The UK Leverage Ratio Framework

BSA Response to the FPC CP and PRA CP 14/21

August 2021

Building Societies Association

Introduction

The BSA is pleased to respond to the combined consultations on the Leverage Ratio (LR) framework. In this response - which is broadly supportive -we address both FPC and PRA proposals together in one document, but divide our response into two parts, dealing respectively with the proposals for systemic or international banks, and those affecting smaller domestic deposit-takers only. Among BSA member building societies, we count one existing O-SII, two others that might reach O-SII size within the foreseeable future, and forty that are likely to remain sub-systemic in the longer term.

General observations

The BSA and its members have consistently favoured robust and appropriate standards of financial stability, and of individual firm resilience. Our members account for nearly 20% of the cash savings market, and specialize in higher-value savings rather than transaction accounts. So general depositor confidence -promoted by vigorous and visible financial stability measures -remains of overriding importance to them. Our members also rely heavily on a resilient payments and clearing infrastructure provided mostly by systemic banks. And through the FSCS, our members are also continuously exposed to the costs of bank failure, if individual resilience proves insufficient. For all these reasons, therefore, the BSA needs no convincing of the imperatives for resilience and financial stability. But the framework and metrics must be appropriate.

Neither the BSA nor its members advocate, or practise, excessive leverage – that is usually a product of banks' financial engineering. We were ready to accept a differentiated LR under CRR2. But we consider that a universal , inflexible and explicitly risk-insensitive measure should not be the primary requirement for a sector that specialises in a low-risk asset class. Our previous submissions on the topic of the LR are referenced here[1][2]. Nevertheless, we approach the

[1] Leverage Ratio Review - Interim Report : BSA response September 2014
[2] Changes to the UK leverage ratio framework: BSA response to FPC consultation and PRA CP11/17 September 2017

proposals in the combined CP with an open mind and a realistic overview.

FPC measures for systemic and international banks

We agree that the full LR framework should be extended only to certain **international** banks, that is - as proposed by the FPC - those banks with significant (> £10 billion) foreign assets, and to relevant holding companies.

We agree that the LR measures should be applied on a consolidated, sub consolidated or individual basis, as outlined in paragraph 3.3. It is of particular importance that all financial stability and resilience measures are scrupulously applied to ringfenced bodies and their subgroups. Otherwise the purpose of ringfencing is defeated.

On a separate point, we noted a slight difference in wording (use of "and" / "or") in paragraphs 3.3 and 10.2 on the level of application – and some of our members were concerned that they might need to calculate on both consolidated and individual bases. The BSA's understanding is that the norm is for the deposit-taker (and its subsidiaries) to calculate and comply on a consolidated basis only, without the need for parallel solo-entity calculations. We would be grateful if this could be clarified.

We agree that the exposure measure should exclude central bank deposits matched by deposits, in the same currency, and of equal or longer maturity – this was one of the predictable weaknesses of the original LR. On the revised basis, we are content with a calibration of 3.25%.

Although the BSA has opposed the superstructure of leverage buffers additional to the minimum requirement of 3.25%, we are prepared for the time being to accept the application of some increment to the LR minimum, corresponding to the countercyclical and G-SII / O-SII buffers. However, as previously stated, we do not agree that the 35% conversion factor is universally appropriate. While it may be appropriate across the board for universal banks, for deposit takers that specialize in low-risk asset classes such as residential mortgages, it mis-states the relationship between risk weighted and leverage measures. Instead we propose that deposit takers with at least 75% of their commercial assets in residential mortgages should apply a conversion factor of 20%. Other factors may be more suitable for other specific business models.

When we measure the ratio of risk weighted assets to leverage exposure, the average risk weight density is c.20% for large building societies. This indicates a lower scalar would be more appropriate to ensure capital requirements between risk and leverage based metrics remain proportional for a low-risk, leverage-constrained institution.

Although the BSA has disputed the principle that the leverage capital measure should comprise all or practically all CET1, rather than Tier One more generally, we are content with the minimum proportion of 75% CET1 now proposed.

We agree that Additional Tier One capital should only count towards the leverage capital measure where the high level trigger operates no lower than 7% CE T1. Where our largest members have issued AT1 capital, those instruments already carry a 7% trigger and will therefore qualify for the leverage capital measure.

We agree that the reporting and disclosure of leverage ratio information should be rationalised, and the confusing duplication, currently required by the interaction of CRR and FPC/PRA requirements, be eliminated.

