UK FINANCE

A response to the

PRA's consultation paper on

The Strong and Simple Framework: a definition of a Simpler-regime Firm

July 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.

The PRA's proposal

We are pleased to respond to the PRA's consultation paper CP 5/22 on *The Strong and Simple Framework: a definition of a Simpler-regime Firm*. We have long argued for a prudential regime in which the costs of regulation are proportionate to its benefits, recognising that the benefits and associated costs of regulatory compliance differ widely across firms of different size and business model. In particular understanding, interpreting, and operationalising prudential requirements is more challenging for smaller firms. The PRA's fundamental objective of promoting the safety and soundness of firms it regulates, thus forestalling any adverse impact on the stability of the U.K. financial system must be balanced against avoiding regulation that is overly onerous and prevents smaller institutions competing effectively. The PRA's secondary objective of facilitating effective competition between the firms it regulates allows the PRA to develop a regime that gives due regard to competition, whilst maintaining an appropriate level of safety and soundness for firms. A greater emphasis on the competition objective in the development of this new regime would allow for greater ambition and a greater impact from these proposals.

So we are delighted that the PRA is working towards the implementing a Simpler Firms' regime and welcome CP5/22 which makes proposals about which type of firm should be considered as a Simpler Firm.

The criteria proposed would classify a firm as a Simpler-regime firm if it:

- *has less than 15bn in total assets, calculated as a three-year average*
- *has on-and off-balance sheet trading book business of less than 5% of total assets and no more than £44 million*
- *is not on the Internal Rating Based approach for calculating risk requirements*

- *does not operate to a specialised business model, such as custody or clearing and settlement services*
- *has at least 85% of its exposures in the UK*

We note that the PRA's Discussion Paper DP 1/21 proposed a multi-layered approach to firm classification, which we support and that it would start with the lowest layer before moving up. We encourage the PRA to think in parallel about the definition of the higher tiers, so that a more coherent view of the entire regime can be developed. In particular, the definition of a "large but simple" regime for non-systemic firms with retail banking focussed business models will be beneficial to firms aspiring to grow, and to the market more widely, as they achieve the critical mass to compete effectively. This could be simply achieved by increasing the size criterion threshold to, we suggest £25 billion.

In this response we make some high-level points before addressing the different criteria proposed in the CP in turn.

Key messages

Members eagerly await follow up consultation papers

We recognise the need for the PRA to share its views in CP5/22 on the possible scope of the Simpler-firm regime before it consults on Basel 3.1 reforms in Q4 2022. In this way potentially in-scope firms can decide to remain subject to requirements of the currently applicable UK Capital Requirements Regulation (CRR) during any interim period between the PRA's implementation of Basel 3.1 and the implementation of measures under the simpler regime. We welcome this as preparing for the new Basel 3.1 rules will require a major change programme and, depending on business model, a material increase in capital requirements.

Similarly we welcome the PRA's intention to permit a Simpler-regime Firm to choose to be subject to Basel 3.1 reforms. This would be of value to them should, for instance, if they have a planned growth trajectory that suggest they will exceed the proposed £15bn upper boundary, which we recommend should be increased to £25bn, or are considering moving to the IRB approach.

But such firms will be making this choice before knowing what the new Simpler-Regime capital requirements will be. We urge the PRA to consider whether it can accelerate its proposals on the requirements of a simpler regime. We see every merit in implementing the regime at the same time as Basel 3.1 comes into effect, which would, aspirationally, suggest the simpler-firm regime should be finalised by the end of 2023.

A large and simple prudential approach is important too - there is a solution

Since the global financial crisis, no credible competitors of sufficient size have emerged from this new bank cohort to challenge the large established incumbent banks. This may suggest some kind of market failure or unnecessary regulatory barriers that are preventing growth.[1]

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[1] As Sam Woods noted in his Mansion House speech in 2019, "it is notable that no new bank has successfully become a large bank" and nothing has changed in the intervening period.

Although the PRA and FCA has helpfully encouraged the establishment of new banks in the UK, regulatory barriers to growth still exist in the UK banking sector, and in some cases, for instance the review of MREL thresholds, opportunities have not been taken to lower them.

So we welcome the PRA's commitment to develop a 'large-but-simpler' regime for non-systemic UK firms. This could be straightforwardly achieved by increasing the 'simple' size threshold to £25 billion and we strongly urge the PRA to do so. Our expectation is that whilst this would extend the simpler firm regime to a handful of extra firms it is exactly this 'squeezed middle' cohort that are best placed to provide competition to UK systemic banks, with all the benefit of greater customer choice and increased innovation this could bring. It would also help firms that are planning to grow their balance sheets in the medium term by allowing them to plan for the future with a greater degree of certainty.

