

A response to the The PRA's CP16/22 Chapter 2 Scope & application

March 2023

Introduction

UK Finance is the collective voice for the banking and finance industry. Representing more than 250 firms, we act to enhance competitiveness, support customers, and facilitate innovation.

We are pleased to respond to chapter 2 of the PRA's [CP 16/22](#) on implementing Basel 3.1 in the UK, which on scope and levels of application and provides a further welcome update on the PRA's anticipated development of the Simpler-regime.

Question 1: Do you have any comments on the PRA's proposals for the Transitional Capital Regime?

Our members had no comments on the scope of the application, supporting the continued replication of the CRR requirements, whilst offering an optional exemption for those Transitional Capital Regime (TCR) firms that meet the Simple-regime criteria.

Similarly, our members have no concerns about level of application, but in our response to Chapter 9, output floor, have raised some points of clarification.

Question 2: Do you have any comments on the PRA's proposed Simpler-regime criteria?

We support the PRA's continued progress towards creating a simpler-regime for firms whose failure would not pose a significant risk to the UK's financial system as part of a multi-layered approach as set out in the PRA's Discussion Paper DP1/21. We would very much support efforts by the PRA that could enabled this new, more proportionate regime to be implemented at the same time as Basel 3.1 is introduced in the UK.

Application of the simpler-firms regime to foreign banks

Recommendation 2.1

- The Simpler-regime should also be applied to regulated subsidiaries of 3rd country banks.

Rationale

UK subsidiaries of third country banks have relatively higher proportion of their activity based outside UK, and indeed this is one of their reasons for locating in London - the opportunity to access the capital market product manufacturing capability of its internationally significant financial centre and provide sophisticated solutions to their group's wider client base.

Many of the foreign banks with simple business models meet all the proposed threshold conditions of the simpler-regime, except for the non-UK activity test. Such firms may be unduly burdened by the requirement to implement Basel 3.1. Consideration should be given to permitting such third country owned UK banks with a balance sheet size of say less £10 Billion and at least 60% of their assets in the UK to access the Simpler-regime.

Alternatively smoothing around the pathway to the 85% domestic-activity criterion could be introduced. The business model changes needed to move the bank to become more UK focused would mechanistically not feed through to a 3-year average for a while. We suggest that a firm could be deemed to have met the UK activity test unless it has been below the 85% threshold for more than three months in succession or more than half of months in the past year. A rider could be added to this test excluding a firm if it had breached the 75% threshold at any point of time during the past year.

Transparency of criteria

Recommendation 2.2

- The criteria a firm should meet to be eligible for the Simpler-regime should be incorporated into the PRA Rulebook and the new regime implemented at the same time as Basel 3.1

Rationale

The introduction of the proposed Transitional Capital Regime (TCR) is very welcome as it will avoid less potential systemic regime firms having to alter their approach to accommodate Basel 3.1 requirements prior to the finalisation of the simpler-regime. But ideally this would be ready for implementation at the same time as the Basel 3.1.

The PRA proposes that firms meeting the simpler regime criteria on 1st Jan 2024 can choose between being subject to Basel 3.1. standards on the same timetable as other firms (i.e.

implementation in Jan 2025) or can opt into being subject to a transitional regime (TCR) that would be in place until the permanent capital for Simpler-regime is implemented¹.

At present, it is extremely difficult, particularly for small firms, to understand which capital rules apply to their firm as they are distributed across onshored EU legislation, the PRA Rulebook and other regulatory publications such as Statements of Policy, Supervisory Statements and others. This is relevant to the PRA's proportionality principle and competition objective as it puts smaller firms at a relative disadvantage, but do recognise the constraints imposed by the current UK legislation regarding EU legislation.

The introduction of the transitional regime may make this difficult situation more challenging. A firm wishing to apply to use the transitional regime will be required to navigate the interaction between the PRA Rulebook, onshored EU legislation and a Statement of Policy. Basing the regime on a FSMA Modification by Consent will introduce unwelcome opacity and uncertainty into the process.

In our view the criteria, which it is currently proposed will be described in the Statement of Policy, would be better included in the PRA Rulebook itself, incorporating an appropriate mechanism for regulatory consent. This would provide firms with higher levels of clarity and transparency about the regulatory processes involved.

Question 2: Do you have any comments on the PRA's proposed Simpler-regime criteria?

Intermediate firms and the Basel. 3.1

Recommendation 2.3

- The PRA should consider allowing 'Intermediate' firms to opt out of the requirement to move to Basel 3.1.

