UK FINANCE

A response to the PRA's discussion paper

A strong and simple prudential framework for non-systemic banks and building societies

July 2021

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 Discussion Paper DP 1/21 which shares ideas for a simpler yet still strong prudential framework.

Our members welcome the attractive and competitive environment the PRA is seeking to foster. A more efficient regulatory regime would result in an industry that is leaner, more competitive, and less costly for customers. The cost of undue complexity will ultimately be paid for by customers. We agree that the PRA should review the prudential rules and consider where they should be adjusted to reflect UK-specificities and to ensure the overall regime facilitates effective competition between firms. This will help our members challenge each other to deliver better products and services to households and businesses, as well as and supporting continued competition between firms. A more proportionate, simpler yet still strong prudential regulatory framework will support both this objective and, the PRA's secondary competition objective. We recognise that the focus of the DP is on regulation rather than supervision. As these two activities are inevitably linked our response addresses both issues where relevant.

In our view proportionality in banking regulation means adapting the nature and intensity of regulation to the specificities and systemic impact of an individual bank. This would include its risk profile, business model and size, in addition to the "impact category" to which the PRA has assigned it. As a result, proportionality can be subjective and open to interpretation, often informed by the knowledge

and experience of the individual supervisor. Complex approaches and demanding one-off information requests tend to be disproportionately costly for smaller banks, as the DP has acknowledged.

We look forward to participating with the PRA in shaping a more proportionate prudential regulatory framework and would be delighted to discuss with the PRA the views articulated in this response.

Overarching messages

Streamlined or focused approach?

The PRA will appreciate UK Finance cannot definitively answer this question given we represent a wide range of firms. However, an overall majority would probably indicate support for a flexible yet streamlined approach, allowing for proportionate regulation and opportunity for growth, while recognising that with growth comes the expectation that regulatory and supervisory expectations will increase. However, this will not reflect every member's preference, so we recommend the PRA, as much as is realistically possible, provides scope for firms to choose their own individual approach. Continuing this theme, we also support the approach of providing optionality for firms to opt in/out, as a mandatory inclusion for all in scope firms could negatively impact growth plans, given that higher capital requirements could reduce some firms' ability to be competitive.

We would like to take this opportunity to stress the value some small banks attribute to having a dedicated supervisor (or supervisors). While we fully support the introduction of a simpler regime to deliver a more aligned regulatory approach, firms will nevertheless still have their own idiosyncrasies, business models and challenges. Appropriate supervisory dialogue can support individual circumstances and avoids an undesirable "one size fits all" approach.

Streamlining regulatory requirements for firms

We welcome the possibility of simplifying prudential regulatory requirements. It is widely acknowledged that smaller firms typically have less resources available to support them in this activity. Our smaller members often cite the problem of identifying which requirements apply, for example, the complexity arising from the combination of on-shored EU regulations, EBA Q&As, Supervisory Statements and PRA rules. An intelligent handbook which was a single source of all applicable rules and regulations would be of considerable benefit.

Improving efficiency in data reporting

There is currently a large suite of data that firms need to provide to the PRA. Streamlining these requirements would contribute to delivering a strong and simple regime and could potentially be of benefit to firms of all sizes. While we have provided some examples, this is a complex matter, and would welcome further discussions specifically on this issue, details of which go beyond the scope of this response. We are also looking forward to the outcome of the Bank and FCA's data automation initiative.

Pillar 2A

Our smaller members believe Pillar 2A needs reforming. We have suggested that by increasing the conservatism of Pillar 1, it may be possible to remove Pillar 2A for those in scope of this paper altogether. Alternatively, we have provided a number of examples of how the current format could be improved to help these firms. Whatever the PRA decides is appropriate, we strongly recommend that Pillar 2A is reviewed and is simplified in the future.

PRA's view of the future landscape

It would be helpful to understand how the PRA believes the future banking landscape will evolve for firms in scope for this DP. For example, whether the PRA envisages a world with greater or fewer "small firms", what "size" these firms might be and how they could fit into a potentially multi-tiered regulatory framework. We acknowledge that the changes being considered in the DP will take some time to agree and implement, so it would be beneficial for UK Finance and its members to understand the PRA's thinking on banking industry structure, which may affect our individual members' approach to any future framework.

The middle tier firms

There are a number of firms which consider themselves both 'strong and simple' and 'non-systemic', but which may be out of scope for the regime for a variety of reasons, for example, asset size, use (or planned use of) IRB, being a subsidiary of a larger overseas parent, and performing (a few) critical functions, amongst others. Depending on the level of the 'simple but strong' entry criteria, these firms may not benefit from an updated framework, but also would not enjoy the typical attributes of being a "large" firm, potentially placing them at a competitive disadvantage.

It is important that mid-tier firms can operate in an environment conducive to their growth. We strongly recommend that when the PRA designs the regime for the smallest firms, it considers a new framework for this group of firms in parallel to the strong and simple regime, rather than afterwards. We would also welcome the PRA, in conjunction with other regulators where appropriate, considering how they could make smaller, targeted changes to the existing regime that would benefit mid-tier firms from a simplicity or competition perspective, for example, reforming the MREL regime to remove barriers such as the cliff-edge effects.

We acknowledge the regulation and supervision of this group of firms is not the focus of this paper, but it is an important consideration in the overall context of developing a more modern prudential framework. UK Finance would welcome an opportunity to discuss this with the PRA in the near future.

"Scaling" firms

While we very much support the objectives of the paper, those in scope are the smallest of firms, which are likely to have minimal impact on the macro competitive environment, certainly on an individual basis. As a result, it may have a limited impact on the PRA's secondary competition objective. The DP does not seem to provide for "scaling firms", i.e. those with an aspiration to grow. While we understand this is not the focus of this paper, similar to the mid-tier firm issues discussed above, we recommend this group of firms is also considered in parallel to those who are in scope for this framework, as supporting these "scaling banks" to compete more effectively, without significant additional risk to financial stability.

We have synthesised these thoughts and the responses to the DP's questions into a table (Annex 1) reviewing major elements of the UK's regulatory and supervisory regimes for banks and building societies. into a table that is attached as Annex 1.

Please find below answers to the questions in the DP. We would be pleased to have further discussions with the PRA on the issues highlighted in this response and to support the development of this framework in any way we can.

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Responses to DP Questions

Q1: Do you have any comments on our description of the complexity and barriers to growth problems faced by non-systemic banks and building societies?

We agree with the PRA's assessment, and are supportive of the need to consider the "complexity" problem when developing the framework. We concur with the observation that the fixed component of the costs of understanding, interpreting, and operationalising prudential requirements results in a disproportionate burden on the smallest firms. This can often result in a "bottleneck" where the assessment and implementation of new rules is delayed because of the scarcity of time available to subject matter experts who are managing multiple and varied responsibilities within the firm.

As a wider observation, the nature of simplification proposed in the DP indicates an understandable trade-off between higher capital requirements and the ability for the firm to operate to a lighter regulatory regime with less supervisory interaction. The higher liquidity/capital requirement may be challenging to firms, particularly those projecting growth, as a high capital requirement projected over a growing balance sheet may undermine the future investment case. We are concerned that if imposed across the board to all in-scope firms, individual firms' growth plans could be compromised, as the consequential higher capital requirements could stifle smaller firms' ability to compete. The business case for firms to participate in a regime underpinned by higher liquidity and capital requirements must come with a sufficient reduction in regulatory burden (and therefore their related compliance costs) to justify the change.

