BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Publication

Feedback Statement | FS1/21

Responses to DP1/21 'A strong and simple prudential framework for non-systemic banks and building societies'

December 2021

BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

Feedback Statement | FS1/21

Responses to DP1/21 'A strong and simple prudential framework for non-systemic banks and building societies'

December 2021

Prudential Regulation Authority | 20 Moorgate | London EC2R 6DA

Contents

Executive summary

This Feedback Statement (FS) provides a summary of the responses to the Prudential Regulation Authority's (PRA) Discussion Paper (DP) 1/21 'A strong and simple prudential framework for non-systemic banks and building societies'. The DP set out a vision for a prudential framework for banks and building societies (hereafter 'firms') considered by the PRA to be neither systemically important nor internationally active comprising of a number of layered regimes. The objective of the framework would be to maintain the resilience of those firms in scope and of the UK financial sector while using simplified prudential regulation, thereby enabling a dynamic and diverse banking sector in the UK. The DP referred to the overall framework as the 'strong and simple' framework. The DP also asked for views on whether the project should start with a layer for small firms and explored high-level options for its design – it called this layer the 'simpler regime'.

The aim of this FS is to stimulate further debate about the design of the strong and simple framework. It pulls out broad themes from the responses to the DP with the intention of providing an overall summary of the responses. This statement summarises the responses to DP1/21 as far as they concern the matters raised in that DP. It does not include policy proposals, nor does it signal how the PRA is considering designing and implementing a strong and simple framework. Respondents' comments on other policies that are the responsibility of the PRA or the Bank of England that were not discussed in the DP are not covered in this FS.

The majority of respondents were supportive of the long-term vision for a strong and simple prudential framework for non-systemic firms in the UK as presented in the DP; ie that prudential requirements expand and become more sophisticated as the size and/or complexity of firms increase. A majority of respondents showed some or full support for the idea of achieving the vision by having a strong and simple framework comprised of a number of layered prudential regimes, although some respondents were concerned that many layers would make the prudential framework too complicated. A majority of respondents that offered views supported no more than two or three layers. There was a range of views expressed about the merits of starting with the simpler regime, the layer for small firms. Some of the respondents that were supportive also wanted the PRA to provide information about the overall design of the strong and simple framework.

There was support for many of the ideas about how the simpler regime could be designed. Respondents with views thought the criteria for determining firms eligible for any simpler regime that were discussed in the DP, or a significant subset of them, were appropriate. The majority of respondents supported the idea that firms in scope of the simpler regime could choose to operate under the prudential rules for larger firms instead. A majority of respondents that offered views preferred the 'streamlined' approach to designing the prudential requirements under the simpler regime (ie take the existing prudential framework as a starting point and modify those elements that appear to be over complex for smaller firms) to the 'focused' approach (ie adopt a narrower but more conservatively calibrated set of new prudential requirements). Reasons for this included a concern that a conservatively calibrated focused regime could result in increased capital requirements and concerns about creating higher barriers to growth for firms that wish to do so. However, some respondents thought a focused regime could be developed for the very smallest firms. Respondents offered a range of views about the options for prudential requirements that were discussed in the DP.

1 Introduction

1.1 This Prudential Regulation Authority (PRA) Feedback Statement (FS) provides a summary of the responses to Discussion Paper (DP) 1/21, which explored options for developing a 'strong and simple' prudential framework in the UK.[1]

1.2 The aim of this statement is to stimulate further debate about the design of such a framework. This statement is relevant for PRA-regulated banks and building societies that are neither systemically important nor internationally active. This statement does not provide the PRA's views about the merits of the different comments in the responses. It does not include policy proposals, nor does it signal how the PRA is considering designing and implementing a strong and simple framework. This statement covers comments on policies that were discussed in DP1/21. Respondents' comments on other policies that are the responsibility of the PRA or the Bank of England are not covered in this statement.[2]

1.3 The responses described in this statement are presented in an anonymised way. This statement tries to pull out broad themes from the responses with the intention of providing an overall summary of the responses to DP1/21. Where quantitative information about the responses is presented, it reflects staff judgements about how the responses can be grouped into a small number of categories. While this statement does not refer to all of the comments in the responses nor reflect the level of detail in the responses, the PRA will be making use of all of the responses as it considers how best to design and implement a strong and simple framework.

Background

1.4 DP1/21 explored options for developing a simpler prudential framework for banks and building societies (hereafter 'firms') that are neither systemically important nor internationally active. The objective of this framework would be to maintain the resilience of those firms and of the UK financial sector, while using simplified prudential regulation, thereby enabling a dynamic and diverse banking sector in the UK. The PRA welcomed comments to DP1/21, including answers to the questions laid out in it. It stated that the PRA planned to publish a summary of the comments received.

Respondents

1.5 The PRA received 44 responses to DP1/21 from PRA-regulated firms, trade bodies, and a range of other stakeholders.

Discussion paper structure

1.6 **Chapters 2**, **3**, **4**, **5**, and **6** of this statement describe the responses to the corresponding chapters in DP1/21. A list of the questions posed in the DP can be found in the Appendix.

1 April 2021: DP1/21 – A strong and simple prudential framework for non-systemic banks and building societies.
2 DP1/21 focused on how microprudential regulation could be simplified for banks and building societies that are considered neither systemically important nor internationally active. It did not discuss the prudential regime for insurers. It also explained that the prudential regulation of small firms forms part of a wider framework that includes the bank resolution and insolvency regime, the Financial Services Compensation Scheme, the PRA and Financial Conduct Authority's respective processes for authorising new firms, the ongoing supervision and monitoring of PRA-regulated firms, and the macroprudential regime.

Next steps

1.7 The PRA would welcome comments or enquiries about this FS. Please address any comments or enquiries by email to DP1_21@bankofengland.co.uk. Further consultation papers will follow during 2022 and/or 2023.

2 The existing prudential framework for small banks and building societies

2.1 Chapter 2 in DP1/21 described the existing prudential framework for small, non-systemic banks and building societies in the UK. It outlined the reasons why the framework may be overly complex for these firms, and the possible consequences for PRA objectives. It referred to a 'complexity problem' with the existing prudential framework faced by small, non-systemic firms. Chapter 2 also explained that simplifying prudential regulation for smaller firms risked adding to a 'barriers to growth problem'; by having different requirements for smaller and larger firms, a small firm wishing to grow would need to adjust to changes in prudential requirements as it expands.

2.2 The following question was posed in Chapter 2:

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?

2.3 A majority of respondents that included an answer to this question agreed with the description of the 'complexity problem' and that this problem can place small firms at a cost disadvantage to larger competitors, inhibiting competition. However, a few respondents observed that small firms had already incurred the cost of complexity when they implemented existing prudential rules. Some respondents noted that the costs of complexity could also be felt by larger firms with simple business models.

