



BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Annual Competition Report 2016

Prudential Regulation Authority

Annual Competition Report

June 2016

This is the Prudential Regulation Authority's (PRA) first *Annual Competition Report*. It has been produced in response to a request from the Government included in HM Treasury's 2015 Productivity Plan (*Fixing the foundations: creating a more prosperous nation*) that the PRA should publish an annual report setting out how it is delivering against its secondary competition objective (SCO) and, in particular, 'the steps it is taking to drive more competition and innovation in financial services markets and to help ensure that the right incentives exist for new banks to enter the market'.

The PRA's secondary competition objective, as set out in Financial Services and Markets Act 2000, came into force on 1 March 2014 and states that:

'When discharging its general functions in a way that advances its objectives, the PRA must so far as is reasonably possible act in a way which, as a secondary objective, facilitates effective competition in the markets for services provided by PRA-authorised persons in carrying on regulated activities'.

Part 1 of this *Report* explains how the PRA has interpreted the SCO, including how it relates to the PRA's primary objectives of promoting the safety and soundness of PRA-authorised persons and insurance policyholder protection. It also sets out the steps the PRA has taken to implement the SCO and embed it into PRA policy and supervisory decision-making. This work has been given significant focus and impetus by the work of the Bank's Independent Evaluation Office, which undertook a review of the implementation by the PRA of its secondary competition objective. The review's findings, recommendations and the PRA's management response are set out in Part 1 of the *Report*.

Part 2 of the *Report* sets out examples that demonstrate some of the ways in which the PRA is delivering against its secondary competition objective and thereby facilitating effective competition. This includes the PRA's work in facilitating market entry; applying the principle of 'proportionality' internationally and domestically; considering competition issues in structural reform; implementation of macroprudential policy; and the PRA's review on internal ratings based models. Future PRA *Annual Competition Reports* will focus on material included in Part 2 of this *Report*.

The PRA is committed to being open and accountable in the performance of its responsibilities and in the use of its powers. This *Report* is intended to help achieve this.

**© Prudential Regulation Authority
copyright 2016**

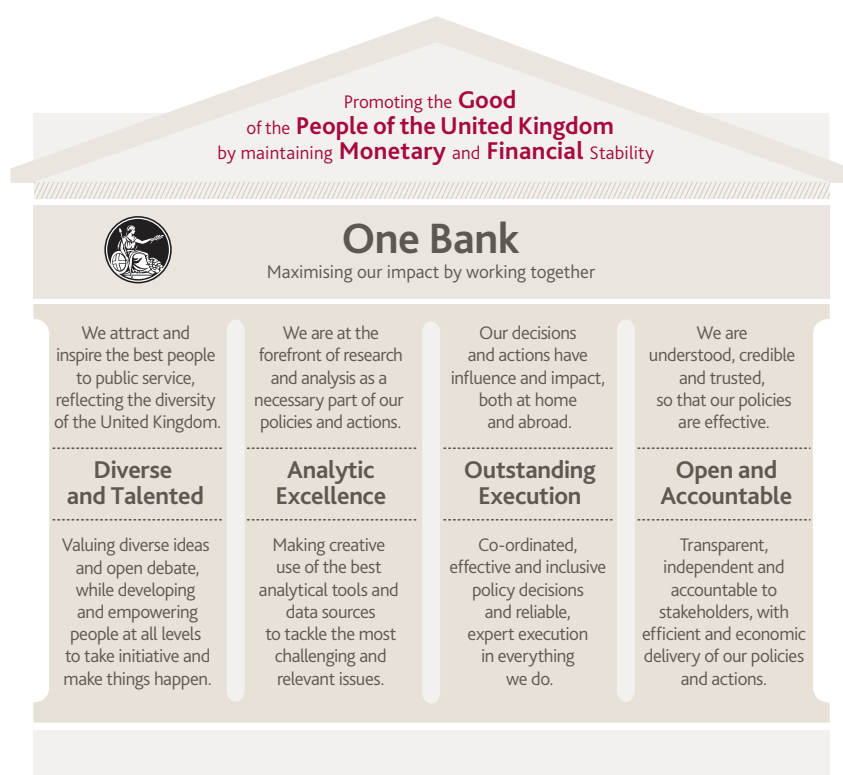
The text of this document (this excludes, where present, the Royal Arms and all departmental or agency logos) may be reproduced free of charge in any format or medium provided that it is reproduced accurately and not in a misleading context.

The material must be acknowledged as Prudential Regulation Authority copyright and the document title specified. Where third party material has been identified, permission from the respective copyright holder must be sought.

Any enquiries related to this publication should be sent to us at enquiries@bankofengland.co.uk

Contents

Abbreviations used in this report	3
Foreword by the Chief Executive	4
Part 1	7
1 Interpreting the secondary competition objective	7
2 Implementing the secondary competition objective	10
Part 2	16
3 Application of the secondary competition objective in the work of the PRA	16





Abbreviations used in this report

CMA	Competition and Markets Authority
CP	Consultation Paper
CRD	Capital Requirements Directive
EEA	European Economic Area
FCA	Financial Conduct Authority
FPC	Financial Policy Committee
IEO	Independent Evaluation Office
IRB	Internal Ratings Based
LTI	Loan to income
LTV	Loan to value
NBSU	New Bank Start-up Unit
NDF	Non-Directive Firms
PRA	Prudential Regulation Authority
PSR	Payment Systems Regulator
RFB	Ring-fenced bank
SCO	secondary competition objective
SIMR	Senior Insurance Managers Regime
SMR	Senior Managers Regime
SRPC	Supervision, Risk and Policy Committee

Foreword by the Chief Executive



Andrew Bailey
Deputy Governor,
Prudential Regulation
and Chief Executive of
the PRA

The PRA's secondary competition objective came into effect in March 2014. It was an important step, representing the first time that competition was formally embedded into the objectives of the prudential regulator of banks and insurers in the United Kingdom. Moreover, to the best of my knowledge, this is not an arrangement that is common in other countries.

There is no reason why effective competition should undermine prudential standards that emphasise the safety and soundness of firms and the stability of the financial system. I would draw a clear distinction here in terms of the meaning of 'effective'. Past experiences in the United Kingdom have demonstrated amply the scope for unstable competition, based on firm business models that are not viable, to undermine the objectives of the prudential regulator. An emphasis on stable competition, which encourages long-term viability, will promote the prudential objectives of the PRA.

There are many aspects of stable competition, only some of which are directly relevant to the policies of the PRA. In my view, an important contributor to stable competition is to ensure that the orderly failure of firms is possible. An industry in which firms cannot be allowed to fail is also likely to be one in which very few firms seek to enter and compete with well entrenched, established participants. This has been the pattern for a long time in UK banking.

Therefore, solving the too big, or too important, to fail issue for UK banks is not only a sound prudential objective, but also good for competition.

