The Strong and Simple Framework: The simplified capital regime for Small Domestic Deposit Takers (SDDTs) Consultation paper | CP7/24

Table of Contents

Privacy statement

By responding to this consultation, you provide personal data to the Bank of England (the Bank, which includes the Prudential Regulation Authority (PRA)). This may include your name, contact details (including, if provided, details of the organisation you work for), and opinions or details offered in the response itself.

The response will be assessed to inform our work as a regulator and central bank, both in the public interest and in the exercise of our official authority. We may use your details to contact you to clarify any aspects of your response.

The consultation paper will explain if responses will be shared with other organisations (for example, the Financial Conduct Authority). If this is the case, the other organisation will also review the responses and may also contact you to clarify aspects of your response. We will retain all responses for the period that is relevant to supporting ongoing regulatory policy developments and reviews. However, all personal data will be redacted from the responses within five years of receipt. To find out more about how we deal with your personal data, your rights, or to get in touch please visit **Privacy and the Bank of England**.

Information provided in response to this consultation, including personal information, may be subject to publication or disclosure to other parties in accordance with access to information regimes including under the Freedom of Information Act 2000 or data protection legislation, or as otherwise required by law or in discharge of the Bank’s functions.

Please indicate if you regard all, or some of, the information you provide as confidential. If the Bank receives a request for disclosure of this information, we will take your indication(s) into account but cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system on emails will not, of itself, be regarded as binding on the Bank.

Responses are requested by Thursday 12 December 2024.

Consent to publication

The PRA publishes a list of respondents to its consultations, where respondents have consented to such publication.

When you respond to this consultation paper, please tell us in your response if you agree to the publication of your name, or the name of the organisation you are responding on behalf of, in the PRA's feedback response to this consultation.

Please make it clear if you are responding as an individual or on behalf of an organisation.

Where your name comprises 'personal data' within the meaning of data protection law, please see the Bank's Privacy Notice above, about how your personal data will be processed.

Please note that you do not have to give your consent to the publication of your name. If you do not give consent to your name being published in the PRA's feedback response to this consultation, please make this clear with your response.

If you do not give consent, the PRA may still collect, record and store it in accordance with the information provided above.

You have the right to withdraw, amend or revoke your consent at any time. If you would like to do this, please contact the PRA using the contact details set out below.

Responses can be sent by email to: CP7_24@bankofengland.co.uk.

Alternatively, please address any comments or enquiries to:
Strong and Simple Hub
Prudential Policy Directorate
Prudential Regulation Authority
20 Moorgate
London
EC2R 6DA

1: Overview

1.1 The Prudential Regulation Authority's (PRA's) 'strong and simple' initiative seeks to simplify the prudential framework for small, domestic-focused banks and building societies, while maintaining their resilience. This was set out in consultation paper (CP) 5/22 – **The Strong and Simple Framework: a definition of a Simpler-regime Firm** and discussion paper (DP) 1/21 – **A strong and simple prudential framework for non-systemic banks and building societies**.

1.2 Having first consulted on the criteria for determining eligible firms in CP5/22, the PRA has developed its proposals for simplified prudential regulation for Small Domestic Deposit Takers (SDDTs) and SDDT consolidation entities[1] [2] in two phases. Phase 1 focused on non-capital related prudential regulation, specifically liquidity and disclosure requirements. These requirements, along with the criteria that must be met to be an SDDT, were finalised in policy statement (PS) 15/23 – **The Strong and Simple Framework: Scope Criteria, Liquidity and Disclosure Requirements**.

1.3 This CP sets out proposals for Phase 2, the proposed simplified capital regime and additional liquidity simplifications for SDDTs. The PRA is proposing to simplify all elements of the capital stack, including Pillar 1, Pillar 2A, buffers, and the calculation of regulatory capital. This CP also proposes to revoke the Interim Capital Regime (ICR), which is a temporary and optional regime that provides SDDT-eligible firms and consolidation entities with the option to remain subject to existing Capital Requirements Regulation (CRR) capital provisions until the capital regime set out in this CP is implemented. The near-final rules for the ICR and ICR consolidation entities are set out in PS9/24.[3]

1.4 The PRA considers that the proposals in this CP, together with Phase 1 simplifications, would create a significantly simplified prudential regime for SDDTs with simpler and more straightforward supervisory processes and reporting requirements. Together, the proposals would create a much simpler, more certain, and less costly capital regime for SDDTs which could enhance competition in the UK banking sector and support a dynamic and diverse banking sector in the UK.

1 The full definition of an SDDT and an SDDT consolidation entity, including the SDDT and SDDT consolidation entity criteria, are set out in the **SDDT Regime – General Application Part of the PRA Rulebook**.

2 For ease of reading, any references to SDDT(s) hereafter in this CP should be treated as applicable to both SDDTs and SDDT consolidation entities, unless stated otherwise.

3 References to ICR firms should be treated as references to ICR firms and ICR consolidation entities, unless stated otherwise.

1.5 This CP should be of interest to PRA-authorised banks and building societies ('firms'), PRA-designated UK investment firms, and their qualifying parent undertakings, which for this purpose comprise financial holding companies and mixed financial holding companies, as well as credit institutions, investment firms, and financial institutions that are subsidiaries of these firms, regardless of their location.

1.6 This CP should be of particular interest to SDDTs, firms who meet the SDDT criteria and are considering becoming an SDDT, firms that anticipate being subject to the ICR, and entities that do business with SDDTs.

1.7 The SDDT regime operates on an opt-in basis. Firms meeting the SDDT criteria (SDDT-eligible firms) can enter the regime by consenting to a Modification by Consent (MbC) to become an SDDT. The PRA proposes that firms that have taken up this MbC would be in scope of the measures proposed in this CP (ie as well as the Phase 1 simplifications).

1.8 This CP has been published on Thursday 12 September 2024 alongside four other publications:

- PS9/24 – **Implementation of the Basel 3.1 standards near-final part 2**[4]
- CP8/24 – **Definition of Capital: restatement of CRR requirements in PRA Rulebook**[5]
- CP9/24 – **Streamlining the Pillar 2A capital framework and the capital communications process**[6]
- CP10/24 – **Updates to the UK policy framework for capital buffers**[7]

1.9 Taken together, these publications provide stakeholders with information about the PRA's intentions for the proposed overall capital framework for SDDTs (covering Pillar 1, Pillar 2A, buffers, and the definition of capital). Providing this information at the same time should help stakeholders respond to this CP by giving them the full picture of what simpler prudential regulation as an SDDT might look like.

1.10 The near-final rules and policy proposals in the above publications are made jointly with the proposals set out in this CP, and readers are encouraged to refer to these publications when considering the proposals in this CP. Together, this CP and the publications detailed in paragraph 1.8 set out the overall package that would form the capital regime for SDDTs.

4 PS9/24 sets out the PRA's implementation of the Basel 3.1 standards by publishing the second part of the near-final rules.
5 CP8/24 sets out the PRA's proposals on the restatement of the CRR definition of capital requirements in the PRA Rulebook.
6 CP9/24 sets out the PRA's proposals on retiring the refined methodology to Pillar 2A and streamlining firm-specific capital communications.
7 CP10/24 sets out the PRA's proposals to streamline some of its policy materials on capital buffers.

Overview of the proposals set out in this CP

1.11 The proposals in this CP focus on creating a significantly simpler capital regime for SDDTs while ensuring they maintain adequate capital. The PRA considers these proposals would advance the PRA's primary and secondary objectives. In summary, the proposals are:

- a Pillar 1 framework for SDDTs based on the Basel 3.1 standardised approaches (SAs) to credit risk and operational risk as set out in PS9/24 and PS17/23, respectively;
- simplification of the Pillar 1 framework for SDDTs through the disapplication of the due diligence requirements in the standardised approach to credit risk (CR SA), simplifications to the market risk framework, the disapplication of capital requirements for counterparty credit risk for derivatives (with some minor exceptions) and credit valuation adjustment (CVA) risk, and consequential changes to the Leverage Ratio and Large Exposures rules;
- simplifications to the Pillar 2A methodologies for credit risk, credit concentration risk, and operational risk;
- a new Single Capital Buffer (SCB) framework to replace the current buffers framework (consisting of the Capital Conservation Buffer (CCoB) and Countercyclical Capital Buffer (CCyB), which together make up the combined buffer, and the PRA buffer), and the removal of automatic capital conservation measures under the maximum distributable amount (MDA) framework;
- the replacement of the current cyclical stress testing framework with a non-cyclical framework;
- removal of the CCyB adjustment[8] between buffers and Pillar 2A which would make the capital stack much simpler for SDDTs to understand;
- simplifications to the Internal Capital Adequacy Assessment process (ICAAP) and a reduction in the frequency of the Internal Liquidity Adequacy Assessment Process review (ILAAP);
- simplifications to certain complex capital deduction rules;
- simplifications to reporting requirements, in line with the proposals set out above;
- the revocation of the Interim Capital Regime (ICR) so that firms that opted into the ICR would be required to implement either the full Basel 3.1 standards (as set out in PS17/23 – **Implementation of the Basel 3.1 standards near-final part 1** and PS9/24),[9] or the capital regime proposed in this CP from the implementation date proposed in paragraph 1.41; and
- some changes to the way the SDDT regime will operate in light of the proposed changes to the capital regime for SDDTs (see Chapter 8).

