Bank of England PRA

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Dear Chief Financial Officer,

Significant risk transfer financing: Prudential expectations

Context

We are writing to you to highlight practices we have observed in relation to illiquid and structured financing portfolios across regulated firms. While the principal concerns outlined in this letter are informed by supervisory information received regarding significant risk transfer ('SRT') financing activities, we expect firms to consider the application of the feedback contained in this letter to all relevant financing portfolios. Banks engaged in these businesses should ensure that the regulatory capital approach they adopt appropriately reflects the substance of the transactions, including the liquidity of the underlying collateral.

We are writing to you in your role as the Senior Manager[1] (SMF2: Chief Finance Function) responsible for the management of the financial resources of the firm, to outline prudential concerns identified in this area. We ask you to consider how these

[1] www.prarulebook.co.uk/pra-rules/senior-management-functions/25-09-2023.

concerns apply to your business and to identify any actions required to update practices to appropriately address them.

Concerns

This letter covers: (i) our core prudential concerns and specific areas of focus arising from our recent supervisory activities; (ii) associated ongoing expectations of firms; and (iii) supervisory expectations with respect to relevant near-final policy changes published as part of policy statement (PS) 9/24 – Implementation of the Basel 3.1 standards near-final part 2.[2]

The scale and complexity of financing portfolios and the effectiveness of risk management and control frameworks varies across firms. We expect firms to analyse the characteristics of different collateral types when determining the appropriate regulatory capital treatment. We are concerned that, in certain areas, not all banks are demonstrating a sufficiently thorough assessment of collateral eligibility. Particularly surrounding the application of Article 299(2)(c) UK CRR,[3] which governs collateral eligibility for securities financing transactions ('SFTs') in the trading book.

We have identified that for certain financing portfolios, banks have adopted an imprudent approach associated with the recognition of collateral for regulatory capital purposes, resulting in a potential undercapitalisation of the risks. For example, we consider that the repackaging of illiquid assets into a tradeable format, is not, without appropriate supporting evidence, sufficient to justify regulatory capitalisation under trading book rules for accompanying SFTs.

The PRA's Fundamental Rules[4] apply to all PRA-authorised firms, and collectively support our general objective of promoting the safety and soundness of regulated firms. Where necessary, the PRA will consider an exercise of statutory powers to impose requirements such that any shortcomings are adequately addressed.[5] We expect the risks described in this letter to be appropriately capitalised by firms under Pillar 1 of the UK capital framework. SFTs backed by illiquid collateral which fails to meet the requirements for inclusion in the trading book, should follow the applicable rules for banking book exposures. We remind you that you should use Pillar 2A to capitalise risks that are either not addressed or only partially addressed under Pillar 1.

2 www.bankofengland.co.uk/prudential-regulation/publication/2024/september/implementation-of-the-basel-3-1-standards-near-final-policy-statement-part-2.

3 www.legislation.gov.uk/eur/2013/575/article/299/data.xht?.

4 www.prarulebook.co.uk/pra-rules/fundamental-rules.

5 For instance, under section 55M of the Financial Services and Markets Act 2000: www.legislation.gov.uk/ukpga/2000/8/section/55M.

We also note that these expectations are aligned with near-final rule changes announced as part of PS9/24 and associated supervisory expectations. PS9/24 and the associated near-final instrument,[6] will introduce three additional collateral eligibility requirements for SFTs in the trading book. Firms will be responsible for demonstrating compliance with these requirements. We will expect firms to consider the following when analysing collateral eligibility, consistent with Article 299A(1a) and (1c) in the near-final instrument:

- When assessing market liquidity, including under stressed conditions (near-final instrument Article 299A(1a)), we will expect firms to assess relevant secondary market liquidity associated with the specific collateral. While supplementary analysis, for example relating to primary issuance volumes, may be relevant in specific circumstances, we recognise that there can also be important differences (eg for seasoned and newly originated assets) which should be appropriately considered. We expect that without demonstrable secondary market liquidity, and absent any other relevant supporting evidence, this eligibility requirement would not be met.
- When assessing the ability to value the underlying collateral (near-final instrument Article 299A(1c)), consistent with the requirements in Articles 103 and 105, we will expect firms to have due regard to the extent to which the position can be marked-to-market daily by reference to an active, liquid two-way market. For marked-to-model positions that make use of liquid proxies as a key input for valuation purposes, we expect firms to appropriately consider all material risks associated with the collateral and the extent to which these are reliably captured in the model. We expect that for collateral with material unobservable parameters, significant illiquid basis risks or other important factors which cannot be reliably modelled, this eligibility requirement would not be met.

Next steps

In this letter we have set out prudential concerns associated with a subset of less liquid financing activities. We expect firms to consider the concerns highlighted and, where necessary, ensure that associated policies, control frameworks and reporting are enhanced to address any issues identified.

Supervisors will be in contact with relevant firms to request a response to this letter. Such firms should provide a written response by Wednesday 11 June 2025 and as part of this, we request that firms outline:

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6 www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/policy-statement/2024/september/ps924app2.pdf.

a) The policies and procedures in place to ensure compliance with Article 299(2)(c) UK CRR, which governs collateral eligibility for SFTs in the trading book.
b) Any proposed enhancements to these policies and procedures in response to this letter, including any resulting changes to the regulatory capital approach for SFTs associated with specific collateral types and the impact of these changes.
c) The current regulatory capital approach applied to SFTs for specific collateral types. This should be sufficiently granular to capture details of the trading book/banking book boundary as currently applied, including any changes related to (b) above. Please provide summary metrics (eg financing or collateral balances) showing the materiality of each specific collateral type. Highly liquid collateral can be excluded from this list.

Subject to the responses received, we will consider the need for further engagement with firms either on a bilateral or cross-firm basis, consistent with the 2025 supervisory priorities letters.[7,8]

If you have any questions relating to this letter, please contact your supervision team in the first instance.

Yours sincerely,

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[7] www.bankofengland.co.uk/prudential-regulation/letter/2025/uk-deposit-takers-2025-priorities.
[8] www.bankofengland.co.uk/prudential-regulation/letter/2025/artis-2025-priorities.