2.4 There was slightly less agreement with the description of the 'barriers to growth problem' as respondents felt the transition from simpler to more complex prudential rules could be managed through good planning.

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

3.1 Chapter 3 in DP1/21 outlined a long-term vision for a strong and simple prudential framework for non-systemic firms in the UK and explained how the PRA could realise this vision over time.

The long-term vision

3.2 DP1/21 noted that the diversity of PRA-regulated firms that are not considered systemically important suggested it was unlikely to be feasible to have a single set of strong and simple prudential rules applying to all non-systemic firms while still maintaining their resilience. The DP suggested it would be more appropriate to have requirements that expand and become more sophisticated as the size and/or complexity of firms increase – this was the PRA's long-term vision for a strong and simple framework. The DP asked the following question:

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?

3.3 The vast majority of respondents were supportive of the vision. Among the respondents that disagreed with the vision, some felt it did not put enough weight on enabling non-systemic firms to compete with larger, systemic firms, or that a strong and simple framework was not necessary because current prudential rules already include elements of proportionality.

3.4 Other comments made in response to this question emphasised the importance of a strong and simple framework adhering to the Basel Core Principles for Effective Banking Supervision.[3] Respondents raised concerns over how long it would take the PRA to build the entire strong and simple framework, and expressed a desire to understand the design of the overall strong and simple framework.

A layered framework

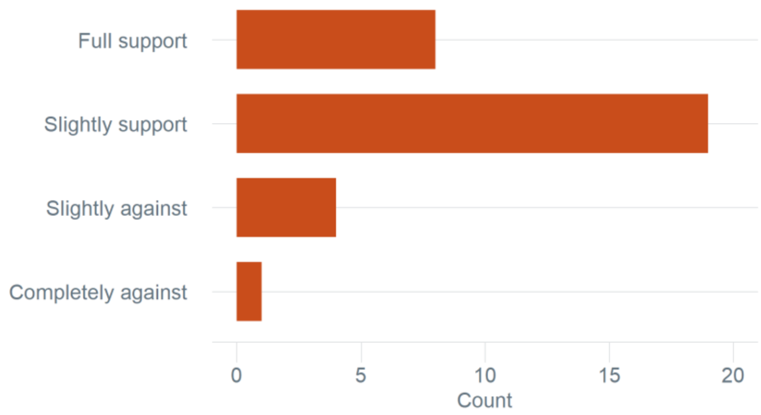
3.5 DP1/21 suggested one way in which the requirements could expand and become more sophisticated as the size and/or complexity of firms increase would be for the strong and simple framework to comprise a number of layered prudential regimes. DP1/21 asked the following question about this idea:

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

3.6 A majority of respondents showed some or full support for this idea (**Chart 1**). However, some respondents were concerned that having many layers would make the prudential framework too complicated.

3 Available at: Basel Core Principles for Effective Banking Supervision.

Chart 1: Level of support for a strong and simple framework consisting of several layers [a]



Sources: Bank calculations.
(a) Based on responses to Q3 in DP1/21. Staff judgement has been used to assign the responses to the categories. The number of 'no responses' is not shown in the chart.

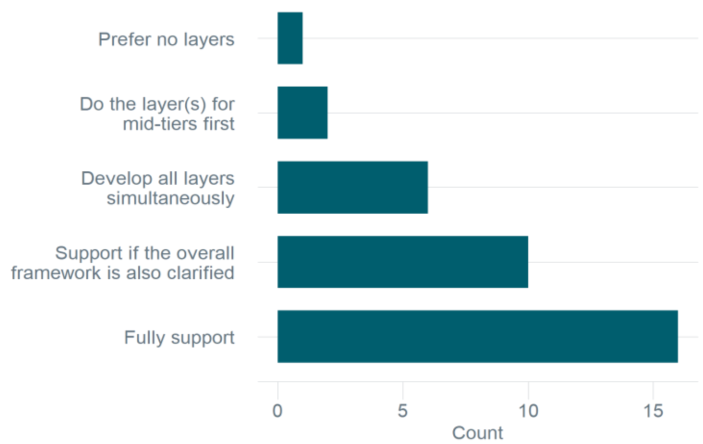
Building the framework

3.7 DP1/21 explained that developing a strong and simple framework would take a number of years to design and implement and that therefore the PRA was considering starting with the layer for the smallest firms. The DP referred to this layer as the 'simpler regime'. The following question was asked in the DP:

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

3.8 There was a range of views expressed by the respondents (**Chart 2**). There was strong support for starting with the simpler regime, while other respondents were supportive if the PRA could provide information about the overall design of the overall strong and simple framework. Some respondents would prefer the PRA to develop layers simultaneously or the layers for the larger firms first.

Chart 2: Level of support for starting with the simpler regime [a]



Sources: Bank calculations.
(a) Based on responses to Q4 in DP1/21. Staff judgement has been used to assign the responses to the categories. The number of 'no responses' is not shown in the chart.

4 A simpler prudential regime for small banks and building societies

4.1 Chapter 4 in DP1/21 discussed options for how a simpler regime for the smallest banks and building societies could be designed. It covered: how firms in scope of the regime could be determined; the development of prudential requirements under the regime; arrangements for how firms could transition out of it; and how the regime might evolve over time.

Determining firms in scope of a simpler regime

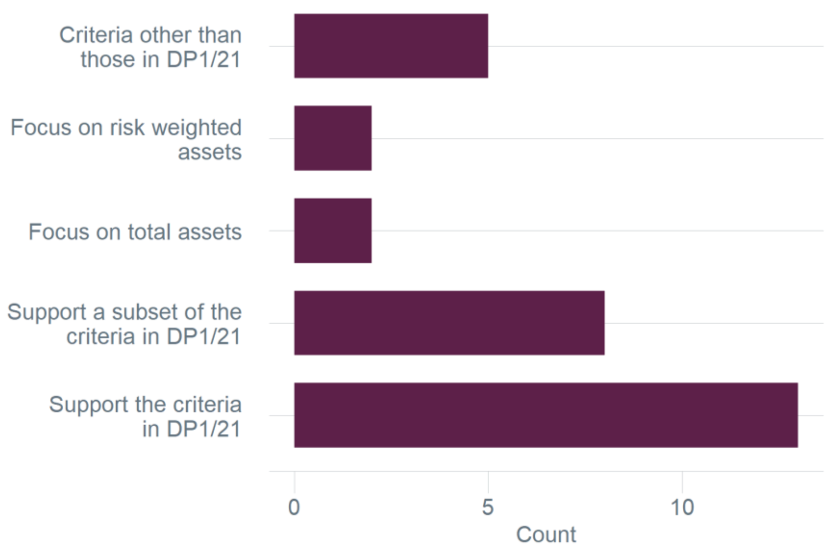
Scope

4.2 Determining which firms should be in scope of the simpler regime was considered as the first key design choice. DP1/21 stated that the basis for determining whether a firm is in scope would ideally be simple, objective, and transparent. It suggested that scope criteria could be based on a combination of size, international activity, trading book activity, use of internal models, resolvability, and highly risky forms of business activity. The DP posed the following question:

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

4.3 While a significant number of respondents did not comment on this issue, those that did thought the criteria discussed in the DP, or a significant subset of them, were appropriate (see **Chart 3**).[4]

Chart 3: Views on the criteria for determining firms in scope of the simpler regime [(a)]



Sources: Bank calculations.
(a) Based on responses to Q6 in DP1/21. Staff judgement has been used to assign the responses to the categories. The number of 'no responses' is not shown in the chart.

