Changes to the UK leverage ratio framework

BSA response to FPC consultation and PRA CP11/17

September 2017

Building Societies Association

Introduction

The BSA, representing the UK's 44 building societies, is pleased to respond to the combined FPC and PRA consultation on changes to the leverage ratio (LR). The FPC/PRA policy directly affects our largest member, while our second and third largest members are within sight of the relevant threshold, and all other member societies have an interest in this policy in view of its eventual roll-out to other deposit-takers.

Summary

We welcome the formalisation of the exclusion of central bank deposits from the exposure measure, but we do not support the accompanying recalibration of the LR minimum to 3.25%, which we regard as premature at this stage, and which could have unintended adverse consequences in related policy areas such as MREL. We also draw attention to the growing confusion from the range of different bases on which the LR is to be calculated and reported.

General observations

The BSA opposed the introduction of the leverage ratio as a single, indiscriminate Pillar 1 measure, with an elaborate superstructure of additional buffers paralleling the existing framework of capital buffers. We regarded this parallel regime as undermining the primacy of risk-based capital requirements and creating unintended consequences and perverse incentives. Indeed, we identified the problems caused inter alia by the inclusion of central bank deposits in the exposure measure as far back as June 2014 in a paper submitted to the Bank. We saw that as an instance of why the LR should at most function as a back stop (or, in the latest parlance – a "guardrail") and not become the binding Pillar 1 requirement for whole classes of institutions. We adhere to that view, and the fact that the authorities now accept the inadequacy of the unmodified LR broadly confirms our analysis.

Nor is this the only adjustment in prospect, which calls into question the wisdom of recalibrating the LR minimum now when further modifications are likely. The main source of future changes to the LR is the set of proposals contained in the EU CRR 2 package, and in particular the new text for Article 92 (d), and the whole of Part Seven – Leverage, in Regulation 575/2013 (CRR). Depending on the progress of these proposals through co-decision, they may become EU law before Brexit, or (depending on the nature of any transitional period) be required to be implemented soon after Brexit. There are three points to note :

- The CRR 2 text does ***not*** include the change now being formalised by the FPC / PRA (though it could be introduced in the various stages of co-decision, if agreed).
- The CRR 2 text specifies that the **LR minimum is 3%**. Once this text is in force, it will not be possible for the UK (until it establishes a separate post-Brexit regime) to deviate and maintain a Pillar 1 minimum LR at 3.25%
- The CRR 2 text makes other adjustments to the exposure measure (excluding public lending by development banks, officially guaranteed export credits, pass-through

promotional loans, and part of the trade exposures of clearing members of QCCPs), none of which benefit our members, ***without any recalibration*** of the 3% minimum.

The range of adjustments is already confusing the public disclosure of the LR, a point on which the CP is strangely silent on (paragraphs 3.13 and 3.14). All credit institutions are already required to disclose the LR calculated strictly in accordance with the present text of the CRR. For that purpose, they may not exclude central bank deposits. Those large deposits-takers subject to the UK framework will now, if they have not done so already, also disclose the LR on the UK basis, excluding central bank deposits. That being the case, and given the CRR 2-derived changes in prospect, it is hard to see (unless the CRR-mandated disclosures are marginalised to the point of invisibility) how the recalibration "makes clear to the public the standard against which the PRA is supervising firms".

This confusion is not, of course, the PRA's fault, but the result of different policy workstreams and EU legislation proceeding at different speeds, and so requiring some inconsistent reporting until all the pieces are finally in place. However, the BSA's understanding is that, while the principle of excluding central bank deposits from the LR exposure measure is broadly accepted at the Basel Committee, whether or not to recalibrate the 3% remains controversial (and this absence of agreement meant the measure could not be included in the CRR 2 proposal text). With all this uncertainty, we think it would be wiser for the Bank / PRA to refrain from any interim recalibration for the time being.

Interaction with MRELs

Recalibration of the LR minimum from 3 % to 3.25 % may be broadly neutral, at the aggregate level, for those entities subject to the LR at present – as far as the LR itself goes. We have analysed the theoretical impact on our sector, and (because building societies prudently maintain high, and very high quality, liquidity, with large sums held in reserve accounts at the Bank) it is neutral to mildly positive, again so far as the LR itself goes.

The difficulty comes where the LR also contributes to the MREL metric. As outlined in the Bank's final policy on MREL, and consistent with current EBA RTS (though the latter are subject to change as a result of CRR 2), those large deposit takers subject to full MREL (loss absorption amount plus recapitalisation amount) face having to maintain the higher of MREL = 2 x Pillar 1 + Pillar 2A risk-based capital requirements , and MREL= 2 x leverage ratio minimum of 3%. As we have separately argued to the Bank / PRA, we already think this metric overstates the necessary MREL – since the LR, being admittedly a rough and ready long stop / "guardrail", not a carefully calibrated risk measure, inevitably overstates the loss absorption amount. **Recalibrating the LR minimum to 3.25% compounds this problem for those of our large members subject (actually or prospectively) to full MREL.** Even if the increase in the LR minimum to 3.25% merely offsets the effect of excluding central bank deposits, the knock on increase in MREL from, effectively, 6% measured on the current LR basis, to 6.5% measured on the new basis, could have a substantial net negative effect. As rehearsed in our previous communication, our large members – as lenders specialising in lower-risk assets - are particularly vulnerable to unintended effects arising from the LR, and in the MREL context are particularly badly affected since building societies cannot use structural subordination, and will therefore have to meet MREL with reserves, capital instruments or near equivalents, or the new senior non-preferred instrument when that becomes available, all at greater cost or opportunity cost.

We note that the CP already recognises the potentially greater costs to mutuals from the recalibration to 3.25% (paragraph 3.25). But the indirect effect through the MREL metric (corresponding to an effective leverage-type requirement of 6.5%) is even greater, and does not appear to have been taken into account in the CP.

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The Building Societies Association (BSA) is the voice of the UK's building societies and also represents a number of credit unions.

We fulfil two key roles. We provide our members with information to help them run their businesses. We also represent their interests to audiences including the Financial Conduct Authority, Prudential Regulation Authority and other regulators, the Government and Parliament, the Bank of England, the media and other opinion formers, and the general public.

Our members have total assets of over £345 billion, and account for approximately 20% of both the UK mortgage and savings markets