The voice of banking

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PRA CP 25/16: The implementation of ring-fencing: reporting and residual matters

~ Industry comments submitted by the BBA ~

Introduction

The BBA welcomes the opportunity to comment upon PRA CP 25/16 on reporting and residual matters arising from the implementation of ring-fencing. We represent 200 banks from 50 countries and have consulted the larger UK banking groups within membership that will be part of the ring-fencing regime in the preparation of this submission.

The consultation paper (CP) is the third of a series of three and represents an important step in the completion of the regulatory regime in which ring-fenced banks (RFBs) will operate. As the PRA recognises, ring-fencing involves a highly complex business reorganisation and ties into other regulatory initiatives, not least on recovery and resolution and operational continuity.

If banks are to make an orderly transition to their new ring-fenced structures before the statutory deadline of 1 January 2019, then there are important steps that need to be taken in 2017 and 2018. We therefore appreciate the publication of the third CP within the planned timetable and the publication of Policy Statement 20/16 'The implementation of ring-fencing: prudential requirements, intragroup arrangements and the use of financial market infrastructures' (PS20/16) and the appendices setting out the final rules and supervisory statements implementing the proposals consulted upon in CP 37/15 and also as related in Policy Statement 10/15 on legal structure, governance and the continuity of services and facilities.

Part 1

Part one of the CP sets out comprehensively the reporting requirements that will apply to RFBs:

- Chapter 2 sets out the PRA's approach to reporting requirements for RFBs.

- Chapter 3 sets out proposals to extend the Capital Requirements Regulation (CRR) reporting requirements that currently apply on a consolidated basis to banking groups affected by ring-fencing to an RFB sub-group; this is needed to enable the PRA to monitor the adequacy of an RFB sub-group's financial resources.

- Chapter 4 sets out proposals for new reporting by an RFB sub-group of transactions with group entities that are not members of the RFB sub-group; this is needed to enable the PRA to assess potential dependencies of an RFB sub-group on, and risks to the sub-group emanating from, group entities that are not members of the RFB sub-group.

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- Chapter 5 sets out proposals for new reporting requirements to monitor an RFB's use of exceptions to excluded activities and prohibitions under The Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014 (EAPO); this is needed to enable the PRA to monitor and report on an RFB's use of the exceptions as part of its annual report to Parliament (the PRA Annual Report) as required by the Financial Services and Markets Act 2000.

- Chapter 6 sets out proposals for new reporting requirements to monitor an RFB's compliance with specific PRA ring-fencing rules, and the extent to which an RFB has acted in accordance with certain PRA supervisory statements.

The reporting requirements appear, generally, to be a logical extension of the existing reporting structure to the new ring-fencing regime. In putting together the new requirements the PRA has sought to avoid duplication, use existing definitions and to draw as far as possible from the existing reporting framework. While members may have points that they would wish to raise with you in respect of this, our main observation is that paragraph 2.12 appears to suggest that modifications to the reporting requirements will only be considered but only on a case-by-case basis and in limited circumstances (such as where no RFB Sub-Group is formed), whereas we argue that proportionality is a higher concept that should apply as a general principle to all of the PRA rules proposed under CP25/16.

In relation to the proposals to identify and assess the dependency on shared customer income it is not clear how RFBs should define a 'shared customer'. A customer who is part of a wider group company, may have a sister company or subsidiary banking across the ring-fence. Would this, represent a 'shared' customer for the purposes of these rules?

Further clarity is needed on how to identify a 'shared customer', 'shared customer income' and what industry standard criteria RFBs could apply to assess the perceived risks. We suggest that an industry discussion with the PRA on the proposed data to be submitted on shared customer income would be helpful.

The exception to the proposed reporting requirements being largely derived from the existing reporting structure are the proposals set out in Chapter 5. These relate specifically to the requirement under the ring-fencing legislation for the PRA to include within an annual report to Parliament an assessment of the extent to which RFBs have used the exceptions to the excluded activities and prohibitions set out in the EAPO.

As paragraph 5.7 observes, reporting on the use of exceptions will be underpinned by existing PRA rules. Under existing notification requirements, a firm must notify the PRA if it becomes aware of any breaches, or potential future breaches, of the legislative requirements that apply to the firm; an RFB would therefore need to notify the PRA if it conducted a transaction or incurred an exposure prohibited under the EAPO. Paragraph 5.8 then summarises the proposed reporting templates for monitoring an RFB's use of the exceptions, spanning:

- Risk management transactions
- Collateral transactions
- Dealing in shares and debentures
- Securitisations and covered bonds
- Transactions with central banks
- Customer derivatives
- Trade finance
- Exposures to conduits

These exceptions will be reported through template PRA116a, which requires the provision of significant granular information to the PRA. As noted in the CP, the ring-fencing legislation requires

that the PRA's rules make provision for the group ring-fencing purposes (as defined in section 142H(4) of FSMA). We consider that the nature of the information (and operational implications of providing such information) to be provided through template PRA116a could be disproportionately granular when considered against the group ring-fencing purposes.

As such – and in view of the statutory requirement that the PRA report only "in general terms" on the extent to which RFBs are making use of the exemptions set out in the EAPO – we suggest that consideration be given as to whether all information to be provided through template PRA116a should be required in the format under consultation, or whether elements of this information could be provided at a higher level.

