing financial stability remains highly net beneficial, at approximately £11.5 billion per annum.

Outline of the analysis

17.4 The analysis in this chapter considers both the impacts on individual firms, the implications for the deposit-taking sector as a whole, and the macroeconomic implications of the proposals set out in this CP. The analysis proceeds by:

(a) discussing the affected firms and the markets in which they operate, and the baseline from which the impact of the proposals is to be calculated;

(b) setting out the benefits expected from the proposals in this CP;

(c) estimating the direct costs to firms, which consist predominantly of the capital and balance sheet costs that are imposed directly on firms; and

(d) articulating the macroeconomic impacts of the change that may occur as a result of changes to firms' capital positions.

17.5 FSMA requires that the cost benefit analysis provides 'an analysis of the costs together with an analysis of the benefits that will arise … if the proposed rules are made'.[64] The relevant costs and benefits in this analysis therefore reflect those changes that the PRA anticipates affected firms will

62 July 2020: https://www.bankofengland.co.uk/prudential-regulation/publication/2020/capital-requirements-directive-v; and October 2020: https://www.bankofengland.co.uk/prudential-regulation/publication/2020/capital-requirements-directive-v-furtherimplementation.
63 August 2013: https://www.bankofengland.co.uk/prudential-regulation/publication/2013/strengthening-capital-standards-implementingcrd-4.
64 Section 138J(7) of FSMA.

make in response to the proposals, and not simply the mechanical change in nominal regulatory requirements. For example, the PRA has not assessed the impact from a baseline that assumes there was no regulation in place. Rather, the baseline considers firms existing business strategies, which includes their response to existing requirements. The subsequent analysis only considers any changes arising where the proposals substantially alter the regulations currently facing firms.

17.6 There are a number of reforms to bank capital requirements that are currently under consideration in the UK, which could influence the estimated costs and benefits and associated competition impacts of the leverage framework. These include the remaining Basel III reforms that are expected to be introduced by Sunday 1 January 2023, implementation of some on-shored CRR II measures, and the Bank of England's review of the Minimum Requirement for own funds and Eligible Liabilities (MREL) regime.[65] As some of the proposals in these areas (in particular Basel III) are not yet finalised, it is not possible to include estimates of possible interactions between them and the proposals on leverage.

Affected firms and markets

Firms and CRR consolidation entities

17.7 As mentioned in the Scope of Application chapter, the leverage ratio framework is proposed to be applied to firms with:

(i) retail deposits equal to or greater than £50 billion; or

(ii) non-UK assets equal to or greater than £10 billion

calculated at the relevant level of application.

17.8 In total, 35 firms would be subject to the leverage framework, comprising 34 banks and 1 building society (see Table 8). Firms falling outside the abovementioned threshold would be expected to meet a leverage ratio of 3.25% at all times. Some firms are already subject to the leverage ratio framework, so only a subset of firms in Table 9 would face adjustment costs as a result of extending the scope of the leverage ratio framework.

Table 8 – Population of affected firms

	Firms currently in scope[a]	Additional firms in scope[b]	Total
Banks	13	21	34
Building societies	1	0	1
Total	14	21	35

Source: Bank of England
Notes: (a) Firms already in scope of the FPC's leverage ratio
(b) Firms exceeding the retail deposits (£50 billion) and non-UK assets thresholds (£10 billion)

Impact on markets and low risk-activities

17.9 The impact of the proposals on markets and the provision of low-risk activities has been assessed and outlined by the FPC, and set out in its consultation in Part 1. The PRA agrees with that assessment.

65 February 2021: https://www.bankofengland.co.uk/prudential-regulation/publication/2021/february/implementation-of-basel-standards.

Impact on competition

17.10 The PRA is required, when exercising its general functions and so far as is reasonably possible, to act in a way which, as a secondary objective, facilitates effective competition.

17.11 Overall, the PRA expects no impact on competition in UK markets as a result of the leverage framework.

17.12 The FPC and PRA considered applying the leverage ratio to a wider scope of firms, and concluded that the competition implications would be considerable. If the leverage ratio were applied as a requirement to smaller firms, it may have a negative impact on competition in the markets supplied by these firms, including because of a possible interaction with the MREL framework. If the interaction with the MREL framework were to result in a requirement to meet additional MREL for these smaller firms, it is likely that smaller firms would need to meet the additional MREL requirements with more costly CET1 capital due to challenges related to the type of capital or term debt instruments they can issue in markets. Larger firms are more likely to be able to issue (cheaper) Additional Tier 1 (AT1) and eligible liabilities (EL) instruments. The PRA's proposal to apply the leverage ratio as a supervisory expectation is anticipated to mitigate any impact on smaller firms and on competition. MREL is set with reference to regulatory requirements, not supervisory expectations. The Bank, as Resolution Authority, does not intend to propose changing this approach.