Likewise, a world in which the buffers of loss absorbency required to be maintained by banks are markedly higher for the small relative to the large firms is inconsistent with effective competition. But more than that, such an arrangement will, as we have seen in the past, tend to push smaller firms to take more risk per unit of assets on their balance sheet, with bad consequences. So again, our prudential and competition objectives naturally point in the same direction.

The PRA's competition objective is limited because we are not a front-line competition regulator. The focus is strictly on the impact on competition of our general policies. It is therefore not about how we supervise individual firms, but about how we form our general policies. The competition objective

has already played an influential role in the PRA's key areas of policy. These include applying the principle of proportionality to domestic regulations, such as the reform of the Pillar 2 capital regime for banks and governance regimes, work on mortgage loan to income ratios and structural reform. We have also undertaken other activities that are important for competition, including our policies on new bank authorisations. The PRA has authorised fourteen banks, and currently we have a substantial pipeline of interested parties. The PRA also co-operates closely with a number of domestic and international stakeholders on competition issues. One particular example is the PRA's research work that assisted the Competition and Markets Authority on its retail banking market inquiry.

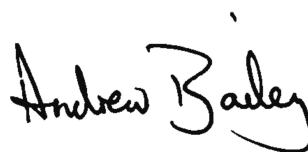
During the last year, the Bank of England's Independent Evaluation Office has carried out a review of our implementation of the secondary competition objective. The review was published in March. It has confirmed that competition issues are prioritised when the PRA designs its prudential policies, that the objective is generally well understood by PRA staff and that sustainable structures and processes have been put in place to embed the competition objective into the PRA's work.

The review has rightly shown that there is more to be done to communicate the PRA's

approach to its competition objective both internally and externally. This will be a priority for the year ahead, starting with this first *Annual Competition Report*.

There also remain policy areas where we will seek to make progress in the coming months and the PRA will look for opportunities to influence these. For example, we recognise the potential impact on competition of too wide a gap between standardised and internally modelled capital requirements for prime mortgages, including by having more risk sensitivity in the standardised approach for credit risk capital requirements. The PRA welcomes internal model applications by smaller banks and we will do what we can to help them meet the required prudential standards.

The competition objective is a welcome complement to the PRA's primary objectives. It has played an important role in influencing our work over the last year and will continue to do so.



30 June 2016



Part 1

Embedding the secondary competition objective (SCO) into the PRA's processes and ways of working ensures that competition issues are considered fully in the work of the PRA. The PRA has made considerable efforts in this regard and this part of the *Report* sets out the way in which the PRA has interpreted the SCO, including the relationship between the SCO and the PRA's primary objectives, and the measures it has taken to ensure that consideration of the SCO is fully included in its policy and supervisory decision making processes.

Although good progress has been made, the PRA recognises that there is more to be done to embed the SCO, including for example implementing the recommendations of the Independent Evaluation Office (IEO) which published a report on the way in which the PRA has implemented its SCO in March 2016. Further details of this work are included at the end of this part of the *Report*.

1 Interpreting the secondary competition objective

This section of the *Report* sets out the PRA's approach to interpreting the SCO, focusing in particular on how it aligns with the PRA's primary objectives.

1.1 The secondary competition objective

The PRA has two primary objectives: to promote the safety and soundness of the firms it regulates, focusing on avoiding and minimising adverse effects that they can have on the stability of the UK financial system; and an objective specific to insurance firms, to contribute to the securing of an appropriate degree of protection for those who are or may become policyholders.¹

The PRA's secondary competition objective came into force in March 2014 and states that:

'When discharging its general functions in a way that advances its objectives (see section 2F), the

PRA must so far as is reasonably possible act in a way which, as a secondary objective, facilitates effective competition in the markets for services provided by PRA-authorised persons in carrying on regulated activities'.²

The introduction of the PRA's SCO was part of a far broader set of reforms to the UK regulatory landscape in the wake of the financial crisis. These included the creation of the PRA itself in April 2013 as a subsidiary of the Bank of England, and an associated wholesale reshaping of the regulatory approach to prudential supervision. These post-crisis reforms provide important context for the nature of the PRA's SCO.³

The SCO applies to the exercise of the PRA's general functions. The general functions are the functions of making rules under FSMA, preparing and issuing codes under FSMA and determining the general policy and principles by reference to which the PRA performs particular functions under FSMA.⁴ As the PRA's rule-making functions include revoking, amending and re-making any existing rules, the SCO is engaged when the PRA revisits and reviews its existing stock of rules as well as when making new rules. The SCO is also engaged where the PRA determines and revises general policy, such as its policy on the authorisation of firms and on the setting of capital guidance. In designing policies, the PRA has regard to a number of 'regulatory principles' that are set out in FSMA, in particular the principle of 'proportionality'. That is, burdens imposed on a firm's activity are proportionate to the benefits expected, and where appropriate, the PRA will exercise its functions in a way that recognises the difference in the nature, size and complexity of businesses carried out by different firms. Therefore, in designing policies and making rules, the SCO complements this principle by recognising that a 'one size fits all' approach could cause market distortions. Part 2 of this *Report* sets out examples of how the PRA has applied this principle.

The introduction of the PRA's SCO was part of a far broader set of reforms to the UK regulatory landscape in the wake of the financial crisis

1 See FSMA sections 2B and 2C. More detail on the PRA's primary objectives is set out in the 2012 Q4 *Bank of England Quarterly Bulletin* 2012 Q4 available at www.bankofengland.co.uk/publications/Documents/quarterlybulletin/2015/q402.pdf.

2 Section 2H(1) FSMA.

3 See Section 1.1 of the IEO evaluation of the PRA's approach to its secondary competition objective, March 2016, for more detail on the context of the SCO, available at www.bankofengland.co.uk/about/Documents/ieo/evaluation0316.pdf.

4 Section 2J FSMA.

The SCO does not require the PRA to act in a manner that is incompatible with its primary objectives. In many cases the PRA's primary and secondary objectives will be aligned, as described in Box 1. The SCO does not mean that the PRA is a 'competition regulator'. This role falls to the concurrent competition regulators for financial services — the Competition and Markets Authority (CMA), the Financial Conduct Authority (FCA) and the Payment Systems Regulator (PSR). The PRA's responsibility for facilitating effective competition is distinct from, but complementary to, these authorities' responsibilities to promote competition.

Box 1: How the PRA's primary and secondary objectives align

Strong and effective competition in markets generates greater choice, lower prices, and better-quality goods and services for consumers. For businesses, a competitive environment encourages innovation and efficiency, both of which can help to drive productivity and growth in the economy as a whole. Acting to promote safety and soundness of banks and insurers and insurance policyholder protection by addressing market failures is likely to enhance effective competition.

