NEW SUPERVISORY REGIME FOR NON-SYSTEMIC BANKS

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Contents

Introduction

Overview

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 Discussion Paper, "A Strong and Simple Prudential Framework for Non-Systemic Banks and Building Societies", on April 29, 2021 outlining its proposed changes to the prudential framework regime for non-systemic banks and building societies to ensure the resilience, stability, and soundness of smaller firms.

In the Discussion Paper, the PRA notes that this simplified framework will apply to banks and building societies which are neither systemically important nor internationally active; however, it does not set a quantitative level below which a firm is considered small.

Given the diversity of non-systemic firms, the PRA expects the new simplified framework to increase in sophistication as the complexity and size of the firms increase. The PRA has noted that the design of this framework will require substantial criteria to be considered such as size, activities, and risk exposures, prior to its development. The PRA has stated two design approaches will be considered, a streamlined approach and focused approach, with input considered from the industry.

Steps for Implementation

01

The PRA has welcomed comment from the sector in response to the consultative questions posed

02

Following the response to the discussion paper, the PRA will design rules and requirements for the proposed regime.

03

The PRA will invite comment from the sector following the announcement of the proposed regime which will be taken into consideration for the final design.

04

Once the simpler regime has been designed and implemented, the PRA will work on the development of the higher layers of the framework.

Existing Prudential Framework

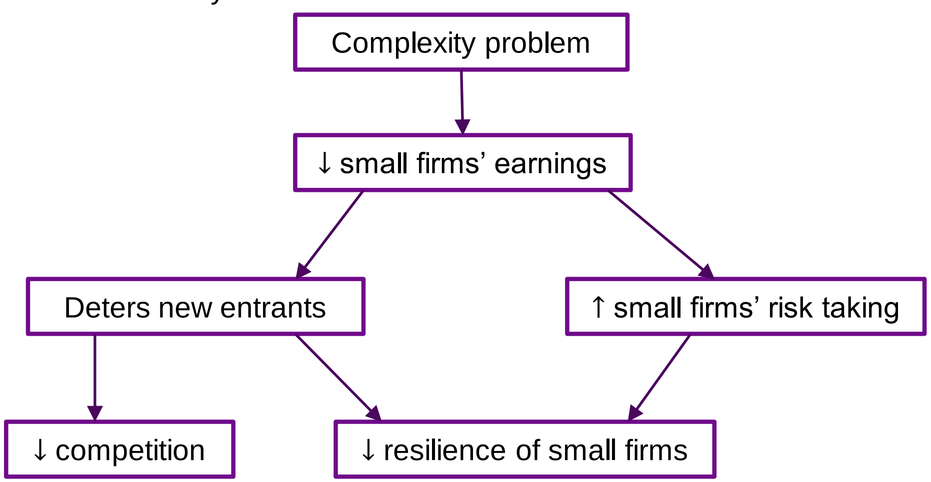
The existing prudential framework broadly applies to all PRA-regulated firms in the same manner reflecting the minimum standards set out in the Basel framework with certain simplified rules for small, non-complex credit institutions. However, these standards were designed for large international banks leading to compliance issues for small domestic banks.

Complexity Problem

The application of the same prudential requirements for all firms regardless of size and complexity gives rise to the complexity problem.

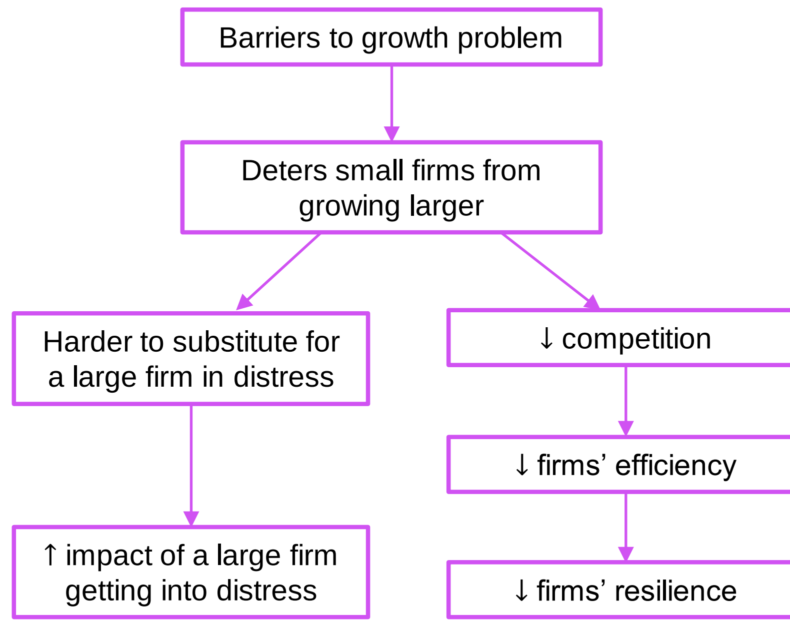
This occurs if costs to firms of understanding, interpreting, and operationalising a prudential requirement, or set of requirements, are higher relative to the associated public policy benefits for smaller firms than for larger firms. The PRA defines public policy benefits as “the contributions that prudential requirements make to the safety and soundness of PRA-regulated firm.”