---

8 As detailed in **PS15/20 – Pillar 2A: Reconciling capital requirements and macroprudential buffers**.

9 As well as the capital buffer framework and the Pillar 2A methodologies that apply outside of the SDDT regime.

1.12 In addition to the proposals in this CP, the proposed retirement of the refined methodology, as set out in CP9/24, would also contribute to making the capital stack simpler for SDDTs. CP9/24 proposes that SDDTs would be subject to the retirement of the refined methodology since they would be subject to the Basel 3.1 standardised approach to credit risk.[10]

1.13 The proposals in this CP focus on simplifications to the capital framework for SDDTs which address points respondents raised to DP1/21.[11] Respondents were broadly in favour of the continued use of the Basel standards for calculating risk weights for credit risk (instead of a greatly simplified but conservative regime); retaining but simplifying the Pillar 2A framework where possible; and a buffer framework comprised of a single buffer that is more constant and therefore predictable. In addition, respondents expressed strong support for Common Equity Tier 1 (CET1) capital, Additional Tier 1 (AT1) capital, and Tier 2 capital remaining eligible capital instruments for firms, and for retaining but simplifying the ICAAP.

1.14 In line with the responses to DP1/21, the PRA has followed a 'streamlined approach' in developing its proposals for the SDDT regime. This approach aims to simplify the current prudential requirements rather than creating a new prudential framework for SDDTs that is significantly different from, and likely more conservative than, the prudential framework that applies to other firms. The PRA considers that this approach would allow SDDTs to operate under simpler prudential requirements, while preserving risk sensitivity in SDDTs' requirements and expectations. It would also prevent the creation of new barriers for firms wanting to enter or leave the SDDT regime by making transitioning out of the regime simpler than it would be if a significantly different prudential framework were to apply to SDDTs.

1.15 The PRA considers that the proposed simplifications would reduce SDDTs' costs because they would make the capital regime simpler to understand and implement for these firms. In addition, the PRA's proposed buffer framework for SDDTs is designed to reflect challenges small firms have indicated they face in raising new regulatory capital quickly in response to changes in regulatory buffers (because there may not be a deep market for their capital instruments always available, or their access to external funding or opportunities to generate capital organically are limited). The introduction of a more constant and predictable buffer would allow SDDTs to hold lower management buffers (ie they would not feel the need to maintain 'buffers on buffers' as a form of self-insurance against increases in regulatory buffers) and hence reduce their costs. The PRA would generally anticipate, as a result of

10 See Chapter 2 in CP9/24 for an explanation for why the Basel 3.1 standardised approach to credit risk means the refined methodology can be retired.

11 DP1/21 started the review of whether the PRA could simplify the prudential framework for small, domestic-focused banks and building societies. FSMA 2023 introduced a statutory requirement for the PRA to keep its rules under review. Please refer to PS4/24 – **PRA statement on the review of rules** for more details.

lower management buffers, some SDDTs to voluntarily have lower capital ratios than they otherwise would.

1.16 The PRA considers that the proposals set out in this CP would advance its primary objective of safety and soundness by maintaining SDDTs' resilience. Additionally, by making prudential regulation simpler and reducing costs for SDDTs, the proposals could increase SDDTs' capacity to build and conserve capital while continuing to support their customers.

1.17 The PRA considers the proposals would also advance its secondary objectives. The secondary competition objective, which requires the PRA to facilitate effective competition between firms, would be advanced if lower costs due to simplified prudential regulation reduce prices and increase the volume or variety of banking services in the UK.

1.18 The secondary objective to facilitate competitiveness and growth would be advanced because the proposals would increase or maintain the risk sensitivity of prudential regulation of SDDTs and would support effective competition in the UK (which in turn could lower the costs of financial intermediation and improve access to financial services in the UK). The proposals could make the UK a more attractive place for foreign banks to do business because they should reduce costs of SDDT-eligible banks with small foreign parents. Lower costs could potentially increase incentives for small foreign banks to establish banks in the UK.[12]

1.19 Under this secondary objective, the PRA is required to facilitate the competitiveness and medium- to long-term growth of the UK economy subject to aligning with relevant international standards. The PRA considers the proposals are consistent with relevant international standards. Although the proposals would mean some prudential requirements for SDDTs would differ from the Basel Committee on Banking Supervision's full set of standards for prudential regulation of banks (the Basel Framework), those standards are designed to apply to internationally active banks whereas SDDTs are domestically focused. SDDTs also have much simpler business models than most internationally active banks, so the full complexity of the Basel Framework is not necessary for SDDTs. However, under the proposals, the PRA would apply international standards to SDDTs where it considers those standards would advance the safety and soundness of these firms or promote effective competition. And in designing the strong & simple framework, the PRA intends to continue to align with the Basel Core Principles for effective banking supervision, which form the de facto minimum standards for the sound prudential regulation and supervision of banks and banking systems.

1.20 To achieve these effects, the PRA has looked at the sources of potential complexity for small firms in the current framework, and assessed which elements are disproportionate in

---

12 See paragraphs 3.2-3.6 in the SoP – **Operating the Small Domestic Deposit Taker (SDDT) regime** for a description of the circumstances in which the PRA considers that it may be appropriate for a firm that is a member of a foreign group to become SDDT.

the sense that SDDTs may find the costs of understanding, interpreting, and operationalising these requirements higher relative to the associated public policy benefits ('the complexity problem').[13] The proposals include, among others, the following examples:

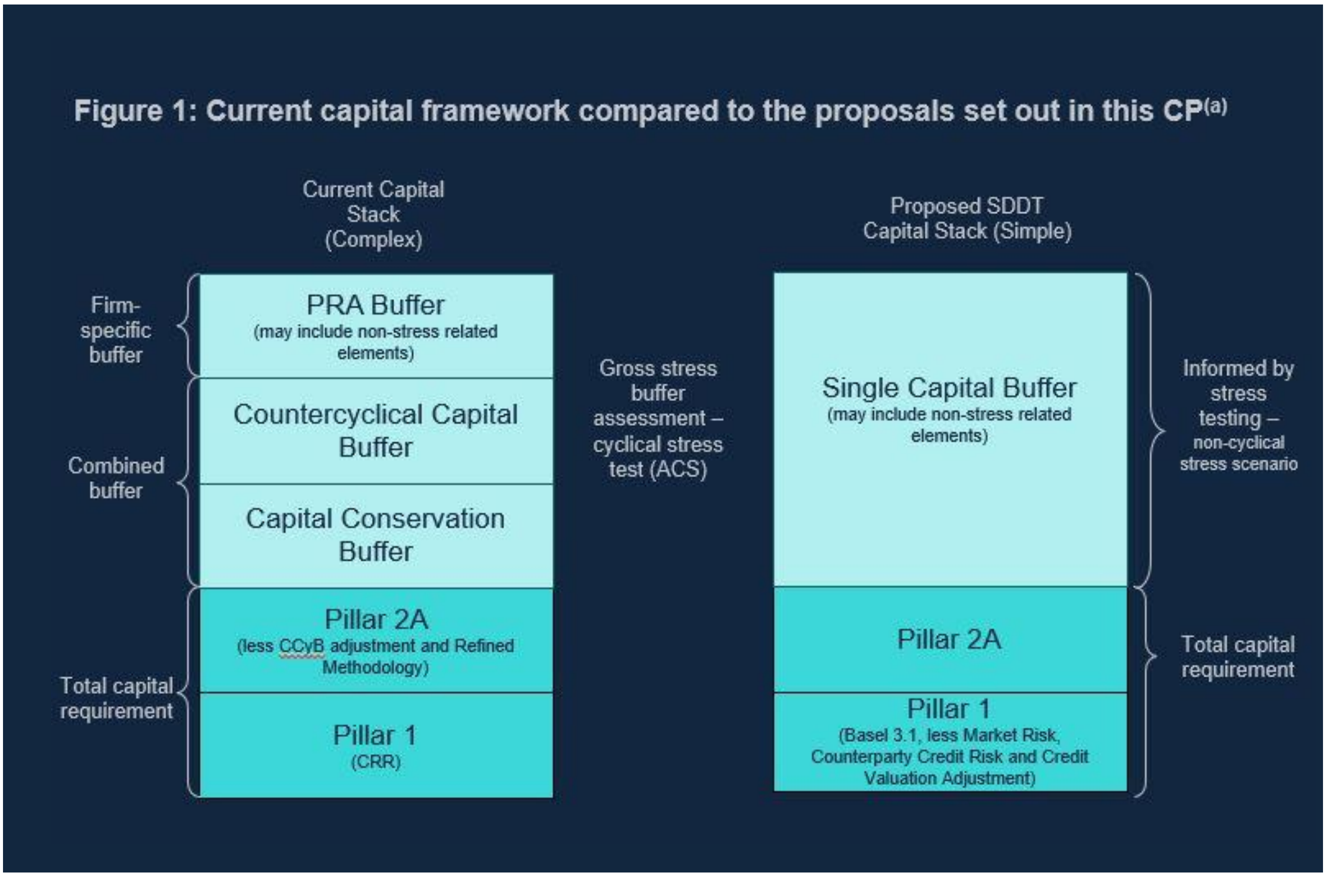
- the proposed changes to Pillar 2A methodologies that would simplify and increase the transparency of SDDTs' Pillar 2A calculations, while ensuring SDDTs remain appropriately capitalised for the risks they face;
- the simplifications to the ICAAP that would make the process less resource intensive for SDDTs, while ensuring that the aims and benefits of the process are maintained;
- the proposed buffer framework that would materially simplify the buffer framework applying to SDDTs by introducing a single buffer (the SCB), which would be relatively constant over the economic cycle and would not be subject to MDA restrictions. The PRA considers that the proposed buffer framework for SDDTs would be easier to understand and manage. As noted above, it would also alleviate the difficulties SDDTs have faced in responding to changes to buffers under the existing buffer framework, which may allow them to maintain lower management buffers; and
- the proposals in this CP, combined with the proposals in CP9/24 mean SDDTs would no longer face existing complex capital adjustments between Pillar 1 and Pillar 2A, and between buffers and Pillar 2A, which can be difficult to understand.[14]