We agree with the PRA that the entry, or not, by a firm into the strong and simple framework should be a matter for each firm and an optional decision for them.

Q2: What do you think of the long-term vision for the strong and simple prudential framework for non-systemic banks and building societies in the UK?

We support the PRA's objectives of delivering approaches that are most appropriate for the size and potential systemic impact of the firm, albeit that smaller firms are not necessarily less complex in all instances.

We agree that a more proportionate approach should seek to match the cost of regulatory compliance more closely to the size of the business. It is inevitable that the solutions will require trade-offs such as a lower cost of regulatory compliance for a higher liquidity/capital requirement. The PRA should be mindful that this could act as a barrier to entry for lower risk new entrants. For example, the DP proposes that HQLA could be restricted to only Level 1 assets. Such an approach could limit the use of highly rated securities, such as covered bonds that have a lower cost of carry. While we understand these are the trade-offs to be considered, avoiding barriers to entry should be a parallel priority, whilst not jeopardising the overall safety and soundness of the financial system.

Q3: What are your views on having a prudential framework for non-systemic banks and building societies containing several layers?

There is a risk that layers could in themselves create undesirable complexity within the new structure. Layers could also create further compliance costs should firms be required to move between layers on a regular basis, depending on the metrics used to delineate them. This could become a barrier to growth if it becomes resource intensive or financially prohibitive to move from one layer to another, which would result in supporting small firms with static models, but undermining their appetite for growth.

If a layered approach were to be introduced, the PRA should consult with the industry (as we know it would) about their development, then be very clear as to how they will be applied in practice, taking into account the range of firms and their various business models, alongside considerations such as the PRA's forecast of new bank approvals, possible investor appetite for complexity and the less regulated growth of competing fintech firms.

Whilst a layered approach introduces greater complexity overall, there will be many firms which are not close to the layer thresholds and do not expect to frequently transition between layers. These firms would benefit the most from a layered regime, particularly those smallest firms, for example with total assets below approximately £5 billion, although we recognise that it is the PRA's prerogative to not permit a firm to enter the strong and simple layer where additional factors make this inappropriate.

The criteria used in the current regulatory categorisation of a firm are relatively opaque, with insufficient granularity to reflect the different business models and sizes that impact their risk to the wider financial system; for example, non-systemically important banks range from £17m to £90bn. As the PRA's thoughts develop, we look forward to working with it to ensure clarity on the pathway for growth as a firm moves through the layers, from 'streamlined' to 'less streamlined'. This should include clarity about the triggers, transition mechanism and timing, as well as impact of reaching the next tier, for business and capital planning purposes.

The structure for transition should be flexible enough so that a firm having an unusually strong (or weak) performance year, does not erratically flip from one layer to another. Any quantitative metrics should be based upon a moving average looking back, for example, 3 to 5 years. It would be undesirable to have too many different regulatory 'tools' with different levels; for example, MREL has its own trigger ranges, which are separate from others. The definition of layers should consider the risk profiles of firms as well as asset size, as set out in our response to question 6 below.

The PRA should also seek to "future-proof" any layering. It is foreseeable that as market conditions change so may the appropriateness of the calibration and scope of the layers changes in scope will create strategic uncertainty and higher compliance costs.

We recognise that regulatory and supervisory layering may be appropriate and that firms at the two extremes of the strong and simple range may need to be treated differently, but thought will need to be given to ensure any layering is equitable.

Q4: What do you think of starting with a simpler prudential regime for the smallest banks and building societies?

We agree that the PRA should build on its experience with credit unions by focussing the next strong and simple building block on the smallest firms. However, whilst the smallest firms arguably have the most to gain from a layered approach, it would not be ideal to introduce a "simplest" layer first and then have to recalibrate the requirements shortly afterwards to fit in with the approach for firms in the layers above. We encourage the PRA to consider the structure of other layers to avoid then changing the regime for the smallest firms to ensure it remains proportionate with the rest of the framework.

In parallel, the PRA should also consider how the regime might apply to mid-tier firms, which will be out of scope for this 'entry-level' framework, ensuring there is an improvement in their ability to compete. Such considerations should also aim to mitigate unintended consequences and avoid reinforcing the impact of some of the existing issues that prevent growth in the other layers in the banking system.

An extended transition period to meet future recalibration requirements might be beneficial in this regard, rather than delaying simplification for the smallest firms. We support the PRA taking its time to ensure there is adequate engagement with the industry to test the future framework, ensuring that the PRA "gets it right" first time.

Q5: Do you have any views on how to define whether a bank or building society is domestic or internationally active?

Firms that are prudentially regulated by the PRA should not be automatically excluded from eligibility for the strong and simple prudential regime on the basis that they have a non-UK parent. Examples might include solo regulated UK subsidiaries of non-UK banking groups, or a UK headquartered firm with branches and subsidiaries elsewhere in Europe, but which is not a subsidiary of a bigger international banking group. Each firm should be considered individually given the significance of this criteria.

An "internationally active" firm must of course apply the full set of Basel standards, according to the Basel framework. Although the Basel framework refers to "internationally active" more than forty times, what is "internationally active" is yet undefined in the Basel framework, meaning individual jurisdictions can decide what this term means. This helpfully provides the PRA with some interpretive leeway.

Although the Basel framework applies on a consolidated basis to internationally active firms, and to internationally active firms at every tier in a banking group, our interpretation is that it need not be applied to non-internationally active firms in an internationally active consolidation group.

For example, the U.S. only applies the full set of the Basel framework to a limited number of U.S. headquartered banking groups. As we understand it, no U.S. subsidiaries of non-U.S. headquartered banking groups are subject to the full set of the Basel framework by the U.S. authorities in respect of the U.S. subsidiary (or group of entities headed by the U.S. subsidiary).

We accept many of these non-U.S. headquartered banking groups are indeed internationally active, but the U.S. component is not considered internationally active by the U.S. authorities merely because they are part of such a group. We believe it would be appropriate for the PRA to take a similar approach in the UK. This would be a key factor in maintaining the UK as a globally significant international financial centre. It is also worth noting that the vast majority of firms in the U.S., including some fairly large banking groups, are not considered to be internationally active and are not subject to the full set of the Basel framework requirements.

Factors that may be relevant in considering whether a UK subsidiary is not internationally active might include (amongst others):

- Whether it has any branches or subsidiaries outside the UK?
- If its customers/clients are mostly in the UK, or with a strong connection to the UK?

The assessment could also be based on the UK firms' deposit-taking activities and the scope of depositor protection schemes.

We believe it would be helpful if overseas issuance of secured and unsecured debt to professional investors and funding arrangements with overseas funding providers or investors such as warehouses could be excluded from the assessment. Such a liability-focused assessment could be augmented by a cap on lending, (but not liquid assets) outside the UK.

The PRA should provide, as far as possible, transparency with regards to their view of a firm's home state regulatory standards, so that the UK solo regulated firm can tailor their levels of financial and non-financial dependencies accordingly.

Q6: What other criteria could be used to determine banks and building societies in scope of a simpler prudential regime?

