SUPERVISORY EXPECTATIONS FOR NEWLY AUTHORISED BANKS

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Executive Summary

Following Brexit, the UK Government has sought out ways to improve, clarify, and simplify the regulatory regime for UK financial institutions. The Prudential Regulation Authority has published numerous consultation papers outlining its planned improvements to the supervisory regime for UK financial institutions. As part of this effort, the PRA published a Supervisory Statement, "Non-systemic UK banks: The Prudential Regulation Authority's approach to new and growing banks", on April 15, 2021 outlining its supervisory expectations for newly authorised non-systemic banks in the UK.

The PRA has noted that this is an area of interest for the regulatory authority following a joint report by the PRA and Financial Conduct Authority (FCA), "A review of requirements for firms entering into or expanding in the banking sector one year on" in 2013.

The PRA has acknowledged a common theme among newly authorised banks whereby a number of new banks have underestimated the work required post-authorisation, particularly regarding risk, capital and liquidity management, leading to an inability to operate in a stressed environment resulting in banks' exit of the market. This theme has led the PRA to amend its supervisory expectations for newly authorised banks leading to particular areas of concern for recently authorised and prospective deposit-taking banks.

Key Areas of Concern:

- **Business model**: new banks are not often profitable in the early years requiring regular capital injections to continue operations. The PRA's expectations will require firms to have credible capital plan, realistic business plans, and accurate forecasts by 5 years post-authorisation.
- **Governance**: new banks often face issues of poor governance which is often a leading indicator of poor performance. The PRA's expectations will require new banks to have robust and comprehensive governance arrangements reflecting the bank's business model and risks.
- **Risk management**: new banks are often expected to design risk management and control frameworks which are untested at the point of authorisation limiting their ability to effectively utilise them post-authorisation as the business develops. Under the new regime, post-authorisation banks will need to prioritise the development of a mature risk management and control environment that is fully embedded within the business model.
- **Capital and Liquidity**: new banks face a common theme of poor capital management. New banks should pay particular consideration to the maintenance of its' capital resources in relation to its' risk exposures.
- **Operational resilience**: new banks will also be expected to incorporate operational resilience into all business plans and controls at the outset requiring firms to spend considerable time testing and refining their plans.
- **Recovery and Resolvability**: due to limited profitability in the early years, many new banks become unviable requiring them to exit the market. New banks will now be expected to develop realistic and credible recovery and wind-down plans allowing them to exit the market in an orderly manner should they become unviable.

Introduction

Overview

On 15 April 2021, the Prudential Regulation Authority (PRA) published a Supervisory Statement, "Non-systemic UK banks: The Prudential Regulation Authority's approach to new and growing banks", outlining its supervisory expectations for newly authorised non-systemic banks in the UK.

The Supervisory Statement builds upon the 2013 joint report by the PRA and Financial Conduct Authority (FCA), "A review of requirements for firms entering into or expanding in the banking sector one year on" to highlight its expectations for deposit-taking banks post-authorisation emphasising the fact that it does not expect new banks to meet all expectations but rather time should be spent to build and demonstrate capabilities.

The Supervisory Statement applies to the following financial institutions:	
Banks in their first few years of being authorised by the PRA as a deposit-taker (less than 5 years post-authorisation)	✓
Prospective banks interested in and currently applying for authorisation as a deposit-taker	✓
Banks incorporated outside of the UK authorised to accept deposits through a branch in the UK	X
Systemically important firms, referring to firms that are designated under the other systemically important institutions (O-SII) identification process	X
Building societies	X
Credit unions	X
UK designated investment firms	X

Note: *The PRA's supervisory expectations outlined specifically excludes UK branches and subsidiaries. The PRA has stated that the supervisory expectations outlined in this Supervisory Statement will be tailored for UK subsidiaries of international groups according to the nature, scale and complexity of the firm's UK operations.*

PRA – Timeline of Expectations

Year 0

Business model: Untested business model, most banks loss making

Governance: Appropriate number of independent non-executive directors. Established good practice is at least two. Chair must not perform an executive function and there is a strong expectation that they should be independent

Risk management: Framework and policies in place. Untested as firm has not yet operated as a bank

Capital: PRA buffer set on new bank basis (6 months forward operating expenses). In addition to buffers, hold enough capital to meet business plan while remaining above buffers for 12 months. ICAAP meets minimum standards, but untested, and is fit for purpose

Liquidity: ILAAP meets minimum standards but untested, and is fit for purpose

Year 3

Business model: Business model refined based on experience. Forecasts are more accurate. Credible strategy to achieve profitability

Governance: Appropriate number of independent non-executive directors. Established good practice is at least 3, including the chair

Risk management: Bank is testing and refining framework and policies in light of experience. Risk management is fit for purpose, with a focus on developing risk management and controls for the most material risks

Capital: PRA buffer set on new bank basis (6 months forward operating expenses). Undertaking advanced stress testing and a clear plan for transitioning to stress test buffer. Forward looking view of capital to ensure buffers are not used in the usual course of business. ICAAP meets minimum standards and is fit for purpose

Liquidity: ILAAP meets minimum standards and is fit for purpose

Year 5

Business model: Settled business model. Either profitable or a credible strategy to achieve profitability with definite capital support to achieve that. Realistic forecasts.

