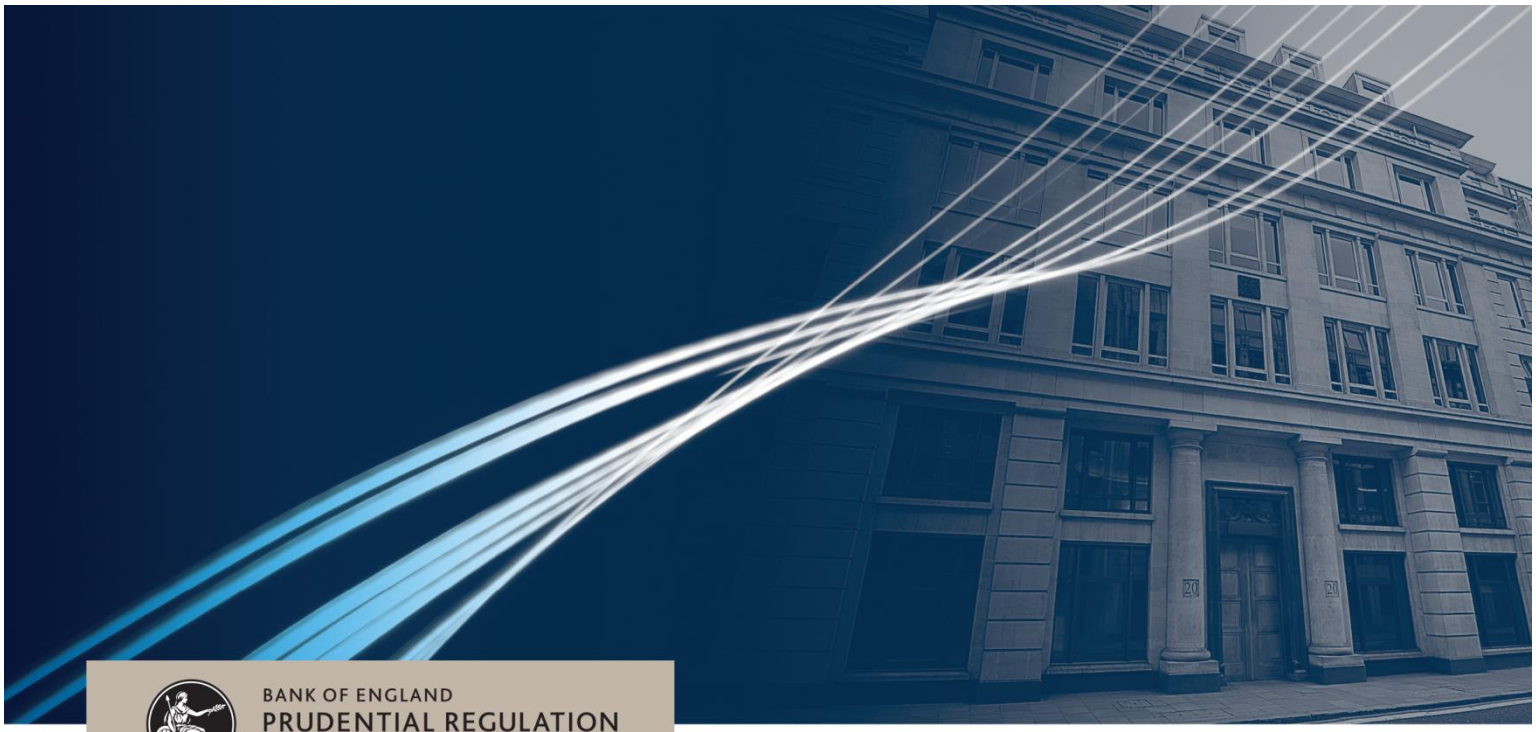

BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

Consultation Paper | CP20/17

Changes to the PRA's large exposures framework

October 2017

Prudential Regulation Authority
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London EC2R 6DA

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Responses are requested by Thursday 4 January 2018.

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Contents

1 Overview

1.1 This consultation paper (CP) sets out the Prudential Regulation Authority's (PRA) proposed changes and clarifications to requirements relating to intragroup transactions in the Large Exposures (LE) Part of the PRA Rulebook. The PRA also proposes to update Supervisory Statement (SS) 16/13 'Large Exposures' to reflect PRA expectations.[1]

1.2 The PRA has reviewed the intragroup LE framework as part of its overall review of the groups policy framework.[2] The details of this review and the proposed guiding principles are included in CP19/17 'Groups policy and double leverage'.[3] The proposals aim to simplify the overall intragroup LE framework, improve the consistency of the process of granting intragroup permissions and facilitate the orderly resolution of banking groups.

1.3 This CP is relevant to PRA-authorised UK banks, building societies, PRA-designated UK investment firms and their qualifying parent undertakings, which for this purpose comprise financial holding companies and mixed financial holding companies, as well as credit institutions, investment firms and financial institutions that are subsidiaries of these firms, regardless of their location.

1.4 This policy has been designed in the context of the current UK and EU regulatory framework. The PRA will keep the policy under review to assess whether any changes would be required due to changes in the UK regulatory framework, including those arising once any new arrangements with the European Union take effect.

Background

1.5 The PRA sets capital requirements on an individual firm basis to ensure the safety and soundness of PRA authorised persons (firms). The LE framework complements the capital framework by aiming to protect firms from large losses resulting from the sudden default of a single counterparty or a group of connected counterparties (GCC).[4]

1.6 In determining a GCC, a firm has to consider its exposures to the rest of its group. In general, the Capital Requirements Regulation (CRR) limits a firm's total exposure to the rest of its group to 25% of its eligible capital.[5] This limits the intragroup contagion risk.

