UK FINANCE

A response to the

PRA's consultation paper on

Definition of Capital: update to PRA Rules and supervisory expectations

May 2022

Introduction

UK Finance is the collective voice for the banking and finance industry. Representing more than 300 firms, we act to enhance competitiveness, support customers, and facilitate innovation.

We are pleased to respond to the Prudential Regulation Authority's (PRA) consultation paper which proposes transferring the UK Technical Standards for own funds requirements for institutions into PRA rules, reflecting revisions to the Capital Requirements Regulations (CRR) and clarifying the PRA's expectations regarding capital issuances and reductions.

Key messages

Support for intention of the consultation paper

We note that UK own funds regulation currently includes both the CRR and the UK Technical Standards (UKTS) for own funds which can be cumbersome for firms to navigate. So we support the proposed revocation of the UKTS and its replication in the PRA Rulebook. Moving all relevant own funds material to the Rulebook, with amendments to reflect the 2019 revisions to the CRR and clarification of the PRA's expectations of CRR firms regarding capital issuances and reductions will be helpful.

Application to Eligible Liabilities

We note that the proposals in CP2/22 would amend the Own Funds and Eligible Liabilities part of the PRA Rulebook. The Resolution Authority has indicated that it does not currently intend to make any UKTS relating to Eligible Liabilities, giving it a degree of flexibility and pragmatism which we support. So our response to CP2/22 therefore considers only the PRA's proposals as they apply to own funds.

The new General Prior Permission

We support the granting to firms by the PRA of a general prior permission (GPP) to allow them to reduce any form of own funds up to a specific amount, in a series of transactions over a period of up to 12 months. The information that the PRA proposes firms should submit is relevant and easily accessible. Where no change to a pre-exiting GPP is sought it by the firm it may be renewed upon application to the PRA without it re-submitting the rationale for the permission, the present and forward-looking capital impacts and planned capital action. This is welcome and proportionate.

Timing of deduction of permitted amount from capital resources

We understand that the PRA's intention is that the amount of own funds instruments subject to the GPP should be deducted from a firm's capital resources at the point at which it is granted.

We note that this is aligned to the approach defined by the EBA and applied in the EU. However, this approach is not derived from international standards established by the Basel Committee. We believe the EU approach is unduly prudent and will substantially reduce firms' appetite for using GPPs. This reduces the potential efficiency savings GPPs could offer for both the PRA and UK firms. We suggest the PRA uses this review to consider if it should align its approach more closely with internationally agreed standards, rather than the EU's CRR.

Even once approval a GPP is granted, the decision to buy-back or call own funds instruments remains at the sole discretion of the issuing firm and will invariably be taken on a case-by-case basis nearer the time of execution. Deducting the full amount set out in the GPP upfront is an unhelpful departure from what is currently the PRA's helpfully pragmatic stance. This requires own funds instruments to be deducted only when there is sufficient certainty that the transaction will proceed. We see no reason why the GPP should be any different.

We also believe that deducting capital could give unhelpful signals to the market as to a firm's intention to call or buy back capital securities. Any deductions will presumably be visible in published capital ratios and could distort market prices as investors' view deductions as confirming the exercise of upcoming call options.

We note that buybacks of share CET 1 capital are revocable and can be cancelled, even post announcement to the market. An example of this was the cancellation of share buybacks by many firms in March 2020 as a result of the COVID-19 pandemic. Despite this, we appreciate and accept the requirement to deduct from own funds once buybacks are announced rather than completed.

The calls of non-CET1 capital instruments – AT1 and Tier 2 – are irrevocable once announced to the market. However, until any public market announcement is made, it is an option that may not to be exercised. So we think it reasonable to only deduct these own funds instruments at the point of sufficient certainty – in this case once an announcement has been made – as opposed to the time at with the GPP is granted. This remains a prudent approach; despite irrevocable call announcements being made, capital securities will remain on a firm's balance sheet until the call date and will be available to absorb losses in full during that time. So it is

our view that AT1 and Tier 2 securities should only be removed from own funds after they have been removed from the balance sheet.

This point equally applies where firms apply for a GPP increase; the actual amount of own funds reduced in the period could be lower than the GPP amount. Requiring firms to deduct the full amount from own funds upfront could ultimately reduce the number of firms who use this GPP waiver. Again this would go against the intended efficiency savings the GPP is aimed at introducing and which we support.

Share premiums and other technical amendments

We note that the PRA will require firms to have prior permission upon “de-recognition” of own funds instruments. We would welcome clarification of how this requirement interacts with the VREQ process some firms have been asked to submit to de-recognise own funds instruments.

Publishing of permissions

As the notification of a firm’s plan to reduce capital instruments can be market sensitive we welcome the PRA’s statement that it will publish its permission in relation such a reduction at the same time as the firm’s own announcement to the market of its intensions is made.

Tier 2 notifications

We note that the PRA expects a firm to ‘discuss’ with it any new or complex fealties of Tier 2 instruments as describes in paragraphs 2.3 to 2.5 of SS7/13, whereas there is no requirement to do so in relation to plain vanilla Tier 2 instruments.

Whilst we do not object to such a requirement it would be helpful to understand the nature of such discussions. Would the PRA be able to veto a firm’s Tier 2 capital raising plan, making it effectively a requirement of the firm to apply for prior permission to issue? Within what time period of time could the firm reasonably expect a response from the PRA after a discussion of any novel features?

Members would find helpful if the PRA could provide further guidance on when firms need to contact the supervisor in advance with respect to capital ESG bonds – is this limited to sustainability linked bonds when the interest rate on that instrument is, to an extent, linked to sustainability linked KPIs, or whether this is also intended to capture the broader ESG use of proceeds bonds.

Side agreements

We note that paragraph 2.3 of SS7/13 requires a firm to consider all arrangements related to a capital instrument. The proposed amendment to this paragraph makes it clear that a firm should take into account in its analysis the effect of any side agreements of which it is aware, whether or not it is party to such side agreement.

Of course UK Finance and our members would be delighted to discuss the contents of this brief response to the PRA's consultation if appropriate.

Responsible Executive

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