Therefore, the PRA's primary and secondary objectives are often fully aligned. For example, reducing 'too big to fail' distortions has made both the financial system safer and financial market competition more effective. In the run-up to the recent financial crisis, the expectation of government-funded support for institutions that were perceived to be 'too big to fail' actually meant that debt investors expected to incur only limited losses in the event of these firms failing. This created artificially low funding costs for

1.2 Interpreting the secondary competition objective

The SCO contains a number of elements, each of which needs to be considered to ensure that the objective is met.¹

1. Competition is a secondary objective. The SCO only applies when the PRA is advancing one of its primary objectives and the PRA's powers cannot be used solely to advance the SCO.² While the SCO requires the PRA to, so far as is reasonably possible, act in a way which facilitates effective competition, this remains a secondary objective and does not override the PRA's primary prudential objectives.

these firms, placing them at a competitive advantage relative to smaller rivals and enabling them to increase risk taking. Reducing these 'too big to fail' distortions is likely to have made both the financial system safer and competition more effective.

Nevertheless, cases may exist where, within the range of prudential regulation options available to the PRA, certain options would deliver greater benefits to competition. Complex regulations can have unintended consequences and as a result, the effectiveness of competition may be reduced. For example, regulation could create barriers to entry, expansion or exit.

The existence of the SCO means that the PRA should consider, but is not necessarily required to adopt, those options which would deliver greater benefits to competition for a given objective of safety and soundness or policyholder protection. An added advantage of looking at prudential regulation through a competition lens is a check on whether prudential interventions are being applied proportionately, and to guard against the risks of unintended consequences.

The SCO does not mean that the PRA is a 'competition regulator'. This role falls to the concurrent competition regulators for financial services

¹ More detail is available in the 2015 Q4 *Bank of England Quarterly Bulletin*, available at www.bankofengland.co.uk/publications/Documents/quarterlybulletin/2015/q402.pdf.

² See, for example, FSMA, sections 2F, 55M(2)(c) and 137G(1).

2. The objective is to 'facilitate' effective competition. This helps to ensure that the PRA understands the impact policy choices have on competition, but does not dictate the issues that policy should address.
3. Only 'effective competition' matters. Competition is not effective when there are market imperfections in play, such as implicit government subsidies. Competition is effective when market imperfections are insignificant or have been addressed by policy. Box 2 below explains this in more detail.
4. The PRA must consider competition when exercising its 'general functions'. The PRA's general functions include rule making under FSMA, preparing and issuing codes under

FSMA and determining the general policy and principles by which the PRA performs particular functions under FSMA. The PRA's view is that firm-specific decisions are not in scope of the SCO unless they involve the discharge of general functions.

5. The SCO is limited to what is 'so far as is reasonably possible'. The SCO recognises that the PRA may have limited policy choices, for example where it is bound by national law.
6. The markets to which the SCO is relevant are broad. The SCO is potentially relevant to markets beyond the United Kingdom, possibly to any market in which PRA-regulated firms undertake regulated activities.

The PRA must consider competition when exercising its 'general functions'

Box 2: Defining 'effective competition'

Competition in markets for financial services is not perfect. Where market failures exist, policy makers can seek to achieve 'effective competition', that is, achieving an outcome where market and regulatory failures are either insignificant or have been addressed.

In a 2015 Q4 *Bank of England Quarterly Bulletin* article, the PRA describes three aspects of effective competition:

1. **Suppliers compete to offer a choice of products or services on the most attractive terms to customers, such as lower prices or better quality.** At the same time, suppliers appropriately price in the risks associated with their businesses such that they have confidence in their ability to meet their service obligations.
2. **Customers have the confidence to make informed choices.** These choices are based on those quality attributes that are easy to observe. Products and services can be obtained, and customers receive the products and services they expect, at a price that allows suppliers to earn a return on their investment commensurate with the level of risk taken. Suppliers do not place unreasonable or unnecessary restrictions on products and services that would prevent customers from exercising choice.
3. **Effective entry, expansion and exit.** It is possible for suppliers, including those offering new products and services, to enter the market and to expand; and suppliers offering products or services on unattractive terms, or which are unable to meet their obligations, to exit the market in an orderly fashion.

2 Implementing the secondary competition objective

This section sets out some of the practical steps the PRA has taken to implement the SCO. The PRA's approach in this regard has benefited greatly from the findings and recommendations of the review undertaken by the Bank's Independent Evaluation Office (IEO) into the PRA's approach to its SCO.¹ The IEO's findings, recommendations and the PRA's management response² to the review are reflected in the actions described below but are also summarised in Boxes 5 and 6 towards the end of this Part of the *Report*.

2.1 Structural changes and increasing capability

The PRA has undertaken a series of measures to embed the SCO in its ways of working, to ensure that competition issues are considered wherever relevant.

The PRA is committed to attracting and inspiring the best people to deliver on its objectives, including the SCO. It is vital that the PRA has competition expertise on which it can draw. The PRA has taken a number of steps to expand its competition capabilities, for example by appointing a senior advisor on competition, who brings external experience to the PRA from competition regulation and academia and provides independent advice and challenge in the course of PRA decision-making. Full-time competition experts have been recruited to provide ongoing support to the PRA's policymakers and supervisors.

Internal guidance has been updated to ensure that competition issues are identified at the earliest possible stages of policymaking. For example, 'trigger' questions have been developed and included in the PRA's updated internal policy guidance. These are set out in Box 3. The revised policy guidance highlights the importance of considering the SCO when

developing policy and engaging with the PRA's senior advisor on competition and the PRA's in-house experts in order to ensure that competition issues are given due attention. This process is facilitated by periodic horizon scanning exercises to identify emerging competition issues well in advance.

2.2 Research agenda

The PRA is undertaking a number of research projects as part of the 'One Bank Research Agenda'³ on the relationship between prudential regulation, financial stability and effective competition. Previous empirical studies that consider the relationship between competition and financial stability have been inconclusive with some studies suggesting a positive relationship and others concluding that there is a negative relationship.⁴ Drawing on expertise from across the Bank, the research that is being undertaken by the PRA will develop indicators of effective competition in UK retail banking markets and provide the building blocks for more detailed analysis of the relationship between competition and measures of financial stability. Deepening the Bank's understanding of the role of competition in the financial system will help build the evidence base to support and influence policymakers and help the Bank better understand the impact that micro and macroprudential regulation may have on competition.

The PRA has also undertaken research to understand the impact of internal ratings based (IRB) models on the pricing of mortgages. This research has been used by the CMA in its market investigation into retail banking to explore their concerns that 'the disparity on mortgage risk weightings has the potential to distort competition and act as a barrier to entry and expansion for smaller banks in retail banking'. The key findings of this research are set out in Box 4.

The PRA has undertaken a series of measures to embed the SCO in its ways of working, to ensure that competition issues are considered wherever relevant

- 1 See the IEO evaluation of the PRA's approach to its secondary competition objective, March 2016; available at www.bankofengland.co.uk/about/Documents/ieo/evaluation0316.pdf.
- 2 See the PRA's response to the Independent Evaluation Office's evaluation of the PRA's approach to its secondary competition objective, March 2016, available at www.bankofengland.co.uk/about/Documents/ieo/praresponse0316.pdf.
- 3 More detail is available at www.bankofengland.co.uk/research/Pages/onebank/agenda.aspx.
- 4 For example Vives, X (2010) and Hanson, S G, Kashyap, A K and Stein, J C (2011) suggest there is a trade-off between competition and financial stability. Beck, T, Demircuc-Kunt, A and Levine, R (2006) and Schaek, K, Cihak, M and Wolfe, S (2009) find that systemic crises are less likely in more competitive banking systems.