1.7 The PRA takes into account the overall business model of the group and the strength of a firm's relationship with other entities in the group when setting its prudential requirements. A number of entities within the banking group may operate together as if they were a single firm to manage funding, liquidity and risk more efficiently. In such situations, where group entities are strongly incentivised to support each other, the PRA may permit intragroup exposures greater than the LE limit. There are a number of conditions that these entities have to meet, but the PRA has overall discretion when considering whether to exempt these exposures from the LE limit.

1 December 2013: www.bankofengland.co.uk/pra/Pages/publications/largeexpos.aspx.
2 Groups policy refers to the PRA's framework for assessing and mitigating these risks. The financial position of a firm may be adversely affected by its relationships with other entities in the same group or by risks that affect the financial position of the whole group, including reputational contagion.
3 October 2017: www.bankofengland.co.uk/pra/Pages/publications/cp/2017/cp1917.aspx.
4 As defined in Capital Requirements Regulation (CRR) Article 4(1)(39).
5 Eligible capital is defined as Tier 1 plus a portion of Tier 2 (up to 1/3rd of Tier 1 capital).

Intragroup permissions

1.8 Firms can apply to the PRA, subject to CRR conditions[1] being met, to assign a 0% risk weight for exposures to certain entities established in the United Kingdom within their consolidation group. These exposures are exempt from the LE limit and are also excluded from a firm's leverage ratio.[2] All the entities included in this permission are referred to as a firm's core UK group (CUG). The PRA provides guidance in SS16/13 on how it will assess whether the CRR conditions have been satisfied.

1.9 A firm can also apply to the PRA to increase its total exposures to certain cross-border group entities from 25% to 100% of its own eligible capital. The PRA expects these entities to meet the same conditions as for CUG permissions except for the condition that such entities are established in the United Kingdom. These entities are referred to as the non-core LE group (NCLEG). Where a firm has both a CUG and an NCLEG permission, the LE limit is determined on an aggregate basis and not on an individual basis. Total exposures from a firm's CUG to its NCLEG are limited to 100% of its CUG eligible capital as defined in rule 1.2 of the LE Part of the PRA Rulebook.

Intragroup exposures due to internal minimum requirement for own funds and eligible liabilities (MREL)

1.10 The Bank of England's approach to setting a minimum requirement for own funds and eligible liabilities (MREL),[3] sets out the framework for calibrating MREL to ensure that groups can be resolved effectively.

1.11 The Bank also published a consultation paper on 2nd of October 2017 that covers its proposed policy framework on the setting of internal MREL.[4] The Bank's proposed approach requires material operating entities to issue internal MREL resources to its parent entity or to its resolution entity within the group. This ensures that the critical functions provided by the material operating entities can continue during and after resolution.

1.12 Internal MREL resources can include own funds and eligible liabilities. Exposures to own funds are not subject to LE limits in accordance with the regulatory capital framework.[5] Similarly, exposures to entities that are included in a firm's CUG permission are exempt from LE limits. All other intragroup exposures due to internal MREL are currently subject to LE limits.

Summary of proposals

1.13 The PRA is proposing the following regarding intragroup permissions:

- enhanced guidance on the application of criteria for CUG and NCLEG permissions;
- changing the NCLEG calibration basis for firms that have both a CUG and an NCLEG permission; and
- changing how the NCLEG permission applies at the UK consolidated group level.

1 CRR Article 113(6).
2 Commission Delegated Regulation (EU) 2015/62 of 10 October 2014 amending Regulation (EU) No 575/2013 of the European Parliament and of the Council with regard to the leverage ratio, January 2015; http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32015R0062&from=EN and CRR Article 400(1)(f).
3 November 2016: www.bankofengland.co.uk/financialstabilitiy/Documents/resolution/mrelpolicy2016.pdf.
4 www.bankofengland.co.uk/financialstability/Documents/resolution/mrelconsultation2017.pdf.
5 CRR Article 390(6)(e).

1.14 Due to MREL, the PRA is also proposing to allow firms to apply to exempt from the LE limit,[1] exposures identified and reported as internal MREL.

Implementation

1.15 The PRA is proposing that the changes to the rules and proposed guidance takes effect after the completion of the consultation period and following publication of the final policy.

Responses and next steps

1.16 This consultation closes on Thursday 4 January 2018. The PRA invites feedback on the proposals set out in this consultation. Please address any comments or enquiries to CP20_17@bankofengland.co.uk.

2 Intragroup permissions

2.1 This chapter proposes: (i) updates to SS16/13 aimed at clarifying the intragroup permissions assessment process (Appendix 1); and (ii) changes to simplify and clarify the PRA intragroup LE rules (Appendix 2).

Additional guidance for intragroup permissions

2.2 CUG and NCLEG permissions require approval from the PRA. SS16/13 provides guidance on how the PRA will assess whether the conditions specified in the CRR for CUG permissions have been satisfied. These guidelines are also relevant for NCLEG permissions because the PRA expects that members of an NCLEG should meet the same conditions as are required for CUG permissions except for the condition that they are established in the United Kingdom.

Proposals

2.3 Group entities included in an intragroup permission have to be subject to the same risk evaluation, measurement and control procedures as the firm.[2] The PRA is proposing to include further guidance on how it will assess compliance with this condition.

2.4 The PRA is also proposing to include a non-exhaustive list of documents that the firms should submit in support of an intragroup permission application.

2.5 Another condition for entities to be included in an intragroup permission is that there is no current or foreseen material practical or legal impediment to the prompt transfer of own funds or repayment of liabilities from the counterparty to the institution.[3] As members of an NCLEG are usually not incorporated in the United Kingdom, they may be subject to regulatory requirements in other jurisdictions. As part of the assessment process, the PRA will consider the likelihood that specific measures or restrictions will be or have been placed on a member by a regulatory or other body in the relevant jurisdiction and whether such measures constitute a material impediment.