PRA proposals for smaller domestic deposit-takers

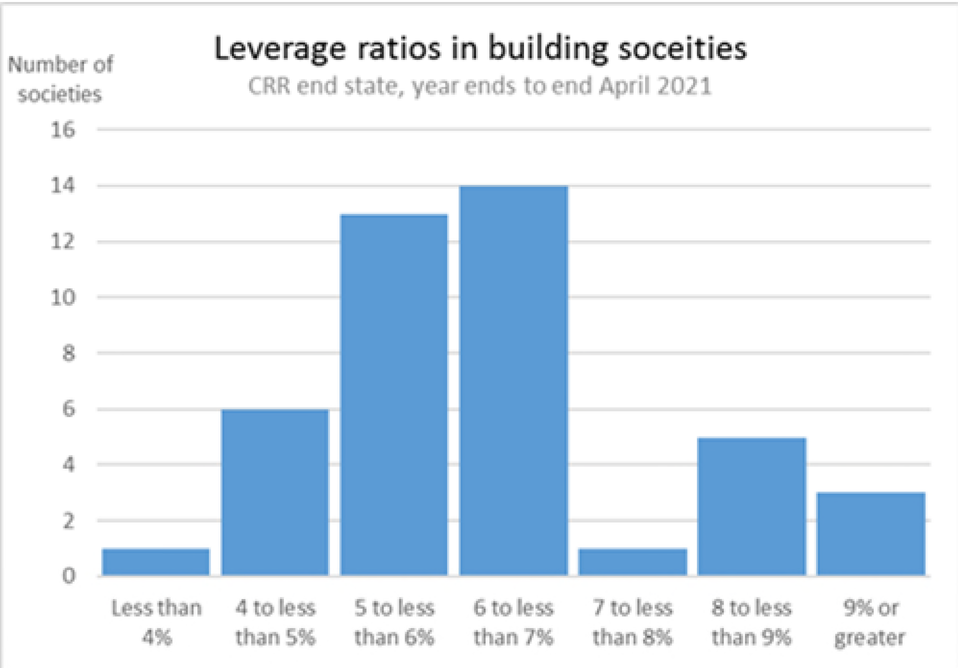
We strongly support the PRA's proposal not to apply the LR framework as a binding requirement to smaller domestic deposit-takers. The proportionality case is very well made, both in respect of the threshold of retail deposits and the threshold of foreign assets. The PRA is to be congratulated once again for actually devising and implementing a **proportionate** solution, along the lines of the latest[3]

[3] Proportionality is the 3rd of 5 principles underlying the Government's overall approach to regulation : Reforming the Framework for Better Regulation: a consultation. (BEIS) July 2021

Government thinking. Indeed, the PRA is once again in the vanguard of this initiative. The proposal is also to be welcomed on grounds of competition – it suitably advances PRA's secondary competition objective.

As stated above, none of our members practice excessive leverage, and we consider the enhanced supervisory expectation will prove a suitable and effective tool – a guard-rail in the true sense – to avoid these risks. Building societies' current leverage ratios are comfortably above the expected minimum of 3.25%, in some cases substantially so: the sector weighted average is 5.1 % , the median is around 6.1 % and the distribution is shown on the histogram below.

This analysis underlines our case that the PRA can be fully confident that excessive leverage will not arise in the building society sector.



In line with the proposals, we welcome the clarification in paragraphs 9.7, and especially 17.12, that for these domestic and non-systemic firms, the LR (not being a Pillar 1 requirement) will not feature in the setting of MREL. Again, the Bank and the PRA are to be congratulated on a practical and proportionate approach that heads off anti-competitive effects. We will address this topic further in our response to the Bank's subsequent consultation on MREL.

Other comments

We are broadly in favour of the various modifications outlined in Chapter 11. Some implement international standards and are not problematic, others – outlined on page 35 – allow simplified and more proportionate methods to be used by smaller firms in calculating the leverage exposure measure as well. We support these changes.

The change to averaging requirements from month-end, to daily across a quarter, looks at first sight both burdensome and pointless. Even if firms can adapt their calculations, that does not make it the right decision -but it seems to be a done deal in Basel. Fortunately it will not be applied to smaller domestic firms.

Conclusion

Notwithstanding out historic objections to the leverage ratio, we are broadly content with the specific proposals from both FPC and PRA with the exception of the conversion factor for LR buffers,

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Our members have total assets of over £435 billion, and account for 23% of the UK mortgage market and 17% of the UK savings market.