Rationale

We note that the Basel regime is designed for systemically important and internationally active banks. Discussion Paper DP1/21 envisages a number of "tiers" of proportionate regulation, with Globally Significant Banks (GSIBs) as a highest tier and Simpler Regime firms as the lowest. In addition to allowing Simpler Regime firms to opt into the transitional regime, we propose that the PRA should also allow other non-Basel banks, i.e. banks which are neither Systemically Important (DSIB/GSIB) nor internationally active to also have this flexibility whilst the intermediate regime is under development.

The position would then be summarised in the following chart:

¹ Could the terminology "TCR" for this regime be avoided given the potential for confusion with "Total Capital Requirement" or "Total Capital Ratio". We propose that another acronym, such as Strong & Simple Transitional Regime (SSTR), in used in its place

GSIBs	Basel 3.1		
DSIBs	Basel 3.1		
Other Basel Banks	Basel 3.1		
Intermediate Banks	S&STR or Basel 3.1		<i>Not DSIB/GSIB Trading<5%; FX<2%; 85% UK; Activity Exclusions</i>
Small Banks	S&STR or Basel 3.1		<i>£20bn; Trading < 5%; FX<2%; 85% UK; Activity Exclusions; Not IRB</i>

Use of fixed size thresholds

Recommendation 2.4

- Thresholds should be subject to regular review and indexation.

Rationale

In our previous consultation response, we expressed our opposition to the use of fixed quantitative thresholds. Inflation, increases in the size of the economy and lending markets mean that a £20bn threshold today will be very different to the same nominal level in, say, 10 years' time. With fixed thresholds, firms will exit the Simpler-regime over time, making it gradually less proportionate. This has already been observed in the MREL regime, where the limits have not changed since they were introduced.

Firms' decisions on whether to use the transitional regime will be based not on their current size but on the size they expect, or aspire, to be during their planning horizon which is typically five years. If there is not clear guidance of how thresholds will be indexed, firms will by default assume that they are fixed. Even for banks that are not growing relative to the economy, the PRA's analysis may thus over-state the value of the Simpler-regime.

Proposal

The PRA acknowledged this feedback in FS1/21 but decided not to introduce indexation. This decision should be reviewed and thresholds subject to periodic review to support the regulatory principle of proportionality.

Opting into the regime

Recommendation 2.5

- Firms should be able to opt in and subsequently out of the regime when further detail of the simpler firms regime become known.

Rationale

Eligible firms meeting the Simpler-regime criteria will be invited to apply for a modification to be subject to the TCR. However expecting firms to make this decision without knowing what it will require will put them in a very difficult situation and may discourage firms from opting in.

This dilemma could be solved by providing firms with a second opportunity to “opt out”/confirm their “opt in” once the permanent capital regime rules are published.

Mortgages risk weights

Recommendation 2.6

- Transitional banks should be permitted to use the Basel 3.1 risk weights for mortgage exposures.

Rationale

Basel 3.1 reforms include a number of separate changes which have been driven by different priorities. The change to mortgage risk weights was explicitly driven by a recognition that these risk weights put smaller non-IRB bank at a disadvantage compared to larger IRB peers. Indeed, the PRA expressly referred to this reform in their recent remit letter of 17 January 2023²:

“The PRA has continued to pursue its existing secondary competition objective, notably by ... implementing Basel 3.1 standards to level the playing field in mortgage lending between large and small firms by reducing the differences in risk-weighted assets (RWA) between firms”

It would seem perverse to introduce Simpler-regime explicitly to benefit smaller banks and then to refuse to allow exactly these banks to benefit from this change from the effective date, or alternatively to require small banks to opt out of the simpler firms regime just to benefit from this reform.

Proposal

Whilst the transitional regime in other respects should be unchanged compared to the current regime, we propose that that Simpler-regime should be allowed to opt into the new more risk sensitive Basel 3.1 rules on mortgage risk weights, without being required to opt into the full Basel 3.1 regime.

Transitioning out of the regime

Recommendation 2.7

² <https://www.bankofengland.co.uk/-/media/boe/files/letter/2023/prc-remit-letter-to-chancellor.pdf>

- The PRA should clarify more precisely its expectations of firms transitioning out of the Simpler-regime.

Rationale

The CP proposes (SoP para 4.2 et seq.) that should “a firm ceases to meet the scope criteria between 1 Jan 2024 and the implementation date of the risk-based capital framework in the Simpler-regime, it must notify the PRA”. This is not unreasonable.