The complexity problem could be mitigated by changing prudential requirements to achieve the current level of resilience in simpler ways lowering the costs of the requirements and better reflecting the specific risks faced by smaller firms.



Barriers to Growth Problem

The PRA has noted that a simplification of prudential regulation for smaller firms has the potential to increase existing barriers to growth as a small firm wishing to grow will need to adjust to different prudential requirements as it grows. Therefore, the costs of this change may deter smaller firms from growing.



Long-Term Vision for Prudential Framework

In the long-term, the PRA intends to create a simplified prudential framework for non-systemic domestic banks enabling a more dynamic and diverse banking sector in the UK. The framework will be flexible enough to accommodate different business models supporting the safety and soundness of firms and maintaining UK financial stability.

Key Principle: the simplified prudential framework must continue to meet the Basel Core Principles for Effective Bank Supervision

Plan for Simplified Regime

- Requirements which expand in sophistication as the size and complexity of firms increase
- Requirements would converge to the requirements for large firms including the full Basel standards once firms reach a certain size and/or complexity
- Number of layered regimes
- Requirements will need to change gradually without significant jumps to reduce barriers to growth
- Begin with simpler regime for the smallest firm and then build out the other layers of the strong and simple framework

Note: this plan may change following the PRA's onshoring of the Basel rules post-Brexit

Basel Core Principles for Effective Banking Supervision

29 Core Principles

Supervision: Supervisors' powers and responsibilities, forward-looking supervisory approach, effective supervision, use of appropriate tools…

Regulation: Capital and liquidity adequacy, risk management and governance, credit, loss provisioning…

Set minimum standards

Apply to the whole banking sector

Allow proportionality to reflect the range of jurisdictions and firms in scope

Used by the IMF/WB in FSAP* reviews

*Financial Sector Assessment Program (FSAP)

Simplified Regime for Small Firms (1 of 2)

The simpler regime will be designed for small firms that aren't internationally active with a pronounced complexity problem and with activities and business models such that their resilience could be assured under a relatively simple set of prudential rules.

Scope criteria:
- **Domestic firm determined by 2 components**: (1) measure of activity outside the UK, and (2) an upper bound on those measures for a firm to be considered domestic
- **Pronounced complexity problem**: most straightforward size measure is total assets with possible alternatives based on total assets minus high-quality liquid assets or on total retail deposits
- **Activities and risk exposures**
- **Optionality**: in-scope firms could opt in to the simpler regime via PRA approval or opt out via a waiver
- **Group treatment**: firms could be assessed for the simpler regime on a standalone entity basis or within the broader group

Key design choices:
- How different the simpler regime should be from the existing prudential framework
- The extent to which the resilience of small firms can be maintained with a standardised approach to determining capital requirements
- What liquidity requirements should apply to small firms
- Whether regulatory-mandated disclosures contribute to the resilience of small firms
- What other requirements and expectations are necessary to ensure the resilience of small firms

Approach	Advantages	Disadvantages
Streamlined	• Calibration of requirements may be lower than the focused approach would require • Greater consistency with the wider prudential framework minimises new barriers to growth	• Wide range of requirements are retained, meaning less simplification
Focused	• Maximises simplification by reducing the prudential rules to a small set of core requirements	• Calibration of requirements may have to be very conservative • Significant differences to the wider prudential framework create new barriers to growth

Simplified Regime for Small Firms (2 of 2)