In general, we support the in-scope criteria outlined in the DP. The complexity of activities should receive a higher weighting than other criteria such as balance sheet size. We note the largest firm not designated as an 'other systemically important institution' (O-SII) has assets of close to £90 billion.

We suggest the following additional criteria that could be used to determine in-scope firms;

- The risk spectrum of lending (secured vs. unsecured, subprime vs. prime, retail vs non-retail).
- Interconnectedness with the financial system, domestic vs international.
- Credit quality of existing book, product types (complexity and number) and whether the firm has a trading book.
- Firms where the Bank of England's preferred resolution strategy is modified insolvency under the provisions of the Banking Act 2009 and relevant secondary legislation.

In the context of ring-fencing, it may be beneficial to consider how those rules would interact with the point at which the rules become mandatory, given the ring fencing rules do not apply to any entity with deposits of less than £25bn.

Whatever the final criteria a proportionate overlay should be applied so that there is no cliff edge effect of excluding a firm from scope.

Q7: Would enabling in-scope banks and building societies to choose whether to operate under a simpler regime be a beneficial feature? How could that feature operate?

We support the approach of allowing firms to opt in/out of the strong and simple regime. The voluntary adoption of the current (or similar to current) rules should be permitted for smaller firms which could otherwise operate within a simplified but higher capital requirement.

The strong and simple approach should be flexible to allow for different business models and growth aspirations and would be best delivered through dialogue between the PRA and the firm. The firm's last ICAAP and the following C-SREP could facilitate such dialogue. There should also be an opportunity for firms to change their opt in/out decision from time to time depending on their circumstances, though we would recognise the appropriateness of a minimum waiting period of a small number of years before modifying a pervious decision.

Q8: Do you have any comments on these other issues related to firms in scope of a simpler regime?

Although we understand the issue, we are undecided as to the level of concern that should be attributed to "systemic as a herd" risks, and the materiality and likelihood of this risk occurring. We suggest this is an issue which is potentially best monitored, including through thematic simplified stress testing, and addressed at a supervisory level, rather than adapting the current proposal, if implemented.

The criteria utilised to determine eligibility for a simpler regime should be based on the size and/or complexity of the firm and should not be based on whether a foreign bank's UK subsidiary is able to share the costs of understanding, interpreting and operationalising prudential rules with the wider group. If the latter criteria were utilised that could automatically exclude UK subsidiaries of non-UK banking groups that have simple business models and are small from benefitting from the proposed regime**.**

Q9: What could capital quality requirements under a simpler regime look like?

We are aware that some of our smaller members do not rely entirely on CET1 capital so disallowing AT1 may lead to inefficient firm structures and/or a smaller number of qualifying small firms. So, we agree with the PRA that existing ATI issues should be grandfathered until maturity/early , but further suggest that the loss absorbency of AT1 merits its continued use in any strong and simple regime, as in our view the existence of AT1 instruments are not materially prejudicial to the PRA's objectives.

As the DP points out, for the smallest firms Tier 2 subordinated debt capital is likely to be more common than AT1 and is simpler in nature. It should therefore be given at least as much recognition under a simpler regime as under the currently. We note however that the Pre-Issuance Notification (PIN) process for new Tier 2 capital could be streamlined by the PRA, perhaps by providing a template form of debt agreement which would avoid the need for an independent legal opinion to be provided for each issuance. In addition, the PIN process for plain vanilla CET1 ordinary share capital could be streamlined and an independent legal opinion only required for instruments with more complex terms. The costs and timescales to obtain an independent legal opinion and follow the PIN process for each issuance can be excessive for the smallest firms, particularly if only modest amounts of new capital are being raised.

Articles 36 to 49 of CRR, setting requirements for CET1 deductions are relatively complex, especially in Article 48. Interpretation of some of these rules and their representation in Own Funds reporting (e.g. in CA5) can be a difficult exercise for a small firm without significant in-house expertise so we encourage the PRA to consider how these could be simplified.

Q10: What are your views about a focused approach based on a simple but conservatively calibrated capital requirement?

We welcome many elements of the focused approach which would reduce the regulatory burden on smaller firms. However, a focused approach as outlined in the DP, requiring significantly more conservative risk weights than the standardised approach, is not likely to be attractive to the smallest and simplest firms, and could reverse much of the effort invested by the PRA and our members in recent years in establishing a more level playing field. The standardised approach already creates a very considerable disadvantage for small firms compared to those with IRB waivers. Box D of the DP highlights the risks that high and non-risk sensitive prudential requirements may incentivise risk-taking activities and we agree with this observation.

Some smaller firms (without IRB waivers) will already have developed internal credit risk modelling techniques and will wish to continue dedicating resource in this area. The PRA must be aware of the risk of unintended consequences where there is no longer an incentive to develop/maintain more sophisticated models for a firm's own internal capital assessment and risk management purposes.

We acknowledge that from the regulatory perspective, reducing complexity of capital requirements will reduce risk-sensitivity, which will result in the increase of capital requirements to reflect a more conservative approach. A balance needs to be struck between having a focused approach without

requiring an unduly conservative capital requirement calibration. As a generalisation, smaller firms are more likely to have less complex capital structures, based on the most expensive CET1 instruments. These firms would want to avoid a higher capital calibration as this is likely to increase the cost of their capital.

It will be important to avoid creating cliff-edges in capital requirements which will discourage organic growth which in turn impacts on competition. Any increases in capital required should be graduated and proportionate. For example, in the current MREL regime, crossing a loosely defined threshold results in a firm facing significant increases in future capital and eligible debt requirements, rather than the incremental capital required being proportionate to incremental changes in risk.

Q11: How could Pillar 1 risk weighted capital requirements be simplified under a streamlined approach?

CCR and CVA credit risk management requirements related to firms' hedging activities benefit from the implementation of EMIR, ranging from risk management, trade repository and central clearing requirements. The PRA should consider that all firms below a certain threshold of exposures be exempt from both reporting and capital requirements for CCR and CVA. Such a threshold could be set at combined CCR and CVA not exceeding 2% of their total capital requirements, given that2% aligns with the Pillar 1 market risk requirement for open foreign exchange positions. Reporting to trade repositories would still permit regulatory monitoring and confirmation that these risks are not building in particular firms. Such a change could possibly be accelerated under materiality assessments without having to wait for the roll-out of the simpler regime.

Some firms might experience that their overall assessment of their operational risk between Pillar 1 and 2A are fixed or semi-variable in nature. Capital requirements are set, however, based on Pillar 1 and linked to one set of metrics (BIA and Standardised) whereas Pillar 2A is linked to RWA, which may not accurately reflect true fixed or semi-variable operational risks. Such firms would welcome a regime that sets a fixed or semi-variable operational risk capital charge without the calibration and implementation challenges of the current Pillar 1 and 2A calculations. For firms with smaller and simpler operations, consideration could be given to setting Pillar 2A add-ons partly or fully on a fixed basis rather than as a percentage of RWA, reflecting that the size of the risks involved do not always scale with RWAs.

Rules about the availability of credit ratings for determining risk weights for exposures to institutions could be simplified. CRR Articles 120, 121 and 131 are quite intricate, with the interplay of the availability of a short-term credit rating and the tenure of the exposure itself resulting in some degree of confusion as to what risk weight to apply.