4 The criteria discussed in the DP were a firm's size, whether firms use the internal ratings based approach, whether firms undertake activities such as trading or other highly risky forms of business activity, whether firms provide certain types of service to the rest of the financial system or to the wider economy, and a firm's resolution strategy.

4.4 There was a wide range of suggestions as to what the maximum size for a firm in scope of a simpler regime should be, ranging from less than £1 billion to up to £15 billion of assets with £5 billion being the most commonly suggested threshold.

4.5 There was general agreement that firms with a trading book, internal ratings based (IRB) models, or those that have critical functions, should be excluded from a simpler regime. Some respondents suggested that any size limit should be based on risk weighted assets rather than total assets to reflect the riskiness of firms' activities. Some respondents also cautioned that niche lending should not be equated to high risk lending if firms with the latter were excluded from the regime. There was general agreement that the simpler regime should be available only to firms assigned to a modified insolvency resolution strategy.

Defining domestic firms

4.6 DP1/21 explained that internationally active firms are subject to the Basel standards and hence cannot be in scope of a simpler regime that differs from those standards. It asked the following question:

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

4.7 There was a range of views about how a firms' international activity should be quantified, encompassing measures based on both the composition of firm's balance sheets and their group structures. Concerns were raised that an overly broad interpretation of 'internationally active' might exclude many small firms from a simpler regime. For instance, some respondents challenged that a firm should not be considered 'internationally active' because it conducts business in the Crown Dependencies or British Overseas Territories.

Optionality

4.8 DP1/21 acknowledged that small firms would have their own growth plans and some therefore might not want to operate under the simpler regime, even though they met the scope criteria. It asked the following question:

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?

4.9 A majority of respondents supported optionality, with only one response suggesting such a feature would be overly complex. The prevailing view was that firms should automatically be in scope of the simpler regime, but have the ability to opt out by way of a waiver. A minority preferred a supervisory dialogue on the use of the simpler regime, based on the Internal Capital Adequacy Assessment Process (ICAAP) and Capital Supervisory Review and Evaluation Process (C-SREP).

Other issues

4.10 DP1/21 discussed a number of choices the PRA would have to make in applying the scope criteria and asked:

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

4.11 There was uncertainty among all the respondents whether small firms in a simpler regime could be 'systemic as a herd' and the effect a simpler regime would have on it. One response noted that the fact building societies have similar balance sheets – which may mean they could get into distress at the same time – was for structural reasons and not due to prudential regulation.

4.12 There were a small number of responses on whether subsidiaries of wider banking groups should be in scope of the simpler regime, but they showed a range of contrasting views.

4.13 Several respondents suggested that a simpler regime should be designed for small and UK-focused standalone entities and hence parts of large UK banking groups and UK subsidiaries of foreign banks should be out of scope. Some thought that subsidiaries of wider groups should not be in scope because they should be able to draw on resources in the wider group when it comes to interpreting and implementing prudential regulation. However, others challenged the idea that entities draw on the resources of wider groups. One respondent felt it was inappropriate to base scope criteria on whether a foreign bank's UK subsidiary can share resources with its wider group, suggesting that this would exclude some UK subsidiaries of non-UK banking groups operating in the UK retail-banking sector.

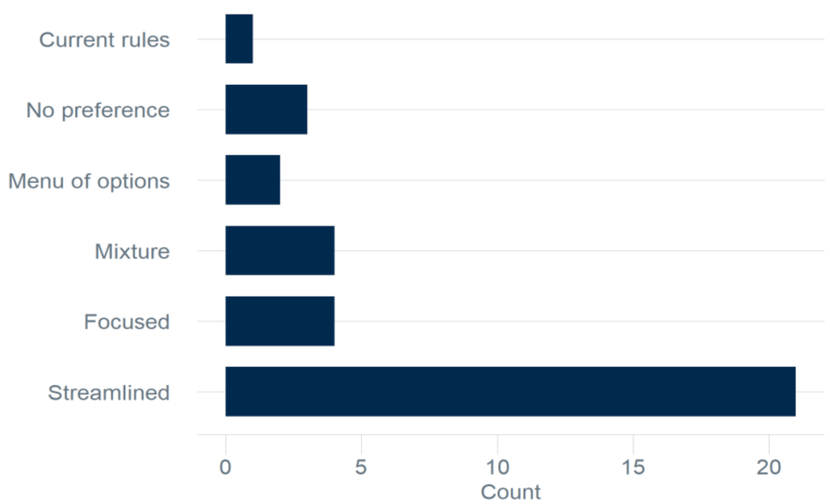
A focused or streamlined approach

4.14 The DP described how options for setting prudential requirements under a simpler regime could sit on a spectrum between a fully 'streamlined' approach and a fully 'focused' approach. The former would take the existing prudential framework as a starting point and modify those elements that appear to be overly complex for smaller firms, while leaving all the elements present in some form. The latter would be based on a narrower but more conservatively calibrated set of new prudential requirements. The DP asked:

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

4.15 The majority favoured the 'streamlined' approach (**Chart 4**). The responses suggest that this was in part because of concerns that a conservatively calibrated focused regime could result in increased capital requirements. There were also some concerns that costs sunk in achieving compliance with existing regulatory requirements would have to be borne again to achieve compliance with a new focused regime.

Chart 4: Support for a focused versus streamlined approach to designing a simpler regime [(a)(b)]



Sources: Bank calculations.
(a) Based on responses to Q21 in DP1/21. Staff judgement has been used to assign the responses to the categories. The number of 'no responses' is not shown in the chart.
(b) 'Mixture' refers to responses that made explicit mention of a simpler regime with streamlined and focused elements. 'Menus of options' refers to responses that suggested firms could pick between streamlined and focused rules.