17.13 The proposal to apply the leverage ratio to all firms with significant non-UK assets is consistent with Basel standards applying to internationally active firms. It would capture international broker-dealers, ensuring that there is a level playing field between firms that operate in similar markets.

Costs and Benefits of proposals

Benefits

17.14 A minimum leverage ratio requirement aims to promote individual firms' resilience through ensuring that capital is adequate to absorb losses. The leverage ratio is a non-risk based measure and treats all exposures equally regardless of their estimated risk. The financial crisis revealed significant weaknesses associated with risk weightings – calculated using both internal models and standardised approaches – used to calculate the risk-weighted ratio.[66] For example, the average risk weights of major global firms fell almost continuously from around 70% in 1993 to below 40% at the end of 2008. Some of the losses incurred by firms during the financial crisis were due to exposures to products seen as 'very low risk' on the basis of their historical record; and losses on mortgages in the United States did not factor in the possibility of a nationwide house price falls as those had not been present in the available data.[67]

17.15 Complementing risk-based capital requirements with a leverage ratio requirement gives banks better protection against uncertainties and risks that are hard to model. Furthermore, restricting the build-up of leverage in the banking sector during benign conditions where capital levels may be driven down from perceptions of low-risks will help to avoid destabilising deleveraging processes that can damage firms across the financial system and the wider economy. Additionally,

66 Modelling uncertainty, banks' modelling choice to reduce risk weights, vulnerability from systemic crises by disregarding the correlation of losses across banks, and impeded market discipline resulting from complexity and lack of transparency were identified.

67 'The Financial Policy Committee's review of the leverage ratio', July 2014: https://www.bankofengland.co.uk/paper/2014/the-fpc-review-of-the-leverage-ratio-consultation-july-2014.

the relative simplicity of the leverage ratio might make it more readily understood by market participants and more comparable across firms than risk-weighted measures.

17.16 The proposal to extend the leverage requirements to all firms with significant non-UK assets would improve their resilience by addressing concerns with the reliability of risk weights, as stated above. Subjecting a greater number of firms to the leverage ratio requirement is also expected to limit system-wide leverage more effectively. By extending the scope in line with BCBS standards, the proposal would enable comparability between the firms and their international peers, and provide transparency in comparing leverage ratios to market participants, promoting market discipline.

Direct costs to firms

17.17 The direct costs to firms of the proposals are those costs that firms face directly to: (i) operationalise the new rules within their business; and (ii) adjust the amount of capital they hold and make other balance sheet adjustments. The direct costs are discussed below under these two headings.

Operational costs

17.18 When assessing the operational costs, the PRA considered that affected firms are currently subject to reporting requirements under which they submit regulatory data on their leverage ratio positions. The PRA assessed the additional operational costs resulting from the proposal and expects them to be minimal.

Capital and other balance sheet costs

17.19 The capital and other balance sheet costs are comprised of: (i) the one-off costs of raising any additional capital to firms for which the leverage ratio is the binding regulatory requirement rather than risk weighted requirements (affected firms); and (ii) the cost to affected firms of remunerating this additional capital on an ongoing basis. These costs are summarised in Table 9 below.

17.20 The PRA estimates the capital impact on affected firms by comparing the current risk-based capital requirements to the new binding capital requirements if the firms were subject to the leverage ratio (ie the greater of the risk-based and leverage ratio capital requirements). Firms for which the risk-based requirements are the binding requirements would see no increase in their capital requirements, and hence have no capital impact. However, firms that are bound by the leverage ratio would face an increase in their binding requirements that is equal to the difference between the risk-based and leverage ratio capital requirements.

Table 9 – Summary of capital and other balance sheet costs to firms [(a)]

	Additional firms in scope[(b)]	Total
One-off increase in capital (£bn)	4.69-7.14	4.69-7.14
Ongoing costs of capital (£bn p.a.)	0.25-0.54	0.25-0.54

Source: Bank of England
Notes: (a) Firms already in scope of the FPC's leverage ratio face no additional capital increase
(b) Firms exceeding the retail deposits (£50 billion) and non-UK assets thresholds (£10 billion)

17.21 The 'one-off increase in capital' measures the difference between the current capital requirement and the capital requirement after the policy changes. The 'ongoing costs of capital' measure the ongoing incremental funding cost of capital. These costs do not account for other regulatory changes that might affect the estimated impacts. The estimates assume the current level of CCyB of 0% and do not include potential future requirements, such as the Basel III output floor. The PRA expects that a higher CCyB would increase the estimated impact of the proposals, but the introduction of the output floor would reduce it. For smaller firms that are subject to the supervisory expectation, the PRA does not expect any immediate impact on capital held by these firms.