Given the long lead time firms have had to prepare for and implement the Basel 3.1 standardised operational risk approaches, any significant subsequent variation in requirements, which may they require changes in business models and capital raising timetables, should be implemented over an appropriate transition period.

Q12: How could Pillar 2A capital requirements be simplified for small banks and building societies, while maintaining resilience?

Our smaller members almost universally believe that Pillar 2A is overly complex. It may now be the time to acknowledge that for smaller banks Pillar 2A requirements are redundant. So, we would welcome a regime that is based on a more conservative Pillar 1 approach, the replacement of Pillar 2A by an amount held to cover solvent wind down costs, supplemented by a simplified stress testing

requirement and where necessary RMG scalars. We also believe that there would still be considerable value of scenario/stress testing as part of a firm's own forward-looking risk mitigation activity.

It is appropriate to address this issue as part of the strong and simple regime since smaller banks are primarily affected by the issue. Larger firms are unaffected as they commonly use the IRB approach (which limits the chance of inappropriate risk weights) and are generally less prone to concentration with their more 'universal bank' business models.

Whilst the PRA is considering this more radical proposal of removing Pillar 2A altogether, firms have noted a number of issues the simplification of which would ease understanding of the Pillar 2A process and ICAAP production provide benefits, starting with risk categories:

- Credit Risk: in order to support a more risk sensitive framework, firms would welcome the consistent implementation of the Pillar 2A offset for credit risk, designed to eliminate some of the excess prudence, thus competitive disadvantages of the Standardised regime. Regulators should allow firms to 'offset' excess capital held via the standardised approach against at least the Herfindahl-Hirschman Indicator (HHI) concentration add-on, but more ideally against all classes of risks. This should enable all non-systemic banks and building societies, not just under the simpler regime, to compete more effectively in the residential mortgage market. The offset should only be available where the supervised firm has developed a strong and proportionate credit monitoring and management system. The rules currently allow the PRA not to grant the offset. The PRA buffer (Pillar 2B) is designed address any potential reason for any judgmentally assessed weakness, so firms should not be penalised twice between Pillar 2A and 2B.

- Credit Risk – Retail: given the lack of available data, it may be overly burdensome to ask firms to undertake an analysis of the additional capital requirement resulting from a UK concentration (vs an internationally diversified bank). We suggest that small firms should be able to rely on the PRA benchmark figures provided.

- Credit Underestimation Risk: due to size, it is overly burdensome to ask small firms to develop proxy IRB models to determine whether the Pillar 1 credit number is sufficient. As an alternative the PRA could determine a more granular approach for Pillar 1 Credit Risk, potentially informed by banks' individual portfolios and key risk metrics.

- Credit Concentration Risk – geographic component: the add-on penalises all UK-based focused lending other than residential mortgages subject to the standardised approach. As the focus of the proposals are domestic firms, this element of the concentration risk should be eliminated as the design of the regime, and the calibration of Pillar 1 and 2B calibration should be able to address any concerns. We also recommend that the PRA re-evaluates the levels of granularity that HHI considers, especially the geographic considerations. We also note the HHI calculation takes risk weighted assets as an input, which is overly prudent, exacerbating the particular challenges noted above. Therefore, it's critical that firms affected by the above issue can take a holistic approach across the Pillar 2A credit and concentration risk assessment to ensure an appropriate allocation of capital.

- Credit Concentration Risk – single name component: small firms with limited liquidity and cash management needs will focus their activities with a limited set of counterparties or obligors. We therefore recommend that this risk is covered by a small Pillar 1 requirement. Firms' credit risk management policies are likely to be designed to minimise/spread concentration risk as far as possible (through country & counterparty credit limits. The PRA's PS 17/15 showed the PRA's

intent on giving smaller firms flexibility on treasury exposures (refer to paragraphs 2.29 and 2.30). 'The PRA's methodologies for setting Pillar 2 capital' however fails to mention this. All non-systemic firms, not only those in scope of the new regime would benefit from the PRA re-stating its flexibility through the next update to the Statement of Policy. As most UK banks operate clearing activities from their ring-fenced banks, we trust that the PRA acknowledges that additional capital requirements for such exposure concentrations is unwarranted. Should the PRA not be satisfied that the risk is covered members suggest as an alternative that firms use Wholesale Concentration Risk including Moody's Loss Given Failure approach instead of the HHI approach.

- Operational Risk:
    - It is recommended that we move to a simplified basis for setting Pillar 2A operational risk capital. Significant effort is required to undertake this analysis with results difficult to model due to the lack of data. Furthermore, the AMA approach has been discontinued. We suggest that a base capital requirement could be set, with the PRA applying a PRA buffer add-on only where any material weaknesses are identified in the banks' control environment.
    - Additionally, it would be helpful to align the Operational Risk P2A proposed internal add-on to the incremental operating expenditure incurred because of the stress scenario/testing exercises required to demonstrate Operational Resilience.
    - The PRA could publish the aggregate risk and loss data split but use different business units/asset classes to support firms in benchmarking their own books and to assist in Pillar 2A operational risk assessments, making these assessments simpler and less costly to carry out, rather than asking firms to pay for external benchmarking data that may not have a relevant set of peers in that data set.

- IRRBB: The supervisory outlier test levels are set sufficiently conservatively, which makes the supervisory view largely redundant in setting Pillar 2A requirements.

- Pension Obligation Risk: smaller banks are likely to have to rely on a third-party providing valuations that can then be stress tested. We believe that it's appropriate to continue broadly with the same Pillar 2A (fixed) analysis, however the requirement should be restricted to the two PRA scenarios rather than banks having to develop their own scenario. In addition, rather than using the (2016) stress parameters, acknowledgement that applying and developing stress scenarios analogous to those provided by EIOPA is an appropriate methodology would be welcome.

Setting Pillar 2A by the PRA

Whilst our first preference would be the elimination of Pillar 2A and it replacement by a solvent wind-down add on, should it continue we would welcome further engagement with the PRA on:

- Business Planning: it would be helpful in terms of business planning and capital requirements if the PRA could share with firms the methodology used to calculate Pillar 2A requirements.

- Bank Failure: if the failed bank is to be bought this will have a potential impact on the purchaser which will still be subject to the full capital rules. A failed firm may not be subject to the O-SII buffer, but the potential purchaser could be, which may be a barrier to the successful rescue of the failed firm. The PRA may wish to consider any transitional allowances that may encourage firms subject to the O-SII to rescue failed firms subject to the proposed regime. One potential course of action could be a proportional reduction in the Pillar 2A capital charge.

Q13: In what ways might the setting of capital buffers be simplified under the simpler regime?

We suggest that were more conservative Pillar 1 risk weights to be introduced, the requirement for CCyB and CCB could be removed completely. They introduce extra levels of complexity and are not relevant for smaller firms.

Our understanding is that the CCyB is principally designed to ensure systemically important firms do not reduce lending to the economy in a time of stress, as well as to disincentivise increasing lending into a bubble, and the buffer is built up when the economic cycle is perceived to be peaking, then released as it turns down. We understand that there is no expectation that non-systemic firms should continue to lend in the event of an economic stress, suggesting the CCyB requirement could be removed. The PRA already allows for use of the CCyB in a time of stress, so alternatively the use of the buffer could also be allowed if sufficient evidence is provided to the PRA by a firm, to show that associated risk is acceptable.