4.16 Another common theme in the responses that favoured the streamlined approach was concerning the transition between the simpler and the prudential regime for larger firms. The perception was that transitioning from a streamlined regime would be straightforward while transitioning from a focused regime would be a more complex task, presenting an additional barrier to growth.

4.17 Some respondents suggested that a focused regime could be developed for use by the very smallest firms, alongside a more streamlined approach for firms that wanted to grow. It was also suggested that a streamlined approach could be used initially with the regime gradually changing over time to become more focused in nature.

Prudential requirements

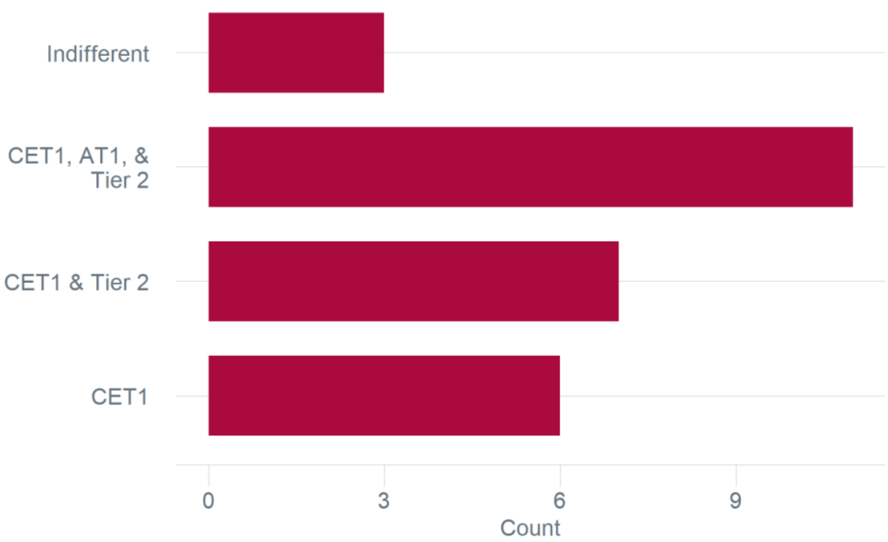
Capital quality requirements

4.18 DP1/21 discussed potential options for simplifying capital quality requirements (ie the numerator of a regulatory capital to risk-weighted assets ratio) for small firms. The DP asked:

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

4.19 There was a range of views about which instruments should count as eligible regulatory capital in any simpler regime (**Chart 5**). The most frequent response was that Common Equity Tier 1 (CET1) capital, Additional Tier 1 (AT1) capital, and Tier 2 capital should continue to count as regulatory capital under a simpler regime. Some respondents stated that the current capital quality requirements were not overly complex, while others were concerned that small firms could be put at a competitive disadvantage if they could not use AT1 capital to meet capital requirements when bigger firms were allowed to do so. However, some respondents preferred a narrower definition of eligible capital.

Chart 5: Views on eligible capital instruments under a simpler regime [(a)]



Sources: Bank calculations.
(a) Based on responses to Q9 in DP1/21. Staff judgement has been used to assign the responses to the categories. The number of 'no responses' or responses staff were not able to assign to any of the categories are not shown in the chart.

4.20 Some building society respondents were of the view that Core Capital Deferred Shares should continue to count as CET1 capital under any simpler regime. Several others stated that simplifications of the prudential rules about deductions from regulatory capital and of the regulatory processes around meeting capital quality requirements would be beneficial for small firms.

4.21 No respondents expressed explicit support for the accommodation of so-called 'growth' shares in capital quality requirements.

Risk weighted requirements

4.22 The DP suggested that, in a 'focused approach', current Pillar 1 and 2A capital requirements could be replaced with a single, simple, capital requirement; but that a significantly more conservative calibration would probably be necessary to maintain the resilience of firms in scope of the simpler regime. DP1/21 asked the following question:

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

4.23 Half of the respondents were opposed to a focused simpler regime that involved higher capital requirements to compensate for a loss of risk sensitivity. They reasoned that it could encourage firms in scope of the regime to move up the risk curve to earn a sufficient return on the additional capital required. They further suggested that it could reduce the competitiveness of these firms, offsetting the purpose of simplification.

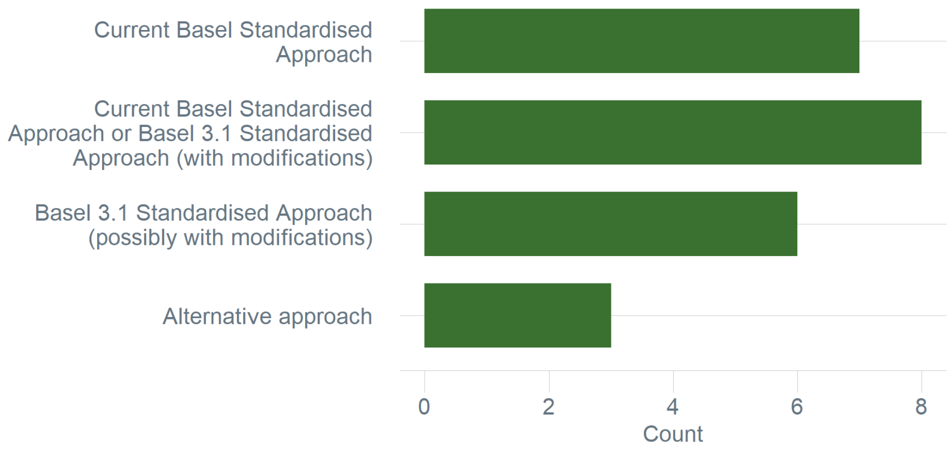
Pillar 1 risk-weighted requirements

4.24 The DP discussed how Pillar 1 risk weighted capital requirements might be simplified under a 'streamlined' approach to the simpler regime and asked the following question:

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

4.25 Respondents were broadly in favour of the continued use of the Basel standardised approach to calculating risk weights for credit risk. There were different views about whether this should be the current standardised approach or (a version of) the standardised approach that will be introduced by the Basel 3.1 reforms (**Chart 6**). Several respondents that were broadly in favour of Basel 3.1 being used suggested that for mortgages the link between the loan to value ratio at origination and risk weights, which is part of the Basel 3.1 reforms, should be modified.

Chart 6: Views on the Pillar 1 approach to credit risk [(a)]



Sources: Bank calculations.
(a) Based on responses to Q11 in DP1/21. Staff judgement has been used to assign the responses to the categories. The number of 'no responses' is not shown in the chart.