Macroeconomic impacts of proposals

17.22 The leverage ratio proposals in this CP are part of the package of measures agreed at an international level following the global financial crisis, which raises the level of capital across the UK financial sector (as well as internationally). As such, the benefits of the proposals set out in this CP should be considered in the context of all proposals addressing financial stability following the financial crisis.

17.23 The PRA set out techniques and models for estimating the macroeconomic benefits of responses to the global financial crisis in CP5/13 'Strengthening capital standards; implementing CRD IV'.[68] Most recently, the PRA updated the estimate of the total benefits to the UK economy of raising capital in the system (as noted in CP5/21) from all the responses to the financial crisis to £22 billion.[69] These benefits arise from reducing the likelihood of firm failure and any subsequent systemic failure, as the increase in capital across all firms makes them more capable of absorbing losses.

17.24 The macroeconomic costs of the leverage ratio are expected to be positive, but are not expected to add significantly to those costs already estimated for all responses to the crisis (including the recent changes noted in CP5/21), although there is considerable uncertainty about the impact. There are a number of reasons why the PRA does not expect the cost to have a material impact on ongoing UK GDP. Firstly, the leverage ratio affects only a proportion of the firms who are subject to the requirements. Consequently, any reduction in lending or other economic activities supported by these firms could, to some extent, be undertaken by other firms.

17.25 Secondly, the transmission channels for passing through higher costs resulting from the leverage ratio are highly uncertain. The leverage ratio is risk-insensitive and it could be expected that firms may increase overall risks on their balance sheets, as higher risk assets generally provide higher returns. However, as noted in Box A in Part 1, it is not clear that UK firms subject to the leverage ratio have increased risk as expected.

17.26 Thirdly, while there is empirical evidence of the extent to which deposit-takers pass-through any increase in funding costs for increases in risk-based capital requirements, there is currently no similar evidence for the leverage ratio.[70] The transmission channels for increases in risk-based capital requirements show that firms can more efficiently change their capital ratios by adjusting higher-risk assets more than lower-risk assets. However, it is unlikely that firms bound by the leverage ratio would use a similar transmission channel, as the leverage ratio is risk-insensitive.

17.27 In total, the PRA expects the total net benefits of all responses to the global financial crisis, including the leverage ratio, to be around £11.5 billion per annum.

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68 August 2013: https://www.bankofengland.co.uk/prudential-regulation/publication/2013/strengthening-capital-standards-implementing-crd-4.

69 CP5/13 reported benefits of all responses to the crisis that raise the amount of capital in the UK deposit-taking sector of £15¼ billion per annum. This amount reflected the annual addition to 2012 chained UK GDP estimates. Given growth in the UK economy since 2013, the benefits are expected to be £22 billion per annum when converted to 2019 GDP (the latest annual figure available at the time of the analysis).

70 For detail of this approach, see de-Ramon, S. and Straughan, M. (2017), 'The economic cost of capital: a VECM approach for estimating and testing the banking sector's response to changes in capital ratios', Bank of England Staff Working Paper No. 663: https://www.bankofengland.co.uk/working-paper/2017/vecm-approach-for-estimating-and-testing-the-banking-sectors-response-to-changes-in-capital-ratios.

18 Appendices

3 Proposed FPC direction and recommendation

The FPC directs the PRA to implement the following measures (the 'leverage measures') in relation to the following firms (each a 'relevant firm'):

- each major UK bank, building society or investment firm;
- each UK bank, building society or investment firm with significant non-UK assets; and
- any holding company approved or designated by the PRA whose consolidated situation (including, where that holding company is part of a RFB sub-group, the consolidated situation of that sub-group) is comparable to any other relevant firm.

The leverage measures are to:

- require each relevant firm to hold sufficient Tier 1 capital to satisfy a minimum leverage ratio of 3.25%;
- secure that each relevant firm ordinarily holds sufficient Tier 1 capital to satisfy a countercyclical leverage ratio buffer rate of 35% of its institution-specific countercyclical capital buffer rate, with the countercyclical leverage ratio buffer rate percentage rounded to the nearest 10 basis points;
- secure that if a relevant firm is a G-SII it ordinarily holds sufficient Tier 1 capital to satisfy a G-SII additional leverage ratio buffer rate of 35% of its G-SII buffer rate; and
- secure that if the relevant firm is a relevant O-SII it ordinarily holds sufficient Tier 1 capital to satisfy a O-SII additional leverage ratio buffer rate of 35% of its O-SII buffer rate.

The leverage measures are to be applied:

- on a consolidated basis in respect of the UK consolidation group of the relevant firm;
- on a sub-consolidated basis in respect of any RFB sub-group that contains a relevant firm ('RFB sub-consolidated basis'); and
- on an individual basis or, at the PRA's discretion, on a sub-consolidated basis (in respect of the relevant firm and one or more of its subsidiaries), for relevant firms that are not subject to the leverage measures on the basis of their consolidated situation pursuant to the preceding bullet points.