A key concern with the CCyB is that when it becomes applicable in the UK, it will impact UK firms indiscriminately i.e. the 'pass through' is 100% and then applied to all RWAs, including those related to Operational Risk, nostros, and even fixed assets.

The CCyB is a particularly difficult requirement to forecast, as the FPC typically only provide visibility up to 12 months ahead and the CCyB can vary between the current rate of 0% and 2.5% of risk weighted assets (RWAs) in a standard risk environment. This means that firms may only have 12 months' notice of an increase in capital requirements of up to 2% of RWAs, which could cause them to hold a buffer "above the buffers" in anticipation of future increases in the CCyB rate.

The P2B stress test which is performed as part of the ICAAP process is a particularly complex exercise for the smallest firms that use internally developed stress testing models. This can increase key person risk where expertise is often concentrated in a few individuals. Setting the combined buffer requirements (CCB, CCyB and PRA Buffer) at a fixed percentage of RWAs this would provide greater certainty and simplicity in forecasting future capital requirements. This outcome is perhaps more desirable for the smallest firms that do not anticipate transitioning to the IRB approach in the medium to long term, and hence where the sophistication of internal stress testing is less critical. In any case, whatever capital buffers, firms would still of course need to hold sufficient capital to reflect its risks, which can be covered flexibly by P2A or the P2B as at present.

As a more general point, internal models vary in complexity and suitability across the industry. The PRA could provide templates for firms to calculate this buffer. This will reduce the requirement for expertise in this field. This template could include the 3 to 5year business plan and capital requirements and the effect of a stress. In addition, based upon the PRA's "sight of data", the P2B requirement could be set as a simple multiple of the Pillar 1 assessment for credit risk, noting that ECL for the next 12 months is captured as under stage 1 for IFRS9, based upon RWA exposure by stage.

More information could also be provided by the PRA in terms of stress testing assumptions for smaller firms. Whilst macroeconomic assumptions are provided, more information on the impact on balance sheet size would be useful. Furthermore, the PRA could produce aggregate data on the impact of the stress on impairment rates for different products stemming from their own models. This would help firms benchmark their outputs.

Overall, we believe the CCyB and CCB buffers are overly complex for simple firms and should be replaced by a standard extra percentage add-on over Pillar 1, although this would not absolve the firm of the need to continue to undertake stress testing. Our first preference however would be their total removal.

Q14: How could the ICAAP be improved and simplified for small firms?

As we note above our radical suggestion entails a removal of the requirement to produce an ICAAP, but its replacement by a simplified stress testing process and solvent wind down requirement. Members tell us that one of the largest ICAAP burdens on small firms is the stress testing requirement. We believe that many firms would still expect to undertake tailored stress testing for their own internal management purposes, for instance for dividend and capital planning purposes, but a cut down regulatory stress testing would be welcome.

Were the PRA not to accept our suggestion of eliminating the ICAAP,, a simplified ICAAP submission template would be helpful for smaller firms, and would also reduce the volume of subjective and often contradictory findings raised by those reviewing the ICAAP document such as the PRA, internal auditors and external auditors. The instructions for these returns may benefit from being clearer and more specific, based on learnings from previous submissions to reduce the scope of multiple interpretations or the need for external advice. It would be preferable if the various FSA071-FSA079 Pillar 2 returns which are submitted as part of the C-SREP process could be simplified or preferably replaced by existing COREP returns.

Again, if the PRA did keep the ICAAP, the PRA should assess whether it could consolidate the ICAAP, ILAAP, RRP & SWD (Strategic Financial Resource Assessments) into a single document, for example, an Annual Strategic Financial Resource Management Assessment. We believe there is significant overlap in a number of areas, such as stress scenario analysis, and management actions prior to the point of non-viability, for instance and whether to mitigate, recover or wind-down the firm. This approach would also be relevant to the issues addressed in questions 16 and 17.

It should also be noted that the ICAAP, ILAAP and other major PRA driven exercises do take up significant Board time and require significant NED expertise. There is a point where they could dominate to the detriment of time spent on running the business (strategic and day-to-day management), which is also important. From a resource perspective, lightening the board burden without reducing risk awareness or quality of governance would be helpful. Similarly, we expect the PRA expends significant supervisory resource on the analysis of even small firms' ICAAPS, which could be better deployed elsewhere. As we note above one potential route would be placing smaller firms ICAAP and ILAAP processes on a two-year alternating review cycle in alternate years for smaller firms.

Q15: How could liquidity requirements be simplified while maintaining the resilience of small firms?

Alternatively, if the current requirements are left in place, but the PRA allows for a greater tolerance, this could allow firms to maintain LCR and NSFR as prerequisites for future growth, provide the PRA with a high level of transparency around liquidity risk and allow technical LCR/NSFR breach levels to be viewed proportionately, on a firm-specific basis.

A streamlined approach involving just the LCR would reduce the volume and complexity of liquidity reporting and would allow firms to focus on a single overarching metric. It might be possible to

incorporate an element of intraday risk within the LCR to further reduce the volume and complexity of liquidity reporting.

Alternatively and optionally, if a firm chooses to continue to comply with current LCR and NSFR requirements but the PRA allows a greater tolerance of firm specific technical LCR/NSFR breach levels, firms could maintain LCR and NSFR providing the PRA with a high level of transparency around liquidity risk, whilst to be viewed proportionately, smoothing the path to layer-transition as they grow.

In any case, a reduction in the overall volume and complexity of liquidity reporting would be a highly desirable outcome for smaller firms. The assessment of intraday liquidity is particularly difficult to calculate and assess for small firms. It's resource intensive due to the volume of data needed to calculate the assessment. The PRA could simplify the calculation by using a simple ratio.

It should also be noted that the HQLA of many of the smallest firms will comprise predominantly reserve accounts held with the Bank of England. A precursor to holding a reserve account is to become a member of the SWIFT network which requires compliance with the Customer Security Controls Framework (CSCF) and independent assessment of the controls in place. These ever-increasing requirements are particularly onerous and costly for the smallest firms and would certainly benefit from simplification.

For the smallest firms the costs of pre-positioning eligible collateral with the Bank of England under the Discount Window Facility can be prohibitive. The initial costs of confirming the eligibility of level C loan collateral (data audit and legal review) have been estimated at between £25k and £100k. A simplified process to confirm eligibility would be desirable for the smallest firms, although we recognise that this is outside the PRA's area of responsibility..

Q16: How could the ILAAP be improved and simplified for small firms?

As we note above, we believe the removal of the requirement to prepare an ICAAP, coupled with higher Pillar 1 requirements would significantly ease the regulatory burden on smaller firms.

If the status quo is maintained however, consideration will need to be given for any unintended consequences of any changes. For example, if the ILAAP-focused approach was to keep the LCR and NSFR, but the streamlined approach resulted in their removal, this could actually have a negative impact and result in more complexity, particularly given that many firms use them as central metrics in their liquidity management policies for business as well as regulatory purposes.

It would be open to the PRA to consider reverting to a version of the ILSA approach which was previously available to firms under £250m-£1bn balance sheet size rather than the current "one size fits all" approach.