Box 3: Trigger questions for PRA staff

To help PRA staff identify competition issues at an early stage, a number of trigger questions, linked to the PRA's definition of effective competition, have been adapted from the OECD competition assessment toolkit.¹ Policymakers use these questions at the early stages of policy

development to help identify the potential for any policy option to have an impact on competition. Answering the trigger questions provides policymakers with a reference point with which to discuss possible issues with the competition specialists in the Prudential Policy Directorate.

Trigger questions

Potential impacts of proposals	Relation to definition of effective competition
a) Could the proposal reduce incentives for suppliers to compete?	
Significantly raises cost of production for some suppliers relative to others (especially new entrants versus incumbents)	(i) Suppliers compete to offer a choice of products/services
b) Could the proposal limit the ability of suppliers to compete?	
Softens pricing rivalry as a result of information on supplier outputs, prices, sales or costs being published (or shared)	(ii) Suppliers compete to offer a choice of products/services
c) Could the proposal limit the choices and information available to customers?	
Reduces mobility of customers between suppliers	(iii) Informed customers get products/services at suitable price
Changes information required by buyers to shop effectively	
d) Could the proposal limit the number or range of suppliers?	
Establishes an authorisation process as a requirement of operation	(iv) Effective entry, expansion and exit possible
Limits the ability of some types of suppliers to provide a service	
Raises cost of entry or exit by a supplier	

¹ See the OECD competition assessment toolkit available at www.oecd.org/daf/competition/46193173.pdf.

Box 4: The impact of risk weights on pricing in the UK owner-occupied residential mortgage market¹

Risk weights are used to calculate the capital that lenders are required to have on their balance sheets in order to reflect the risk of their loans. Firms that calculate mortgage risk weights using the internal ratings based approach tend to have lower risk weights than firms which use the standardised approach, and this difference is exaggerated for lower loan to value (LTV) mortgages. This research explores how the difference in risk-weights affects mortgage prices and is based on a dataset derived from the FCA's Product Sales Database, which contains all mortgages originated by banks and building societies between 2005 and 2015.²

Preliminary results suggest that lower risk weights lead to lower prices and that the effects appear to be material for

low LTV mortgages. However, the results of one of the key models used in the research are not robust to changes in the sample period: they are economically significant for 2009–15, but not for the full 2005–15 sample. The research is still in progress, and further work is required to understand how material the effects are.

The PRA plans to publish the full findings of this research when finalised.

- 1 See Addendum to provisional findings for a summary of the research methodology: The capital requirements regulatory regime (CMA, April 2016), Appendix 2, available at assets.publishing.service.gov.uk/media/5710dc73ed915d117a00006d/addendum-to-provisional-findings-with-appendices.pdf.
- 2 The FCA Product Sales Data include regulated mortgage contracts only, and therefore exclude other regulated home finance products such as home purchase plans and home reversions, and unregulated products such as second charge lending and buy-to-let mortgages.

2.3 Internal and external communication of the PRA's approach to the SCO

The PRA has made progress in communicating the SCO and its practical implications both internally and externally.

Clear articulation of the SCO is key to ensure that it is understood internally and externally. This provides PRA staff with clarity on the statutory requirements of the SCO and the PRA's intended approach to deliver against it. Communicating the SCO externally is also key for the PRA to show that it is proactive in influencing the potential policy effects on competition with key policy stakeholders and the PRA's performance against this objective.

The PRA Board¹ is updated every six months on efforts to embed the SCO, and on how competition considerations are influencing policy development. Updates have included reports on policy initiatives raising competition issues, such as the PRA's work to implement ring-fencing requirements. More generally, the PRA's policy committees (both the PRA Board and its supporting committee, the Supervision, Risk and Policy Committee (SRPC)) frequently

discuss the impact of individual policy initiatives on competition and analysis on competition effects is routinely included in all policy papers. Papers for policy committees also include the views of the Legal Directorate on their consistency with the PRA's statutory objectives, including the SCO. The PRA's senior advisor for competition attends relevant SRPC and PRA Board discussions, with a view to providing independent advice and challenge on competition issues as they arise.

An internal competition training programme for policy staff has been rolled out and extended to staff in supervision. This has been integrated into the PRA's induction processes for new joiners and offered to existing staff on an ongoing basis. The training is designed specifically to ensure that staff understand the PRA's interpretation of the SCO and the relevant analytical framework to use when designing prudential policy initiatives. The training will be supported by dedicated intranet pages on competition.

The PRA published an article in the 2015 Q4 *Bank of England Quarterly Bulletin* on the SCO

¹ The Bank of England and Financial Services Act 2016, which received Royal Assent on 4 May 2016, makes changes to the governance of the PRA. Once this is in force, the PRA's governing body will be the Prudential Regulation Committee of the Bank of England.

and has used speeches and responses to external publications to deliver key messages on competition issues. These included Andrew Bailey's Mansion House speech in Autumn 2015.¹

Looking ahead, the PRA will continue to make efforts to communicate its approach to the SCO both internally and externally. For example, the PRA will seek opportunities to communicate its research findings, either as part of policy communications or as research publications. The PRA will use future Annual Competition Reports as a means of setting out ways in which it is advancing the SCO. In line with the IEO's recommendations, the PRA will continue to ensure that the SCO is articulated and understood internally.

2.4 Working with external stakeholders

A number of regulatory bodies have primary responsibilities for competition in financial services in the United Kingdom, including the CMA, FCA and PSR. Since its creation, the PRA has built strong and effective working relationships with competition regulators, in particular with the FCA and CMA.

Co-operation between the PRA and FCA occurs, in part, through cross membership of boards. The CEO of the FCA is an *ex officio* member of the PRA Board and the Financial Policy Committee (FPC), and the CEO of the PRA sits on the FCA Board, and is also an FPC member. Arrangements also include regular senior-level meetings of the PRA and FCA, with competition as a standing agenda item, complemented by a formal PRA-FCA Memorandum of Understanding. This has been updated to reflect the existence of the PRA's SCO and the acquisition by the FCA in April 2015 of concurrent competition law powers. In addition, the New Bank Start-up Unit,² a joint initiative between the PRA and FCA, is a key area of collaboration (see Part 2 Section 3.1 of this Report). The PRA consults with the FCA and PSR where its policymaking is expected to be of

material interest to them, and *vice versa*. This includes the competition implications of new policy. The PRA also works closely with the CMA, FCA and PSR on competition matters in relation to their market studies and investigations where, for example, the PRA may be requested to supply information about the prudential regulatory regime. For example, as discussed above, the PRA has been assisting the CMA on the retail banking market investigation, in particular in relation to the CMA's work on the impact of the capital requirements regime.³

The PRA also seeks to engage proactively with policymakers, in particular the FPC and HM Treasury, on competition issues arising in recommendations, or primary or secondary legislation requiring implementation through PRA rules.