We recognise that the development of the new Simpler-firm regime will likely take up copious amounts of policy making time and take a number of years to develop and implement, although we hope this could be achieved by the beginning of 2025 to align with the implementation of Basel 3.1 in the UK. In our view the PRA should consider more immediate simplification of the regime for *all* non-systemic firms whilst the simpler firm regime is being created. In the appendix to this response we have set out a number of ways in which this across-the-board simplification could be achieved more immediately.

The role of none CET1 capital instruments

We recall from FS1/21 that there was some debate about whether simpler regime firms should be restricted in their ability to use Additional Tier 1 or Tier 2 capital to fulfil their capital requirements. We strongly support their continued use.

Non-CET1 instruments are beneficial for smaller firms is not just because they provide more attractively priced loss absorbency but also because they avoid dilution of company control, which may be less important for large, listed firms. Unfairly restricting the ability of smaller firms to issue non-CET1 instruments could limit their ability and appetite to grow.

Conversely were a firm to exceed the proposed £15bn threshold, which we think should be increased to £25bn, it would at once be required to issue MREL as well as issuing more cost-effective AT1 and T2 instruments, which may be logistically challenging, given the likely smaller issuance volumes.

Comments on specific criteria

Size

The CP proposes a fixed threshold for Simpler-regime Firms, despite the feedback to the Discussion Paper highlighting concerns about the impact of this approach.

Every year the size of the economy grows. Every year the size of the housing stock, the mortgage sector and the banking sector also grow. Every year the value of money reduces due to inflation, particularly so at the present time. Setting a fixed monetary threshold creates a 'fiscal drag' effect where year after year more and more firms are brought into new aspects of the current regime as economic growth pulls them above its various thresholds.

A fixed monetary threshold is not inappropriate. There should be a clear policy statement that the £15bn, and other thresholds, should be periodically indexed to take account of inflation and growth. It is disappointing that the PRA did not address this criticism when it was raised in response to the Discussion Paper. If the PRA proceeds with this approach, they should explain in the Policy Statement why they consider a fixed threshold approach is appropriate for the Simpler Firms Regime given that the passage of time, and impact of GDP growth and inflation will gradually lower the 'real' threshold.

The impact is even more marked than it first appears. Firm's typically plan on a 3–5-year time horizon. Therefore, the firms that will benefit from the new regime are *not* those firms who are currently below the £15 bn threshold. Only those firms who are not expecting or aspiring to grow to £15 bn over the next five years will be able to benefit. Therefore, this approach creates an unnecessary barrier to growth and particularly affects those firms who are likely having the most effect on competition. For this reason we are suggesting *the asset ceiling be raised to £25bn*, pre-empting the creation of a new 'large-but-simple regime.

The threshold of £15bn would exempt about a third of regulated firms from the 'full Monty' approach to banking regulation. As we note above we see every merit developing a "large but simple" tier in parallel, encompassing firms with an asst size of, for instance between £25bn and £100bn, coupled with a higher Simpler-regime Firm ceiling, perhaps of £25 bn.

We support the phasing approach that would calculate simpler firm eligibility, or the requirement to move up to a large and simple regime, using a three-year average. This will support business planning and avoid sudden and significant changes to the prudential regime to which firms are subject. We support too, the use of the FINREP definition of total assets.

It does appear however that the threshold of £15bn has become more important to the regulator, with MREL also being set at between £15bn and 25bn. Increasing the Simpler-regime Firm limit to £25bn would align its total asset test with the point at which MREL becomes an absolute requirement.

We have many times made the point to the PRA that we consider that central bank exposures/HQLAs should be excluded from total asset measures for regulatory threshold purposes as including them may actively discouraging firms holding sensible levels of liquidity which become marginally very expensive should a firm tip into the MREL zone once its total assets exceed £15bn.

Only limited trading book

We support the use of the Trading Book (CRR) Part of the PRA Rulebook definition of a small trading book business. We also agree that significant foreign exchange positions are inconsistent with the aims of the simpler regime.

Whilst smaller, simpler firms are not currently engaged in activities that create commodity exposures, excluding firms undertaking such activities from the simpler regime could constrain innovation in future, in particular in respect of corporate banking. It may be preferable for the PRA to adopt a *de-minimus* threshold rather than an outright exclusion.

No internal ratings-based approach

We agree that the use of an IRB modelled approach to credit risk is incompatible with a simpler firm approach to prudential regulation and welcome the PRA's confirmation that a firm transitioning to an IRB approach would not lose its Simpler-firm regime eligibility until the relevant waiver had actually been granted.