1.21 As explained above, the PRA's proposed design of the simplified capital regime for SDDTs would maintain their resilience. The PRA has estimated that minimum capital requirements and buffers of SDDT-eligible firms would together be broadly similar on average if they opted into the SDDT regime as they would be if they did not opt in to the SDDT regime (see Chapter 9 for details). Under the SDDT proposals, stress testing – while simplified – would play a similar role in determining buffers as it would outside of the SDDT regime. And, to ensure that risks remain adequately capitalised for SDDTs, Pillar 2A requirements for individual risks would be calculated at roughly the same level as they would be outside the SDDT regime before the application of any adjustments. The balance between the minimum capital requirements and buffers would be tilted more towards minimum requirements than it would be outside of the SDDT regime. This is due to the removal of the CCyB adjustment to Pillar 2A, which would have the effect of making Pillar 2A requirements relatively larger compared to outside the regime, and an SCB on average lower than the combined buffer and PRA buffer. The PRA believes that higher minimum requirements and a lower total buffer expectation is appropriate for the simpler business models and non-systemic nature of SDDTs.

13 See DP1/21 for additional details on the 'complexity problem'.

14 The firm-specific structural adjustments to Pillar 2A for SME lending and infrastructure exposures (see PS9/24 for details) would apply to SDDTs.

1.22 Figure 1 shows the composition of the capital stack for SDDTs[15] under the proposals in this CP compared to the current regime (ie the UK CRR regime plus the Pillar 2A refined methodology).

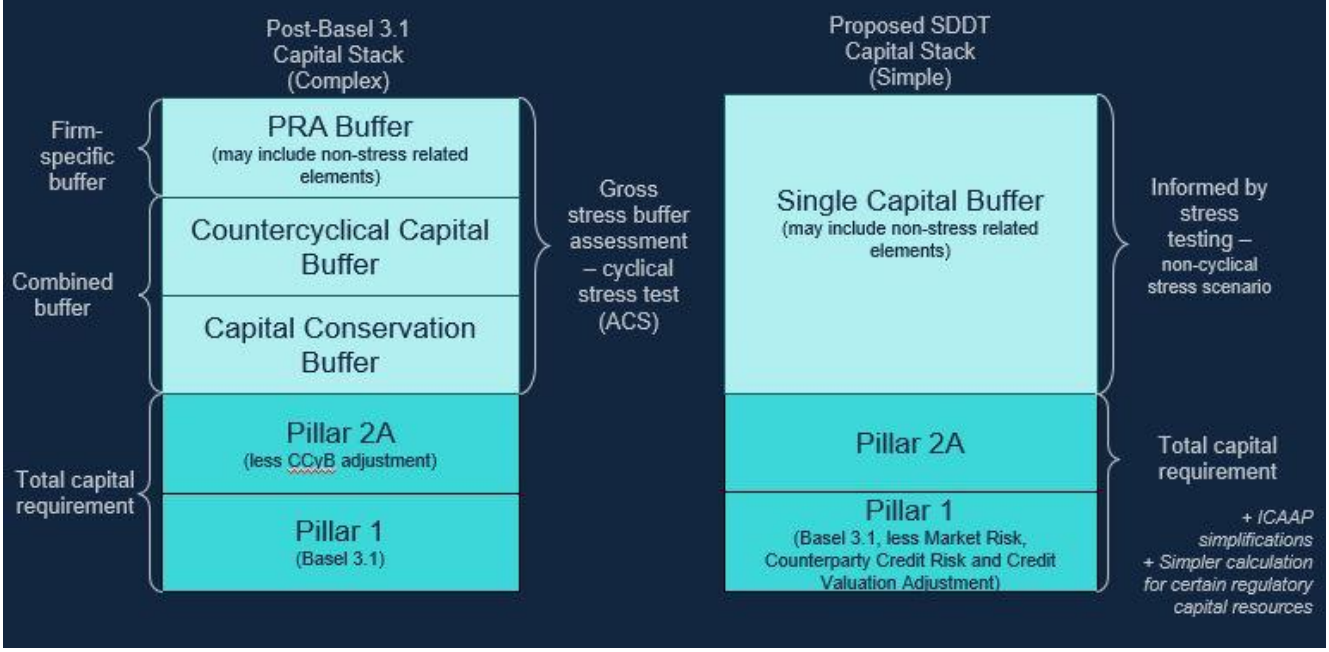


(a) The firm-specific structural adjustments to Pillar 2A for SME and infrastructure exposures (see PS9/24 for details) would apply in the proposed SDDT capital stack.

1.23 Figure 2 shows the composition of the capital stack for SDDTs[16] under the proposals in this CP compared to the capital regime that would apply outside of the SDDT regime at the point the proposals in this CP (ie the full Basel 3.1 standards) would be implemented (see paragraph 1.41 for the proposed implementation date).

15 Figure 1 does not compare the values of the components of the capital stacks.
16 Figure 2 does not compare the values of the components of the capital stacks.

Figure 2: Post-Basel 3.1 capital framework compared to the proposals set out in this CP[(a)]



(a) The firm-specific structural adjustments to Pillar 2A for SME and infrastructure exposures (see PS9/24 for details) would apply in both capital stacks.

1.24 Chapters 2-8 in this CP set out the policy proposals and their associated benefits and costs. These benefits and costs are aggregated and, where appropriate, quantified in Chapter 9 of this CP. The PRA considers that the proposed application of the Basel 3.1 standardised approaches to credit risk and operational risk would create several benefits for SDDT-eligible firms compared to the approaches that apply currently (for instance, better risk capture by firms). The proposals would create one-off implementation costs for SDDT-eligible firms. The other proposals in this CP would generate a range of benefits for SDDTs compared to outside of the SDDT regime. These benefits arise from SDDTs' capital requirements being more certain and the capital stack being simplified. SDDTs would also face lower costs from reduced reporting requirements and simpler supervisory processes. But there may be costs for SDDTs and the PRA from implementing the capital regime for SDDTs. Overall, the PRA considers the proposals would have positive net benefits.

1.25 The PRA has a statutory duty to consult when making rules (FSMA s138J), or new standards instruments (FSMA s138S). When not making rules, the PRA has a public law duty to consult widely where it would be fair to do so. The proposed changes to Pillar 2A and buffers, which are set out in proposed supervisory statements and statements of policy, would together significantly change the way that SDDTs' capital stacks are calculated. The PRA believes it is important to set out clearly all proposed policy for calculating the capital stack. The PRA considers that the SDDT capital stack achieves the aims of strong and simple, but the PRA is keen to seek the views of interested participants on whether the aims of the regime have been achieved.