2.6 In relation to NCLEG permissions, CRR Article 400(3) also requires that any remaining concentration risk can be addressed by other equally effective means. The PRA proposes to include a non-exhaustive list of factors that it will consider as part of the assessment of this condition.

1 CRR Article 395(1).
2 CRR Article 113(6)(c).
3 CRR Article 113(6)(e).

2.7 The conditions specified in CRR Article 400(3) were included in Chapter 4 of the LE Part of the PRA Rulebook. As meeting these conditions are a requirement under CRR, the PRA is proposing to remove Chapter 4 from the PRA Rulebook.

2.8 In addition to the specific CRR conditions, the PRA will make a wider judgement as to whether it is appropriate to grant intragroup permissions. The PRA is proposing to clarify that its wider judgement is based on whether group entities are strongly incentivised to support each other, whether the permission is consistent with the overall business model of the firm and furthers the PRA's safety and soundness objective.

Application of NCLEG permissions at the individual level

2.9 At present, where a firm has both a CUG and an NCLEG permission, intragroup exposures from the CUG to the NCLEG are limited on an aggregate basis and not on an individual basis. The total exposures from the CUG to the NCLEG are limited to 100% of the CUG eligible capital. However, as the PRA supervises firms in reference to individual firms and consolidated groups, not in reference to CUGs, the requirement to calculate own funds for the CUG is difficult to supervise and burdensome for firms.

Proposals

2.10 Having re-assessed the cost and benefits of the current approach, the PRA is proposing to limit a firm's exposures to members of its NCLEG on an individual basis to 100% of the firm's eligible capital and not on the aggregate basis of the CUG's capital.

2.11 The PRA is also proposing to remove the requirement to submit FSA018 but to retain oversight of the aggregate exposures between a firm's CUG to its NCLEG over a certain threshold. Instead, firms would have to notify the PRA if the aggregate exposures to its NCLEG from all members of its CUG, that are not PRA-authorised firms, exceed 25% of the firm's eligible capital.

Application of NCLEG permissions at the UK consolidated level

2.12 Intragroup permissions are primarily applicable at the individual level as intragroup exposures net out at the consolidated level. However, where the UK consolidated group is part of a wider international group, aggregate exposures from the UK consolidated group to group entities outside that consolidation are also subject to the LE limit at the UK consolidated level. The PRA has reviewed how the NCLEG permission should apply on a UK consolidated basis to ensure that granting an NCLEG permission at the individual level is consistent with the LE limit that applies at the UK consolidated level.

Proposal

2.13 The PRA is proposing that intragroup exposures that are subject to an NCLEG permission on an individual basis are excluded from the aggregate UK consolidated LE limit. Other exposures from the UK consolidated group to the wider group would remain subject to the LE limit as per CRR Article 395(1).

3 Intragroup exposures due to internal MREL

3.1 The purpose of internal MREL is to facilitate the orderly resolution of groups. It also supports the continuity of critical economic functions as the material entities in a banking group are less likely to enter resolution.

3.2 Internal MREL exposures do not carry the risk that the LE framework is designed to mitigate. LE limits are designed to protect a firm from a sudden default of a counterparty or group of connected clients. Internal MREL is specifically designed to channel losses upwards to the resolution entity in a group. Therefore, intragroup exposures that arise due to internal MREL should be distinguished from business as usual intragroup exposures.

Proposals

3.3 The PRA is proposing that firms can apply to exempt internal MREL exposures from the LE limits. Firms will have to demonstrate to the PRA that the exposures satisfy the Bank of England's internal MREL eligibility criteria and also meet the conditions in CRR Articles 400(2)(c) and 400(3). For further details on the Bank of England's internal MREL instrument eligibility, see Section 8 of the proposed Statement of Policy in the Bank's CP on its approach to setting internal MREL.[1]

3.4 The PRA proposes to require firms to notify the PRA of the internal MREL exposures that it exempts under this policy proposal on a quarterly basis.

4 The PRA's statutory obligations

4.1 Before making any rules, the Financial Services and Markets Act 2000 (FSMA)[2] requires the PRA to publish a draft of the proposed rules accompanied by:

- a cost benefit analysis;
- a statement as to whether the impact of the proposed rules will be significantly different to mutuals than to other persons;[3]
- an explanation of the PRA's reasons for believing that making the proposed rules is compatible with the PRA's duty to act in a way that advances its general objective,[4] insurance objective[5] (if applicable), and secondary competition objective;[6] and
- an explanation of the PRA's reasons for believing that making the proposed rules are compatible with its duty to have regard to the regulatory principles.[7]

4.2 The PRA is also required by the Equalities Act 2010[8] to have due regard to the need to eliminate discrimination and to promote equality of opportunity in carrying out its policies, services and functions.

4.3 The PRA should also have regard to aspects of the government's economic policy as recommended by HM Treasury.[9]

1 www.bankofengland.co.uk/financialstability/Documents/resolution/mrelconsultation2017.pdf.
2 Section 138J of FSMA.
3 Section 138K of FSMA.
4 Section 2B of FSMA.
5 Section 2C of FSMA.
6 Section 2H(1) of FSMA.
7 Sections 2H(2) and 3B of FSMA.
8 Section 149.
9 Section 30B of the Bank of England Act 1998.

Cost benefit analysis

Intragroup permissions

4.4 The main benefit of the PRA's proposed changes to SS 16/13 is to provide additional guidance and clarity to firms applying for CUG and/or NCLEG permissions. Although firms would have to provide more information upfront, the PRA considers that this will make the application process more efficient. The cost of compliance with these proposals should be minimal as the information requested should be readily available to all firms.

