THE LONG ROAD TO THE LEVEL PLAYING FIELD

The PRA's new proposals for applicants and new banks are certainly a step in the right direction – but do they go far enough?

Since the establishment of the PRA in 2013 and the PRA/FCA New Bank Start-Up Unit in 2016, barriers to entry for new banks in the UK have been successively lowered and clarified. Competition has been seen as a worthy pursuit – without diluting the financial stability objectives of the regulators.

The results are visible: in the period 2010-2013, 2 new UK HQ banks were authorised. Since 2013, 22 new start-up banks have been authorised with over 20 more applicants in the pipeline.

This has encouraged competition in the delivery of financial services, promoted the emergence of innovative business models, and facilitated more choice for customers.

However, these numbers are only a subset of the total number of applicants who have expressed serious interest in becoming banks over the years. Many have faltered even before starting and many collapsed just before crossing the finishing line (and some even after).

Why this Consultation Paper?

While the industry recognised the constructive and supportive authorisation framework established in the UK (and many other jurisdictions admired it), there were challenges:

a) Many expectations of applicants and new banks were considered to be disproportionate – e.g. around the setting of capital requirements or the sheer volume of analysis and paperwork required to be produced through the authorisation process. **This is not a level field at the point of entry.**

b) While the barriers to entry were lowered, barriers to growth were not. Sam Woods alluded to this challenge in this excellent speech in October 2019 where he noted: *"we've done a lot to lower prudential barriers to entry into the banking sector, with the result that we've got a lot of new banks. But have we done enough to lower the equivalent barriers to growth, given no little bank has recently become a really big bank?* **This is not a level playing field post-entry.**

In our view, the Consultation Paper ("CP") is evidence that the regulators have neither been deaf, nor blind, to the challenges facing the industry. While the CP merely clarifies some positions that the PRA has expressed in the past or discussed with applicants and new banks in one-to-one conversations, it also brings forward some material changes to key barriers, e.g. capital requirements, in the initial stages of a bank's life.

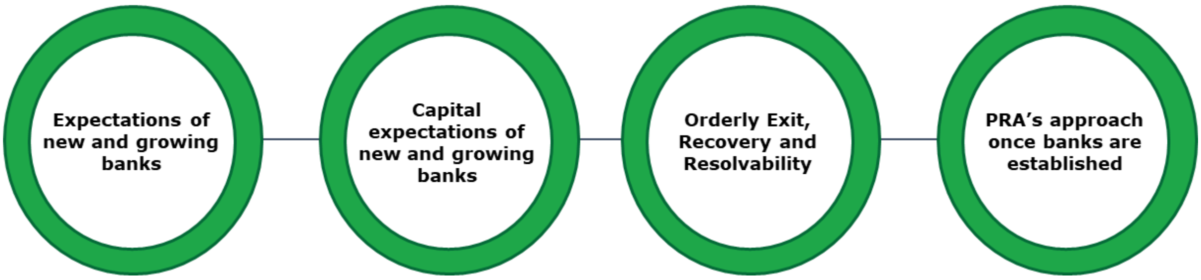
This CP applies to newly authorised non-systemic UK banks i.e. banks which have been recently authorised by the PRA to accept deposits and to applicants which are interested in applying for an authorisation to accept customer deposits in future. The proposed amendments mentioned in this paper would take effect from the first half of 2021, while the public consultation on this matter closes on the 14th of October 2020.

While the measures outlined in the Consultation Paper may not be sufficient to satisfy all in the industry, they target important areas where the industry has raised concerns in the past.

The key points from the paper and impacts on relevant firms are outlined below.

PILLARS OF THE CP

The CP (and the attached draft Supervisory Statement) are centred around 4 key themes:



Pillars	Key Messages
Expectations of new and growing banks	**Know Yourself** • Firms must know themselves inside out – a clear understanding of their business model, vulnerabilities and path to profitability is essential. • Having a novel, untested model is not a disqualification – but firms must expect more scrutiny of their governance and risk management arrangements. **Competence with independence** • Boards and senior management have an extremely high set of expectations – they must be accountable for the fate of their firms, manage the firm effectively, have appropriate independent challenge, and must have a succession plan for the evolution of the business. The PRA pointedly notes "*the individuals who have the skills to launch and build the business in its early years may not be best suited to lead the business as it grows*". In stating this, they have articulated a key theme that has been discussed many times with applicant firms. • Conflicts of interest must be appropriately identified and mitigated. The PRA provides clarity around another point which has been hotly debated over the last few years: "*Where the chief executive (SMF1) of a bank is also one of its founders, the board should implement appropriate checks, balances and measures to identify, monitor and manage any potential conflicts of interest*." The language does not exclude a founder from being the CEO but creates a duty of responsibility for the Board to manage any conflicts. **Accelerators with brakes** • Firms must not let their ambitions distract them from managing their risks. Cars with high-performance engines need great quality brakes to manage difficult manoeuvres. In the same vein, ambitious business models must evidence a robust internal environment of controls, checks and balances. **Accountability at all times** • Outsourcing brings efficiencies and allows firms to leverage existing capabilities available in the market. However, firms only outsource activity – not accountability. Firms must maintain appropriate governance over outsourcing relationships and must not operate as "*empty shells*".
Capital expectations of new and growing banks	**The prudent household rule – 6 months of cover** • The PRA buffer is to be calibrated to six months' projected operating expenses, defined as costs associated with the day to day running of the business. This significantly eases the burden on firms to assess PRA buffers in the early stages of their life. • Operational expenses do not provide cover for stressed situations or solvent winding down. Firms are expected to undertake appropriate stress testing to assess their vulnerability to stresses even if the results may not influence buffer calibration in the initial 5 years. • There should be a plan for transitioning out to buffers calibrated based on stress testing – firms would be able to avoid cliff-effects with appropriate forward planning. **The KISS Principle** • **Keeping it simple, stupid:** As understood from previous conversations, the PRA's preference is for firms to adopt simple share structures consisting of one class of shares fully subordinated to all other capital and