Where the leverage measures are to be applied on a consolidated or RFB sub-consolidated basis, they may be applied to a holding company approved or designated by the PRA, as appropriate.

In designing its approach to exercising its discretion over the appropriate level of consolidation at which to implement the leverage measures, the PRA should have regard to, among other things:

- the desirability of alignment between the levels of application of the leverage measures and measures under the risk weighted capital framework; and
- the potential for the leverage measures applied on an individual basis to disproportionately impact the capital position of relevant firms driven by their group structure, given the potential consequences for the provision of market liquidity in aggregate for the UK financial system.

For the purposes of the leverage measures, the FPC specifies the following:

- The total exposure measure shall exclude any assets constituting claims on central banks, where they are matched by deposits accepted by the firm that are denominated in the same currency and of identical or longer maturity.
- The minimum proportion of common equity Tier 1 that shall be held is:
    - 75% in respect of the minimum leverage ratio requirement;
    - 100% in respect of the countercyclical leverage ratio buffer; and
    - 100% in respect of the G-SII and O-SII additional leverage ratio buffers.

The FPC recommends to the PRA that in implementing the minimum leverage ratio requirement it specifies that additional Tier 1 capital should only count towards Tier 1 capital for these purposes if the relevant capital instruments specify a trigger event that occurs when the common equity Tier 1 capital ratio of the institution falls below a figure of not less than 7%.

4 Draft amendments to 'The Financial Policy Committee's powers over leverage ratio tools'

The changes will consist in adding a new Box 2. The rest of the Policy Statement will not be amended.

Box 2: Changes to the UK leverage ratio framework following the FPC's review in 2021

In June 2021, the FPC conducted a comprehensive review of the UK leverage ratio framework in light of revised international standards, and its ongoing commitment to review its policy approach. This box outlines the changes the FPC proposes to make to the leverage ratio framework that is outlined in this *Policy Statement*. The FPC coordinated closely with the Prudential Regulation Authority (PRA) in its review and published a joint FPC/PRA consultation outlining the comprehensive changes proposed to the UK leverage ratio framework on 29 June 2021.

The FPC proposes to amend the UK leverage ratio framework by making changes to the scope of application, and the level of consolidation (section 2.2 of this *Policy Statement*). The rest of the framework outlined in this document would remain unchanged. The PRA also proposes changes to its implementation of the leverage ratio framework outlined in PRA Consultation Paper CP14/21.

The changes proposed to this *Policy Statement* are:

i) To extend the scope of application of the framework to capture
- each major UK bank, building society and investment firm;
- each UK bank, building society and investment firm with significant non-UK assets; and
- any holding company approved or designated by the PRA whose consolidated situation (including, where that holding company is part of a RFB sub-group, the consolidated situation of that sub-group) is comparable to any other relevant firm.

  The PRA has set out proposed quantitative thresholds to capture such firms in its concurrent consultation as £50 billion retail deposits or £10 billion non-UK assets (calculated on an individual, consolidated or sub-consolidated basis as applicable).

ii) To apply the framework:
- on a consolidated basis in respect of the UK consolidation group of the relevant firm;
- on a sub-consolidated basis in respect of any RFB sub-group that contains a relevant firm ('RFB sub-consolidated basis'); and
- on an individual basis or, at the PRA's discretion, on a sub-consolidated basis (in respect of the relevant firm and one or more of its subsidiaries), for relevant firms that are not subject to the leverage measures on the basis of their consolidation situation pursuant to the preceding bullet points.

  Where the leverage measures would be applied on a consolidated or RFB sub-consolidated basis, the FPC proposes that they would be able to be applied to a holding company approved or designated by the PRA, as appropriate.

The FPC proposes to keep the rest of the current framework unchanged, as introduced in 2015, and amended in 2017 (see *Box 1*) and 2020[71] (subject to the PRA's proposed implementation of changes to the LEM as set out in the PRA's Consultation Paper CP14/21). This maintains the current approach for setting the minimum capital requirement and its calibration, the leverage ratio buffers and their calibration, the capital quality limit, and the approach for calculating the total exposure measure (save for changes proposed separately by the PRA, which the FPC supports).

The FPC considers that the existing leverage ratio framework delivers a level of resilience at least as great as that required by international standards. A key aspect is that the vast majority of the UK leverage requirement has to be met with the highest quality of capital (section 2.3). At the same time, the framework has elements the FPC considers of particular benefit to financial stability, such as the additional countercyclical leverage buffer, the leverage buffer for O-SIIs (section 2.1), the exemption of deposit-matched central bank reserves (Box 1), and the higher buffer usability achieved by relying on the PRA's existing supervisory powers rather than mandatory distribution restrictions. The FPC would keep under review whether the circumstances that prompted the introduction of the central bank reserves exemption remain applicable.