1.26 The PRA **Practitioner Panel** was consulted on key elements of the capital framework set out in this CP.

1.27 In carrying out its policymaking functions, the PRA is required to comply with several legal obligations. The analysis in this CP explains how the proposals have had regard to the most significant matters, including an explanation of the ways in which having regard to these matters has affected the proposals.

1.28 In developing these proposals, the PRA has had regard to its framework of regulatory principles. The PRA's analysis of the most relevant regulatory principles is detailed in Chapters 2-8 of this CP.

Changes to PRA rules and policy materials

1.29 The proposals in this CP would result in changes to the following parts of the PRA Rulebook and existing policy materials:

Table 1: Proposed changes to policy materials

Policy material	Proposals
PRA Rulebook Instruments	**The PRA Rulebook: CRR Firms: SDDT Regime Instrument [2025] would amend the following Parts of the PRA Rulebook:** • Glossary • Capital Buffers • Counterparty Credit Risk (CRR) • Credit Risk: General Provisions (CRR) • Credit Risk: Standardised Approach (CRR) • Credit Risk Mitigation (CRR) • Credit Valuation Adjustment Risk • Disclosure (CRR) • Internal Capital Adequacy Assessment • Internal Liquidity Adequacy Assessment • Large Exposures (CRR) • Leverage Ratio (CRR) • Market Risk: General Provisions (CRR) • Market Risk: Internal Model Approach (CRR) • Market Risk: Advanced Standardised Approach (CRR) • Market Risk: Simplified Standardised Approach (CRR)

	• Operational Risk • Own Funds (CRR) • Regulatory Reporting • Reporting (CRR) • Reporting Pillar 2 • Required Level of Own Funds (CRR) • SDDT Regime - General Application • Trading Book (CRR) **and would revoke the following Part:** • SDDT Regime – Interim Capital Regime **and would create the following new Part:** • SDDT Regime - Interim Capital Regime (Transitional Provisions)
Supervisory statement (SS)	**This CP would amend:** • Implementing capital buffers (**SS6/14**) • The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP) (**SS31/15**) • Non-systemic UK banks: The Prudential Regulation Authority's approach to new and growing banks (**SS3/21**) • The minimum requirement for own funds and eligible liabilities (MREL) – buffers and Threshold Conditions (**SS16/16**) • Pillar 2 reporting, including instructions for completing data items FSA071 to FSA082, and PRA111 (**SS32/15**) • The PRA's approach to supervising liquidity and funding risks (**SS24/15**) • Guidelines for completing regulatory reports (**SS34/15**) **This CP would introduce:** • Draft SS – The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP) for Small Domestic Deposit Takers (SDDTs)
Statement of policy (SoP)	**This CP would amend:** • SoP – **The PRA's methodologies for setting Pillar 2 capital** ('Pillar 2 SoP')

	• SoP – **Operating the Small Domestic Deposit Taker (SDDT) regime** **This CP would introduce:** • Draft SoP – The PRA's methodologies for setting Pillar 2 capital for Small Domestic Deposit Takers (SDDTs) **This CP would delete:** • SoP – Operating the Interim Capital Regime

1.30 As detailed in Table 1, the PRA is proposing to introduce for SDDTs the following 'new documents':

- a new draft SS – The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP) for Small Domestic Deposit Takers (SDDTs) ('draft SDDT ICAAP SS'); and
- a new draft SoP – The PRA's methodologies for setting Pillar 2 capital for Small Domestic Deposit Takers (SDDTs) ('draft SDDT Pillar 2 SoP').

1.31 In line with the proposal to introduce two new policy documents for SDDTs, the PRA proposes to descope SDDTs from the following existing documents:

- SS31/15 – The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP); and
- Statement of policy – The PRA's methodologies for setting Pillar 2 capital.

1.32 This CP proposes to carry forward the policy in the existing documents to the new documents, as set out in paragraph 1.30 above, subject to the simplifications proposed in this CP. In carrying forward the policy in existing documents, the PRA has incorporated the changes proposed in CP9/24. The PRA considers that this approach would assist SDDTs in understanding the proposed simplified regime applicable to them.

Structure of the CP

1.33 The CP is structured as follows:

- **Chapter 2 –** Pillar 1
- **Chapter 3** – Pillar 2A
- **Chapter 4** – Capital buffer framework
- **Chapter 5** – The Internal Capital Adequacy Assessment Process (including proposals to change the frequency of the Internal Liquidity Adequacy Assessment Process)
- **Chapter 6** – Simplified capital deductions

- **Chapter 7** – Reporting
- **Chapter 8** – Operating the SDDT regime
- **Chapter 9** – Aggregated cost benefit analysis (CBA)

Background

1.34 In DP1/21, the PRA sought views on developing a simplified prudential framework for non-systemic banks and building societies with the aim to maintain the resilience of those firms, and the stability of the UK financial sector, while using simplified prudential regulation by removing or adapting rules which offer little prudential value for these firms. This framework would enhance effective competition and enable a dynamic and diverse banking sector in the UK.

1.35 In CP5/22, the PRA proposed a set of criteria to identify firms that would be eligible to access the SDDT regime. Following the responses to CP5/22, the PRA proposed a revised set of criteria in **CP16/22** which was finalised in PS15/23. In CP16/22, the PRA also set out proposals to introduce the ICR for SDDT-eligible firms; a temporary regime that would provide these firms with the option to remain subject to requirements equivalent to the existing Capital Requirements Regulation (CRR) capital rules, until such time that the proposed simplified capital requirements for SDDTs, as detailed in this CP, were implemented. The near-final ICR rules have been set out in PS9/24.[17]

1.36 In CP4/23 – **The Strong and Simple Framework: Liquidity and Disclosure requirements for Simpler-regime Firms**, the PRA proposed simplifications to liquidity and disclosure requirements that would apply to SDDTs. These simplifications were finalised in PS15/23. PS15/23 also finalised the implementation dates for these simplifications and the MbC to become an SDDT. As of 22 August 2024, 32 firms had become SDDTs.[18]

Impact on mutuals

1.37 FSMA requires that the PRA assesses whether, in its opinion, the impact of its proposals on mutual societies would be significantly different from the impact on other firms (s138K FSMA 2000). For the purpose of this CP, all references to 'mutual societies' refer to SDDT-eligible building societies, which are the only group of mutuals within the proposed scope of application of the proposals set out in this CP.

1.38 It is the PRA's view that the impact of the proposals on building societies' capital requirements and buffers would not be significantly different from the impact on banks with a

17 The ICR and SDDT MbCs are separate, albeit based on the same eligibility criteria. Therefore, while the offer of the ICR MbC is available, SDDT-eligible firms would be able to take up the SDDT MbC without taking up the ICR MbC and vice versa.

18 From the Financial Services Register website: **Register Home Page (fca.org.uk)**.

similar focus on residential mortgages. The benefit of more certain capital requirements and buffers may be felt relatively more by building societies because of the restrictions they face as mutuals on raising and distributing capital.

Equality and diversity

1.39 In developing its proposals, the PRA has had due regard to the equality objectives under s149 of the Equality Act 2010. The PRA has performed an assessment and considered the equality implications in formulating its proposals. The PRA considers that the proposals do not give rise to equality and diversity implications.

Level of application

1.40 The proposed level of application of the SCB is set out in Chapter 4. The PRA has not proposed changes to the level of application of the other areas of policy covered by this CP. The level of application for individual policy areas would therefore be as follows:

- For the Pillar 1 proposals (see Chapter 2), SDDTs would need to meet requirements on an individual basis, and SDDT consolidation entities would need to meet requirements on a consolidated basis where they must meet consolidated requirements under Part 3 (Capital Requirements) of the CRR;
- For Pillar 2A proposals (see Chapter 3), the PRA would normally set SDDTs' Pillar 2A requirement on an individual basis. The PRA would additionally set Pillar 2A requirements on a consolidated basis for SDDT consolidation entities which must comply with the overall financial adequacy rule in Internal Capital Adequacy Assessment 2.1 on a consolidated basis;
- For the SCB proposals (see Chapter 4), the PRA would apply the SCB at each level of consolidation which applies to an SDDT and its UK group. This means that, where only individual requirements apply, the PRA would set the SCB on an individual basis only. But where both individual and consolidated requirements apply, the PRA would set the SCB on both an individual basis and on a consolidated basis for SDDTs and SDDT consolidation entities respectively;
- The proposals for a non-cyclical stress test framework (see Chapter 4) and the ICAAP proposals (see Chapter 5) would need to be met in line with the level of application of the ICAAP rules set out in Chapter 14 of the Internal Capital Adequacy Assessment Part of the PRA Rulebook;
- The ILAAP proposals (see Chapter 5) would need to be met in line with the level of application of the ILAAP rules set out in Chapter 14 of the Internal Liquidity Adequacy Assessment Part of the PRA Rulebook;
- For the simplified capital deduction proposals (see Chapter 6), SDDTs would need to meet requirements on an individual basis, and SDDT consolidation entities would need to meet requirements on a consolidated basis where they must meet consolidated requirements under Part 2 (Own Funds and Eligible Liabilities) and Part 3 (Capital Requirements) of the CRR; and

- For the reporting proposals (see Chapter 7), these would apply in line with the level of application set out in the Reporting (CRR) Part, the Regulatory Reporting Part, and the Reporting Pillar 2 Part of the PRA Rulebook, as relevant.