2.5 Assessment of the implementation of the SCO by the Bank of England's internal Independent Evaluation Office

In early 2015, the Bank of England's Court of Directors asked the IEO to undertake an assessment of the PRA's approach to the SCO, with a view to facilitating Court oversight of the strategy adopted. The IEO conducted an evaluation between April and October 2015 and published its findings with recommendations on 23 March 2016.⁴ The IEO review made numerous positive findings, but found some PRA staff had residual misgivings about the compatibility of the SCO with the primary objectives. In the view of the IEO, such concerns may have slowed the PRA's early progress in embedding and communicating on the SCO. The IEO has set out its recommendations under three broad headings as set out in Box 5. The PRA has accepted the IEO's findings and recommendations in full in its published management response.⁵ The full list of actions in the management response is set out in Box 6.

Looking ahead, the PRA will continue to make efforts to communicate its approach to the SCO both internally and externally

- 1 See speech by Andrew Bailey given at the City Banquet Mansion House, London, 'Progress on prudential regulation and three areas to complete', available at www.bankofengland.co.uk/publications/Documents/speeches/2015/speech854.pdf.
- 2 More detail is available at www.bankofengland.co.uk/pranbsu/Pages/default.aspx.
- 3 See Addendum to provisional findings: The capital requirements regulatory regime (CMA, April 2016), available at assets.publishing.service.gov.uk/media/5710dc73ed915d117a00006d/addendum-to-provisional-findings-with-appendices.pdf.
- 4 See the IEO evaluation of the PRA's approach to its secondary competition objective, March 2016; available at www.bankofengland.co.uk/about/Documents/ieo/evaluation0316.pdf.
- 5 See the PRA's response to the Independent Evaluation Office's evaluation of the PRA's approach to its secondary competition objective, March 2016, available at www.bankofengland.co.uk/about/Documents/ieo/praresponse0316.pdf.

Box 5: Summary of IEO recommendations

Input into policy decisions

Recommendation 1: Identification and prioritisation of competition issues

- Refine processes to ensure competition issues are consistently identified early in policy making, including by:
 - developing 'trigger' questions to help identify where additional analysis is needed; and
 - strengthening existing horizon-scanning exercises.
- Ensure research focuses on the questions the PRA needs to answer, including on the relationship between the PRA's primary and secondary objectives.
- Keep the adequacy of existing specialist competition resources under review.

Infrastructure supporting policy decisions

Recommendation 2: Clear articulation of the PRA's approach to the SCO

- Ensure sufficient clarity among PRA policy staff on the statutory requirements of the SCO and the PRA's intended approach to delivering on those requirements.
- Improve internal dissemination of recent thinking on the SCO, including potential synergies with the PRA's primary objectives, and interpretation of 'effective' competition.
- Accelerate 'learning by doing' by consolidating what is known about competition issues commonly arising in policy design.

Recommendation 3: Embedding the SCO into policymaking

- Update internal guidance to stress that the SCO is relevant throughout policy making, not just in cost benefit analysis, and that it implies developing policy options that facilitate competition.
- Use internal guidance to reinforce the intended proactive approach to the SCO when influencing the development of prudential policy, including in domestic and international forums.

Recommendation 4: Governance

- Enhance the effectiveness of the six-monthly updates to the PRA Board, including through more systematic reporting on policy initiatives.
- Demonstrate consistent compliance with the SCO across internal and external policy materials.

Recommendation 5: External co-ordination with competition regulators

- Build understanding of the PRA's remit, and invest further in co-ordination with relevant competition regulators.

Output of policy decisions

Recommendation 6: External communications

- Use forthcoming communication vehicles (eg new *Annual Competition Report* on competition) to set out more fully the PRA's recent experience and evolving thinking towards the SCO.
- Find opportunities to communicate the PRA's approach to the SCO to a suitably wide set of stakeholders.

Box 6: Summary of the PRA actions in response to IEO report

Input into policy decisions

1. Identification and prioritisation of competition issues

- Update internal policy guide to give clear role for competition experts in earliest stages of policy identification and prioritisation and include a set of trigger questions to help all staff identify material competition issues in the course of developing policy.
- Use policy-focused horizon scanning to prioritise selection of research projects and use the Research Hub¹ to ensure resources are properly ring-fenced.
- Deepen expertise, provide intellectual leadership and disseminate knowledge more widely through provision of training, use of secondments and dedicated research.

Infrastructure supporting policy decisions

2. Clear articulation of the PRA's approach to the SCO

- Enhance clarity of internal articulation of the PRA's approach to the SCO through use of presentations, bespoke training courses, seminars, inclusion in staff induction programmes and intranet pages dedicated to competition.

3. Embedding the SCO into policymaking

- Update internal policy guide to ensure competition issues are identified, analysed and articulated throughout the policymaking process.
- Take proactive approach to influencing policymaking with the SCO in mind, both domestically and when pursuing the PRA's international strategy.

4. Governance

- Strengthen systematic reporting on policy initiatives to ensure the PRA Board receives the information it needs to raise, challenge and debate relevant competition issues.

- Update internal policy guide to ensure that discussions and decisions relating to competition are properly identified to facilitate discussion by the PRA's policy committees.

5. External co-ordination with competition regulators

- Strengthen links with competition regulators for example through regular senior level engagement, including competition as a standing agenda item for senior level bilaterals with the FCA, and use of secondments.
- Ensure PRA-FCA Memorandum of Understanding remains up-to-date.

Output of policy decisions

6. Enhance external communications

- Set out approach to SCO in *Quarterly Bulletin* article,² approach documents,³ speeches⁴ and Bank submissions to external policy reviews.
- Use *Annual Competition Report* to reinforce key messages and showcase illustrative examples of the impact of the SCO in practice.

1 See www.bankofengland.co.uk/research/Pages/onebank/researchhub.aspx.

2 See www.bankofengland.co.uk/publications/Documents/quarterlybulletin/2015/q402.pdf.

3 See www.bankofengland.co.uk/publications/Pages/other/prasupervisoryapproach.aspx.

4 See www.bankofengland.co.uk/publications/Documents/speeches/2015/speech854.pdf.

Part 2

3 Application of the secondary competition objective in the work of the PRA

This part of the *Report* provides examples that illustrate some of the ways in which the PRA has delivered, and intends to deliver, against its SCO. It includes for example, steps the PRA has taken to facilitate entry into the markets in which PRA authorised firms operate, and policy measures that, by applying the principle of proportionality, facilitate effective competition.