	debt, with full voting rights, and equal rights across all shares in relation to dividends and rights upon liquidation. • PRA expects firms to avoid complex share structures where the same objectives can be achieved more simply.
Orderly exit: recovery and resolvability	**<u>What if the god of death says: today?</u>** • The PRA does not assume to operate a zero-failure regime. Infant mortality is real - failures will happen (particularly for newer firms) in a market driven by competitive forces and firms must have the ability to "die" and exit the market in an orderly manner. • While focusing on the ICAAP and ILAAP is only natural for a new and growing bank, the PRA observes that recovery plans remain an area of specific weaknesses. They are often unrealistic and unusable in stress. Solvent Wind-Down Plans should also be developed and kept updated. • Where a firm is unable to wind down in a solvent manner, resolution may be activated. As the PRA notes: *"For smaller banks that do not supply transactional accounts or other critical functions to a scale likely to justify the use of resolution tools, the preferred resolution strategy is the applicable insolvency procedure. Usually, this is the Bank Insolvency Procedure (BIP)."* • Firms must ensure they have Single Customer View (SCV) capabilities to enable an orderly exit. **MREL / Minimum Requirement for own funds and Eligible Liabilities** • MREL is mentioned in the paper without any specified changes. This may disappoint a number of stakeholders at new and growing banks, given that this is perceived as both a burdensome requirement and an impediment to further growth. In particular, the inclusion of a number of medium-sized banks in the UK MREL regime is a point of contention, given that these institutions do not present a systemic risk to the UK market.
PRA's approach once banks are established	**The onset of adulthood** • As applicants grow and start on a growth path, expectations from them mature as well. The PRA expects firms to be open and transparent throughout their growth journey, discussing issues and challenges, articulating plans and forming honest working relationships. • The PRA outlines its expectations from maturing banks across 7 dimensions: business model, governance, risk management, capital, liquidity, operational resilience and recovery and resolution. For each dimension, an indicative range of expectations is outlined, aligned to the expected maturity of the firm (see appendix). • Where firms are not seen to be open or are seen not to anticipate the growing expectations from them, the PRA will take appropriate action and exercise its powers, which may include varying a firm's permissions action.

THE WAY FORWARD

This CP intends to level the playing field for new banks, both at the point of entry and post entry.

The paper does not create disruptive change; at the same time, it recognises the challenges faced by the industry and takes meaningful steps to support firms and businesses to launch and compete in the UK FS market.

The new plans also make it easier for new banks to exit the market while ensuring that they don't cause excessive disruptions to their customers and the wider UK financial system. New banks are required to have solvent wind down plans from the point of authorisation and to maintain these until they are mature enough to transition onto a PRA buffer based on stress tests.

For more details on how Avantage Reply can support your journey as an applicant, new or established bank, please reach out to the contacts below.

CONTACTS

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AVANTAGE REPLY

Avantage Reply, part of the Reply Group, is specialised in Financial Services with a focus on Risk, Treasury and Capital and Financial Performance Management. With offices in Amsterdam, Brussels, Edinburgh, Frankfurt, Hamburg, London (head office), Luxembourg, Milan, Munich and Rome Avantage Reply counts some of the world's most significant financial groups among its clients, including well-known and respected organisations in the Banking, Insurance, Investment Management and Services, and Post Trading Services sectors.

The firm's delivery capabilities cover advisory services (Risk/Finance/Treasury Subject Matters Expertise), Program and Project Management, Business, Functional, and Data Analysis.

For further information: www.avantagereply.com

Appendix: The PRA's expectations of banks as they mature

	Year 0	Year 3	Year 5
Business Model	Untested business model, most banks loss making	Business model refined based on experience Forecasts are more accurate Clearer path to profitability	Settled business model Either profitable or clear path to profitability with definite capital support to achieve that Realistic forecasts
Governance	Minimum two independent nonexecutive directors, with strong preference for independent chair	Minimum three independent nonexecutive directors, including the chair	Meets best practice including, dependent on size and complexity, having a majority independent board
Risk Management	Framework and policies in place Untested as firm has not yet operated as a bank	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	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	Buffers set on new bank basis (6 months forward operating expenses) In addition to buffers, banks hold enough capital to meet business plan while remaining above buffers for 12 months Internal Capital Adequacy Assessment Process (ICAAP) in place but untested	Buffers 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	Buffers set on stress test basis Sophisticated capital management with credible capital models ICAAP is a robust document which is an integral part of the firm's management process and decision making
Liquidity	Internal Liquidity Adequacy Assessment Process (ILAAP) in place but untested	ILAAP meets minimum standards and is fit for purpose	ILAAP is a robust document which is an integral part of the firm's management process and decision making
Operational resilience	Design 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 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		

Source: PRA, Consultation Paper CP9/20, Non-systemic UK banks: The Prudential Regulation Authority's approach to new and growing banks (July 2020)