Implementation

1.41 The PRA proposes that the implementation date for the changes resulting from this CP, other than certain proposed changes to the SoP – Operating the Small Domestic Deposit Taker (SDDT) regime (see Chapter 8), would be 1 January 2027. The PRA considers this date would give SDDTs and the PRA sufficient time to exchange feedback on the proposals set out in this CP and sufficient time for the resulting final rules to be implemented in a way that ensures a smooth transition to the simplifications set out in this CP for SDDTs. The PRA proposes that the changes to the SoP (apart from those related to foreign exchange permissions set out in Chapter 2) would take effect upon the publication of the PS finalising those changes, as these would provide further detail on how the SDDT regime would operate, including changes relevant to the implementation of the measures in this CP.

Question 1: Do you have any comments on the proposals in this CP and the proposed implementation date?

Further simplifications proposals

1.42 As the PRA progresses the implementation of the strong and simple framework, it will consider whether its primary and secondary objectives would be advanced by applying any of the proposals in this CP to a wider range of firms and engage the Financial Policy Committee (FPC) where relevant. DP1/21 and CP4/23 suggested that the PRA would consider whether and how to build out other layers of the strong and simple framework for larger firms that are not internationally active. The PRA gathered views from relevant stakeholders about this during 2023 and anticipates that it will communicate further on this in due course.

1.43 As new policies are being developed, the PRA may assess them and consider whether they can be simplified further for SDDTs, in line with the strong and simple framework principles.[19]

[19] The PRA has already proposed to do this in relation to its proposals in CP23/23 – **Identification and management of step-in risk, shadow banking entities and groups of connected clients**.

Responses and next steps

1.44 This consultation closes on Thursday 12 December 2024. The PRA invites feedback on the proposals set out in this consultation. Please address any comments or enquiries to **CP7_24@bankofengland.co.uk**.

1.45 When providing your response, please tell us whether you consent to the PRA publishing your name, and/or the name of your organisation, as a respondent to this CP.

1.46 Please also indicate in your response if you believe any of the proposals in this consultation paper are likely to impact persons who share protected characteristics under the Equality Act 2010, and if so, please explain which groups and what the impact on such groups might be.

1.47 SSs and SoPs covered by this CP have been updated as part of these proposals to reflect the UK's withdrawal from the EU. Unless otherwise stated, any remaining references to EU or EU-derived legislation refer to the version of that legislation which forms part of assimilated law.[20]

[20] For further information please see **Transitioning to post-exit rules and standards**.

2: Pillar 1

Overview

2.1 This chapter sets out the PRA's proposals for Pillar 1 risk-weighted capital requirements for SDDTs. Informed by the responses to DP1/21 – **A strong and simple prudential framework for non-systemic banks and building societies** on the potential design of SDDT regime, the PRA proposes to apply the risk-weighted Pillar 1 capital requirements that apply to all firms, but to simplify elements within those requirements for SDDTs.

2.2 The proposals in this chapter would amend:

- Glossary
- Credit Risk: General Provisions (CRR) Part
- Credit Risk: Standardised Approach (CRR) Part
- Credit Risk Mitigation (CRR) Part
- Credit Valuation Adjustment Risk Part
- Counterparty Credit Risk (CRR) Part
- Large Exposures (CRR) Part
- Leverage Ratio (CRR) Part
- Market Risk: General Provisions (CRR) Part
- Market Risk: Internal Model Approach (CRR) Part
- Market Risk: Advanced Standardised Approach (CRR) Part
- Market Risk: Simplified Standardised Approach (CRR) Part
- Operational Risk Part
- Required Level of Own Funds (CRR) Part
- SDDT Regime – General Application Part
- Trading Book (CRR) Part
- SoP – Operating the Small Domestic Deposit Taker (SDDT) regime (the 'SDDT Operationalisation SoP') (Appendix 11), which was published previously in PS15/23. As outlined in Chapter 1, the PRA proposes that the changes to this SoP would take effect upon the publication date of the PS.

2.3 Chapter 7 includes proposed changes to reporting that arise from the proposed changes set out below.

2.4 The PRA proposes that the risk-weighted Pillar 1 capital requirements that apply to SDDTs from 1 January 2027 would be based on those in the PRA's implementation of the Basel 3.1 standards, as set out in PS17/23 – **Implementation of the Basel 3.1 standards**

near-final part 1 and PS9/24 – **Implementation of the Basel 3.1 standards near-final part 2.** The PRA considers that those standards would improve risk measurement and make the calculation of risk-weighted assets (RWAs) more robust across firms. The riskiness of an asset is the same regardless of whether it is held by a large or small firm. Applying them to the key risks faced by all firms, including SDDTs, would facilitate competition and promote safety and soundness of SDDTs. The PRA engaged with small firms regarding their feedback on the Basel 3.1 proposals during the consultation period for CP16/22 and has taken into consideration their feedback in the development of near-final rules for the CR SA and CRM.[21] Hence, the PRA has used the Basel 3.1 Pillar 1 approach to credit risk as the starting point for designing the proposed risk-based Pillar 1 capital framework for SDDTs.

2.5 In designing the proposed simplifications to Pillar 1 framework for SDDTs, the PRA has focused on simplifying capital requirements where complexity is a particular issue and where consistent with safety and soundness.

2.6 The PRA considers that these proposals would preserve the benefits of having consistent and comparable Pillar 1 capital requirements across SDDTs and non-SDDTs for key risks and would avoid the risk of creating barriers to entry and to exit from the SDDT regime.

2.7 In summary, the PRA proposes to:

- apply the PRA's implementation of the Basel 3.1 standards for calculating Pillar 1 RWAs for credit risk (except the due diligence requirements) and operational risk to SDDTs;
- descope SDDTs from Pillar 1 capital requirements for counterparty credit risk (CCR) for derivatives (with some exceptions[22]) and credit valuation adjustment (CVA) risk;
- require SDDTs to apply the credit risk approach to measuring Pillar 1 capital requirements for positions in the trading book, as well as removing capital requirements for SDDTs' market risk business activities related to foreign-exchange and commodity risks; and
- remove the Interim Capital Regime (ICR) at the point that the SDDT capital regime is implemented.

21 Overall, the PRA received formal written responses to CP16/22 from 126 respondents. In addition, the PRA received responses through various other channels including over 70 meetings with stakeholders to discuss their views.

22 See paragraph 2.41 for details on the exceptions.

Credit risk

2.8 The PRA proposes to require SDDTs to calculate RWAs using the **standardised approach to credit risk (CR SA) and the SA credit risk mitigation (CRM) methods** set out in PS9/24.[23]

2.9 The SDDT regime is intended for small firms that are focused on deposit taking from, and lending to, households and corporates in the UK and the SDDT criteria have been designed to capture this type of firm.[24] Therefore, credit risk is a key risk for SDDTs. The PRA considers applying Pillar 1 capital requirements for credit risk to SDDTs is necessary to maintain the resilience of SDDTs.

2.10 The PRA's implementation of the Basel 3.1 CR SA and the available credit risk mitigation (CRM) methods set out in PS9/24 introduce more granular requirements that better reflect the riskiness of firms' exposures. This is the case for small and large firms. They have been calibrated to deliver a level of resilience aligned with Basel 3.1 standards, while addressing UK specificities and operational challenges, including those faced by smaller firms.

2.11 Table 2 shows the available CRM methods. CRM methods introduce more complexity to SDDT regime, but they are optional. The PRA is proposing to include SDDTs in the scope Basel 3.1 CRM methods, so an SDDT could use them if the benefits of CRM methods outweigh the costs of increased complexity.

Table 2: CRM methods available to SDDTs

CRM method	Description
On-balance sheet netting	A method for recognising on-balance sheet netting under all approaches to credit risk, which the PRA is restricting to recognition through exposure value only.
Financial collateral simple method (FCSM)	A method for recognising financial collateral, by reducing risk weights, to reflect the effect of funded credit protection.