4.5 The PRA considers that the proposed changes to NCLEG permissions at the individual level will simplify the PRA's overall approach to intragroup permissions. Limiting a firm's total exposures to entities in its NCLEG to 100% of its individual eligible capital regardless of whether the firm has a CUG permission would have minimal impact on firms. A review of firms' LE reporting indicates that the majority of firms' exposures to entities in their NCLEG are already within the proposed limit. Only two firms reported trading book exposures in excess of the new proposed limit. The PRA considers that these firms could apply eligible credit risk mitigation techniques with minimal costs to the firm. Alternatively, these firms could choose to reduce the excess exposures or hold additional own funds requirements for LE in the trading book. The proposed changes will enhance the safety and soundness of firms. They will also reduce the need to calculate eligible capital at the CUG level where prudential requirements are not applied and reduce reporting requirements.

4.6 The PRA's proposal to exempt all intragroup exposures that benefit from an NCLEG permission on an individual basis from the LE limit at the consolidated level is a relaxation of the LE rules. The changes also remove any uncertainty about how the NCLEG permissions apply at a consolidated level. The change was needed for firms where the permissions at individual level were considered ineffective because the LE limit at the consolidated level was equal to or smaller than the NCLEG limit that applied at the individual level. As this is a relaxation of the rules, there should be no extra cost to firms.

Intragroup exposures due to internal MREL

4.7 The exemption of exposures that arise as a result of internal MREL requirements is a relaxation of the LE rules to facilitate the orderly resolution of banking groups. The PRA considers that there should be minimal incremental costs to the firms as a result of requiring firms to apply for the exemption of internal MREL exposures from the LE limit. The benefits of the exemption would outweigh any incremental costs.

Compatibility with the PRA's objectives

4.8 The PRA has a statutory objective to promote the safety and soundness of banks, building societies, credit unions, insurers and PRA-designated investment firms. The proposals in this CP are intended to further that objective by ensuring that the PRA has an LE framework to ensure that risks associated with intragroup exposures are managed appropriately, and to improve the PRA's supervision of firms' intragroup exposures. The proposed updates to the draft SS aim to promote transparency in the way that the PRA assesses whether conditions for CUG and NCLEG permissions are met, supporting more efficient decisions across all firms.

4.9 When discharging its general function in a way that advances its primary objectives, the PRA has, as a secondary objective, a duty to facilitate effective competition in the markets for services provided by PRA-authorised persons. The PRA's LE framework provides rules for limiting and assessing intragroup risks in a consistent manner across all firms thereby enhancing effective competition. Specifically, allowing firms with an NCLEG permission to disregard individual exposures to its NCLEG on a consolidated basis when calculating LE limits

will provide a more level playing field for smaller banking groups that do not benefit from significantly higher capital at a consolidated level.

Regulatory principles

4.10 In developing the proposals in this CP, the PRA has had regard to the regulatory principles. One principle that is of particular relevance is that the PRA should exercise its functions as transparently as possible. The PRA judges that the proposals outlined in this CP to bring greater clarity and transparency to the PRA's LE framework.

Government economic policy

4.11 In March 2017, HM Treasury made recommendations to the Prudential Regulation Committee (PRC) about aspects of the Government's economic policy to which the PRC should have regard when considering how to advance the objectives of the PRA and apply the regulatory principles as set out in FSMA.[1]

4.12 One of the considerations is that the Government is keen to see more competition in all sectors of the industry, particularly retail banking. This includes minimising barriers to entry and ensuring a diversity of business models within the industry.

4.13 The PRA considers that the proposals in this CP, in particular, the proposals on how intragroup permissions apply at the UK consolidated level, will enhance a level playing field for small and large banking groups.

4.14 The PRA also considers that the proposals in this CP will not materially affect London's position as a leading international financial centre or negatively impact on institutions and the financial system. The PRA considers that the policy proposals will enhance the safety and soundness of firms and the stability of the financial system.

Impact on mutuals

4.15 In the PRA's opinion, the impact of the proposed rule changes on mutuals is expected to be no different from the impact on other firms.

Equality and diversity

4.16 The PRA has performed an assessment of the policy proposals and does not consider that the proposals give rise to equality and diversity implications.

1 Information about the PRC and the recommendations from HM Treasury are available on the Bank's website at www.bankofengland.co.uk/about/Pages/people/prapeople.aspx.

Appendices

Appendix 1: Draft amendments to Supervisory Statement 16/13 'Large Exposures'

In this appendix new text is underlined and deleted text is struck through.

1 Introduction

1.1 This supervisory statement is aimed at firms to which CRD IV applies.

1.2 This statement outlines the Prudential Regulation Authority's (PRA's) expectations in relation to large exposures requirements within the CRR. It covers:

- Applications to include undertakings within a core UK group (CRR Article 113(6)) and non-core large exposure group (CRR 400(2)(c)).
- Applications to exempt exposures that arise as a result of internal MREL requirements (CRR Article 400(2)(c)).
- Sovereign large exposures exemptions (CRR Article 400(2)(g or h)) and exposures to trustees.

1.3 This statement should be read in conjunction with the specified CRR articles, the requirements in the Large Exposures Part of the PRA Rulebook and the high-level expectations outlined in The PRA's approach to banking supervision.[1]

2 CRR Article 113(6): core UK group applications

2.1 CRR Article 113(6) permits a firm, subject to conditions, to apply a 0% risk weight for exposures to certain entities within its consolidation group. CRR Article 400(1)(f) then requires that exposures that would be assigned a 0% risk weight under CRR Article 113(6) are fully exempted from the large exposures limit stipulated in CRR Article 395(1).

Application process

2.2 Firms wishing to apply a 0% risk weight to relevant exposures should make a formal application to the PRA, through which they should seek to demonstrate how the conditions set out in CRR Article 113(6)(a)–(e) are met.