A simplified ILAAP submission template would be helpful for smaller firms and might include optional sections which are not required for simpler firms, such as transfer pricing mechanisms. This might also reduce the volume of subjective and often contradictory findings raised by those reviewing the ILAAP document such as the PRA, internal auditors, and external auditors. The ILAAP rules contained in SS24/15 apply to all firms regardless of size. This can result in documents which are too big and not representative of the complexity of the firm. The need to assess all 14 risk drivers and Pillar 2 risks is not required. The set should be revised and cut down for smaller firms. This can be performed by assigning the risks to the types of firms, e.g. internalisation risk is focused for broker dealers only.

The ILAAP process consists of several components, including policies and processes, which have already been reviewed and challenged by relevant Executive and or Board level Committees throughout the year. Rather than submit an annual ILAAP report to the management body and PRA, describing these processes in a large document, an alternative would be for simplified firms to submit a brief document. This document from the management body would provide its assessment of the how the firm meets the OLAR and explains its main supporting arguments, based on having the previously mentioned ILAAP processes in place.

Alternatively, several sections of the ILAAP could be removed and put into an appendix (i.e. business model, financial position and plan, regulatory liquidity reporting etc.) as these are all well-understood areas for firms and can detract from the focus on the sources of risk, current funding plan, liquidity stress testing and conclusions.

Equally there could be reduced requirements for a firm if it had demonstrated historic (and forecast) liquidity above a particular threshold e.g. LCR in excess of135%. If a firm had, and was expected to continue to meet, this regulatory threshold then there could be the option to reduce its regulatory obligations with respect to the detail of the ILAAP in return for the support of the higher buffer.

There could also be a two-year update cycle for the ILAAP in alternative years to the ICAAP, which would be a more proportionate approach for very small firms.

As discussed in this response, there is an opportunity to combine reports to create simplicity. The ICAAP and ILAAP could be more aligned, creating a consolidated capital and liquidity assessment to accompany formulation of an institution's strategic plan. We support the focus to reduce the number of regulatory returns specifically where a lot of the information is duplicated across several returns.

Whatever the outcome of the policy developments proposed in this DP, the PRA should also assess the aggregate risk of non-systemic firms being insufficiently protected from liquidity shocks. Internal governance and audit expectations would continue to be met, especially in reference to stress testing.

Q17: How could recovery planning be extended to cover solvent wind-down planning under a simpler regime?

To ensure no sector-wide unintended risks of disorderly wind-down from smaller firms, solvent wind down planning (SWD) should run alongside recovery planning. We see solvent wind down planning as the substitute for the removal of Pillar 2A and ICAAP requirements as we have described above, although there would need to be more clarification along the lines of PS9/17 about the required liquidity and funding resources over the expected solvent wind-down period.

Given that for most simpler firms the contents of the recovery plan and SWD would not be expected to change significantly from year to year, a requirement to update each document in alternate years would be a helpful simplification. Furthermore, the resolution pack might only need to be reviewed once every three years, subject to there being no material change in the business in intervening years.

Q18: How could governance, remuneration, and risk management aspects of the prudential framework be made simpler for small banks and building societies?

In terms of governance, requests for information on applications for approval of SMFs can sometimes be quite unnecessary, particularly where the individual has already been approved. Whilst the Senior Managers & Certification Regime has driven accountability and ownership across the organisation, which is beneficial, it is noted that the complexity of definitions combined with the ongoing

administrative burden of annual requirements has a disproportionate effect in smaller firms. The process of applying for SM&CR approval could certainly be streamlined for smaller firms, with a simplified Form A application, perhaps based on multiple choice questions and proforma templates for responsibilities maps & matrices, statements of responsibility etc. Time-limited approvals might not be the best solution as this could simply defer the problem if the individual is not approved at the end of the period, and the public visibility, through the FS register, of the time-limited status of the individual concerned might have unintended reputational consequences for the individual.

The size thresholds for the allocation of a longer list of prescribed responsibilities could also be reviewed and increased.

The remuneration policies for smaller organisations can be onerous and disproportionate compared to larger firms and could also impact the recruitment of talent. A helpful simplification for smaller firms would be to increase the de-minimis threshold monetary value above which the malus, clawback and deferral arrangements apply in respect of variable remuneration.

Q19: Are there aspects of the PRA's prudential policy on operational resilience that you think could be simplified under a simpler regime?

Given that both operational resilience and outsourcing are under considerable discussion across UK firms now, we would ideally wait for the outcome of these various conversations before this point can be properly addressed.

However, smaller firms could be made exempt from the obligation to update the outsourcing register, if their third-party risk management framework is deemed robust by their supervisory team.

The need for dual-regulated firms to evidence consideration for Maximum Tolerable Disruption (MTDs) thresholds for both FCA and PRA policies (when the lower will now suffice) seems superfluous and is something that could be further simplified (i.e. a single FCA policy requirement).

The PRA could also consider aligning Important Business Service to that of the FCA's (i.e. client focussed rather than considering the firm's safety and soundness), which would provide the benefit of consistent client focus.

The PRA could publish the aggregate risk and loss data split but use different business units/asset classes to support firms in benchmarking their own books and to assist in pillar 2 operational risk assessments, making these assessments simpler and less costly to carry out. As a wider point, the PRA have significant access to aggregate industry data. We recognize that the PRA publishes some of this in aggregate, such as the Mortgage Lenders and Administrators Return (MLAR). Publishing more of this in aggregate would support smaller firms' assessment of risk.

Q20: What, if any, Pillar 3, and other disclosures should be required for small banks and building societies?

We note that some firms' disclosure requirements are already more limited than others, which may limit actual resource savings from reduced the disclosure requirements. Firms and the PRA should examine the trade-off between lower levels and disclosure and the ease of raising capital. We note that ESG expectations are also relevant, and in practice many firms would still choose to disclose.

It is arguable that Pillar 3 disclosures in practice tend only to provide significant benefit for larger firms. The resource that goes into Pillar 3 reporting for most firms in this bracket will be disproportionately

high compared to the benefits received. Removing the requirement for Pillar 3 disclosures for the smallest firms would remove this potentially onerous reporting requirement and allow firms to focus on improving the quality of disclosures in the annual accounts.

Q21: Would a more 'focused' or a more 'streamlined' design approach best deliver the objectives of the simpler regime?

A binary choice between streamlined and focused for the entire industry may not be optimal as many members will find most benefit in the middle ground, maximising the advantages of the two approaches. However, an approach where both a focused and a streamlined regime is available with clear transition paths may support the right objectives for each firm and their growth plan.

One potential benefit of the streamlined over the focused approach is that it enables smaller firms to develop expertise in a part of the full set of rules that will be useful when they grow and must apply the full set. This will be more useful than having to learn an entirely new set of rules as they transition from a potentially focused set of rules to the full set of rules.

Given that firms have already invested heavily in achieving compliance with the existing set of diverse and often complex regulatory requirements, the streamlined approach is more likely to appeal than a simpler but more conservative focused approach. However, if the PRA did opt for a more streamlined approach, we would caution the PRA against stripping back too many of the existing processes they have currently have in place, which are important for firms' own risk management and governance.