23 The firm-specific structural adjustments to Pillar 2A for SME lending and infrastructure exposures (see PS9/24 for details) would apply to SDDTs.

24 See paragraph 2.1 in CP5/22 – The Strong and Simple Framework: a definition of a Simpler-regime Firm.

Financial collateral comprehensive method (FCCM)	A method for recognising financial collateral, by reducing exposure values, to reflect the effect of funded credit protection.
Other funded credit protection (OFCP) method	A bespoke method for recognising other funded credit protection (pledged cash and cash-assimilated instruments, pledged life assurance policies, and instruments issued by third-party institutions that will be repurchased on request).
Risk weight substitution method	A method that involves substituting the risk weight of the exposure with that of the protection provider to reflect the effect of unfunded credit protection.

2.12 Including SDDTs in the scope of CR SA and the available CRM methods would preserve the benefits of having a consistent and comparable calculation of RWAs both inside and outside the SDDT regime. It would also avoid adding barriers to growth for SDDTs because a firm would not need to change the approach to calculating RWAs for credit risk when it leaves the SDDT regime.

2.13 The PRA's implementation of the Basel 3.1 standards increases risk sensitivity of the Pillar 1 capital requirements for credit risk but introduces more complexity and could increase operational burden for SDDTs relative to the CRR standardised approach to credit risk. However, the PRA considers that the benefits of greater risk sensitivity would outweigh the costs of any increase in complexity for SDDTs. This view is supported by the responses from small firms to the CP16/22, and the changes to CR SA and CRM methods post consultation (as set out in PS9/24).[25] There is evidence of prudential regulation shaping firms' behaviour, including how risk insensitive measures can encourage higher risk lending, which could undermine the PRA's primary safety and soundness objective.[26]

2.14 The PRA proposes that SDDTs would not be subject to the CR SA **due diligence requirements**. The CR SA due diligence requirements set out in PS9/24 comprise two elements: (i) monitoring counterparties to ensure an adequate understanding of counterparties' risk profiles and characteristics; and (ii) for certain exposures where external

25 Furthermore, in response to DP1/21, firms revealed their preference for greater risk sensitivity of the capital requirements over simpler but more conservatively calibrated requirements, more similar to the design of a leverage ratio requirement. For more details see Chart 6 in Feedback Statement 1/21 – **Responses to DP1/21: A strong and simple prudential framework for non-systemic banks and building societies**.

26 For a detailed discussion of this issue and a review of the literature see Hinterschweiger, M, Neumann, T, and Saporta, V (2018), **Risk sensitivity and risk shifting in banking regulation**.

credit ratings are used, a requirement to increase risk weights if the due diligence assessment suggests an exposure has higher risk characteristics.

2.15 The two elements of the CR SA due diligence requirements are intended as a package. They already include proportionality by mentioning that due diligence shall be appropriate to the nature, scale and complexity of the institution's activities. To enhance that proportionality, the PRA proposes to disapply the CR SA due diligence requirements for SDDTs. The PRA considers this would not have any bearing on SDDTs' resilience, while reducing the operational burden. This is because SDDTs may not have the operational capacity to assess when an exposure has higher risk characteristics than is implied by the external credit rating.

2.16 However, SDDTs do still need to monitor their counterparties to understand and manage their risks. SDDTs will continue to be subject to the Fundamental Rule requiring that a firm must have effective risk strategies and risk management systems and to relevant obligations in the Internal Capital Adequacy Assessment Part of the PRA Rulebook.

Operational risk

2.17 The PRA proposes that SDDTs use the OR SA set out in PS17/23 to calculate Pillar 1 operational risk capital requirements. Consistent with Basel 3.1 standards, the PRA will replace all existing approaches for calculating Pillar 1 operational risk capital requirements with a single standardised approach that measures risks appropriately and advances the PRA's primary safety and soundness objective. The PRA considers the OR SA is proportionate and builds in a lower burden of assessment for smaller firms, so is appropriate to apply to SDDTs. It builds in proportionality both through its simplicity of calculation based on financial statement information, and through its differentiation based on a firm's size and complexity. Further, applying the OR SA to SDDTs would avoid creating additional barriers to growth for SDDTs, as the OR SA would apply to firms both inside and outside the SDDT regime.

2.18 Pillar 1 and Pillar 2A operational risk requirements are linked: the proposed simplifications to the approach to operational risk in Pillar 2A for SDDTs are set out in more detail in Chapter 3.

Market risk

2.19 The PRA proposes that SDDTs calculate Pillar 1 capital requirements for their **trading book business** using the CR SA and that SDDTs do not have to calculate market risk capital requirements for business activities subject to **foreign exchange and commodity risk**.

2.20 The SDDT criteria provide that an SDDT must have an on- and off-balance sheet trading book business that would be equal to, or less than, both of the following thresholds: 5% of the firm's total assets; and £44 million. Firms cease to meet these criteria when they have been above the relevant threshold for more than three months in succession, or more than half of the months in the past year. These thresholds are aligned with the derogation for small trading book business used in the Trading Book (CRR) Part of the PRA Rulebook that permits firms to use the credit risk approach, rather than the market risk approach, to calculate capital requirements for their trading book business.

2.21 Market risk requirements are complex and the proposal to exclude them from the SDDT regime would offer meaningful simplicity for SDDTs. The PRA considers the application of CR SA would mean SDDTs' trading book positions would be adequately capitalised.

2.22 Under the proposals in this CP, if a firm remains an SDDT it would continue to apply the CR SA to its trading book business.[27] An SDDT must notify the PRA if it ceases to meet the SDDT criteria. The PRA expects a firm to have prepared for when it ceases to meet the SDDT criteria so it is able to comply almost immediately with the prudential regime that applies to non-SDDTs but the PRA would consider the time a firm needs to do that when deciding when to revoke the firm's SDDT modification direction.[28] The PRA considers this approach would simplify the exit process for an SDDT.

2.23 The PRA is not proposing to change the derogation for small trading book business for non-SDDTs. Non-SDDTs would continue to have the option (but not the obligation) to use the credit risk approach when calculating capital requirements for the trading book business if they meet the thresholds set out in the Article 94 of the Trading Book (CRR) Part of the PRA Rulebook.

2.24 The PRA is proposing to add to Article 94 a requirement on SDDTs to not enter into, buy, or sell a trading position for the sole purposes of meeting the SDDT criteria. This is analogous to the existing requirement in Article 94 on firms to not take these actions for the sole purpose of meeting the scope criteria in the derogation for small trading book business.

2.25 The SDDT criteria requires an SDDT to have a net foreign exchange position that does not exceed 3.5% of its own funds and, does not, on average, exceed 2% of its own funds. Under CRR Article 351, a firm does not have to calculate a capital requirement for the sum of its overall net foreign-exchange position and its net gold position if the sum of those positions

27 Outside of the SDDT regime, a firm would have three months to switch to applying the market risk approach after it ceased to meet the 5% and/or £44 million threshold in the derogation for small trading book business. Under the proposals here, an SDDT that ceases to meet the 5% and/or £44 million threshold in the SDDT criteria could have more or less than three months to switch to applying the market risk approach depending on how long it is before the PRA revokes the SDDT modification direction.

28 See paragraph 4.3 of the statement of policy – **Operating the Small Domestic Deposit Takers (SDDT) regime**.

is equal to or less than 2% of its own funds. Exempting SDDTs from having to calculate market risk capital requirements for business activities subject to foreign exchange risk would simplify Pillar 1 capital requirements for SDDTs. The PRA considers that since most SDDTs would not need to calculate a capital requirement for foreign-exchange risk outside of the SDDT regime, exempting SDDTs from having to calculate market risk capital requirements for business activities subject to foreign exchange risk would not reduce their resilience.[29]

2.26 A firm could be meeting the SDDT criteria but have an overall net foreign-exchange position above the 2% threshold when it takes advantage of the smoothing provisions in the foreign exchange criterion included in the SDDT criteria: ie a firm would meet this criterion unless it has been above the 2% threshold for more than three months in succession, or more than half of the months in the past year, without breaching the ceiling on foreign exchange exposures of 3.5% of own funds.[30]

2.27 The PRA expects foreign exchange positions between 2% and 3.5% of own funds would be a rare and temporary event for SDDTs. The PRA considers that not capitalising an occasional use of smoothing provisions in the foreign exchange criterion would not have a material impact on SDDTs' resilience.