Governance: Appropriate number of independent non-executive directors. Established good practice is at least a majority independent board

Risk management: Mature control environment. Fully embedded risk management framework linked into stable business model. Framework provides forward looking view across all risk types. Continuous improvement to ensure framework remains fit for purpose given business and regulatory developments

Capital: PRA buffer set on stress test basis. Sophisticated capital management with credible capital models. ICAAP is a robust document which is an integral part of firm's management process and decision making

Liquidity: ILAAP is a robust document which is an integral part of the firm's management process and decision making

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Operational resilience: Design and integrate operational resilience into business processes and controls from the outset, and follow all relevant policies

Recovery and Resolvability: Credible recovery plans in place – sufficiently detailed and practical to ensure they reflect the complexity and size of the firm and would be useable in a stress. Board approved solvent wind down plan in place (while bank is on the new bank buffer approach). Undertake a forward-looking, realistic assessment of how its preparations for resolution would enable the bank to achieve the outcomes for resolvability. Meet the PRA rules on depositor protection

[SS3/21 'Non-systemic UK banks: the Prudential Regulation Authority's approach to new and growing banks' (bankofengland.co.uk)]

New Bank PRA Capital Buffer

The PRA has noted that new banks face a common theme of poor capital management thus impacting their abilities to carry out operations.

The PRA expects all UK financial institutions to maintain adequate capital resources, in terms of quantity and quality, to ensure their ability to meet creditors' claims and continue operations.

In accordance with these expectations, the Supervisory Statement outlines the PRA's new approach for the calculation of the capital buffer for newly authorised banks which is detailed below.

Note: *This calculation method only applies to banks which have:*

1. *Been operating for 5 years or less since being authorised without restriction; and*
2. *Yet to achieve a profit over a full year of trading*

New PRA Capital Buffer

- Banks are expected to calibrate their PRA buffer to be equal to 6 months projected operating expenses associated with the day-to-day running of the business

Operating expenses should include:

- Administrative expenses (comprising staff and other admin expenses)
- Depreciation (of property, plant and equipment)
- Depreciation of investment properties
- Other operating expenses
- Expenses of share capital repayable on demand

- This PRA buffer should appear in the bank's ICAAP with the projection covering the 6 months after the ICAAP reference date
- The PRA has noted that the interaction between the PRA buffer and the Capital Conservation buffer (CCoB) will remain the same whereby to avoid double counting, the component of the PRA buffer that relates to operating expenses is calculated as the excess amount of capital required over and above the CCoB.
- New banks are not expected to calibrate the PRA buffer using a stress test as new banks would need to hold a very large amount of capital which would give rise to a disproportionate level of capital relative to the financial stability risks posed by new banks.

Recovery Planning Expectations

The PRA has noted that the recovery plans produced by newly authorised banks are often unrealistic and wouldn't be appropriate in a stressed environment. The PRA expects newly authorised banks to develop credible recovery plans that are sufficiently detailed and practicable with consideration paid to the complexity and size of the firm. The recovery plan should incorporate the following: the range of recovery options available, the impacts and limitations of these actions, and the actions can be undertaken in a timely manner. Detailed below are the components of recovery planning:

	Key Considerations	Recovery Plan
Identifying a Stress	How will the firm spot the emergence of a stress? How will the firm monitor the unfolding of a stress? How will the issue be escalated?	Early warning and recovery indicator framework Escalation and governance procedures for invoking the recovery plan
Devising a Strategy	What are the firm's options for responding to a stress?	Recovery options and implementation plans
	What are the total benefits of all the options that could be realised together under different types of stress?	Recovery capacity
	How can the options be made more credible?	Preparatory measures
	Which stakeholders will need to be informed/involved if the firm takes action?	Communications plan
Testing and Improving	How can the firm test how it will respond to a stress?	Scenario testing and fire drills
	How can the firm produce a document which is useful and usable in a stress?	Plan structure and playbooks
	How will the firm ensure the recovery plan will be used in practice?	Ownership of the plan Governance for producing and updating the plan Integration with the risk management framework