The BBA and relevant banking groups are concerned that extensive use of these exceptions could additionally give rise to the perception (by Parliament and/or the public) that banking groups have not met with both the spirit and the letter of the new ring-fencing regime. The EAPO allows an RFB to rely on a number of exceptions to the excluded activities and prohibitions and these exceptions are important to the business of an RFB and its ability to provide permitted services to its clients. Amongst other things, the exceptions allow RFBs to manage their own risks and to hold various forms of security or collateral that arises provided to the RFB as a result engaging in permitted activity with customers. We therefore believe that close attention will need to be given in the PRA Annual Report to the explanation given of the use of the exceptions and that this qualitative explanation will be as important as any figures that the PRA considers necessary to provide to Parliament in support of its report.

We also make the following points:

- Banks will be keen to understand the level of detail that will be included in the PRA Annual Report to Parliament and the nature of any data that may be published in support of the PRA Annual Report; as the PRA no doubt understands, data provided for supervisory purposes often does not lend itself to public reporting. There will therefore be a need to ensure that an appropriate approach is adopted. Banks would appreciate a clearer understanding of how the data may be used and the timetable involved in the process in order to support them in developing an appropriate internal governance process into their plans for steps to be taken in implementing their ring-fencing structures.

- Paragraph 5.2 explains that as the PRA will need to make its first report to Parliament in mid-2019, and that supervisors will discuss with firms the extent and nature of data required to cover the initial period from 1 January 2019. Our understanding is that this will cover only the initial Q1 period, possibly on a bespoke basis. While this is appreciated, there will still be a need for the banks to have a clear understanding of the information that will be required and the deadline to which they will be working. This is necessary to support banks in ensuring that they have relevant data systems in place ahead of 1 January 2019 so as to make a Q1 report possible and also to build into their governance arrangements the scrutiny of the report to be made.

- As part of the reporting requested in Template PRA 116, RFBs are required to report the position risk requirement for transactions entered into under Articles 14(2), 14(3) and 14(5) EAPO which give rise to exposures to relevant financial institutions. We note that RFBs will be relying on Articles 14(2) and (3) EAPO to allow them to incur such exposures which arise in the context of collateral arrangements provided to the RFB to protect it against default risk, and not just in the context of hedging transactions. We note the considerable challenges that exist in reporting on exposures to relevant financial institutions that form part of an RFB's collateral arrangements. For example, if the exposures arises in the context of a charge over book debts, or other exposures that might be captured from time to time under a floating charge. We therefore welcome the PRA's pragmatism in not seeking to include these within the proposed Template PRA 116, noting that the costs of collecting such information would be disproportionate to the risks involved in the activity being monitored. It would nevertheless be helpful if the PRA could

confirm in the PS that it is not expecting the transactions relying upon Articles 14(2) and (3) of the EAPO solely to comprise hedging transactions and to confirm that where the transactions are not hedging transactions, that no reporting is required in template PRA116. We would also see merit in explicit confirmation from the PRA that the reporting template will not serve to limit the ability of RFBs to undertake the full range of hedging activities as permitted under the EAPO.

Part 2

Part 2 focuses upon residual matters relating to ring-fencing upon which the PRA has decided to consult upon. Our only comments are as follows.

7 Double leverage

We acknowledge the PRA's decision not to impose a double leverage restriction on other group members (other than the UK parent of an RFB), or on a UK parent of an RFB for investments outside of the RFB sub-group. We look forward to further detail being provided on how the PRA will assess the consolidated capital requirements of groups containing both an RFB sub-group and NRFBs in its forthcoming discussion paper scheduled, as we understand, for Q1 2017. It would be beneficial if the PRA could give further clarity on their concerns surrounding the use of double leverage and a further cost benefit analysis in the forthcoming paper would be helpful for firms. It would be helpful also to have a better understanding of other risks that the PRA expects will drive proportionally higher capital requirements at the level of the RFB sub-group compared to the consolidated group.

8 Reverse stress testing

We have no comments on the reverse stress testing provisions.

9 Recovery planning

We can see merit in the PRA giving thought to what proportionality/materiality might look like in the context of recovery planning. It would be interesting to understand, for instance, whether there might be a case for the aggregation of non-ring-fence activity, e.g. where a banking group with an RFB included a large investment bank and a small asset manager.

10 Operational continuity and financial market infrastructures

Given the very significant sums involved, RFBs will want the scope to use a range of CCPs in order to achieve margin efficiencies. Our understanding is that the CP is not intended to preclude this.

We also note that Chapter 10 of the CP does not restate or refer to the criteria for the "exceptional circumstances" in which an RFB may access an inter-bank payment system through an intermediary (as set out at paragraph 8.2 of PS 20/16 and, in more detail, at paragraphs 9.6-9.9 of PRA Supervisory Statement 8/16 (SS 8/16).

Similarly, Chapter 10 of the CP does not expand upon the guidance at paragraphs 9.12 and 9.13 of SS 8/16 that "the PRA expects an RFB to participate in CSDs and CCPs in a manner that is appropriate given the activity and business model of the RFB".

We assume that the lack of reference to these sections of PS 20/16 and SS 8/16 means that there is no change to the PRA's existing policy and guidance on these points. This could, however, be usefully confirmed in the policy statement that will follow the CP.

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