2.3 The PRA will assess individual applications against CRR Article 113(6) on a case-by-case basis. The PRA will only approve applications where the conditions stipulated in CRR Article 113(6) are met.

2.4 Firms should note that the PRA will still make a wider judgement whether it is appropriate to grant this treatment even where the conditions in CRR Article 113(6) are met. In making that judgement, the PRA will consider whether group entities are strongly incentivised to support each other. The PRA will also consider whether the treatment is consistent with the overall business model of the firm and furthers the PRA's safety and soundness objective.

1 www.bankofengland.co.uk/pra/Pages/supervision/approach/default.aspx.

2.5 It is the PRA's intention to continue to apply a high level of scrutiny to applications under CRR Article 113(6).

Application of criteria

2.5A In relation to CRR Article 113(6)(c), the PRA will consider the following non-exhaustive list of factors when assessing whether the condition is met:

- regular and transparent mechanisms for communication are established within the consolidated group to enable the senior management, business lines, the risk management function and other control functions to share and access information about risk measurement, analysis and monitoring;

- internal procedures and information systems are integrated, consistent and reliable throughout the consolidated group so that all sources of risk can be identified, measured and monitored on a consolidated basis and also, to the extent necessary, separately by entity, business line and portfolio; and

- key risk information is regularly reported to the central risk management function of the consolidated group to enable centralised evaluation, measurement and control of risk across the relevant group entities.

2.6 In relation to CRR Article 113(6)(d), the PRA will consider the condition to have been satisfied if:

- the relevant counterparty is incorporated in the United Kingdom; or

- it is an undertaking of a type that falls within the scope of the Council Regulation of 29 May 2000 on insolvency proceedings (Regulation 1346/2000/EC); and

- it is established in the United Kingdom other than by incorporation; and

- the firm can demonstrate that the counterparty's centre of main interests is situated in the United Kingdom.

2.7 In relation to CRR Article 113(6)(e), the PRA will consider the following non-exhaustive list of factors when assessing whether this condition has been met:

- the speed with which funds can be transferred or liabilities repaid to the firm and the simplicity of the method for the transfer or repayment. As part of our overall assessment, we would consider one of the indicators to achieving prompt transfer as being ownership of 100% of the subsidiary undertaking;

- whether there are any interests other than those of the firm in the undertaking, and what impact those other interests may have on the firm's control over the undertaking and the ability of the firm to require a transfer of funds or repayment of liabilities;

- whether there are any tax disadvantages for the firm or the undertaking as a result of the transfer of funds or repayment of liabilities;

- whether the purpose of the undertaking prejudices the prompt transfer of funds or repayment of liabilities;

- whether the legal structure of the undertaking prejudices the prompt transfer of funds or repayment of liabilities;

- whether the contractual relationships of the undertaking with the firm and other third parties prejudices the prompt transfer of funds or repayment of liabilities; and

- whether past and proposed flows of funds between the undertaking and the firm demonstrate the ability to make prompt transfer of funds or repayment of liabilities.

2.8 When demonstrating how CRR Article 113(6)(e) is met, the PRA considers that in the case of a counterparty which is not a firm, the formal application should include a legally binding agreement between the firm and the counterparty. This agreement will be to promptly, on demand by the firm, increase the firm's eligible capital by an amount required to ensure that the firm complies with the provisions contained in CRR Part Two (Own funds) and any other requirements relating to eligible capital or concentration risk imposed on a firm by or under the regulatory system.

2.9 For the purpose of demonstrating compliance with CRR Article 113(6)(e), the PRA considers that the agreement to increase the firm's eligible capital may be limited to eligible capital available to the undertaking. It may reasonably exclude such amount of eligible capital that, if transferred to the firm, would cause the undertaking to become balance sheet insolvent, in the manner contemplated in section 123(2) of the Insolvency Act 1986.

2.10 The PRA does not expect a firm to which this section applies to use any member of its core UK group (which is not a firm) to route lending, or to have exposures to any third party in excess of the limits stipulated in Article 395(1).

2.11 The PRA will typically expect to receive the following information and documents in support of an application:

- an up-to-date organisation chart of the fully consolidated entities in the group, specifying, in relation to each entity, whether the entity is an institution, financial institution or an ancillary services undertaking as those terms are defined in the CRR.

- a description of the risk management policies and controls of the counterparty;

- written policies describing group company risk measurement, evaluation and control procedures in the areas of credit risk, market risk, liquidity risk and operational risk and a description of how these policies are applied by each entity;

- a description of the process that ensures a prompt transfer of own funds and the repayment of liabilities; and

- a statement signed by representatives and approved by the management body of each of the parent undertaking and the relevant group entities attesting that there are no practical or legal impediments to the transfer of funds or repayment of liabilities between group entities and the firm.

3 CRR Article 400(2)(c) — non-core large exposures group exemptions (trading book and non-trading book) and internal MREL exemption

3.1 CRR 400(2)(c) permits the PRA to fully or partially exempt exposures incurred by a firm to certain intra-group undertakings from the large exposures limit stipulated in CRR Article 395(1). The PRA will consider exempting non-trading book and trading book exposures to intra-group undertakings that meet specified conditions (set out in the large exposures rules and in CRR Article 400(3)). Guidance in respect of these conditions is outlined below. Firms should note however that under CRR Article 400(2)(c) intra-group exposures that do not meet the criteria in Article 400(2)(c) are to be treated as exposures to a third party.

3.2 The PRA expects that members of a non-core large exposures group meet the conditions set out in CRR Article 113(6) except for the condition to be established in the United Kingdom — CRR Article 113(6)(d).