Exclusion of firms providing certain clearing, settlement, and custody services

We agree that firms that focus on the broad provision of services such as clearing, settlement, payment system provision and correspondent banking to other banks should not be within the target population for a simpler regime, due to their increased interconnectivity and complexity. We agree that they should therefore be excluded.

Whilst small and simple firms do not currently provide these activities for customers, making this part of the regime could constrain innovation in future, in particular in respect of corporate banking. Therefore we support the PRA restricting this exclusion to the provision of these services to banks and building societies only.

Domestic activity

We support the notion that the simpler regime should be not applied to international firms or firms with significant international activity. However, many firms with simple business models will be descoped from the proposals because of the 85% UK domestic activity rule. Examples include:

- mortgage lending to UK expatriates which are secured on UK property
- exposures in Jersey, Guernsey, Isle of Man and Gibraltar, islands that are closely linked to the UK and are an extension of the firms' UK domestic business.

The PRA could consider the ultimate risk of such activity as a basis for determining domestic vs international activity. For instance the risk profile of expatriate mortgage lending secured on UK property is no different to that of lending to a UK resident and in most cases tends to be lower. In terms of operationalisation, the PRA could adapt MLAR return to capture domestic / international analysis to capture the relevant information.

We therefore urge the PRA to reshape the international activity criterion so that lending to individuals located outside the UK but secured against property located in the UK are not excluded from the scope of the simpler firms' regime.

Furthermore, aligning the 'domestic activity' threshold with that of the Disclosure part of the PRA rulebook would be helpful. The definition of a 'small and non-complex institution' is one that has 'more than 75% of both *[its*] consolidated total assets and liabilities, excluding in both cases the intragroup exposures, relat[*ing*] to activities with counterparties located in the United Kingdom'.

Level of application of scope criteria

We agree with this criterion and making the assessment at the highest level of the UK consolidation group. We also support the proposed, case dependent, application of the simpler approach to the

PRA's prudential supervision of a firm that is a UK subsidiary of a group based outside of the UK through a waiver or modification process. We would urge the PRA to consider accelerating the issuing of the policy considerations that would inform its assessment in such cases and, where practical, encourage the adoption of a rules-based approach to minimise uncertainty for affected firms that may wish to take advantage of the simpler firms regime.

Application of the scope criteria

We look forward to the PRA's consultations on allowing a firm to opt out of the 'default' simpler regime and transitioning proposals including how a firm would be treated if it unexpectedly and temporarily becomes or ceases to be a Simpler-regime Firm, as well as its thoughts on introducing notification or reporting requirements, necessary for it to verify that a firm is a Simpler-regime Firm.

Responsible Executive

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Appendix - Measures that could simplify the regulatory and supervisory regime for all firms, including mid-tier firms'

Being clearer on risk management expectations

Rightly bank's risk management should be enhanced and become more sophisticated as firms become larger and more complex. The PRA could helpfully set out in more detail the risk management capabilities they expect firms to have as they scale up. Supervisory Statement 3/21 "*Non-systemic UK banks: The Prudential Regulation Authority's approach to new and growing banks*" does this for firms up to five years and the Building Society Sourcebook also does this for building societies. Clearly articulated expectations in a similar vein for expectation of firms' risk management, as they move through potential impact categories would be of benefit for all firms and, we expect, also for the PRA.

Pillar 2A

The role of Pillar 2A capital should be reviewed. The ICAAP and ILAAP processes are helpful exercises for senior management of the firm to undertake. Smaller members believe that to avoid Pillar Two overlays the regulatory expectation is that they should be able to evidence that they hold sufficient capital against credit risk under Pillar One to a 99.9% confidence level - this is at odds with the PRA's position that it is not a zero-tolerance to failure regulator. Is there room to adjust the perceived confidence level for smaller banks?

It is our view that capital held for Pillar 2 risks cannot be used to absorb losses should they crystalise as firms cannot run down their Total Capital Requirements (TCR) (Pillar 1 + Pillar 2A) without a risk of breaching Threshold Conditions.

Therefore the nature of Pillar 2A capital should be considered. Instead capital for these risks should be held as part of the buffer regime as discussed in Sam Woods's recent 'Bufferati' speech. We recognise this proposal would require a significant change to the capital regime and in the meantime have highlighted some areas where the PRA could take quick action that could be applied to all firms below £50bn, not just those below £15bn.

- Remove or reconsider the concentration risk add-on for geographic exposure. The HHI methodology penalises firms for being focussed UK domestic lending when this is often preferable to firms having exposures in other countries which, whilst increasing diversification, introduces new and unfamiliar risks. In addition, it is contrary to the proposed strong and simple regime which suggest that firms should have to have at least 85% of their credit exposures in the UK to be classified as simple.