The FPC has considered its review with regard to its secondary objective, subject to the achievement of the financial stability objective. The FPC has also had regard to the recommendations sent by the Chancellor of the Exchequer to the Governor on Wednesday 3 March 2021; and conducted a cost-benefit analysis. These considerations are set out in more detail in the *FPC Consultation Paper.*

The Government on 14 June 2021 laid secondary legislation to align the FPC's power of Direction with changes made under the Financial Services Act 2021. If Parliament approves the MPM Order 2021[72], the FPC proposes to use its power of Direction (rather than Recommendation) for the changes proposed in this Box. The FPC's proposed Direction and Recommendation is contained in the *FPC Consultation Paper*.

Extending the scope of application

In 2015, the FPC introduced the leverage ratio framework to apply to major UK banks and building societies. At the time, the FPC stated it would expect to broaden the scope to include all PRA-regulated banks, building societies, and designated investment firms, subject to its review (Section 2.2). In its 2016 *Framework for the systemic risk buffer* publication, the FPC expressed its intention to apply the leverage ratio to major UK banks and building societies at the level of RFB sub-groups (where applicable). Subsequently, in 2018, the PRA applied the leverage ratio framework to RFBs[73], within scope of the leverage ratio framework, with FPC support.

The FPC continues to consider that the leverage ratio should apply to the major UK banks and building societies and their RFBs. These firms account for the majority of UK banking assets, and their provision of critical financial services to the UK economy means that their failure could pose material threats to domestic financial stability. The risk concerning these firms remain in line with the FPC's assessment in 2015.

71 https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/supervisory-statement/2020/ss4515-update-dec-2020.pdf.
72 The Bank of England Act 1998 (Macro prudential Measures) (Amendment) Order 2021
73 PS28/18 'UK leverage ratio: Applying the framework to systemic ring-fenced bodies and reflecting the systemic risk buffer', November 2018: https://www.bankofengland.co.uk/prudential-regulation/publication/2018/uk-leverage-ratio-applying-the-framework-to-systemic-rfbs-and-reflecting-the-srb.

There are a number of other firms that are large, have complex business models, and are inextricably interlinked with the UK financial system. Some of these firms are also important for financial market functioning because of their roles in the provision of liquidity and market making. As such, the FPC considers their failure could also pose material threats to financial stability.

These firms are unlikely to be captured by the existing scope of the framework. While they share a number of qualitative features, the FPC considers that the simplest and most-broadly shared feature is these firms' holdings of non-UK assets. The FPC therefore, proposes to extend the criteria for scope to include PRA-regulated banks, building societies and investment firms with significant non-UK assets. This also consistent with the FPC's commitment to the implementation of robust prudential standards in the UK, that would maintain a level of resilience that is at least as great as, or exceeds that required by international baseline standards.

The FPC recognises that these firms may engage in activities associated with both lower risk weights and lower margins, such as repos, securities lending, and client-clearing services.

In 2016, the FPC identified specific aspects of the original design of the leverage ratio that may impact incentives to provide liquidity in financial markets. The FPC considers that there are changes in the latest Basel standards that could mitigate the potential adverse impacts on market functioning that extending the leverage ratio to firms with significant non-UK assets might have. Specifically, in its July 2016 *Financial Stability Report*, the FPC had judged that the treatment of outright purchases and sales of securities in the UK leverage ratio standard might act to discourage market-making activity, and noted that there would be merit in changes to that treatment in any internationally agreed leverage ratio standard. The FPC also noted that there would be merit in any internationally agreed leverage ratio standard allowing initial margin posted by clients to reduce banks' potential exposures to a default of those clients in centrally cleared derivative transactions, provided appropriate safeguards are in place. The Basel Committee on Banking Supervision (BCBS) has since adopted changes to this effect, and the FPC notes and welcomes that the PRA is proposing to implement these. The FPC has also reiterated its intention for the leverage ratio framework not to apply at the level of individual activities.

The FPC has considered whether to extend the scope of application to other firms, in addition to those mentioned above. In its considerations, the FPC notes that other smaller, domestic firms are subject to broadly the same risk-weighted and liquidity regulatory requirements as the major UK firms, derived from international standards. The FPC notes that even where the requirements for these may be simplified, the PRA's objective is to maintain the resilience of those firms[74].

