

PRA'S CONSULTATION ON AMENDMENTS TO THE UK LARGE EXPOSURES REGIME

1. Key takeaways

- The UK large exposures (LE) regime, which applies to UK banks and banking groups, seeks to limit the aggregate size of firms' exposures to individual counterparties and groups of connected counterparties (GCCs). The core of the regime is that a firm's exposure to a single counterparty or GCC cannot exceed 25% of its Tier 1 capital.
- On 18 October 2024, the Prudential Regulation Authority (PRA) published consultation paper (CP 14/24) on proposed amendments to the regime (the Consultation), partly in order to ensure the regime reflects the most recent international LE standards (the Basel LEX standards). The Consultation follows recent Basel-related changes to the LE regime that came into force in January 2022.
- The Consultation proposes amendments to the PRA LE rules and the accompanying supervisory statement, which would:
 - remove the option for firms to exceed LE limits for trading book exposures to third parties;
 - restrict the conditions under which firms can exercise the option to exceed LE limits for trading book exposures to intragroup entities;
 - change the architecture of the non-core large exposures group (NCLEG) permission regime, such that firms can obtain either a standard NCLEG permission or a higher NCLEG permission (the difference between the two being the size of permitted trading book exposures to NCLEG members);
 - where a firm reduces exposure to a counterparty using a credit risk mitigation (CRM) technique, require the firm to treat the reduced part of the exposure as having been incurred to the CRM provider; and
 - make other minor changes, such as how exposure value to securities financing transactions (SFTs) should be calculated.
- The PRA invites feedback to the Consultation by 17 January 2025 and proposes to implement the bulk of the amendments shortly after the publication of the final policy statement, subject to certain transitional provisions for firms with existing NCLEG permissions.

2. Trading book excess allowance

- Under the current LE rules, a firm can exceed its LE limit for exposures to each counterparty or GCC in its trading book by up to 500% of its Tier 1 capital. This excess allowance is subject to a punitive capital requirement, which increases incrementally as the excess over the LE limit increases and is calculated via a complex methodology.
- In the Consultation, the PRA explains that it considers this excess allowance to be inappropriate with respect to third party exposures, because the allowance permits significant contagion risk to build up within the financial system that is not fully mitigated by the accompanying additional capital requirements. It therefore proposes to eliminate the excess allowance option for third party trading book exposures.
- By contrast, with respect to intragroup trading book exposures, the PRA's view is that eliminating the excess allowance option could lead to fragmentation of risk management in integrated banking groups that have a range of booking arrangements. The PRA therefore proposes to retain the trading book excess allowance for intragroup exposures, but subject to (i) a limit of 85% of the firm's Tier 1 capital and (ii) an additional capital requirement equal to 100% of the amount of the exposures that exceed the LE limit.

3. NCLEG permissions

- A firm can apply to the PRA to assign a 0% risk weight to exposures to UK entities within its consolidation group and thereby exclude those exposures from LE limits. This is known as a ‘core UK group’ waiver. The Consultation does not propose any changes to the operation or effect of core UK group waivers.
- A firm can also apply to the PRA to be allowed to increase its total exposures to certain cross-border group entities from 25% to 100% of Tier 1 capital (such group being known as the NCLEG). At present, separate NCLEG permissions are required with respect to trading book and non-trading book exposures because of the complex capital calculations relating to the trading book excess allowance.
- The PRA is proposing in the Consultation to simplify the NCLEG regime. There will be two levels of NCLEG permission (standard and higher), which will exempt from LE limits:
 - a firm’s non-trading book exposures to members of its NCLEG up to 100% of its Tier 1 capital;
 - a firm’s non-trading book exposures to members of its NCLEG up to 100% (standard permission) or a higher specified percentage of no more than 250% (higher permission) of its Tier 1 capital less the firm’s total non-trading book exposures to members of its NCLEG.
- Existing legacy NCLEG permissions will remain in place and will (in effect) be treated as standard permissions. Firms who currently benefit from a higher NCLEG trading book exposure limit (by means of a rule modification under the current regime) will need to apply for a new higher NCLEG permission, subject to a transitional arrangement that will allow them to continue to rely on their current rule modification until March 2026.

4. Credit risk mitigation (CRM)

- CRM techniques can reduce the quantum of an exposure to a counterparty for LE purposes. In light of the Basel LEX standards, the PRA consulted in 2021 (CP5/21) on mandatory substitution for all such reduced exposures, which would require the firm to reassign the reduced exposure to the collateral issuer or protection provider (CRM provider) for LE purposes. The purpose of this change is to ensure that firms’ exposures to CRM providers are properly captured by the LE regime.

- In the Consultation, the PRA clarifies that the value of the exposure to be assigned to the CRM provider will be the exposure value assigned to the counterparty before taking into account the effect of the CRM minus the exposure value assigned to the counterparty after taking into account the effect of the CRM. This is an extension of the mandatory substitution approach that already applies in certain contexts under the existing LE regime.
- The effect of this rule change is that the entirety of the exposure will be attributed to a combination of the counterparty and the CRM provider, albeit that certain exposures to CRM providers will be exempt from LE limits under the existing LE exemption provisions (e.g. where the exposure to the CRM provider represents a claim on a sovereign that receives a 0% credit risk weight). The PRA has confirmed there will be no additional specific exemptions for exposures to CRM providers.

5. Other changes

- In the Consultation, the PRA also proposes certain other minor changes to the LE regime, including removing:
 - the option for firms to use their internal models to calculate exposure values to SFTs (to align with the post-2021 position on the calculation of exposure values to derivatives);
 - the option for firms to use immovable property as CRM for LE purposes; and
 - the exemption from LE limits for exposures to the Financial Services Compensation Scheme (to align with the Basel LX standards).

6. Impact

- The changes to the trading book excess allowance rules, the introduction of mandatory substitution for CRM and the removal of certain leniencies in the rules (e.g. using immovable property as CRM) will render the LE regime somewhat more onerous than it is today.
- However, the cumulative impact of these changes is likely to be relatively modest. For instance, PRA data indicates that very few firms ever used the third party trading book excess allowance and that any reduction in exposures to CRM providers as a result of the new mandatory substitution rules is unlikely to be material. Firms may also welcome the proposed simplification of the NCLEG permissions regime and of

the intragroup trading book excess allowance capital requirement calculation.

- On an operational level, firms should review their LE calculation methodology to ensure they capture the changes proposed by the Consultation. In particular, firms may wish to model the effect of the new mandatory substitution rules on their existing collateral inventory and consider whether they may

need to restructure existing arrangements and/or reduce exposures to certain CRM providers.

- Firms that currently benefit from a higher NCLEG trading book exposure limit should also ensure that they are prepared to apply for a higher NCLEG permission in due course.

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