3.1 Facilitating market entry

The New Bank Start-up Unit¹ is a joint initiative of the PRA and FCA which helps new banks navigate the authorisation process and enter the market, and provides supervisory support for new banks during their early years. The PRA is fulfilling its commitment, with the FCA, to make the process clearer and more accessible, with the aim of facilitating entry into the market for applicants who can demonstrate they will meet the PRA's and FCA's conditions for entry. Applicant firms now benefit from having a single source for the information and support they need to start a new bank and from the ongoing interaction they receive once authorised. Box 7 provides more detail.

The New Bank Start-up Unit is a joint initiative of the PRA and FCA which helps new banks navigate the authorisation process and enter the market

¹ More detail is available at www.bankofengland.co.uk/pranbsu/Pages/default.aspx.

Box 7: The New Bank Start-up Unit

The New Bank Start-up Unit (NBSU) was launched on 20 January 2016. It is a joint initiative between the PRA and the FCA providing regular information and support to firms seeking to become a bank, or which have recently been authorised as a bank, in the United Kingdom. The NBSU builds upon the current PRA and FCA joint authorisation process, set out in the March 2013 report, 'A review of requirements for firms entering into or expanding in the banking sector'¹ which itself ushered in significant changes to make the process of obtaining authorisation as a bank smoother. The NBSU is a virtual unit supported by staff from within the PRA and FCA, and has three principal outputs: (1) a dedicated website; (2) the provision of seminars; and (3) a single point of contact.

1. The focal point of the NBSU is the dedicated website which outlines in detail the authorisation process, providing applicant firms with a step-by-step guide to the authorisations process. This includes an explanation of how a firm should prepare its application to become a bank and how that application will be assessed, as well as information on what life is like as a regulated UK bank;

2. The first NBSU seminar was hosted jointly at the PRA's offices by the PRA and FCA on 22 March 2016 and was heavily oversubscribed. The seminar saw 120 individuals representing around 100 firms and industry participants listen to a dozen speakers regarding the authorisation process and supervisory requirements for new banks. The PRA and FCA intend to hold a further seminar late in 2016, and future seminars thereafter; and
3. The NBSU also provides a dedicated helpline and email address for firms to contact. This is in addition to the case officer assigned to each firm once its application is in train who is available to firms to provide formal and informal support and advice.

The PRA has already made significant progress in the area of new bank authorisations: fourteen banks have been authorised since April 2013,² and currently there is a pipeline of around 20 interested applicants, of which six have applied formally to become a bank. Since its launch on 20 January to 31 May, the NBSU website has had 14,776 page views.

¹ Available at www.bankofengland.co.uk/pranbsu/Pages/publications/reports/2014/reviewrequirements.aspx.

² Between April 2013 and April 2016. Twelve new banks were authorised between April 2013 and March 2016.

3.2 Proportionality

The PRA has been proactive in identifying potential areas where a more proportionate approach could be adopted without lowering regulatory standards. These include:

- Less onerous regulatory reporting requirements, including Pillar 3 disclosure requirements.
- Considering whether small firms need to be subject to all elements of the regulatory framework, for example, firms below a certain threshold might be exempt from the Net Stable Funding Ratio.

The PRA will continue work to narrow the gap between capital requirements based on standardised approaches to those based on internal models where they are unduly large, both by making standardised approaches more risk sensitive and by constraining internal models from producing excessively low capital.

Domestic regulation

The PRA has also made significant efforts in applying proportionality to its approach to designing and implementing policies in the United Kingdom, which, as a result, influenced the policy outcome and facilitated effective competition.

Senior managers regime

The Senior Managers Regime (SMR) and Senior Insurance Managers Regime (SIMR)¹ which came into force on 7 March 2016, introduced a new framework for strengthening individual accountability and corporate governance for deposit-takers, insurers and PRA-designated investment firms. The new framework is based on the principle of clear individual responsibilities for key decision makers and stronger powers of approval, supervision and enforcement for the PRA and FCA. Collectively, the SMR and SIMR apply to all firms regulated by the PRA; from credit unions and non-directive insurance firms

(NDFs)² to new entrants, UK branches of non-European Economic Area (EEA) banks and insurers (incoming non-EEA branches) and UK-headquartered systemically significant institutions. The design and implementation of these regimes were shaped by the PRA's application of the SCO and the principle of proportionality. The SMR and SIMR achieve these objectives in a number of ways, including but not limited to:

- Fewer responsibilities that must be allocated to a senior manager approved by the PRA for credit unions, banks and building societies with assets under £250 million ('small banks'), incoming non-EEA branches, insurance special purpose vehicles, and small NDFs.
- A requirement on each firm to produce a 'responsibilities map' whose length, content and level of detail should reflect its size and complexity.
- Allowing smaller, less complex firms to outsource some of their key functions (such as internal audit) to external service providers, subject to the firm having adequate oversight arrangements in place over the provider, including a senior manager in the firm who must be responsible for managing the relationship and overseeing the work of the external service provider.
- The ability of individual directors and senior managers moving between regulated firms to submit a shortened form to the regulators, where there has been no change to the basic information already provided about the individual's fitness and propriety.

Remuneration

Banks, building societies and investment firms subject to CRD IV³ are required by the Remuneration Part of the PRA Rulebook to ensure that their remuneration policies,

The PRA will continue work to narrow the gap between capital requirements based on standardised approaches to those based on internal models where they are unduly large

1 See updates on strengthening accountability available at www.bankofengland.co.uk/pr/Pages/supervision/strengtheningacc/default.aspx; and the prudential regime, and implementation of the Senior Insurance Managers Regime, for non-Solvency II firms — PS26/15, available at www.bankofengland.co.uk/pr/Pages/publications/ps/2015/ps2615.aspx.

2 Firms outside the scope of Solvency II.

3 See directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, available at eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32013L0036.

practices and procedures are compliant with the CRD requirements. The PRA has taken a proportionate approach to monitoring compliance, recognising the differences in size and complexity of firms and the likely greater impact on smaller firms. The PRA has therefore divided firms into three levels with the PRA adopting a different supervisory approach for each level.

1. Level one firms¹ must apply all the CRD remuneration provisions (deferral, bonus cap, payment in shares and other instruments, performance adjustment). Subject to an annual supervisory review, firms must also submit a Remuneration Policy Statement which includes lists of staff identified as material risk-takers, information on profit-based measurement and risk adjustment of bonus pools, the quantum and number of guaranteed variable remuneration awards offered and the quantum and number of *ex-post* performance adjustments made to remuneration awarded.
2. Level two firms must apply all the CRD provisions but are not subject to an annual review.
3. Level three firms can disapply the requirements relating to deferral, payment in shares and other instruments and performance adjustment and do not have to apply the bonus cap. They are also exempt from an annual supervisory review.

