UK FINANCE

A response to the PRA's consultation

Non-systemic UK banks: The Prudential Regulation Authority's approach to new and growing banks

October 2020

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 PRA's Consultation Paper CP9/20 on its supervisory expectations of new and growing non-systemic banks. Our members welcome the attractive and competitive environment the PRA is looking to foster. Innovation and competition in the UK will help our members challenge each other for the delivery of better products and services to consumers and maintain their competitiveness globally.

We also welcome the PRA's confirmation that it is not seeking a zero-failure regime. Our members appreciate the need for banks to be able to fail in an orderly fashion without a threat to financial stability. Innovation and competition through the entry of new banks into the UK banking market should not increase the risk to depositors, the financial system or to public finances.

More broadly we look forward to working with the PRA on its Future Financial Regulatory Regime initiative to create a strong but simpler and more proportionate regime for banks that are not systemically important.

In our view proportionality in banking supervision means adapting the nature and intensity of supervision to the specifics of the bank – its risk profile, its business model and size. As a result, proportionality can be subjective and open to interpretation, and often informed by the knowledge and experience of the individual supervisor – complex supervisory approaches and demanding information requests tend to be disproportionality costly for smaller banks.

So we were pleased to see that the recent PRA CP12/20 proposed the inclusion of additional criteria relating to the frequency and intensity of the Pillar 2 SREP process based on a firm's nature, scale

and complexity with the objective of creating a more proportionate and attractive regulatory environment in the UK that will allow banks of all shapes and sizes to thrive as they support households and businesses.

We note that there are other reviews in train on MREL and Leverage which should also keep in mind the need for competition in the banking sector and encourage the development of new banks. In particular in the areas of competition and the creation of level playing fields, we consider that that current "one size fits all" approach in certain areas of policy creation and supervision does not support new banks seeking to establish a viable market presence in the UK.

We note that the consultation makes reference in a number of places to the need for fast growing firms to consider MREL requirements. We do not believe this is helpful. In our view MREL should be irrelevant to firms within its scope. Referring to MREL in this way is likely to create confusion for the boards of such firms and more importantly to cast a damper on their ability to attract investor funding. *We strongly suggest references to future MREL requirements should be minimised in the Policy Statement resulting from this consultation*.

expectations of new and growing banks

We welcome the transparency that the formalisation of the current PRA policy approach through the consultation paper and the draft supervisory statement brings. The proposed guidelines enable impacted members and new or aspiring entrants to understand the PRA's expectations and shape their business and investment plans accordingly. The guidelines also enable investors or prospective investors in industry to understand the expectations on their investment targets better. As a result, communication between impacted firms and their investors on the likely progressive evolution of capital needs and management on boarding can be anchored more easily to openly articulated regulatory standards.

Our members in scope of the consultation understand and agree with the PRA's expectation to set out the path to profitability, strengthen governance and invest in risk management and controls. The proportionality implied in the expectations about the growth journey of the firm is very welcome.

capital expectations of new and growing banks

Our members within the scope of the proposals made in CP9/20 welcome the simplicity of the proposed new approach to setting the PRA buffer prior to moving to a stress test basis. We would request the PRA to consider offsetting positive net interest and fee income against the operating expenses for the same period if the firm can demonstrate that these are stable and sustainable even under a stress.

We would also welcome the possibility of setting P2B based on wind-down requirements, where for instance the PRA is content that the firm's proposals to reduce operational expenses are credible, including an understanding of the flexibility of any outsourcing contracts which are widely used by newer banks.

However, for new banks, setting a PRA buffer based on six months operating expenses can result in a disproportionate increase in overall capital requirements. This effect is particularly intensified for a

bank which is close to its breakeven point (typically but not always between 3 and 5 years of its operations post authorisation). Once break-even is achieved, an assessment of forward operating expenses is a valid measure whilst a bank transitions to a stress testing approach. However, in arriving at the amount of capital to be held a growing bank should only be required to hold capital to support the costs necessary to maintain the continuity of critical services for its expected customer base over the six month period. For example, growing business includes both marketing and product development expenses. Such costs should not be included in six months forward expenses as they would be pared back significantly in the event of a solvent wind down.

Some of our members view the PRA's expectations and the resultant method to setting buffer requirement as discriminatory to certain business models. Publicly available records show that new banks competing for mainstream rather than niche customer segments, which went on to reach full year profitability, took best part of 6-7 years post authorisation. The concern is that by not creating conditions for challenge in the mainstream banking markets, competition may not quickly benefit most customers through innovation, and act as barrier to entry into the mass market for consumers and SMEs. As a result, we would request that the PRA take a flexible approach that reflects the typical experience of bringing a particular business model to maturity, rather than applying a one-size-fits-all approach.