Where a firm is not able to comply with the Basel 3.1 requirements immediately on becoming aware that it ceases to meet the scope criteria then the PRA indicates it may grant some limited further time to comply.

Further where a firm achieves IRB approval, then the PRA would engage with the firm before permission to ensure that a firm is ready to move to Basel 3.1. standards.

Both these accommodations are helpful although it would be beneficial to have more detailed discussions on exactly what are the expectations and timelines to transition, and what the likely duration of the TCR might be, both for the Simpler-regime and, in the longer term the next layer up of more proportionate regulation above the simpler-regime.

The simpler permanent capital regime

We note that the PRA is considering whether the Basel 3.1 regime should act as the starting point for the Simpler-regime. Most of our members believe that Basel 3.1 (other than for mortgage risk weights) is more complicated so the attractiveness of the Simpler-regime will depend on the extent to which it is modified.

Increase in threshold from £15bn to £20bn

Recommendation 2.8

- The MREL lower total asset size threshold should be increased to £20 billion.

Rationale

We welcome the increase in the total asset threshold to £20 billion, the effect of which is that a smaller number of firms will be squeezed between the two regime. But UK Finance continues to encourage the PRA to further increase the threshold to £25bn to align with the indicative MREL upper total asset threshold. We recognise that MREL and the Simpler-regime use different calibrations of total assets – the simpler firms one being backward looking, averaged over the last 3 years whilst MREL is based on a firm’s projection of its total assets in the future.

Should this not be possible in the short term then the lower MREL threshold should be increased to £20bn.

Consistency with other thresholds

Recommendation 2.9

- The Bank of England's multi layered threshold regime should be simplified.

Recommendation

Banks have to monitor more than 50 different regulatory thresholds which the Simpler-regime should seek to align and simplify. The welcome increase to £20bn of simpler-regime threshold nonetheless creates another one. The opportunity to revisit and simplify all thresholds applying to all firms, not just non-systemic ones, should be taken to ensure they interact in a coherent manner. As we note above there is an obvious conflict between the (lower) MREL threshold and the currently proposed Simpler-regime threshold.

Other issues

Simplified Pillar 2 approach

Recommendation 2.10

- Firms should only be required to undertake a full ICAAP in the year in which the PRA performs a C-SREP.

Rationale

A review of proportionality of the ICAAP process especially for those firms that qualify for the Simpler-regime would be welcome. Such firms do not represent a significant systematic risk to the UK financial system, partly in recognition of which the PRA typically only undertakes a C-SREP/L-SREP every 3 years. We therefore question if it is necessary to prepare a full ICAAP on an annual basis, which can be costly. The PRA should seize the opportunity to reduce the regulatory burden on small firms to a level more appropriate to the level of risk they represent to the UK financial system.

Firms and their boards will still wish to stress their capital capacity annually, but smaller firms are able to do so without preparing a full ICAAP each year as their simplicity allows changes impacting stress capital capacity to be immediately understood and managed.

We suggest that the full ICAAP should be limited to C-SREP years, with sufficient pre-warning to prepare the full documentation. This could be supplemented in interim years by a simpler alternative designed to monitor material changes in structure, business model and capital requirements.

Interaction of simpler-regime with Basel 3.1

Recommendation 2.11

- PRA should provide further clarity on how the strong and simple regime will interact with Basel 3.1.

Rationale

Timelines for future strong and simple communications outlined in February 2023's FCA Regulatory Initiatives Grid suggest that the strong and simple and Basel 3.1 timelines are not yet aligned. This prevents an holistic review of the options available to small firms in time to enable an informed decision in advance of 1 January 2025. Explicitly, firms are requested to make a decision as to whether to adopt the strong and simple regime before there is clarity over what this would entail.

Q & A function

Recommendation 2.12

- As an alternative to a Q&A process the PRA should convene a forum of its own technical subject matter experts and representative industry experts to address issues of interpretation and operationalisation of its requirements.

Rationale

In the past the FSA hosted “standing groups”, attended by both industry and regulators, where questions of rule interpretation and implementation could be discussed and clarified. Minutes of these meetings would be shared to ensure maximum visibility for all industry participants.

If the PRA does not expect to have an EBA-like Q&A process, such a forum would be helpful. This would also be consistent with the increased focus of the PRA on evaluation of rules as it would give the PRA visibility over issues with which firms are having difficulty.

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