- Remove or reconsider the concentration risk add-on for single name. Smaller banks and building societies will be exposed to larger firms as part of their day-to-day operations, for instance in relation to cash management, the use of clearing services and liquidity provision. Large Exposure rules already limit exposures. In some cases it will be less risky for smaller firms to have exposure to one or two large banks than have a range of exposures to smaller banks. Such a larger portfolio is harder to manage and may introduce potential operational resiliency issues. Furthermore it is also not always feasible for less large banks to have

relationships with multiple banks. So this add-on is not always incentivising the least risky behaviour.

- Confirm that with the redesign of the operational risk capital requirement, which is generally expected to lead to an increase in Pillar 1 capital, any increase will be offset by a reduction in Pillar2A add-ons.

Reporting

The regulatory reporting burden has increased substantially since the introduction of COREP and FINREP. Whilst a small bank is not required to populate each and every data item it will have to regularly consider whether each item should now be populated.

Less complex banks with smaller balance sheets typically pose less systemic risk. Supervisory reporting requirements should recognise this and be materially reduced, focusing on the small number of data items that reflects the internal MI that senior management uses. The PRA should also critically examine what information they receive in from FINREP and COREP returns, which elements are never used, and which returns are genuinely required to support the supervisory process.

In addition, there is overlap with Bank of England statistical returns, Bank of England SMF collateral information, FINREP and ad-hoc returns. For example, firms provide mortgage data in the Product Sales Data, Mortgage Lenders Administration Returns, the Loan Book Data report and collateral information to the markets area. These data sets overlap with each other and could be combined into one return for firms and probably more useful, consistent data for the Bank of England and PRA. We recognise that this is an objective of the ongoing Transforming Data Collection project, of which we are very supportive.

For reporting that the PRA does need, more detailed worked examples and definitional guidance should be provided, the lack of which has tripped up some firms in the past.

Supervision

Mirroring the new banks' supervision team, the PRA should create a specialist scaling bank supervisory area (including specialist and policy resources) and with increased resources, compared to the supervision of those firms with a static balance sheet and business model. This would better allocate resources to risk and would enable:

- A more dedicated supervisory resource focussed specifically on scaling banks, ensuring a consistent and detailed approach to growing bank supervision.
  The ability for growing firms to have a C-SREP or L-SREP dialogue more frequently than the 3–5-year cycle which established smaller firms are currently subject to. Such more frequent capital and liquidity assessments would ensure a more proportionate capital and liquidity regime, benefiting financial stability and competition. It would also ensure that MREL is not scaled off an out-of-date Total Capital Requirement.

Access to IRB Approaches

Although we agree that a firm using an IRB approach should not be eligible for the simpler firms regime greater access to IRB approaches could improve competition between systemic and less large firms.

In our view the predominant hurdle for competition is the significant gap between the risk weights afforded by the A-IRB and that of the Standardised Approach. Members acknowledge that for many asset classes[2] the gap will narrow with the forthcoming implementation of Basel 3.1. In principle, we also recognise that the PRA shows some accommodation through its approach to Pillar 2A offset detailed in PS 22/17. But there is insufficient certainty for firms, which prevents them pricing prime residential mortgages competitively.

The most significant impediment for new firms developing A-IRB compliant models is the lack of access to default data. We note however that the Bank of England collects and stores all the data any firm scaling up would need to develop advanced modelling approaches. We call upon the PRA to consider a model under which aspiring growing firms can gain access to such data in the interest of increasing competition in the mainstream mortgage market.

MREL

We continue to suggest that the MREL regime, including its total asset threshold, should be subject to regular review to take account of economic growth and inflationary impacts and recommend that the size threshold be increased to £25 billion with MREL requirements stepping up as a firm's asset size moves towards £50bn.

Recovery planning

Firms undertake recovery planning to an annual cycle which is a resource intensive process. Increasing this to a biennial expectation, would allow them in the alternate years to devote resource to actually improve processes and implement enhancement programmes between submissions.

The PRA's Safety and soundness objectives can still be met by still be met via the annual liquidity and capital assessments the other enterprise-wide scenario testing submissions, for instance ICAAP, Reverse Stress test, and ILAAP).

CCyB

The Counter Cyclical Buffer (CCyB) is a macro prudential tool designed to ensure firms continue to lend in a downturn. As we note above simpler firm regime banks would not pose a risk to macroprudential stability.

The buffer is based on RWAs not total assets giving IRB firms an advantage over those on the standardised approach. as IRB risk weights are generally lower for the same lending exposure.

Simpler regime firms should therefore be exempted from the CCYB requirement.

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[2] Although the 10% credit conversion factor applied to undrawn credit cards under Basel 3.1 will increase the gap between A-IRB and Standardised approach risk weights