Conversely some fast-growing banks may move to profitability more rapidly yet still represent little risk to the financial system. We argue such firms do not automatically warrant higher buffers solely on the basis of their early profitability.

Further, the current implicit approach of moving from wind-down to stress testing avoids cliff effects- when firms' buffers under wind-down grow larger than those calculated under stress testing, it is appropriate to transition to stress testing. The proposed approach would make this transition from a now smaller 6-month operating expense buffer to stress testing more difficult to manage.

We propose an alternative approach for setting the PRA Buffer:

Until break-even is achieved

PRA buffer should be set based on the bank's internal assessment based on its wind-down cost. For new banks in the early years of existence this is a prudent view as the PRA buffer would be utilised only in a scenario of extreme stress, the point at which the bank would have already started enacting its 'Capital Preservation Plan' including having reduced its marketing costs, reduced customer and onboarding costs, cancelling new product development and partial sell down of liquid assets. Contractual revenue due from customers and from assets held in a bank's High-Quality Liquid Asset (HQLA) portfolio should be recognised in the calculation of the net wind-down costs.

From break-even point through to one full trading year of profitability

PRA buffer should be based on an assessment of 6 months forward operating expenses required to cover the costs necessary to maintain the continuity of critical services for existing customers based on the Operational Continuity in Resolution (OCIR) definition, *or* the solvent wind down costs if the plan is credible and the firm can demonstrate that its costs are lower than the Pillar 2B buffer. This approach would reflect differences in business models.

After observing profitability for one full trading year

The PRA buffer should be based on a stress-test based methodology wherein the PRA buffer is taken as the maximum shortfall of capital over a period of 12 months from the ICAAP assessment point (excluding Capital Conservation Buffer and Countercyclical Buffer). The stress being referred to here is the 'macro-economic' stress test with a 100% weighting applied to it. This stress test should be based on Bank of England's recommended stress scenario combined with a bank's own expert judgement.

We believe that the PRA's proposed calculation of Pillar 2B would put considerable strain on new banks at a critical time in their development and consider the alternative approach proposed above addresses the perceived problem in a more effective and practical way.

Members see a risk in the PRA's expectation of timing for a firm becoming profitable. There is a concern that the regulatory expectation may drive banks to modify their risk appetite and take on greater risks in order to meet those expectations, than they otherwise would have accepted.

An example of this is enforcing the current calculation EU methodology for the Leverage Ratio for small banks which could encourage management to take potentially perverse decisions. As explained below, leverage ratio can be improved by the firm in two ways:

Turning to capital markets to raise debt

As has been seen in recent years, if an institution is unable to attract sufficient investor appetite, it increases the risk of paying an excessive coupon to raise debt. Smaller banks do not need to issue in 'market size' and the lack of a credit rating during the early years of a bank's life can prohibit any debt market entry. Wholesale market debt issuance, more so than retail deposit funding also increases total operating costs of the bank with the cost of servicing the debt being funded from capital, whilst the bank is still potentially 'loss-making' and dependent on equity funding.

Making investment decisions that would generate a return on assets greater than 3.25% (UK LR minimum requirement)

This hurdle incentivises banks to engage in risk shifting by investing in relatively higher-risk assets than they could earn from either placing their deposit balances at the central bank or holding HQLA.

We request that the regulator considers profitability in the context of the risks of a firm's business model, rather than as an absolute objective. As the economic shock from Covid-19 to households and businesses has demonstrated, no bank is immune from macroeconomic approach proposed above to address the perceived problem in a more effective and practical way. Further dialogue on how a firm could demonstrate a viable pathway to profitability would be welcome in order to promote consistency of supervisory assessment. The industry would benefit from consistency in definition with that used for OCIR requirements and for associated Liquidity Buffers.

We would also welcome greater clarity on what the expectation of 'definite capital support' means for firms at Year 5. For example, does this mean binding commitments from investors? Could firms demonstrate this through organic capital generation? If so, over what period of time would firms need to demonstrate sustainable capital growth?

In-scope members welcome the proposal that there is a two-year transition path to a stress-test based setting of PRA buffer. Firms are looking forward to engaging with the PRA to agree their individual transition path - particularly those which are imminently due to move to stress testing.