2.28 The SDDT criteria require that SDDTs hold no positions in commodities or commodity derivatives. The PRA considers exempting SDDTs from having to calculate market risk capital requirements for business activities subject to commodity risk would simplify Pillar 1 capital requirements for SDDTs but not reduce SDDTs' resilience.

2.29 However, SDDTs should monitor and manage risks from their trading book business, and foreign exchange and gold positions as appropriate to their business. SDDTs would continue to be subject to the Fundamental Rule requiring that a firm must have effective risk strategies and risk management systems and to relevant obligations in the Internal Capital Adequacy Assessment and Risk Control Parts of the PRA Rulebook.

2.30 To monitor the extent to which SDDTs have such exposures, the PRA proposes to subject SDDTs to reporting requirements for their trading book business, and business activities subject to foreign-exchange risk (see Chapter 7). If the PRA considered that business activities subject to foreign-exchange risk were posing risks to an SDDTs' safety and soundness, the PRA would consider applying prudential measures to mitigate the associated risks.

---

[29] However, the PRA is proposing to disapply the own fund requirements for foreign-exchange risk via the disapplication of Article 92(3)(c).

[30] See SDDT Regime – General Application 2.1(4), 2.7, 2.8 in the PRA Rulebook.

Consequential changes to the statement of policy – Operating the Small Domestic Deposit Takers (SDDT) regime and the SDDT criteria rules

2.31 To assess itself against the SDDT criteria, a firm must measure its overall net foreign exchange position using the method set out in Article 352 of the CRR.[31,32] Outside of the SDDT regime, a firm with a permission under Article 325(9) of the Market Risk: General Provisions (CRR) Part and/or Article 352(1) of the Market Risk: Simplified Standardised Approach (CRR) Part (a 'foreign exchange permission') could, respectively, exclude structural FX and/or use a delta it has calculated itself when measuring its overall net foreign exchange position for the purposes of assessing itself against the SDDT criteria.

2.32 The PRA proposes that an SDDT would no longer be subject to the rules that require it to calculate market risk capital requirements for business activities subject to foreign exchange risk and proposes to disapply Market Risk: General Provisions (CRR) Part and the Market Risk: Simplified Standardised Approach (CRR) Part for SDDTs. However, the PRA considers it is appropriate that an SDDT could continue to use a foreign exchange permission for the purposes of assessing itself against the SDDT criteria, just as a non-SDDT would be able to. If SDDTs could not do this, a firm's measure of its overall net foreign exchange position could vary depending on whether it is an SDDT. This possibility would make the SDDT criteria less fit for purpose.

2.33 In order that an SDDT could continue to use a foreign exchange permission for the purposes of assessing itself against the SDDT criteria, the PRA proposes to use the power conferred under s.138BA of FSMA 2023 to offer foreign exchange permissions to SDDTs. Consistent with the PRA's proposed approach to using the s.138BA permission power,[33] the PRA proposes to set out in the SoP – **Operating the Small Domestic Deposit Taker (SDDT) regime**: the availability of the foreign exchange permissions to an SDDT for the purpose of measuring its overall net foreign exchange position in the SDDT criteria; and the criteria that the PRA expects to take into account when assessing these permissions. These parts of the SoP would come into effect on 1 January 2027. The factors are aligned with the conditions set out in Article 325(9) of the Market Risk: General Provisions (CRR) Part (for Structural FX) and Article 352(1) of the Market Risk: Simplified Standardised Approach (CRR) Part (delta it has calculated itself) in the near-final Basel 3.1 rules. See Appendix 11 for the PRA's proposed updates to the SoP. The PRA proposes that an SDDT that is granted a foreign exchange permission under the s.138BA power should be subject to the same requirement for ongoing compliance with conditions that would apply to a firm with a foreign

31 Rule 2.1(4) of the SDDT Regime – General Application Part of the PRA Rulebook.

32 Under the near-final rules set out in PS17/23 and PS9/24, Article 352(1), (3)-(5) of the Market Risk: Simplified Standardised Approach (CRR) Part and Article 325(9) of the Market Risk: General Provisions (CRR) Part will correspond to Article 352 of the CRR.

33 See paragraph 2.2 in CP3/24 – **The Prudential Regulation Authority's approach to rule permissions and waivers**.

exchange permission under Article 325(9) of the Market Risk: General Provisions (CRR) Part or Article 352(1) of the Market Risk: Simplified Standardised Approach (CRR) Part. The PRA proposes amendments to the SDDT Regime – General Application Part to give effect to this.

Counterparty credit risk (CCR) and credit valuation adjustment (CVA) risk

2.34 The PRA proposes that SDDTs do not need to calculate Pillar 1 capital requirements for CCR for derivatives in the banking book[34] and the trading book[35] (with the exceptions set out in the paragraph 2.41), including credit derivatives, where a CCR method would need to be used to determine the exposure value. The PRA proposes that SDDTs do not need to calculate Pillar 1 capital requirements for CVA risk.

2.35 Under the PRA's implementation of the Basel 3.1 standards, firms are expected to maintain capital to cover changes in the creditworthiness of the counterparty and the potential default of the counterparty (ie to cover CVA risk and CCR).

2.36 SDDTs' exposures to CCR and CVA risk are unlikely to be material. This is because the SDDT criteria limit SDDTs' trading activity, resulting in small derivative portfolios which are mostly held for hedging purposes. In response to DP1/21, several respondents commented that the SDDT criteria could be designed in such a way to make CCR and CVA risk capital requirements unnecessary.[36]

2.37 Given this, the PRA considers that for SDDTs the costs of understanding and operationalising the Pillar 1 requirements for CCR and CVA risk, even with the use of simplified methods, are disproportionate relative to the CCR and CVA risk faced by SDDTs as their trading activity is limited by the SDDT criteria. The PRA estimates that current CCR and CVA-risk RWAs are approximately 1% of SDDTs' total RWAs, suggesting that these risks are very modest for SDDTs.

2.38 Some SDDTs would be exposed to CCR and CVA risk because of hedging activity. The proposal to not require SDDTs to maintain capital against these risks puts more onus on the effective risk management and controls of SDDTs' derivative portfolios. The PRA considers the proposal would allow SDDTs to redirect efforts from calculating (typically small) capital requirements for these risks to strengthening their practices for managing CCR.

---

34 Ie where Article 92(3)(a) of the Required Level of Own Funds (CCR) Part would otherwise require risk-weighted exposure amounts to be calculated for credit risk and dilution risk.

35 Ie where Article 92(3)(f) of the Required Level of Own Funds (CCR) Part would otherwise require risk-weighted exposure amounts to be calculated for counterparty credit risk.

36 See paragraph 4.28 in FS1/21.

2.39 The PRA expects SDDTs to focus on embedding prudent CCR management practices in line with the proposed draft SDDT ICAAP SS on the Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP) for SDDTs. Under the draft SDDT ICAAP SS (see Chapter 5 for details), SDDTs are expected to choose high-quality counterparties in their hedging activities, monitor the resilience of counterparties, and have contractual arrangements using standard documentation and collateral requirements. Furthermore, under the draft SDDT ICAAP SS, SDDTs are expected to collateralise their exposures and use central counterparties for clearing derivative contracts.

2.40 The PRA proposes to continue to collect basic information about SDDTs' CCR exposures (see Chapter 7). That information would permit the PRA to monitor the size of SDDTs' derivative portfolios relative to total assets and volumes of non-centrally cleared derivatives.

2.41 The PRA proposes to continue to apply capital requirements for CCR to SDDTs in specific cases. If an SDDT is a clearing member of a Central Counterparty (CCP), it must maintain capital against any contributions to the default fund of a CCP and trade exposures to the CCP (just as non-SDDT clearing members of CCPs are required to do).[37] The PRA considers it would be appropriate for an SDDT to hold capital against these exposures to reflect the risk of spillovers from other CCP clearing members in the event of their failure. If an SDDT has a securitisation position that results from a derivative instrument listed in Annex II of the CRR, the references to the exposure measure in the CCR part of the rules would continue to apply. The PRA considers if an SDDT is engaging in the relatively complex activities that result in this type of exposure, the SDDT should be prepared to use the exposure measure in the CCR rules.