The PRA has also adopted a proportionate approach to the Solvency II remuneration requirements, for which there is a prescribed responsibility within the SIMR that has to be allocated to a Non-executive Director, with more granular expectations for the application of remuneration policy by significant insurance firms and groups.²

Whistleblowing

The PRA's policy initiatives on whistleblowing, which, like the SMR, originate from the recommendations of the Parliamentary Commission on Banking Standards, also take into account the SCO and the principle of proportionality. These require firms to:

1. Establish internal whistleblowing channels open to anybody to use;
2. Inform their workers about the PRA and the FCA whistleblowing services, as well as how to use them in such a way as to maintain their legal protections under the Public Interest Disclosure Act, 1998; and
3. Include nothing that would deter workers from making protected disclosures to the PRA or the FCA in employment contracts, settlement agreements or other associated documents.

The rules are applied proportionately to PRA-designated investment firms, deposit-takers with more than £250 million of assets and Solvency II insurers. Effective whistleblowing arrangements can facilitate effective competition by helping to expose wrongdoing by firms that might otherwise give them an unfair competitive advantage.

Prudential regime for non-Solvency II firms³

The PRA has adopted a proportionate approach to those firms outside the scope of Solvency II, NDFs, delivering a simplified and streamlined set of rules in the updated PRA Rulebook that is consistent with the format of the rules applying to Solvency II firms. The PRA maintained the rules that had applied to NDFs prior to 1 January 2016 but redrafted and removed complexity where appropriate such that from 1 January 2016 there has been a clearly defined separate set of rules and supervisory statements for NDFs that are proportionate and specific to those firms.

The PRA has taken a proportionate approach to monitoring compliance, recognising the differences in size and complexity of firms and the likely greater impact on smaller firms

- 1 Level one firms have total assets exceeding £50 billion. Level two firms are those with assets of £15–50 billion. Level three firms are those with assets under £15 billion.
- 2 These are PRA Category 1 and 2 Solvency II firms. See the PRA's approach to insurance supervision, March 2016, for further detail on the PRA 'categories' of impact, available at www.bankofengland.co.uk/publications/Documents/prapproach/insuranceappr1603.pdf.
- 3 See 'The prudential regime, and implementation of the Senior Insurance Managers Regime, for non-Solvency II firms — PS26/15', available at www.bankofengland.co.uk/pr/Pages/publications/ps/2015/ps2615.aspx.

Reporting

The PRA has used its discretion under the Solvency II Directive to exempt smaller insurers in scope of Solvency II from quarterly reporting. Other insurers may also be eligible on a case-by-case basis. The PRA simplified and streamlined the prudential regime for very small insurers outside the scope of Solvency II in December 2015 and consulted on consequential amendments that will simplify and rationalise the reporting requirements to those firms in May 2016.¹

The PRA has also continued to review the reporting requirements for banks, building societies and designated investment firms. This has involved all supervision areas, risk specialists, as well as policy experts and financial stability staff in the Bank of England. A first PRA consultation paper (CP) resulting from this review was published in April 2016.² The proposals in the CP take account of proportionality and balance the PRA's need for data from all these firms with the risk individual firms pose to the PRA's objectives.

Insurers' use of internal models

The PRA issued several Supervisory Statements and letters on aspects of the approval of insurance firms' internal models and the matching adjustment with the aim of enhancing firms' understanding of Solvency II requirements, and encouraging applications to use an internal models and/or the matching adjustment, where appropriate.³ An efficient pre-approval process to support firms' applications for the use of models and a consistent framework with which to assess applications for internal models and/or the matching adjustment supports a more accurate reflection of the risks of firms' business models, facilitating effective competition.

Pillar 2 capital requirements

The PRA's consultation on the 'Pillar 2' capital framework for banks sought to create a more

risk sensitive and consistent approach to setting Pillar 2A capital.⁴ The aim of Pillar 2 capital is to ensure that firms have adequate capital to support the relevant risks in their business, and to encourage firms to develop and use better risk management techniques in monitoring and managing their risks. A firm's Pillar 2 capital consists of two parts: Pillar 2A capital to cover risks to the firm which are either not captured, or not fully captured under Pillar 1; and Pillar 2B, called a capital buffer, to cover risks to which the firm may become exposed over a forward-looking planning horizon, for example due to a change in the economic environment. Under the new regime, supervisors may exercise judgement when assessing credit concentration risk — whether on a single name, sectoral or a geographical basis — for small firms where they identify that the credit concentration risk methodology could overstate risks, or could incentivise risk-taking behaviour. Moreover, the PRA exempted residential mortgage exposures capitalised using the standardised approach under Pillar 1 from its analysis of geographic concentration risk on the view that the Pillar 1 capital requirements already capture this risk. This would benefit smaller firms focused on mortgage lending.

3.3 Structural reform

In October 2015 the PRA published its second CP on the implementation of ring-fencing, covering prudential requirements, intragroup arrangements and use of financial market infrastructures.⁵ One issue that was considered in the consultation was the impact of the reforms on borrowing by (non-financial) mid-market corporates⁶ and the risk that difficulties they may face in accessing investment/corporate banking products that cannot be provided by ring-fenced banks (RFBs) might affect competition in the provision of those services. Mid-market corporates may be particularly vulnerable to an increase in the price of investment banking services. The cost of providing such products

The PRA has also continued to review the reporting requirements for banks, building societies and designated investment firms

- 1 See 'Reporting requirements for non-Solvency II insurance firms — CP18/16', available at www.bankofengland.co.uk/pr/Pages/publications/cp/2016/cp1816.aspx.
- 2 See 'Regulatory reporting of financial statements, forecast capital data and IFRS 9 requirements — CP17/16', available at www.bankofengland.co.uk/pr/Pages/publications/cp/2016/cp1716.aspx.
- 3 See 'Solvency II: consolidation of Directors' letters — CP20/16', available at www.bankofengland.co.uk/pr/Pages/publications/cp/2016/cp2016.aspx.
- 4 See 'Assessing capital adequacy under Pillar 2 — CP1/15', available at www.bankofengland.co.uk/pr/Documents/publications/cp/2015/pillar2/cp115.pdf.
- 5 See 'The implementation of ring-fencing: prudential requirements, intragroup arrangements and use of financial market infrastructures CP37/15', available at www.bankofengland.co.uk/pr/Pages/supervision/structuralreform/default.aspx.
- 6 Turnover between £25 million and £500 million.

may increase as a result of the imposition of intragroup limits on unsecured exposures between an RFB or an RFB subgroup and other members of the banking group. This could constrain intragroup funding and potentially lead to higher levels of wholesale funding from external sources. Moreover, mid-market corporates may have access to a more limited choice of suppliers for investment banking services. While groups subject to ring-fencing account for a small share of equity underwriting, they account for a larger share of bond underwriting for mid-market corporates. The level of market concentration however does not appear unduly high, and ring-fenced groups usually operate as part of broader syndicates, suggesting that issuers could switch volumes to other underwriters. The ability of corporate clients to switch providers is being investigated by the FCA as part of its market study on investment and corporate banking.¹ Overall the PRA's analysis concluded that any competitive distortion is likely to be small. The PRA also made some minor changes to the operational continuity policy applying to RFBs in its Policy Statement published in May 2015.² One of these changes was to broaden the scope of firms to which group services entities are allowed to provide services, by extending the provision to third parties. The decision was taken on the basis that it would facilitate the ability of smaller banks to access services and facilities provided by larger banks' services entities, thereby supporting competition in banking markets.