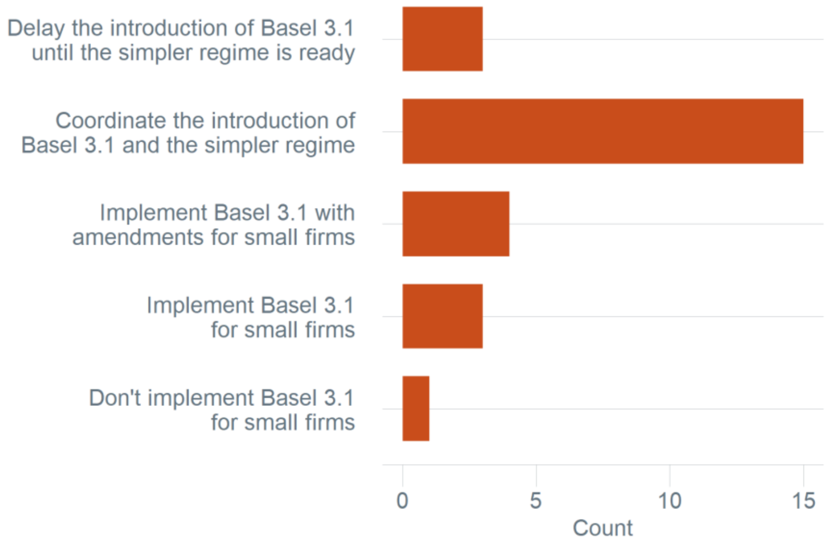
4.26 DP1/21 explained in Chapter 6 that the PRA would consider how the Basel 3.1 reforms should be introduced for small firms. It asked for views that how that should be done:

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?

4.27 Many respondents asked that the PRA coordinate the introductions of the Basel 3.1 reforms and the simpler regime, but did not make specific suggestions for how they would prefer that to be done (**Chart 7**). A few respondents suggested delaying Basel 3.1 until the simpler regime was ready, or to implement Basel 3.1 for small firms (with or without amendments), or not to implement Basel 3.1 for small firms at all.

4.28 On other risks captured by Pillar 1 risk weighted minimum capital requirements, several respondents supported the basic indicator approach for operational risk. A number of respondents thought that using the scope criteria to exclude firms with trading activity should facilitate making Pillar 1 capital requirements for market risk, counterparty credit risk, and credit valuation adjustment unnecessary.

Chart 7: Views on how to co-ordinate the implementation of Basel 3.1 and the introduction of the simpler regime [(a)]



Sources: Bank calculations.
(a) Based on responses to Q29 in DP1/21. Staff judgement has been used to assign the responses to the categories. The number of 'no responses' or responses staff were not able to assign to any of the categories are not shown in the chart.

Pillar 2A requirements

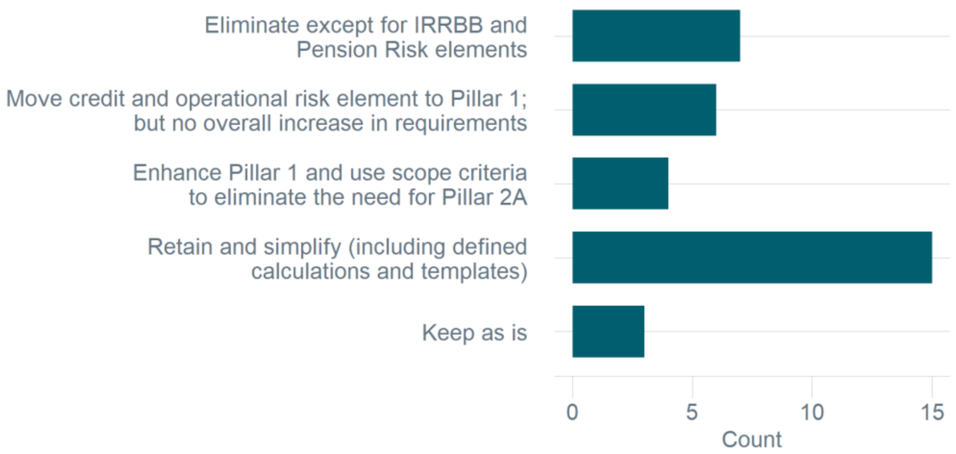
4.29 DP1/21 discussed the role of the Pillar 2A approach in capturing additional risks to which firms might be exposed under the simpler regime. It posed the following question:

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

4.30 Respondents showed near universal agreement that the current approach was overly complex and penal for the smallest firms. The most frequent view was that the Pillar 2A approach should be retained but simplified, providing this did not increase overall capital requirements (**Chart 8**). Approximately half of respondents favoured the removal of Pillar 2A entirely, or a significant reduction in its scope, for example to only cover Interest Rate Risk in the Banking Book (IRRBB) and pension risk elements. A few respondents preferred that the current Pillar 2A approach should continue under the simpler regime.

4.31 The two most commonly highlighted areas for simplification were the concentration risk and operational risk add-ons. A majority of respondents felt the concentration risk add-on, which uses the Herfindahl-Hirshman Index (or HHI) to assess geographical concentration, penalises lending within the UK. The operational risk calculation was considered unnecessarily complicated, with results being non-intuitive, dependent on too many assumptions, and overly penal for small firms. These respondents suggested it would be more appropriate if the calculation were derived from operational stress testing or was part of the Pillar 1 operational risk requirement.

Chart 8: Views on the design of Pillar 2A requirements in the simpler regime [(a)]



Sources: Bank calculations.
(a) Based on responses to Q12 in DP1/21. Staff judgement has been used to assign the responses to the categories. The number of 'no responses' or responses staff were not able to assign to any of the categories are not shown in the chart.

4.32 Several respondents emphasised that for lending books conservatively weighted under Pillar 1 requirements the benefits of Pillar 2A reductions via the holistic approach should be retained. A number of respondents also proposed that Pillar 2 add-ons should be set as fixed, nominal amounts, rather than as percentages of risk weighted assets, to improve clarity and reduce variability.