3.2A For the purposes of assessing whether a member of a non-core large exposures group (NCLEG) meets the condition in CRR Article 113(6)(e), the PRA will consider the specific measures or restrictions, current or foreseen, that a regulator in other jurisdictions has placed or may place on a member and whether such measures constitute a material impediment. The PRA expect firms to provide a description of any such specific measures or restrictions such as restrictions on dividend payment. The firm should provide confirmation if no such measures or restrictions are in place or foreseeable.

Non-core large exposures group non-trading book exemption

3.3 The PRA's rules fully exempt from the large exposures limit any non-trading book exposures from a firm to members of its non-core large exposures group, provided that the total such exposures are no greater than 100% of the firm's eligible capital. ~~If the firm has a core UK group permission then the same can apply provided that the total such exposures are no greater than 100% of the core UK group's eligible capital.~~

Non-core large exposures group trading book exemption

3.4 A firm can also apply for a non-core large exposures group trading book exemption. The amount of trading book exposures that may be exempted will depends on a firm's trading book exposure allocation as defined in the PRA rules.

~~• If a firm has a core UK group permission, its trading book exposure allocation is the product of:~~

~~(i) its proportion of the core UK group's trading book exposures to the non-core large exposures group; and~~

~~(ii) the difference between the core UK group's total eligible capital and the core UK group's total non-trading book exposures to the non-core large exposures group.~~

3.5 Any trading book exposures of a firm to its non-core large exposures group above the firm's trading book exposure exemption must be considered together with total exposures incurred by a firm to members of its group that are not included in a CUG permission, an NCLEG non-trading permission or an NCLEG trading book permission, and will be subject to the CRR large exposures regime (Part Four). This includes the ability to have trading book exposures that exceed the limits laid down in CRR Article 395provided the conditions in this article are met, including the additional own funds requirement in CRR Article 395(5)(b).

3.6 In addition to outlining how to calculate the size of the trading book exemption at any point in time, the PRA rules also specify that firms must allocate exposures to its trading book exposure allocation in order of ascending risk requirements. Therefore, a firm should first allocate the trading book exposures with the lowest risk requirements to its trading book exposure allocation. Once no further trading book exposures can be allocated within the firm's trading book exposure allocation, any remaining trading book exposures are subject to the CRR large exposure regime.

3.7 The PRA has judged that this approach represents the most appropriate way to retain our current intra-group large exposures policy under the CRR. Although there is a degree of additional complexity in calculating the amount of intra-group exposures that can be exempted under our rules the PRA judges that the policy outcome will be broadly similar to that under the current regime. The impact of this approach on the total own funds requirement for excess intra-group trading book exposures will depend on specific firm circumstances.

Internal MREL exemption

3.7A Firms wishing to apply for an internal MREL exemption should make a formal application to the PRA identifying the exposures the firm wishes to be exempted. To be eligible for this exemption, the PRA requires that the internal MREL exposures in scope of the permission must meet the internal MREL eligibility criteria set out in the Statement of Policy on the Bank of England's approach to setting a minimum requirement for own funds and eligible liabilities (MREL).[1]

Application process

3.8 In its review of a firm's non-core large exposures non-trading book exemption, non-core large exposures group exemption and/or internal MREL exemption application, the PRA expects to assess:

- compliance with the conditions set out in the large exposures rules; and
- how the counterparties to be included in the non-core large exposures group meet the conditions for the core UK group except CRR Article 113(6)(d).

3.8A For the purpose of assessing whether any remaining concentration risk can be addressed by other equally effective means for the purposes of CRR Article 400(3)(b), the PRA will consider the following non-exhaustive list of factors, including whether the:

- firm has robust processes, procedures and controls, at individual level and at consolidated level, where relevant, to ensure that use of the exemption would not result in concentration risk that runs counter to its risk strategy and the principles of sound internal group risk management;
- concentration risk arising has been or will be clearly identified in the internal capital adequacy assessment process (ICAAP) of the firm and will be actively managed. The arrangements, processes and mechanisms to manage the concentration risk will be assessed in the supervisory review and evaluation process (SREP).

1 [A link will be included when the final policy is issued].

3.9 Firms should note that the PRA will still make a wider judgement whether it is appropriate to grant this treatment even where the above conditions are met. In making that judgement, the PRA will consider whether group entities are strongly incentivised to support each other. The PRA will also consider whether the treatment is consistent with the overall business model of the firm and furthers the PRA's safety and soundness objective.

4 CRR Article 400(2)(g) and (h) — sovereign large exposures exemption

4.1 CRR Article 400(2)(g) and (h) allows the PRA to exempt exposures which constitute claims on central banks in the form of minimum reserves held at central banks and denominated in their national currencies, and claims on central governments in the form of statutory liquidity requirements held in government securities, which are denominated and funded in their national currencies.

Application process

4.2 A firm seeking a sovereign large exposures exemption should demonstrate in the application to the PRA how the conditions in the large exposures rules are met.

4.3 The PRA will assess individual sovereign large exposures exemption applications against the conditions set out in the large exposures rules.

4.4 Firms should note that the PRA will still make a wider judgement whether it is appropriate to grant this treatment even where the conditions set out in the large exposures rules are met. In making that judgement, the PRA will consider whether group entities are strongly incentivised to support each other. The PRA will also consider whether the treatment is consistent with the overall business model of the firm and furthers the PRA's safety and soundness objective.

Application of criteria

4.5 It is the PRA's intention to continue to apply a high level of scrutiny to applications in respect of CRR Article 400(2)(g) or (h).

4.6 As part of the process of applying for a sovereign large exposure exemption, the PRA will set out the amount of the exposures that may be exempted. In general, the PRA expects the likelihood of the firm's liabilities (that fund the particular exempt exposure) falling alongside a fall in that exposure in an event of default to form one of the key considerations in determining the total amount of such exempt exposures.