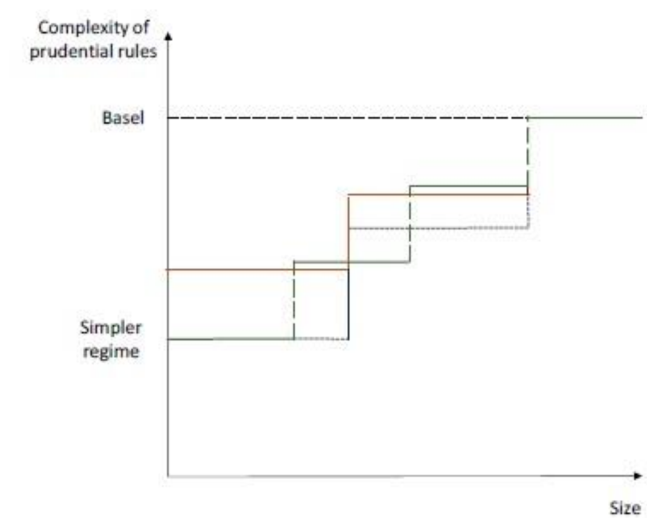
Requirements under simplified regime	Description
Capital quality requirements	Under a focused approach, a Tier 1 capital structure based only on CET1 instruments could also offset risks to resilience arising from other simplifications in the simpler regime. Under a streamlined approach, the treatment of ‘growth’ shares may be used by new firms as part of management incentive packages could be reviewed
Risk-weighted requirements	Under a focused approach, the current Pillar 1 and 2A capital requirements could be replaced with a single, simple, capital requirement such as a capital to risk-weighted assets requirement where the risk-weighted assets are calculated by allocating assets to a limited number of buckets. The calibrations would likely have to be significantly higher to ensure the regime is both simple and strong.
Pillar 1 risk-weighted requirements	A streamlined approach would suggest retaining risk-weighted Pillar 1 capital requirements, but potentially simplifying elements within it
Pillar 2A requirements	The prudential regime for small firms could be simplified significantly if there were ways to reduce or eliminate the need for Pillar 2A capital requirements, while still maintaining the overall resilience of firms.
Leverage ratio	Ongoing review of leverage ratio
Capital buffers	Under a focused approached, there could be no buffer requirement. Under a streamlined approach, the simpler regime could continue with the existing approach where both the CCoB and PRAB apply
ICAAP	There may be some scope to simplify the ICAAP and C-SREP
Liquidity and funding	The key design choice for liquidity requirements under the simpler regime is whether to base them on the existing LCR and the proposed NSFR (streamlined approach) or on a simpler liquidity measure such as a required minimum level of liquid assets as a percentage of funding liabilities (focused approach)
ILAAP	There may be scope to simplify the ILAAP and L-SREP

Measures to Lower Barriers to Growth

Metrics
- The criteria for the strong and simple framework will be based on similar metrics such as total assets as a measure of size
- The PRA intends to commit to using a relatively small set of metrics in the simplified framework as the use of multiple definitions could make it harder for a firm to predict when it will transition between layers of the simplified framework
- The use of many different metrics might discourage a firm from growing thus increasing barriers to growth

Transition Arrangements and Optionality
- The framework could adopt the transition arrangements and the optionality feature
- A firm could have a period to transition towards implementing changes in requirements and have the option to choose to be subject to requirement that are intended for larger and/or more complex firms

Layers
- Whether thresholds deter firms from growing, in size or in breadth of activities, will also depend on the extent to which requirements and expectations change for firms crossing thresholds resulting in the need for a trade-off between the complexity and barriers to growth problems
- The trade-off could be improved by having a greater number of layers in the simplified framework
- The simplified framework will likely look more complex: more layers will mean that a growing firm would have to understand and operationalise changes to regulation more frequently
- There could be a trilemma between the complexity problem, the barriers to growth problem, and the overall complexity of the framework/frequency of regulatory change for a growing firm



Increase the number of layers in order to improve the trade off between simplicity and barriers to growth

How Reply Can Help

The PRA's proposed simplification to the prudential regime is intended to ensure the resilience, stability, and soundness of non-systemic banks and building societies with increasing complexity of requirements as firms grow. The simplified regime will allow small domestic banks to benefit from reduced regulatory costs and scrutiny that are existing problems for small firms under the current prudential framework.

Following industry input and further regulatory considerations, non-systemic banks and building societies must re-evaluate existing business, risk management and regulatory practices to ensure regulatory compliance under the PRA's simplified 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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Rohan Wilson,

Senior Manager

Rohan has significant experience leading regulatory change and risk management projects at key FS clients across challenger and investment banks. He has also supported a European regulator with their internal action plans for resolution of entities.
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Audrey Weber,
Consultant

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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