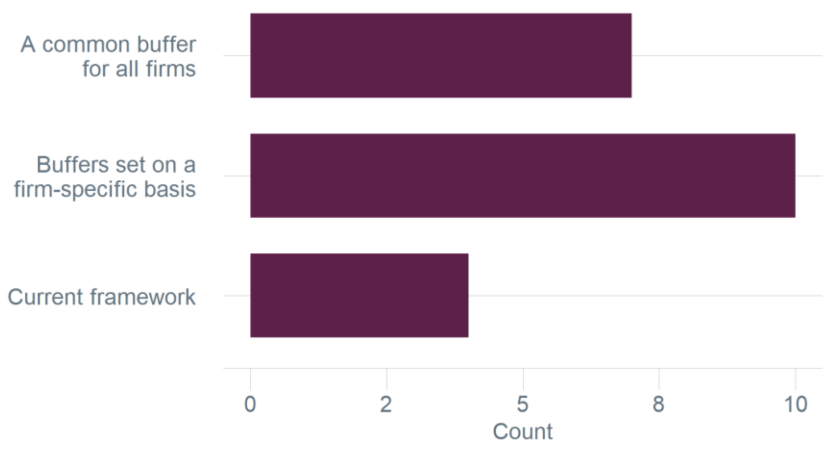
Capital buffers

4.33 DP1/21 discussed the role of a microprudential capital-buffer requirement in a simpler regime (ie a requirement designed to ensure firms have enough capital to absorb losses in stress conditions, while continuing to meet minimum capital requirements). It discussed options for this requirement under a focused and a streamlined approach. The DP asked:

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

4.34 **Chart 9** shows the views expressed about the capital buffer framework in a simpler regime. Among the respondents that stated a preference, most preferred a single buffer requirement that would be set on a firm-specific basis (ie the calibration of the buffer would be set for each firm individually). There were concerns that if a buffer were calibrated at the same level for all small firms it would have to be set higher to account for riskier firms, which would penalise safer firms. However, some respondents preferred a buffer calibrated at the same level for all firms. A few respondents said they were content with the current buffer framework.

Chart 9: Views on the capital buffer framework in the simpler regime [a]



Sources: Bank calculations.
(a) Based on responses to Q13 in DP1/21. Staff judgement has been used to assign the responses to the categories. The number of 'no responses' is not shown in the chart.

Liquidity and funding

4.35 The DP considered whether liquidity requirements under a simpler regime should use a 'streamlined' approach based on existing liquidity metrics such as the Liquidity Coverage Ratio (LCR) and the proposed Net Stable Funding Ratio (NSFR), or a 'focused approach' based on a simpler liquidity measure (such as a required minimum stock of liquid assets as a percentage of funding liabilities). It asked the following question:

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

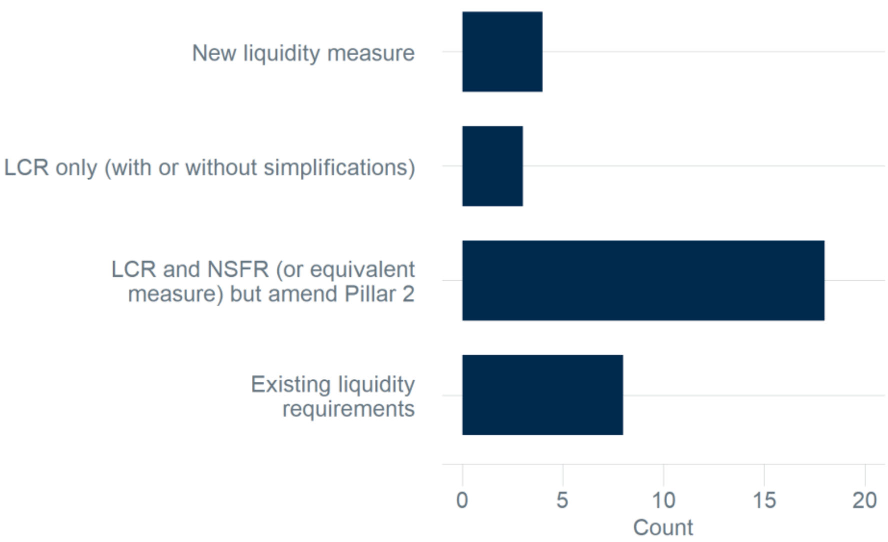
4.36 There was a wide range of views about the design of liquidity requirements under a simpler regime (**Chart 10**). There was significant backing for a liquidity framework that was based on existing rules but possibly with some modifications. This reflected the fact that existing rules were already embedded and were not considered to be overly complex.

4.37 Regardless of the method used, a significant number of respondents thought that the Pillar 2 liquidity policy should be amended. In particular, respondents considered that the current calculation for intraday liquidity risk was over complex and the results over calibrated for the risk.

4.38 Many respondents commented on the cost and complexity of liquidity reporting requirements (see paragraph 4.62 below).

4.39 A small number of respondents favoured a focused approach to liquidity requirements based on a new liquidity measure such as a liquidity stock requirement, or one based on a firm's own overall-liquidity-adequacy-rule (OLAR) measures.

Chart 10: Views on liquidity requirements under the simpler regime [(a)]



Sources: Bank calculations.
(a) Based on responses to Q15 in DP1/21. Staff judgement has been used to assign the responses to the categories. The number of 'no responses' is not shown in the chart. Respondents counted in the category 'LCR and NSFR (or equivalent measure) but amend Pillar 2' includes those that supported the simplified NSFR or other, equivalent, liquidity measures.

ICAAPs, ILAAPs, and recovery, resolution and solvent wind-down planning

4.40 DP1/21 highlighted that there may be scope to simplify the ICAAP and Internal Liquidity Adequacy Assessment Process (ILAAP), as well as the associated C-SREP and Liquidity Supervisory Review and Evaluation Process (L-SREP) processes. DP1/21 further considered how recovery planning could be extended to cover solvent wind-down planning under a simpler regime. It posed the following questions:

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

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

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

4.41 While there was a high level of support in the responses for maintaining both the ICAAP and ILAAP documents, there was a clear view that both could and should be simplified. Most respondents favoured the use of standardised templates and guidance. Other suggestions included the development of a more prescriptive approach to stress testing or simplified Pillar 2-specific returns, to be submitted as part of the C-SREP process. Some respondents felt that parts of the ILAAP that were not relevant for small firms could be dropped. There was wide support for a reduced review cycle of both documents, with respondents suggesting that ICAAPs and ILAAPs be reviewed in alternate years.

4.42 Views on solvent wind-down were split, with some respondents being in favour, arguing it was preferable to resolution as a means of exit and others arguing that solvent wind-down planning would be an unwelcome additional burden. Several respondents proposed that recovery, resolution, and solvent wind-down planning could all be simplified. Other suggestions included combining recovery and solvent wind-down plans, or only requiring firms complete these in alternate years.

4.43 A common theme, raised by nearly all of those who responded, was the desire to avoid the current duplication of information across the ICAAP, ILAAP, recovery and resolution plans, and (potentially in the future) solvent wind-down plans. Some suggested that the consolidation of some, or even all of these into a single document could reduce the duplication of information.

Governance, remuneration, and risk management

4.44 DP1/21 discussed two areas where the existing set of requirements covering governance could potentially be streamlined: the Senior Managers and Certification Regime (SM&CR) and rules covering remuneration. It asked:

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

4.45 A majority of respondents favoured some simplification of the SM&CR, in terms of either minimum requirements, thresholds or processes for approving new individuals, with the latter being a particular focus for many.