SS3/21 'Non-systemic UK banks: the Prudential Regulation Authority's approach to new and growing banks' (bankofengland.co.uk)

Wind-Down and Resolution Expectations

Solvent Wind-Down (SWD)[1]

The PRA expects all newly authorised banks to establish and maintain SWD plans to ensure an exit from the market in an orderly manner encompassing the following:

- Credible, with a realistic prospect of effective implementation and demonstrating how the firm will meet minimum regulatory requirements throughout
- Demonstrate that the business can be wound down in its entirety to the point it can be liquidated safely, repaying all depositors and creditors in full
- Specific, with actions built around the specific business model, operating cost and contractual obligations of the firm
- Measurable, with clear timelines for delivery and a framework for identifying divergences from plan
- Sufficiently granular with detailed projections of the financial and non-financial resources needed to implement the plan and maintain solvency throughout
- Open, with a clear assessment of the key assumptions made and a sensitivity analysis of those assumptions, including analysis of wind down under different scenarios
- Risk-aware, with an identification of the key risks to delivery and contingency plans to mitigate those risks, including a communication strategy
- Adaptable, with consideration of alternative wind down scenarios where possible, including consideration of stressed market conditions, and the ability to be updated and refreshed in an appropriate timeframe as the business grows
- Clearly owned, with an identification of individual accountability for delivery
- Board-approved, with a demonstration of appropriate challenge given prior to their approval
- Closely linked with the recovery plan and with the ICAAP, with clear board approved triggers for when the SWD plan would be initiated

Resolution

The PRA has the following 2 conditions for newly authorised banks:

1. The bank must be deemed 'failing or likely to fail'. The PRA will assess whether a bank is failing or likely to fail to meet its threshold conditions in a manner that would justify the withdrawal or variations of authorisations

2. It must not be reasonably likely that action will be taken – outside resolution – that will result in the bank no longer failing or being likely to fail. The BoE will assess this condition with consultation from the PRA, FCA, and HM Treasury.

The PRA has outlined the following options as preferred resolution strategies:

Orderly Exit

1. Going Concern: Whole Firm Sale

Following unsuccessful recovery orderly exit is achieved through whole firm sale

2. Going Concern: SWD

Following unsuccessful recovery firm exits the market <u>before</u> reaching the point of insolvency by executing SWD plans

3. Orderly Failure/Resolution

SWD is not possible leading to resolution. For most new banks this is a Business Insolvency Procedure with costs incurred by third parties

1. SS3/21 'Non-systemic UK banks: the Prudential Regulation Authority's approach to new and growing banks' (bankofengland.co.uk)

How Reply Can Help

These expectations emphasise the PRA's commitment to ensuring the stability and soundness of the UK's banking sector. The new expectations serve to provide newly authorised deposit-taking banks with clear guidelines for improving their business model, risk management governance as the bank matures. These expectations also serve as a means of ensuring that banks have an efficient and orderly wind-down plan should the bank no longer be viable.

Prospective and newly authorised deposit-taking banks in the UK must re-evaluate existing business operations and risk management practices to ensure regulatory compliance under the PRA's clarified regime.

How Reply Can Help

Avantage Reply has deep experience in working with challenger and neo banks in relation to their risk, regulatory and compliance requirements. Our focus is on proportionality and robustness.

Some of the key ways in which we support our clients:

- Support with on-going regulatory compliance as firms increase in complexity and size to ensure continued adherence;
- End-to-end review and development/enhancement of their compliance for prudential requirements and supporting alignment with regulatory expectations and industry practices;
- Advise on ICAAP/ILAAP requirements under the simplified regime as well as requirements related to capital buffers, Pillar 1 risk-weighted capital and Pillar 2;
- Focus on implementation of scalable, automated solutions (e.g. for regulatory reporting or risk measurements)
- Programme management, transformation and delivery for "change the bank" initiatives; and
- Supporting a comprehensive review of risk management procedures and controls and helping with the implementation of industry leading solutions.

Our people

Vishwas Khanna, Partner

Vishwas specialises in prudential regulation, risk transformations, programme leadership and new bank authorisations. He is a trusted advisor to the C-Suite and senior management at banks and offers objective, independent advice to his clients to influence strategic decision-making.
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Audrey joined Avantage Reply after graduating from Cass Business School with a Master's degree in Actuarial Science and the University of Exeter with a Bachelor's in Economics and Finance. Audrey has recently supported the UK branch of an EU bank with its post-Brexit regulatory reporting requirements.
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