4.7 The PRA will expect the firm to demonstrate that, taking into account the aggregate of all exposures exempted under other sovereign large exposure exemptions granted to the firm, the exemption being sought would not result in an undue risk to the safety and soundness of the firm.

5 Exposures to trustees

5.1 This section clarifies the PRA's expectations on firms when considering exposures to counterparties which act as a trustee, custodian or general partner of an investment trust, unit trust, venture capital or other investment fund, pension fund or a similar fund.

5.2 If a firm has an exposure to a person ('A') when A is acting on his own behalf, and also an exposure to A when A acts in his capacity as trustee, custodian or general partner of an investment trust, unit trust, venture capital or other investment fund, pension fund or a similar fund (a 'fund'), the firm may treat the latter exposure as if it was to the fund. This treatment may be adopted unless such a treatment would be misleading.

5.3 When considering whether the treatment described is misleading, factors a firm should consider include:

- the degree of independence of control of the fund, including the relation of the fund's board and senior management to the firm or to other funds or to both;
- the terms on which the counterparty, when acting as trustee, is able to satisfy its obligation to the firm out of the fund of which it is trustee;
- whether the beneficial owners of the fund are connected to the firm, or related to other funds managed within the firm's group, or both; and
- for a counterparty that is connected to the firm itself, whether the exposure arises from a transaction entered into on an arm's length basis.

5.4 When a firm decides whether a transaction is at arm's length, the PRA expects the following factors to be taken into account:

- the extent to which the person to whom the firm has an exposure ('A') can influence the firm's operations, through for example the exercise of voting rights;
- the management role of A where A is also a director of the firm; and
- whether the exposure would be subject to the firm's usual monitoring and recovery procedures if repayment difficulties emerged.

Appendix 2: Draft amendment to PRA Rulebook

In this appendix new text is underlined and deleted text is struck through

1 **Application and Definitions**

1.1 This Part applies to every *firm* that is a *CRR firm*.

1.2 In this Part the following definitions shall apply:

~~*core UK group eligible capital*~~

~~means the sum of the following amounts for each member of the *core UK group* and the *firm* (the sub-group):~~

1. ~~(a) for the ultimate *parent undertaking* of the sub-group, the amount calculated in accordance with Article 6 of the *CRR* (or other applicable prudential requirements);~~
2. ~~(b) for any other member of the sub-group, the amount calculated in accordance with Article 6 of the *CRR* (or other applicable prudential requirements) less the book value of the sub-group's holdings of capital instruments in that member, to the extent not already deducted in calculations done in accordance with Article 6 of the *CRR* (or other applicable prudential requirements) for:~~
    1. ~~(i) the ultimate *parent undertaking* of the sub-group; or~~
    2. ~~(ii) any other member of the sub-group.~~

~~The deduction in (b) must be carried out separately for each type of capital instrument eligible as *own funds*.~~

exposure

has the meaning given to it in Article 389 of the *CRR*.

Internal MREL exemption

means the exemption in 2.4

Internal MREL exposure

means an exposure that:

1. meets the internal MREL eligibility criteria specified in The Bank's MREL Statement of Policy; and
2. does not take the form of equity

Internal MREL Permission

means a permission given by the *PRA* in respect of Article 400(2)(c) of the *CRR* to apply the *Internal MREL exemption*

non-core large exposures group or NCLEG

means all counterparties that:

1. (a) are listed in a *firm's NCLEG non-trading book permission* or *NCLEG trading book permission*; and
2. (b) in relation to a *firm*, satisfy the conditions in 2.1 or 2.2.

NCLEG non-trading book exemption

means the exemption in 2.1.

NCLEG non-trading book permission

means a permission given by the *PRA* in respect of Article 400(2)(c) of the *CRR* to apply the *NCLEG non-trading book exemption*.

NCLEG trading book exemption

means the exemption in 2.2.

NCLEG trading book permission

means a permission given by the *PRA* in respect of Article 400(2)(c) of the *CRR* to apply the *NCLEG trading book exemption*.

sovereign large exposures exemption

means the exemption in 3.1.

sovereign large exposures permission

means a permission given by the *PRA* in respect of Article 400(2)(g) or (h) of the *CRR* to apply the *sovereign large exposures exemption*.

trading book exposure allocation

means the allocation in 2.2

1.3 Unless otherwise defined:

1. (1) any italicised expression used in this Part and in the *CRR* has the same meaning as in the *CRR*; and
2. (2) any italicised expression used in this Part and in the *CRD* has the same meaning as in the *CRD*.

2 **Intra-Group Exposures: Non-Core Large Exposures Group and internal MREL Exemptions**

NCLEG non-trading book exemption

2.1 (1) A *firm* with an *NCLEG non-trading book permission* may (in accordance with that permission) exempt, from the application of Article 395(1) of the *CRR*, non-*trading book exposures*, including participations or other kinds of holdings, incurred by the *firm* to members of its *NCLEG* that are:

(a) its *parent undertaking*;

(b) other *subsidiaries* of that *parent undertaking*; or

(c) its own *subsidiaries*,

in so far as those undertakings are covered by the supervision on a *consolidated basis* to which the *firm* itself is subject, in accordance with the *CRR*, Directive 2002/87/EC or with equivalent standards in force in a third country.

(2) A *firm* may only use the *NCLEG non-trading book exemption* where~~:~~

~~(a)~~ the total amount of non-*trading book exposures* (whether or not exempted from Article 395(1) of the *CRR*) from the *firm* to its *NCLEG* does not exceed 100% of the *firm's eligible capital*~~; or~~

~~(b) (if the *firm* has a *core UK group permission*) the total amount of non-*trading book exposures* (whether or not exempted from Article 395(1) of the *CRR*) from its *core UK group* (and the *firm*) to its *NCLEG* does not exceed 100% of the *core UK group eligible capital*.~~

A *firm* may calculate the total amount of such *exposures* after taking into account the effect of credit risk mitigation in accordance with Articles 399 to 403 of the *CRR*.