3.4 Implementing macroprudential policy Loan to income ratios

The FPC made a macroprudential recommendation to the PRA and FCA to set limits on the extent to which regulated firms can lend to customers with high loan to income (LTI) ratios. This tool is intended to provide insurance against a scenario where lenders extend a higher proportion of loans at high LTIs than is desirable from the perspective of system-wide stability. By improving the

stability of the financial system, the policy helps to contain the risk that a macroeconomic shock might have direct and indirect impacts on the safety and soundness of the firms that the PRA regulates. The PRA set out a framework for implementing the FPC's macroprudential recommendations that secured this macroprudential aim without having a disproportionate effect on the ability of independent niche firms to compete with rivals that are part of large banking groups. Larger banking groups are able to absorb diverted demand by expanding lending to the extent that the LTI flow limit is not yet binding at group level. This would have been particularly problematic for independent firms whereby the relational nature of this niche service means that clients have a preference for dealing with a single service provider (ie a one-stop shop), thus suggesting that the negative competitive impact might have gone beyond the provision of residential mortgage lending.

3.5 Internal ratings based (IRB) models

The IRB approach allows a firm to use its own parameters, subject to meeting minimum prudential standards, to calculate a risk-weighted capital requirement for credit risk. This should mean that capital requirements are more closely linked to the firm's assessment of the risks in its lending.

The PRA has undertaken a review to consider whether its approach to the internal credit model application process could be made more proportionate for smaller banks and building societies, without undermining the particular credit risk management standards that the IRB approach requires. This work will complement the PRA's ongoing work to narrow the gap between capital requirements based on standardised approaches and those based on internal models where it is unduly large. To understand first-hand the perceived issues with attaining permissions to use the IRB approach, the PRA recently held meetings

The PRA set out a framework for implementing the FPC's macroprudential recommendations that secured this macroprudential aim without having a disproportionate effect on the ability of independent niche firms to compete with rivals

¹ The FCA published an interim report and a final report is expected to be published in Summer 2016. More detail available at www.fca.org.uk/news/investment-and-corporate-banking-market-study.

² See 'The implementation of ring-fencing: legal structure, governance and the continuity of services and facilities — PS10/15', available at www.bankofengland.co.uk/pr/Pages/publications/ps/2015/ps1015.aspx.

with IRB-aspirant firms in conjunction with the Building Societies Association and the British Bankers Association, including some of the consultants who have supported such firms in the development of IRB programmes. The findings of the review are reported in Box 8.

Next steps

The underlying prudential standards relating to IRB are applicable to all IRB applicants, regardless of size. As recent applications have shown, where smaller firms believe they meet

these standards, the PRA is very willing to consider applications from them. In addition the PRA has made changes over time to the application process in order to simplify it, an example being the updated application form in June 2015. Nonetheless we recognise that the application process requires significant resources additional to the considerable effort needed to develop an IRB framework and that the improvements the PRA has made to date have not been communicated to, and are not well understood by, the smaller banks and

The PRA has undertaken a review to consider whether its approach to the internal credit model application process could be made more proportionate for smaller banks and building societies

Box 8: Review of the PRA's approach to IRB model applications from smaller firms

The meetings with industry brought forth many specific issues facing smaller firms. However, many are linked to an overarching perception that the PRA does not welcome IRB applications from smaller firms. This, together with the significant challenges of implementing IRB, has discouraged Boards from approving investment in IRB projects. The following themes have contributed to this perception.

a) Process

A significant amount of feedback was received on: the PRA's current level of engagement with smaller IRB-aspirants and the application process more generally.

There is a strong perception that the PRA is not open for dialogue in the pre-application phase. This has allowed misconceptions to persist around prudential expectations.

Once an application has been submitted, the time taken for the PRA to reach a decision is perceived to be long and the nature of the assessment process opaque. Firms believe that feedback is limited and only given at the very end of the process.

Firms have also said that they are unsighted on the documentation that is required as part of an IRB application.

b) Lack of clarification about regulatory requirements for IRB model approval

Firms did not have a good understanding of the regulatory requirements for IRB model approval. The following were raised as specific areas that firms felt required greater clarification:

- senior management understanding with regard to the necessary length and nature of experience in running the rating system;
- 'use test' and the evidence required to ensure compliance;
- data, specifically the use of external sources to complement internal data;
- roll-out of the IRB approach to other exposure classes; and
- resourcing an independent validation function that reviews the rating systems.

c) Data inadequacies

It also became apparent that as a result of prudent lending, the current economic environment or the effect of a recently established loan book, many small firms have difficulty in building up adequate default and loss data points to facilitate IRB modelling consistent with the CRR standards. Specifically, given that loss data can only emerge post-default, the time taken to adequately model loss given default becomes the greatest constraint, particularly for retail mortgage portfolios.

building societies. Therefore the PRA intends to do the following in response:

a) Process enhancements

The PRA recognises the need to increase engagement with small firms that aim to transition to the IRB approach. This does not mean it will undertake detailed review work in the pre-application phase. However it found in the past that firms who have approached the PRA have benefited from strategic discussions on their IRB frameworks. Therefore the PRA will make more resources available for the pre-application phase and initiate a new approach aimed at delivering improved interaction between firms and the PRA. This is likely to benefit smaller firms that believe they will be in a position to submit an application in the medium term.

With regard to the comments received on the application process, in practice the length of review depends on many factors, including: the complexity of the firm; the quality of the application; and the time it takes an applicant to address identified weaknesses. The PRA intends to make the application process more transparent by moving to a module-based assessment, with

indicative timescales for responses, regular feedback to applicants, and milestones to allow the identification of overall progress.

b) Communication of PRA expectations

The PRA expects firms seeking IRB permission to identify and meet all relevant regulatory requirements. Nonetheless, the PRA recognises that there would be benefit in providing greater clarity in the areas raised by firms (see Box 8). Dedicated content will be provided on the PRA website to assist IRB applicant firms in identifying key texts and understanding PRA expectations.

This new content and details of the process enhancements will be launched later this year. Alongside this, we will also host a seminar for interested parties.

c) Data Inadequacies

Among the other areas outlined above, the PRA will provide further information on its expectations regarding data requirements, including the use of external data to supplement a firm's own data. Firms planning to submit an IRB application are encouraged to speak to their supervisors at an early stage.

As recent applications have shown, where smaller firms believe they meet these standards, the PRA is very willing to consider applications from them



BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

The Bank of England's mission
is to promote the Good of the
People of the United Kingdom
by maintaining Monetary and
Financial Stability

Prudential Regulation Authority
20 Moorgate
London EC2R 6DA

www.bankofengland.co.uk/pra