4.46 A number of respondents suggested that the existing governance approach was adequate and proportionate, or that changes were not warranted. A few suggested radical simplification including of expectations for the composition of boards and the need for certain board committees.

4.47 A number of respondents indicated that they had no views on remuneration rules since they were currently exempt. Those that had views generally proposed simplifications to variable remuneration rules (eg the bonus cap).

4.48 Around a third of respondents mentioned risk management requirements and were generally supportive of the regulator providing more guidance on supervisory expectations, either by extending a version of Supervisory Statement (SS) 20/15 'Supervising building societies' treasury and lending activities' (the 'Building Society Sourcebook') to small banks, or by creating new bespoke guidance.[5] The motivation for this was partly, in the case of responses from building societies, to level a perceived imbalance in the PRA's treatment of building societies and banks. However, a number of respondents from banks indicated they would welcome further guidance, and cited the Building Society Sourcebook as an example of a flexible regulatory approach to risk management expectations.

Operational resilience

4.49 DP1/21 acknowledged that it was probably too early to determine whether there was further scope for simplification of recently published statements on operational resilience since they do not come into effect until 2022. It asked:

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

4.50 The majority of the respondents felt that current prudential policy on operational resilience could be simplified. Suggestions as to how this could be achieved included the PRA providing more guidance, the merging of the relevant supervisory and policy statements into a single document, greater alignment of the PRA and Financial Conduct Authority's respective operational resilience policies, the PRA publishing

5 December 2020: SS20/15 - Supervising building societies' treasury and lending activities.

aggregated data to help firms benchmark, and exempting firms from parts of the policy that less relevant to them.

4.51 However, several respondents felt that the current policy was appropriate, or that it was too early to determine whether there is further scope for simplification of the PRA's approach for smaller firms.

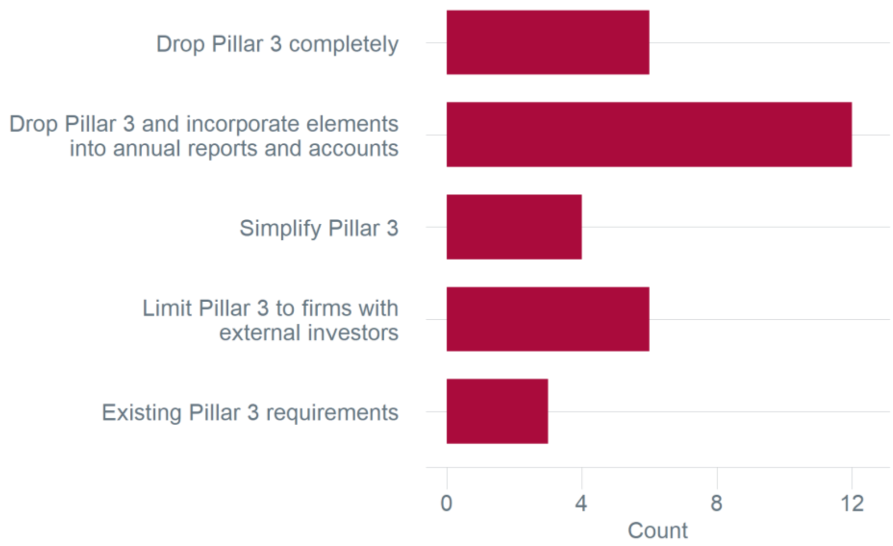
Disclosure

4.52 DP1/21 considered Pillar 3 disclosure requirements and asked the following:

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

4.53 **Chart 11** summarises the respondents. The majority felt Pillar 3 disclosures were overly complex and offered little value for small or unlisted firms. They were mostly in favour of them being dropped entirely, or for them to be subsumed into annual accounts. If Pillar 3 disclosure requirements were to continue, some saw scope for more simplification. Only a small minority felt that the Pillar 3 disclosure requirements should remain unchanged. One response expressed concern that removing Pillar 3 disclosure requirements could result in smaller firms being viewed by the market as riskier, which might result in increased funding costs.

Chart 11: Views on the role of Pillar 3 requirements under a simpler regime [(a)]



Sources: Bank calculations.
(a) Based on responses to Q20 in DP1/21. Staff judgement has been used to assign the responses to the categories. The number of 'no responses' is not shown in the chart.

Overall effects of the policy options

4.54 DP1/21 sought views on the overall policy options and on any areas of the prudential framework not covered by the DP, asking:

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

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?

4.55 The Building Society Sourcebook was the most commonly mentioned area of the prudential framework that respondents felt should be considered when developing the simpler regime, as also raised in response to the question on 'Governance, remuneration, and risk management'. Some respondents suggested that it should be retired or brought into the simpler regime; or, if retained but not extended to banks as well, it should result in a preferential prudential treatment of building societies to reflect their reduced risk profile.

4.56 One frequently suggested improvement was that current stress testing guidance and requirements across ICAAPs, ILAAPs, and recovery and resolution plans should be consolidated, with an internally consistent set of scenarios (also see paragraph 4.43). Respondents suggested that significant resource savings would be possible if the frequency of stress testing and document production was reduced.

4.57 Other suggestions included reducing the disparity of capital requirements between standardised and IRB firms, reducing scope for supervisory qualitative judgement overlays, and setting the base capital requirement as a fixed sterling amount instead of an amount equivalent to €5 million.

4.58 Most respondents felt that, were they introduced, the policy options taken together could have a significant impact on the complexity of prudential regulation for smaller banks and building societies. However, several respondents that agreed raised concerns that if prudential requirements, in particular capital requirements, were strengthened under a simpler regime it could undermine the objectives of developing a strong and simple framework.

Regulatory reporting

4.59 DP1/21 noted that, in developing a simpler regime, the PRA would need to review its regulatory data collections from small firms. The following question was asked:

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?

4.60 There were many detailed responses on the subject of regulatory reporting. There was a common view that the regulatory reporting burden is disproportionate for small firms.

4.61 Several respondents noted that, while the current COREP based regime was complex, firms had already invested in necessary reporting systems and it would therefore be undesirable to have to implement new reporting systems, as this would be a costly and complex exercise. As a result, the majority of respondents favoured simplification of the current reporting framework rather than a wholesale change.

4.62 Nearly all respondents highlighted the problems encountered when completing current returns, and a perception that some require an unnecessary level of detail. A common suggestion to reduce the burden on firms was that both the volume and frequency of reporting should be reduced. For example, there was a near universal view that existing liquidity reporting requirements were burdensome, particularly given the need to submit the Additional Liquidity Monitoring Metrics and the PRA 110 in addition to COREP tables, and should be reduced.