The FPC considers that the individual failure of these firms is not likely to represent a systemic risk to UK financial stability. These firms do not significantly contribute to system-wide leverage. Subject to PRA implementation, the firms proposed in the coverage of the leverage ratio framework would already account for at least three quarters of UK real economy lending and deposit taking. The FPC judges that the systemic risk posed from the disruption to the continuity of the provision of services from these firms in a stress to not be high.

While the majority of these firms apply standardised regulatory risk weights, a small number of them has permission to use internal models. While these models present risks that could be mitigated by a

74 DP1/21 'A strong and simple prudential framework for non-systemic banks and building societies', April 2021: https://www.bankofengland.co.uk/prudential-regulation/publication/2021/april/strong-and-simple-framework-banks.

leverage ratio requirement, the FPC considers that the other mitigants currently under consideration are in proportion to the risk posed by the use of internal models by those firms - in particular, the internationally agreed 'output floor' that limits the risk weights derived from internal models to 72.5% of standardised risk weight when fully phased-in, and the PRA's consultation on a mortgage risk weight floor[75]. The FPC also welcomes the PRA's concurrent consultation on a revised supervisory expectation for all firms not in scope of the FPC's proposed scope of the framework.

Balancing these considerations, and considering its objective for enhancing the resilience of the UK financial system against its secondary objective to promote the growth of the UK economy, the FPC has decided that it would be disproportionate for the PRA to introduce a leverage ratio requirement for firms other than those specified in the proposed scope. This is further supported by the FPC's cost benefit analysis, which suggests that a leverage ratio requirement for smaller firms may be proportionately costlier for them than for firms that the FPC proposes should be covered by the leverage ratio requirement.

In future reviews of the UK leverage ratio framework, the FPC will monitor the extent to which this judgement continues to hold, in light of these firms' future systemic importance and future clarity around the forthcoming regulatory framework, particularly regarding safeguards to internally modelled risk weights (the 'output floor' and the PRA's consultation on a mortgage risk weight floor).

At what level of consolidation would the leverage ratio apply?

The FPC has the power to direct the PRA to set leverage ratio requirements on a consolidated, sub-consolidated, and individual basis. Consolidated capital requirements determine how much capital needs to be held against a group's overall balance sheet. Sub-consolidated capital requirements determine how much capital needs to be held against a sub-group's overall balance sheet. Individual capital requirements determine how much capital an individual firm needs to hold against its own balance sheet, and affect the allocation of capital within the group. Risk-weighted capital requirements are applied on a consolidated, sub-consolidated, and individual basis for different firms.

In its 2015 implementation of the leverage ratio framework, the FPC applied UK leverage ratio requirements at a consolidated level for UK groups (section 2.2), which the PRA subsequently extended to major ring-fenced banks at a sub-consolidated level, with FPC support. These levels of application would remain unchanged under the FPC's proposed approach.

With the proposal on increasing the scope of the leverage ratio, the leverage ratio framework would also apply to firms that are not major UK groups or ring-fenced banks; and at an individual level.

The FPC recognises the benefits in aligning the leverage ratio with the risk-weighted approach, so the leverage ratio can play a strong complementary role. Applying the leverage ratio requirement at an individual level should also be simplest for firms to implement, given it mirrors the existing level

[75] PRA CP14/20 https://www.bankofengland.co.uk/prudential-regulation/publication/2020/internal-ratings-based-uk-mortgage-risk-weights-managing-deficiencies-in-model-risk-capture.

at which other regulatory requirements are applied. As such, the FPC recognises the general benefits of applying the leverage ratio at an individual level[76].

In some cases, firms' group structure can mean that applying the leverage ratio at an individual level may become disproportionately costly compared to applying it at a sub-consolidated level, where a relevant firm has a number of subsidiaries. The leverage ratio framework has been designed on an aggregate basis without reflecting the impact of group structure; and the FPC has repeatedly stated its intention for it not to apply at the level of individual activities. Where such a cost is disproportionate, and the PRA considers sub-consolidation could prudently apply in light of its own objectives, the FPC considers that there would be a benefit to allowing sub-consolidation – particularly as it may avoid the combination of idiosyncratic group structures and the leverage ratio requirement adversely impacting the provision of liquidity in financial markets, which in turn could adversely impact financial stability.

Balancing these considerations, the FPC proposes to direct the PRA to apply the leverage ratio to these firms on an individual basis, but to allow the PRA to exercise its judgement in line with its own statutory objectives to allow firms to apply for sub-consolidation where application at individual level may be deemed disproportionate, subject to strict prudential criteria set by the PRA. In exercising its discretion on the appropriate level of consolidation at which to implement the leverage measures, the FPC proposes to direct that the PRA should have regard to, among other things:

(a) the desirability of alignment between the levels of application of the leverage measures and measures under the risk-weighted capital framework; and

(b) the potential for the leverage measures applied on an individual basis to disproportionately impact the capital position of relevant firms driven by their group structure, given the potential consequences for the provision of market liquidity in aggregate for the UK financial system.