In summary, if asked to choose, members would likely support a flexible yet streamlined approach, providing proportionate regulation whilst allowing the freest transition to more comprehensive mainstream prudential regulation as firms grow in size or complexity**.**

Q22: Are there other areas of the prudential framework, including options for simplification that should be considered when developing the simpler regime?

We recommend that the PRA undertakes a thorough review of regulatory lexicon to ensure it supports both regulators and firms. Many of our members have difficulty understanding (often due to resources restraints) the full set of regulatory expectations, expressed in letters, speeches, policy and supervisory statements etc. Much of the challenge with dealing with complexity by all firms of all size is the lack of a single source for regulation with appropriate references. Having onshored EU regulation, there is an opportunity to create a single, central hub for all regulation with a tightly built guide and topical reference manual between prudential and other reporting requirements to consolidate CRR, EBA RTS and ITSs, PRA SSs, EBA Q&As into a single, comprehensive and credible source of information would be a major but nonetheless welcome achievement.

Examples of areas which could be reviewed include:

- <u>Assigning risk weights</u>: More specific examples could be provided by the PRA on how these should be applied, for example, when netting out exposures to counterparties etc. It would be beneficial if the PRA increased its availability to support smaller firms in making these decisions, rather than firms having to pay for costly legal advice which may not be in line with the PRA's views. The Pillar 2A concentration risk HHI is particularly complex (even with the PRA small firms' discount), and more clarity about how this is calculated would be helpful.

- Operational deposits with the LCR: it can be challenging for some members to understand the supervisory expectations relating to the classification of operational deposits within the LCR. More clarity on definition and regulatory views on how this should be calculated by firms would be helpful.

- Stress testing: it would benefit the smallest firms to simplify the various stress testing frameworks which are required, i.e. within the ICAAP, ILAAP and Recovery Plan as well as Reverse Stress Testing. A set of graduated standard scenarios, or more specifically a defined level of impact severity expected for each type of stress test, would be helpful. The need to devise specific plausible scenarios and keep these relevant to the current economic environment is of less importance than the need to demonstrate resilience to a generic scenario of a specified severity.

In due course the PRA should consult with the industry as to which requirements could be clarified/reviewed. A roadmap to any gradually increased regulatory expectations for firms in the strong and simple approach would be beneficial, along the lines of PS8/21.

Q23: Were they introduced, would the policy options taken together have a significant impact on the complexity of prudential regulation for smaller banks and building societies?

In the aggregate these options would potentially reduce the level of complexity of regulation, although we note that relative commercial attractiveness might be diminished if this resulted in additional levels of conservatism in underlying capital requirements and/or the creation of a 'cliff edge' which might become a disincentive or barrier to the aspiration of longer term growth.

Whilst it is difficult to predict the precise quantum of the overall policy impact of the options outlined, achieving greater regulatory simplification, particularly for the smallest firms, is a worthy outcome so we fully support the introduction of the policy options proposed in the DP.

Q24: How could the reporting requirements be simplified for small banks and building societies? What are the key data small banks and building societies should be required to report?

UK Finance and its predecessor organisations have long called for more efficient and targeted reporting requirements. A reduction in the overall volume and complexity of liquidity reporting would be a highly desirable outcome for smaller firms who currently have to submit PRA110, LCR, NSFR, AMM, Intraday liquidity and the Treasury Assets template, as well as for our mid-tier members..

The introduction of the PRA 110 provides the PRA with a comprehensive view of firms' liquidity and funding profile. UK Finance members would welcome the prompt elimination of the C66, which is duplicative. We would also seek that the PRA review internally their use of the remaining ALMM templates, C68 to C71. Firms' experience from queries (or lack thereof), is that these European templates are scarcely used by the PRA. Should that be the case, they should be eliminated, submission frequency reduced or only required in real or perceived times of firm-specific or wider relevant stress events. In the same reporting suite, there is a specific duplication between the C71 template and the Treasury Asset Return, either of which could be eliminated. The PRA could work with the Bank of England and prevent any duplication of PRA returns and BoE statistical data returns so that just one return on a firm's balance sheet is required. We hope that the PRA would be open to reviewing the need for these returns and look to eliminate duplication without waiting for the proposed new regime.

Another option to reduce the regulatory reporting burden would be to utilise the RegData platform for all reporting, i.e. eliminating all other platforms such as OSCA and BEEDS. Ad-hoc returns which remain in place for over 12 months such as Loan Book data, Basis Risk, Intraday Liquidity, Treasury Assets etc should be systemised via RegData wherever possible to aid automation.

The PRA has an opportunity to consider streamlining FINREP and COREP reports. It would be very beneficial to reduce the amount of duplication and additional splits which are required in the returns. For example, counterparty or product type splits which are included in FINREP (Tables 4 & 8). The PRA could also consider all reporting being on a quarterly basis. Undertaking a review of what data is necessary for them is something that would benefit firms of all sizes.

Reporting is another area that would benefit from a clear, connected and accessible set of rules, supported by a Q&A process, which informs ongoing guidance. Ideally the PRA would develop enhanced explanatory materials around prudential reporting. The materials could cover interpretation clarifications and best practice guidelines on governance and data control, and be written in an easy to understand format.

In any case, this is a key issue, and the depth and detail go well beyond answering in this paper, and we would welcome further conversations with the industry about the reformation of regulatory reporting.

Q25: How would an approach to changing the simpler regime be best implemented?

A simpler regime should evolve predictably, to match the resources available to smaller firms. It would depend on the overall systemic risk assessment made by the regulator about smaller firms in aggregate, should firms' transition to a simpler regime be difficult to achieve in the desired timeframes.

The regulatory expectation of smaller firms would continue to need to be compatible with the regime for larger firms so that as smaller firms growth, any transition up the layers is not difficult to achieve.

However, we would welcome the PRA fast tracking simplification and elimination of requirements on the basis of materiality, without the need to wait for the full implementation of the simpler regime, e.g. the elimination of counterparty credit risk and CVA changes or tactical reduction in reporting requirements. Another example is the minimum loss coverage for non-performing exposures. Some of these changes could show early benefits of reducing reporting requirement without a meaningful risk to the PRA's objectives.

Consideration of a floor for the reporting of Top 10 credit institutions and unregulated financial entities in the large exposures reporting framework. The absence of a floor could result in the reporting of immaterial balances which offer potentially little benefit.

Once the regime has been agreed then implementation should be switched on immediately, so smaller firms can benefit from the new regime.

Q26: How should transition arrangements be designed?

Any changes introduced as a result of a strong and simple review should be well signalled in advance with a final year of "business as usual", which would give the PRA the opportunity to create a baseline against which to compare firms in the future.

Subsequent transitioning “up” the layers from small to big should avoid insurmountable steps for growing firms and should have “phase in” periods to allow time to adjust and plan (e.g. criteria assessed over more than one year). Implications for firms that are growing should be considered when shaping the proposed approach. Calibration of regulatory tiers should have overlap and supervisory discretion and be used as a route-map for growing firms rather than a strictly mechanical framework. The speed of transition (six months, twelve months) would need to be proportionate to the firm and associated costs and risks. The existing supervisory relationships should facilitate this.