4.63 A large number of respondents stressed the need for better guidance notes for completing returns, with a few advocating for the PRA to develop its own version of the European Banking Authority's question and answer system for publishing standard answers to reporting queries.

4.64 Several respondents cited a need for an improved submission process for returns using a common platform or central repository rather than the current mixture of methods. Some of those respondents also suggested that the submission system should be modelled on a tax return approach, whereby only relevant sections are listed for completion based on the system's knowledge of each firm's size and activities.

Evolution and transitioning

Evolution of the simpler regime

4.65 DP1/21 highlighted that, over time, a simpler regime will need to evolve and asked:

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

4.66 DP1/21 suggested that once the regime was in place, changes to it could happen according to a predictable cycle of updates (bar for extraordinary changes to address material and urgent new risks). A number of respondents supported this idea and no respondents were against it. One response pointed to the triennial cycle of major updates to the FRS 102 accounting standard as a possible model.

Transitioning in and out of the simpler regime

4.67 DP1/21 discussed how firms might transition in and out of a simplified regime. It asked the following question:

Q26: How should transition arrangements be designed?

4.68 A number of respondents suggested that any size limit included in the simpler-regime scope criteria should be dynamic, adjusting to reflect general growth in balance sheets. This would avoid a downward drift over time in the number of firms meeting the simpler-regime scope criteria. Respondents also suggested any size limit should be based on moving averages rather than point-in-time measures.

4.69 In addition, a number of respondents stated that there would need to be arrangements in place for firms that unexpectedly (and temporarily) cease to meet the simpler-regime scope criteria. The use of temporary waivers and/or supervisory discretion was mentioned by several respondents as a method by which this could be addressed.

4.70 A number of respondents proposed a transition period, of up to 24 months, to give firms sufficient time to plan for a move out of the simpler regime. Some respondents suggested that the Periodic Summary Meeting be used to confirm which prudential regime a firm should be following.

5 Measures to lower barriers to growth

5.1 Chapter 5 in DP1/21 discussed possible measures to lower barriers to growth faced by non-systemic firms that would not be operating under the simpler regime. It highlighted actions that might be taken as the PRA built out the strong and simple framework to cover a wider set of non-systemic firms and the trade-offs involved.

Number of layers

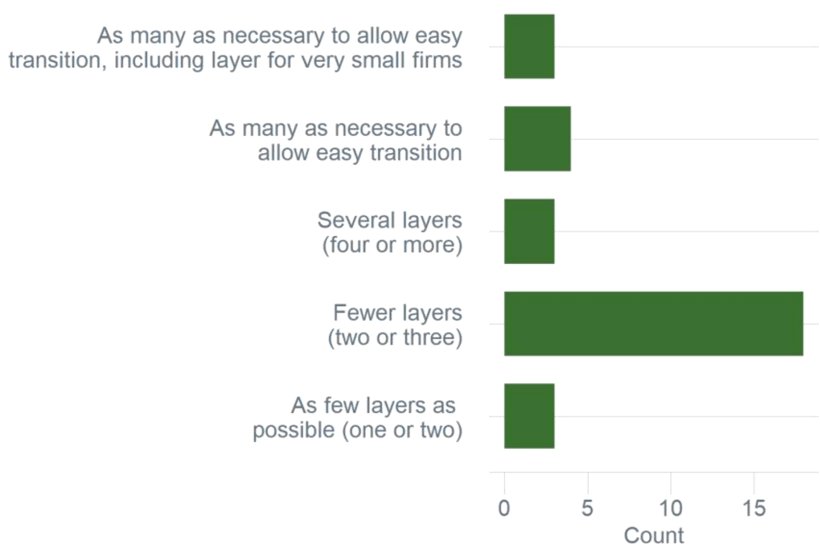
5.2 DP1/21 outlined considerations the PRA would need to make when choosing the number of layers in the strong and simple framework. It asked:

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

5.3 The responses are summarised in **Chart 12**. A majority of respondents that offered a view supported fewer layers (eg no more than two or three). Some respondents preferred more layers and some suggested there should be a layer specifically for the very smallest firms (ie underneath a simpler regime).

5.4 Some respondents emphasised the importance of designing the framework to enable a smooth progression through the layers by growing firms. Other suggestions included that firms should be able to mix and match prudential rules from different layers, and that the thresholds that define the layers should adjust to the size of the banking sector (see chapter 4 of this statement).

Chart 12: Views on the number of layers in the strong and simple framework



Sources: Bank calculations.

(a) Based on responses to Q27 in DP1/21. Staff judgement has been used to assign the responses to the categories. The number of 'no responses' is not shown in the chart.

Transition arrangements and optionality

5.5 DP1/21 discussed how transitional arrangements and giving firms the option to operate in a higher layer could help to reduce any barriers to growth created by a prudential framework comprised of a series of layered regimes. The following question was asked:

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

5.6 Respondents agreed that these features would be important in reducing barriers to growth due to layering. However, several respondents did not think the features would be necessary because layering would not create significant barriers to growth compared to other drivers. There were contrasting views on the role supervisory judgement should have in determining how firms should transition between layers.

6 Future plans for a strong and simple framework

6.1 Chapter 6 in DP1/21 discussed how the PRA could go about developing and implementing a strong and simple prudential framework.

6.2 It first discussed the implementation of the simpler regime and asked a question (Q29) about how the introduction of a simpler regime should be co-ordinated with the forthcoming introduction of the Basel 3.1 reforms; responses to this question are discussed in chapter 4 of this statement. It also explained the links with the PRA Rulebook and the Financial Services Future Regulatory Framework.[6]

6.3 Although DP1/21 did not discuss policy options for the layers of a strong and simple framework above the simpler regime, it asked the following question on what the PRA should consider for larger firms:

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?

6.4 There were a small number of suggestions made in responses to this question. These included that the PRA consider: adopting some of the simplified requirements that will be developed for the simpler regime for the higher layers; exploring simplifications to Pillar 1 and 2A requirements (eg by providing more templates); and reducing the frequency of regulatory assessments. Another respondent suggested exploring whether solvent wind-down planning could be applied to larger, non-complex firms.

6.5 Some respondents mentioned that the process for achieving IRB model approval could act as a barrier to growth, and that the IRB model approval process should be improved.

6.6 Other respondents asked that the PRA design the higher layers so that firms in scope of these layers would not be at a competitive disadvantage relative to firms operating under the simpler regime, or raised concerns about the impact of a strong and simple framework on the competitive position of PRA-regulated firms relative to other lenders.

6 HM Treasury Consultation, October 2020: Financial Services Future Regulatory Framework Review Phase II Consultation.

Appendix: List of questions in DP1/21

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?

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?

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

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

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

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

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?

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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?

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?

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

Q26: How should transition arrangements be designed?

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

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

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?

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.