Review of the leverage exposure measure

The FPC continues to consider that the PRA should apply the internationally agreed exposure definition for the purpose of calculating the minimum leverage ratio requirement and buffers. This would include changes made to the international definition in the process of finalising Basel III. The FPC therefore welcomes the PRA's concurrent proposals to this effect, particularly on implementing the changes for which the FPC had previously advocated.

Following its 2016 review, the FPC decided to exclude from the calculation of the total exposure measure those assets constituting claims on central banks, where they are matched by deposits accepted by the firm that are denominated in the same currency and of identical or longer maturity. This change is outlined in Box 1.

The FPC continues to judge that including central bank reserves in the leverage exposure measure could have unintended consequences. In circumstances where firms' balance sheets increase because of an expansion in the central bank's balance sheets, regulatory leverage ratio capital requirements could effectively tighten. This could prompt firms to deleverage by shedding assets, cutting their supply of credit, or withdrawing from other activities. It could also act as a disincentive

[76] Notwithstanding application at an individual level, the FPC continues to be of the view that the leverage ratio should not be applied to individual activities.

for firms to use central bank liquidity facilities. This could affect the ability of the banking system to cushion shocks, and to maintain the supply of credit to the real economy and support market functioning.

As part of its annual review of its proposed Direction to the PRA, the FPC would keep under review whether the circumstances that prompted the introduction of the central bank reserves exemption remain applicable.

The Financial Policy Committee:

Andrew Bailey, Governor
Jon Cunliffe, Deputy Governor responsible for financial stability
Ben Broadbent, Deputy Governor responsible for monetary policy
Dave Ramsden, Deputy Governor responsible for markets and banking
Sam Woods, Deputy Governor responsible for prudential regulation
Nikhil Rathi, Chief Executive of the Financial Conduct Authority
Colette Bowe
Jon Hall
Anil Kashyap
Elisabeth Stheeman
Carolyn Wilkins
Charles Roxburgh attends as the Treasury member in a non-voting capacity.

5 Draft amendments to SS34/15 'Guidelines for completing regulatory reports'

Appendix 1 - Guidelines for completing data items FSA005 to FSA048 and PRA101 to PRA108

Name		Data item	Instructions
PRA101	Capital+ actuals and forecasts	In force from 4 September 2020 https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/regulatory-reporting/banking/pra101-template-sep-2020.pdf	~~www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/regulatory-reporting/banking/pra101-instructionsdec2018.pdf~~ In force from 1 January 2022 [new link to be inserted on finalisation of policy]
PRA102	Capital+ forecast semi annual	In force from 1 March 2020 https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/regulatory-reporting/banking/pra102-template-1-march-2020.XLSX	~~www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/regulatory-reporting/banking/pra102-instructionsdec2018.pdf~~ In force from 1 January 2022 [new link to be inserted on finalisation of policy]
PRA103	Capital+ forecast annual	In force from 1 March 2020 https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/regulatory-reporting/banking/pra103-template-march-2020.pdf	~~www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/regulatory-reporting/banking/pra103-instructionsdec2018.pdf~~ In force from 1 January 2022 [new link to be inserted on finalisation of policy]

…

Draft update to Instructions on filling in data-points in PRA101 - Capital+

…

Additional information on P&L, balance sheet and leverage data

…

281 Total Leverage Ratio exposure - using a fully phased-in definition of Tier 1 Capital

Please provide the leverage ratio exposure as defined under Article 429(4) CRR.[77]
http://www.eba.europa.eu/regulation-and-policy/supervisory-reporting/implementing-technical-

[77] Which can be found in the Leverage Ratio (CRR) Part of the PRA Rulebook.

standards-amending-commission-implementing-regulation-eu-no-680/2014- with-regard-to-the-leverage-ratio and any subsequent FAQs relating to the exposure measure.

Please use quarter-end figures for the calculation instead of an average-over-the-quarter for reporting this measure.

Draft update to Instructions on filling in data-points in PRA102 Capital+ forecast - semi annual

…

Additional information on P&L, balance sheet and leverage data

…

281 Total Leverage Ratio exposure - using a fully phased-in definition of Tier 1 Capital

Please provide the leverage ratio exposure as defined under Article 429(4) CRR.[78] http://www.eba.europa.eu/regulation-and-policy/supervisory-reporting/implementing-technical-standards-amending-commission-implementing-regulation-eu-no-680/2014- with-regard-to-the-leverage-ratio and any subsequent FAQs relating to the exposure measure.

Please use quarter-end figures for the calculation instead of an average-over-the-quarter for reporting this measure.