We support clear intermediate requirements between the simplest requirements through to the most complex with clear criteria attached to each. We recommend the timing of reviews of all interlinked transitional arrangements (IFRS9, SREP, ICAAP) to be undertaken at the same time, which would assist with business planning.

Eventual implementation should consider including transitional arrangements similar to accounting and tax legislation implementation, which whilst allowing for early adoption, invariably includes provisions and thresholds that trigger compliance requirements on an incremental basis and also incorporates phasing over an agreed timeframe through to full compliance. Similar provisions would also be helpful in managing the transition between regimes or tiers to avoid cliff edge change for institutions caught on the boundary.

Q27: Would it be preferable to have few or many layers in a strong and simple framework for non-systemic banks and building societies?

There should be fewer, rather than many defined layers to provide a broad framework for firms without creating inherent complexity (see question 3) supported by close collaboration between firm and supervisor to drive outcomes.

Q28: Would transitional arrangements or the optionality feature help to reduce the risk a graduated framework increases barriers to growth?

We believe they would, but the key priority is that a simple framework does not limit growth possibilities or lead to a difficult step-up in future / send a poor message about growth aspirations. We strongly support the inclusion of an optionality feature, as it is very important firms can make decisions based on their own idiosyncratic objectives. More generally, we support a transitional arrangement/period for introduction of the changes, we would recommend further consultation with the industry on how best to achieve this.

One of the key barriers to growth is the journey to obtain an A-IRB waiver. At the heart of the issue is the single largest potential cliff-edge for a firm’s growth opportunity. The binary outcome of a long process associated with all the uncertainties of timing the regulatory review and approval process paralyses decision making. The reason for this is the significant difference in the capital required to support mortgages between the Standardised Approach and the A-IRB, particularly for safe, low LTV mortgages.

Growing firms might hesitate to deploy scarce capital into assets without visibility or certainty of how capital requirements for such assets evolve over their economic life, acting as a barrier to growth. Alternatively, firms may use various techniques, such as whole loan sale, white-labelled origination on behalf of investors or securitisation to optimise their deployment of scarce capital.

Aspiring A-IRB firms would invite the PRA to consider a transition regime in terms of balance sheet coverage requirements, and in particular to allow the experience gained from originating and maintaining the servicing and performance records of such mortgages to qualify towards the coverage

requirements. We also suggest the PRA grants an A-IRB waiver permission, on a conditional basis, allowing firms to recognise some of the benefits as they mature into full IRB status over a specified transition period, and considers proposing a way to addressing a smoothing of the road to A-IRB.

Q29: How should the introduction of a simpler prudential regime for small banks and building societies be co-ordinated with the forthcoming introduction of Basel reforms?

It would be prudent to align the regime as closely to the Basel reforms as achieving the PRA's objectives for the framework allows. The optionality to remain in the full set of the Basel framework should be maintained (even if eligible for a strong & simple regime). This will be particularly relevant for firms that might be near a threshold and do not want to switch to the strong & simple regime only to have to subsequently return to the full set of the Basel requirements.

Despite the imminent introduction of the Basel reforms, progress on introducing the simpler prudential regime should not be delayed as it will greatly assist firms' business planning to have visibility of future simpler requirements even though these may not be implemented for a number of years. The timing is important as it would not be efficient for firms to implement the (more complex) Basel 3.1 requirements and then change to a simplified regime.

Q30: Do you have initial thoughts about policy options for the parts of the strong and simple framework that would apply to non-systemic banks and building societies that would not be in scope of the simpler regime?

The PRA may consider other entities that are involved in the market but not subject to the same level of regulation, for example, "shadow banks". It is important when setting the regulation and capital requirements for the firms in scope of this framework to recognise that there will be other (generally larger) market stakeholders who are not subject to the same requirements, and to ensure those smaller firms are not at a competitive disadvantage.

Proposals detailed above should not, in all instances, be applied just to the simpler regime. Rather they should also be considered when looking at non-systemic firms that do not fall within the lower simpler layer of the Strong and Simple Framework.

Annex 1

A Strong and Simple regime for smaller banks and building societies

A possible approach

topic	suggested approach	comment
scope	The threshold should be set to exclude [half] of the firms authorised as licensed deposit takers based on RWAs	The risk sensitivity of RWAs is a more appropriate metric than total assets
Supervisory approach	More minimalist approach using desk-based peer group analysis	Some firms welcome the 'advice' and support they currently receive from their supervisors.
Pillar 1	Capital requirements based on Basel 3.1 standardised approach	At what level could the P1 requirement be set? • *10 ½ %?* *Current median P1 + P2A of lower 50% of deposit takers*
Pillar 2A	Removal of Pillar 2A requirements	The risks covered in P2A are complex for firms to compute and investors to understand. They could be replaced by: • *a one-size-fits all scalar, depending on the level at P1 capital is set* or • *a variable, firm dependent add-on, RMG type scalar -*
PRA Buffer	Removal of PRA buffer requirements	• *replacement by ongoing requirement to stress test to inform a firm's own management buffers* • *expectation that firm would undertake no fewer than 3 scenarios, including ACS* • *RMG add-ons to be assessed separately by PRA*
Large exposures	No greater than 10% of CET1	With removal of Pillar 2A there will no longer be a complex HHI calculation requirement Preserve exemption for exposures to clearing banks as per current CRR for banks with small capital base.
CCyB	Removal of CCyB	CCyB designed to ensure no reining-in of lending by systemic banks in a downturn. Not relevant for non-systemic banks.
CCB	Removal of CCB	Use of more conservative Standardised Approach and possible scalar removes the

		need to conserve capital. Firms will hold management buffer based on stress testing
Liquidity	Removal of need to calculate LCR and NSFR and replacement by a Mismatch Regime[1]	Limits on the mismatch between a bank's inflows (assets) and outflows (liabilities) within different time bands on a maturity ladder - next day, one week, one month, three months /estimated solvent wind down period
Customer deposits	No more than [10%] of retail customer deposits to exceed FSCS limit	Whilst most depositors with smaller firms do not exceed FSCS limits a few do
Stress testing	Firms to undertake no fewer than 3 scenarios, including ACS	No reg capital impact but results to inform firm's own management buffers
Recovery planning	Continuation of relevant, credible, recovery plans, executable in a severe stress	Frequency of submission? • biannually
Resolution planning	Failed firms must maintain continuity of access to their critical functions	Frequency of submission? • biannually
Solvent wind down	Firms to hold 6 months of operating expenses	Frequency of calculation? • Biannually operating expenses to exclude costs that would not be incurred in a wind-down, e.g. marketing expenses
Risk Management & Governance scalars	Possible addition of RMG scalars	In a regime with less supervisory engagement how would PRA assess need for RMG scalars
Leverage ratio	[5%] Leverage ratio	Higher leverage ratio to compensate for less frequent supervisory oversight
Capital composition	CET 1 only, plus grandfathered AT1	But note that Tier 2 capital is simpler to issue and more cost effective for some small firms.
Pillar 3	Removal of Pillar 3 disclosure requirements	The only users of Pillar 3 reports by smaller firms are other banks & building societies
Regulatory reporting	Reg reporting limited to high level capital and liquidity, plus loan book quality	Use pre GFC CEBS 2006 regulatory reporting 'core' templates

[1] See DP07/7 paras 5.6 to 5.12