The draft supervisory statement identifies poor capital planning and management as the cause for firms entering their management buffers ahead of investment rounds. This view comes across as overly simplified. Our members with experience of such situations suggest that it is not management nor their banks' governing bodies that stand in the way of timely access to capital. In this regard the PRA's clearly stated expectations are helpful as they will inform investors' choices. We would request the PRA consider carefully whether any actions taken to impact the capital buffers of a firm on the basis of past performance may undermine the investment case for new investors to support firms' development.

Neither the consultation paper nor the draft supervisory statement addresses the setting of Pillar 2A. The PRA's methodology is a point-in-time approach. Firm typically assess their P2A add-ons as part of the ICAAP at a reference point, which is often looks several months ahead. The PRA's C-SREP process typically follows a further 3-6 months thereafter for the subsequent 12 to 15-month period. Most firms in scope of the consultation would have grown or changed their balance sheets considerably. By setting P2A requirements as a fixed percentage of RWA, particularly those that are likely to be fixed or semi-variable to, firms end up carrying and scaling up requirements that turn out to be in excess of requirements in hindsight.

Members appreciate that the PRA would have found that growth plans are not always met, and that the PRA expressed doubt about projections at the time. That said, firms would request that the PRA consider a more dynamic setting of P2A requirements, in order for P2A to be proportionate to more rapidly growing businesses and balance sheets.

An approach may be, if the PRA is comfortable in respect to the forward-looking analysis of the Base Case and Pillar 2A, then the PRA would fix Pillar 2A across the time horizon under analysis? This could be seen as a 'transition period' where Pillar 2A gradually decreases towards a target Pillar 2A, avoiding cliff edge effects.

If, over time, new information shows that the initial Pillar 2A target is not appropriate anymore (and should for example be higher), the PRA could revert back to higher Pillar 2A thanks to this transition approach.

orderly exit: recovery and resolvability

We note that the PRA proposes that in the future banks should hold capital to be able to continue to meet the suite of capital requirements for 12 months after authorisation/exit from mobilisation prior to moving to a stress testing based approach.

If during this period the board determines that the business model has become unviable, such that it is unlikely to continue to meet its threshold conditions, rather it will execute its solvent wind-down plan and enter the Bank Insolvency Procedure. The overview of the PRA's expectation of key attributes of a strong Solvent Wind Down Plan (SWDP) is helpful. At this point however the quantum of capital required should shrink. As we note above during a SWDP a bank will also reducing assets and

liabilities shrinking its balance sheet, such that PRA P2A add-ons may no longer be reflective of the risks of the bank as it is. Banks are also likely to strongly curtail for instance t marketing, IT infrastructure development plans and other costs such as recruitment. We would expect this to be acknowledged in capital expectations once a bank has entered solvent wind down and the PRA buffer reduced accordingly.

We question how useful a detailed Recovery Plan is for a newer bank that will inherently have very limited recovery options and wonder about the cost/ benefit analysis of this requirement for new banks. Removing the requirement to produce a Recovery Plan would free time from this requirement to focus on building a viable business. Instead we believe the supervisor should focus on a firm's need a solvent wind down plan. This may be triggered before all a firm's recovery options are exhausted. In executing a solvent wind down plan there is an inherent tension for directors between protecting creditors and shareholder interests and their SMCR responsibilities to ensure the firm can exit the market in an orderly way. We would appreciate more dialogue with the PRA about aspects of solvent wind down including:

- Interaction between Recovery Plan and the SWDP
- Potential conflicts between directors' duties
- Implications of pledging assets to the Central Bank
- Is the Solvent Wind Down pathway presumed to culminate in bank insolvency once depositors have been repaid?

the PRA's approach once banks are established

New banks that are 'liability driven' rather than 'asset driven' tend to run very conservative Liquidity Coverage Ratios because the majority of the bank's customer deposits are placed with the central bank as cash reserves. Under the UK Leverage ratio framework, a bank is not allowed to deduct its central bank deposits (or for that matter any government backed loans) if its deposits are less than £50bn (which is a very high threshold for a new bank). This is uncompetitive.

Additionally, it puts a downward pressure on the Leverage Ratio calculation and hence the likelihood of a breach for a new bank in its Leverage Ratio is relatively higher.

Such new banks in their early years tend to have relatively small lending balances. They carry minimal credit risk, and hence have no balance sheet risk or systemic risk due to excessive leverage.

We look forward to participating the Bank's forthcoming review of MREL and working with it to update current thresholds and develop a more graduated approach to its introduction that should seek to avoid unnecessary cliff edge effects during the first five years of a new bank's operation.

Responsible Executive

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