Draft update to Instructions on filling in data-points in PRA103 Capital+ forecast annual

…

Additional information on P&L, balance sheet and leverage data

…

281 Total Leverage Ratio exposure - using a fully phased-in definition of Tier 1 Capital

Please provide the leverage ratio exposure as defined under Article 429(4) CRR. [79] http://www.eba.europa.eu/regulation-and-policy/supervisory-reporting/implementing-technical-standards-amending-commission-implementing-regulation-eu-no-680/2014- with-regard-to-the-leverage-ratio and any subsequent FAQs relating to the exposure measure.

Please use quarter-end figures for the calculation instead of an average-over-the-quarter for reporting this measure.

78 Which can be found in the Leverage Ratio (CRR) Part of the PRA Rulebook.
79 Which can be found in the Leverage Ratio (CRR) Part of the PRA Rulebook.

6 Draft updates to reporting and disclosure templates and instructions

Draft PRA templates/instructions	Hyperlink
UK reporting data items	
Annex X: Reporting on leverage	https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/consultation-paper/2021/june/cp1421app6a.xlsx
Annex XI: Instructions for reporting on leverage	https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/consultation-paper/2021/june/cp1421app6b.pdf
UK Pillar 3 disclosure data items	
Annex I: Disclosure of key metric and overview of risk weighted exposure amounts	https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/consultation-paper/2021/june/cp1421app6e.xlsx
Annex II: Instructions for disclosure of key metric and overview of risk weighted exposure amounts	https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/consultation-paper/2021/june/cp1421app6f.pdf
Annex XI: Disclosure of the leverage ratio	https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/consultation-paper/2021/june/cp1421app6c.xlsx
Annex XII: Instructions for disclosure of the leverage ratio	https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/consultation-paper/2021/june/cp1421app6d.pdf

7 PRA statutory obligations

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

- Purpose of the policy proposals (FSMA s138J(2)(b)).

- Cost benefit analysis (FSMA s138J(2)(a) and (7)(a)); and
an estimate of those costs and benefits (if reasonable) (FSMA s138J(8)).

- Analysis of whether the impact on mutuals is significantly different to the impact on other authorised firms (FSMA s138J(2)(c) and 138K).

- Compatibility with the PRA's primary objectives (FSMA s138J(2)(d)(i), 2B and 2C).

- Compatibility with the PRA's secondary competition objective (FSMA s138J(2)(d)(ii) and 2H(1)).

- Compatibility with the regulatory principles (FSMA s138J(2)(d)(ii), 2H(2) and 3B).

- Have regard to the HMT recommendation letter (BoE Act s30B).

- Have due regard to the public sector equality duty (Equality Act s149).

- Have regard, subject to any other requirement affecting the exercise of the regulatory function, to the principles of good regulation and when determining general policy or principles to the Regulators Code (Legislative and Regulatory Reform Act 2006 s21 & 22)

- Have regard, so far as consistent with the proper exercise of those functions, to the purpose of conserving biodiversity. Conserving biodiversity includes, in relation to a living organism or type of habitat, restoring or enhancing a population or habitat (Natural Environment and Rural Communities Act 2006, s40).

- Consultation of the FCA (FSMA s138J(1)(a)).

- Where the consultation proposals a PRA rule change or amendment to onshored BTS that affects the processing of personal data - consultation with the Information Commissioner's Office (article 36(4) General Data Protection Regulation).

- *For UK Technical Standards Instruments only*: FSMA s138J(1)(a) is replaced with: consultation of the FCA and/or Bank, where that Regulator has an interest in the technical standards (FSMA s138P(4) and (5)).

- *For UK Technical Standards Instruments only*: notice given to HMT of the consultation on the UKTS ('best efforts' basis).

- *For CRR rules only:* subject to certain exceptions, have regard to:

  - relevant standards recommended by the Basel Committee on Banking Supervision from time to time

  - the likely effect of the rules on the relative standing of the United Kingdom as a place for internationally active credit institutions and investment firms to be based or to carry on activities. For these purposes, the PRA must consider the United Kingdom's standing in relation to the other countries and territories in which, in its opinion, internationally active credit institutions and investment firms are most likely to choose to be based or carry on activities

- the likely effect of the rules on the ability of CRR firms to continue to provide finance to businesses and consumers in the United Kingdom on a sustainable basis in the medium and long term

- the target in section 1 of the Climate Change Act 2008 (carbon target for 2050)

(s144C (1) & (2) FSMA – exceptions in s144E FSMA).

- *For CRR rules only* – explanation of the ways in which having regard to the matters specified above has affected the proposed rules (s144D FSMA).
- *For CRR rules only* – publication of a summary of the proposed CRR rules.
- *For CRR rules only* – consideration and consultation with the Treasury about the likely effect of the rules on relevant equivalence decisions (s144C (3) & (4) FSMA).