(3) With respect to the application of requirements laid down in Part Four of the *CRR* on a consolidated basis, a firm may treat the total amount of exposures that are exempt in accordance with an *NCLEG non-trading book permission* on an individual basis as exempt from the limit in Article 395(1) of the *CRR* on a consolidated basis.

[Note: Art 400(2)(c) of the *CRR*]

NCLEG trading book exemption

2.2 (1) A *firm* with an *NCLEG trading book permission* may (in accordance with that permission) exempt, from the application of Article 395(1) of the *CRR*, *trading book exposures* up to its *trading book exposure allocation*, including participations or other kinds of holdings, incurred by the *firm* to members of its *NCLEG* that are:

(a) its *parent undertaking*;

(b) other *subsidiaries* of that *parent undertaking*; or

(c) its own *subsidiaries*,

in so far as those undertakings are covered by the supervision on a *consolidated basis* to which the *firm* itself is subject, in accordance with the *CRR*, Directive 2002/87/EC or with equivalent standards in force in a third country;

(2) The *trading book exposure allocation* for a *firm* ~~that does not have a *core UK group permission*~~ is 100% of the *firm's eligible capital* less the total amount of non-*trading book exposures* (whether or not exempted from Article 395(1) of the *CRR*) from the *firm* to its *NCLEG*.

~~(3) The *trading book exposure allocation* for a *firm* (F) that has a *core UK group permission* is equal to RxTTBE where:~~

~~(a) R is F's *trading book exposures* to its *NCLEG* divided by the total *trading book exposures* of the *core UK group* (and F) to F's *NCLEG*; and~~

~~(b) TTBE is 100% of F's *core UK group eligible capital* less the total amount of non-*trading book exposures* (whether or not exempted from Article 395(1) of the *CRR*) from the *core UK group* (and F) to F's *NCLEG*.~~

(4) A *firm* may calculate its *trading book exposure allocation* after taking into account the effect of credit risk mitigation in accordance with Articles 399 to 403 of the *CRR*.

(5) A *firm* must allocate the *trading book exposures* it has to its *NCLEG* to its *trading book exposure allocation* in ascending order of specific-risk requirements in Part Three, Title IV, Chapter 2 and/or requirements in Article 299 and Part Three, Title V of the *CRR*.

(6) With respect to the application of requirements laid down in Part Four of the *CRR* on a consolidated basis, a firm may treat the amount of exposures that are exempt in accordance with an *NCLEG trading book permission* on an individual basis as exempt from the limit in Article 395(1) of the *CRR* on a consolidated basis.

[Note: Art 400(2)(c) of the *CRR*]
Notifications and reporting

2.3 (1) A *firm* with a *core UK group permission* and an *NCLEG trading book permission* or an *NCLEG non-trading book permission* must give the *PRA* written notice whenever the *firm*:

~~(a) intends, or becomes aware that a member of its *core UK group* intends, for the total amount of *exposures* from the *core UK group* (and the *firm*) to a particular member of the *firm's NCLEG* to exceed 25% of its *core UK group eligible capital*;~~

(b) becomes aware that the total amount of *exposures* from the *core UK group* (including the *firm*) to a particular member of the *firm's NCLEG* are likely to exceed, or have exceeded, 25% of ~~its *core UK group eligible capital*~~ *the firm's eligible capital*;

(c) becomes aware that the total exposures from the members of its *core UK group* (which are not *firms*) to the *firm's NCLEG* are likely to exceed, or have exceeded 25% of the *firm's eligible capital*.

(2) The written notice required under (1) must contain the following:

(a) details of the size and the expected duration of the relevant *exposures*; and

(b) an explanation of the reason for those *exposures*.

~~(3) A *firm* with a *core UK group permission* and an *NCLEG trading book permission* or an *NCLEG non-trading book permission* must submit FSA018 in accordance with SUP 16.12.~~

Internal MREL exemption

2.4 A *firm* with an *internal MREL exemption* may exempt *internal MREL exposures* from the limit in Article 395(1) of the *CRR*.

[Note: Art 400(2)(c) of the *CRR*]

3 **Sovereign Large Exposures Exemption**

3.1 (1) If a *firm* has a *sovereign large exposures permission*, the *exposures* specified in that permission are exempt from Article 395(1) of the *CRR* to the extent specified in that permission.

(2) For the purposes of the *sovereign large exposures permission*, and in relation to a *firm*, the *exposures* referred to in (1) are limited to the following:

1. (a) asset items constituting claims on *central banks* in the form of required minimum reserves held at those *central banks* which are denominated in their national currencies; and
2. (b) asset items constituting claims on central governments in the form of statutory liquidity requirements held in government securities which are denominated and funded in their national currencies provided that, at the discretion of the *PRA*, the credit assessment of those central governments assigned by a *nominated ECAI* is investment grade.

[Note: Art 400(2)(g)-(h) of the *CRR*]

~~4 **Conditions for the Non-Core Large Exposures Group Exemption and the Sovereign Large Exposures Exemption**~~

~~4.1 A *firm* may only use the *NCLEG non-trading book exemption*, the *NCLEG trading book exemption* or the *sovereign large exposures exemption* where it can demonstrate to the *PRA* that the following conditions are met:~~

~~(1) the specific nature of the *exposure*, the counterparty or the relationship between the *firm* and the counterparty eliminate or reduce the risk of the *exposure*; and~~

~~(2) any remaining concentration risk can be addressed by other equally effective means such as the arrangements, processes and mechanisms provided for in Article 81 of *CRD*.~~

~~**[Note: Art 400(3) of the *CRR*]**~~