2.42 Under CRR and the near-final Basel 3.1 rules, a firm may determine the exposure value of Securities Financing Transactions (SFTs) and long settlement transactions in accordance with Credit Risk Mitigation provisions, which are set out in Chapter 3 of the Counterparty Credit Risk (CRR) Part of the near-final Basel 3.1 rules, or in accordance with Counterparty Credit Risk provisions (in Chapter 6 of Title II of Part Three of CRR and Chapter 3 of the Counterparty Credit Risk (CRR) Part). The PRA proposes to continue to apply capital requirements for SFTs and long settlement transactions to SDDTs but to amend Article 111(2) of the Credit Risk: Standardised Approach (CRR) Part of the near-final Basel 3.1 rules to say that an SDDT must determine the exposure value of SFTs and long settlement transactions in accordance with Chapter 3 of the Credit Risk Mitigation (CRR) Part. The PRA intends to consult on changing Article 271 of the CRR – which contains a provision relating to the determination of the exposure value of SFTs and long settlement transactions – as part of

[37] Article 307 in the Counterparty Credit Risk (CRR) Part of the PRA Rulebook and UK CRR Article 107(2).

its consultation on the proposed transfer to the PRA Rulebook of CRR provisions related to CCR (currently scheduled for H2 2024[38]). Therefore, this proposal is dependent on anticipated legislation in relation to revocation of provisions in the UK CRR.

2.43 To make the Pillar 1 framework simple for SDDTs given that the PRA considers it unlikely SDDTs would use the Internal Models Method (IMM), the PRA is proposing amendments to Articles 273, 294, 295, and 296 in the Counterparty Credit Risk (CRR) Part of the PRA Rulebook which would mean SDDTs cannot use the IMM to calculate exposure values; and, when it consults on the proposed transfer to the PRA Rulebook of CRR provisions, the PRA intends to propose further amendments to provisions related to the IMM and to propose a policy that would descope SDDTs from the approach to granting IMM permissions. Those further amendments are dependent on anticipated legislation in relation to the relevant provisions in the UK CRR.

Consequential changes to the Leverage Ratio and Large Exposures

2.44 Some of the calculations for CCR that SDDTs would no longer be required to do for Pillar 1 capital requirements under the proposals set out above are also used for calculating derivative exposures in the leverage ratio (LR) and large exposures (LE) limit for SDDTs. SDDTs are in scope of the LR expectation set out in SS45/15 – **The UK leverage ratio framework**. The LR rules in Article 429c of the Leverage Ratio (CRR) Part of the PRA Rulebook set out that firms shall calculate the exposure value of derivative contracts listed in Annex II of the CRR and of credit derivatives, including those that are off-balance-sheet, in accordance with the standardised approach for counterparty credit risk (though in some circumstances firms may use the simplified standardised approach or the original exposure method). The LE rules in the Article 390(4) of the Large Exposures (CRR) Part of the PRA Rulebook set out that firms shall calculate the exposure values of derivative contracts (those listed in Annex II of the CRR and credit derivatives directly entered into with clients) using one of the methods in Chapter 6 of Title II of Part Three of the CRR. To avoid SDDTs having to do calculations that are no longer required for Pillar 1 capital requirements – and so losing some of the benefits of the proposals above – the PRA proposes to simplify the derivative exposure calculation in the LR and LE limit for SDDTs.

2.45 Currently derivative exposures for the LR and LE limit are calculated according to:

Exposure value = α x (RC + PFE)

where:

- α is the alpha factor equal to 1.4, to build in an additional level of conservatism into the exposure value;

[38] **Regulatory Initiatives Grid November 2023**.

- RC is the replacement cost (see Articles 274(2) and 275 in the Counterparty Credit Risk (CRR) Part of the PRA Rulebook for the full definition); and
- PFE is the potential future exposure (see Articles 274(2) and 278 in the Counterparty Credit Risk (CRR) Part of the PRA Rulebook for the full definition).

2.46 The PRA proposes to simplify the derivative exposure calculation used for the LR and the LE limit by using the current market value of derivatives, subject to a floor at zero, multiplied by an α factor equal to 1.4. Current market value would be calculated based on individual contracts and gross of any collateral held or posted. The proposed exposure calculation would remove the complexities arising from assessing eligible collateral and potential future exposure. The new calculation would be:

$$\text{Exposure value}_{\text{SDDT}} = \alpha \times \max(\text{current market value of derivative contract}, 0)$$

2.47 The PRA considers this approach would make the prudential framework simpler for SDDTs, but it would ensure that these values are still assessed, thereby supporting the role of the LR expectation and the LE limit as important parts of the prudential framework for SDDTs.

Consequential changes to credit risk

2.48 The PRA is proposing to amend the rules in Article 132A of the Credit Risk: Standardised Approach (CRR) Part about how firms calculate capital requirements for exposures in the form of units or shares in collective investment undertakings (CIUs) to reflect the proposed changes to CCR and credit risk capital requirements for SDDTs. Under the proposed amendments of Article 132A of the Credit Risk: Standardised Approach (CRR) Part of the near-final Basel 3.1 rules, SDDTs would be able to continue to use any of the specific methods for CIUs. The PRA is also proposing a change to the threshold for notifying the PRA about the size of CIU exposures in Article 132 of the Credit Risk: Standardised Approach (CRR) Part of the near-final Basel 3.1 rules. The proposed change would avoid SDDTs having to use CCR rules to calculate exposure values for the purpose of the notification requirement where they would no longer be required to do so for Pillar 1 capital requirements.

Interactions with the Interim Capital Regime

2.49 As set out in PS17/23 and PS9/24 firms meeting the SDDT criteria would be able to choose (via a Modification by Consent, MbC) to enter the ICR instead of implementing the Basel 3.1 rules when those come into effect on 1 January 2026. The ICR will allow firms to continue being subject to requirements that are substantively the same as the CRR[39] provisions for Pillar 1 until the implementation date for the SDDT capital regime.[40]

2.50 The PRA will also continue to apply the existing Pillar 2A framework, including the refined methodology, to firms and consolidation entities in the ICR until the SDDT capital regime is implemented.[41]

2.51 As explained in PS17/23, the ICR will avoid the need for SDDT-eligible firms that choose to opt into the ICR regime to implement all Basel 3.1 standards before subsequently moving onto the capital regime for SDDTs.

2.52 The PRA's policy is that the ICR should be in place during the period between the implementation date for the Basel 3.1 standards and the proposed implementation date for the SDDT capital regime. The PRA is therefore proposing that the ICR would cease to apply upon the implementation of the SDDT capital regime.

2.53 At the point when the SDDT capital measures are implemented, firms on the ICR would move onto the SDDT capital regime if they have taken up the SDDT MbC or would implement all Basel 3.1 standards. The PRA proposes that the ICR Pillar 1 capital requirements would therefore be deleted from the PRA rules.

2.54 As outlined earlier in this chapter, the PRA proposes to implement the CR SA (except the due diligence requirements) and OR SA in the SDDT capital regime. In practice, this would mean the CR SA (except the due diligence requirements in the case of firms that are SDDTs) and OR SA would apply to all firms on the ICR from the implementation date for the SDDT capital regime, regardless of whether they choose to opt into the SDDT regime or not.

2.55 The proposed operational aspects of ending the ICR, including proposals for how firms would move from the ICR to either all the Basel 3.1 standards or the SDDT capital regime, are set out in Chapter 8.

Other aspects of Pillar 1

2.56 Under the PRA's implementation of Basel 3.1 standards, all firms are in scope of the CR IRB approach, as set out in PS9/24. SDDTs that wish to develop IRB models and submit an IRB application according to the Basel 3.1 standards would be able to do so. An SDDT would

---

39 The onshored and amended UK version of **Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012**.

40 The one exception is rules related to the internal ratings based (IRB) approach. The PRA will incorporate the Basel 3.1 IRB rules for the ICR, see PS9/24.

41 See PS17/23 – Implementation of the Basel 3.1 standards near-final part 1.

only cease to meet the SDDT criteria when its model has regulatory approval, and hence would be using the model to calculate its future capital requirements.

2.57 The PRA is not proposing to change the Pillar 1 own funds requirements of a CET1 capital ratio of 4.5%, a Tier 1 capital ratio of 6%, a total capital ratio of 8% of RWAs.[42] The PRA considers these requirements provide an appropriate level of safety and soundness for SDDTs.

PRA objectives analysis

2.58 The PRA considers that the proposals in this chapter would advance the PRA's primary objective of safety and soundness, while simplifying Pillar 1 capital requirements for SDDTs. The proposals to apply the Basel 3.1 CR SA, CRM, and OR SA to SDDTs would ensure that, in comparison to CRR provisions, Pillar 1 requirements better reflect the risks faced by SDDTs, while being simple enough to implement. For the items in small trading books, SDDTs could calculate capital requirements using the CR SA. The PRA considers that not capitalising the use of SDDT smoothing provisions within the limited trade activity criterion should not have a negative impact on SDDTs' resilience because such instances are likely to be rare and temporary. Exempting SDDTs from Pillar 1 requirements for CCR for derivatives (with some exceptions) and CVA risk would not reduce SDDTs' resilience since their exposures are limited through the SDDT criteria. Limiting SDDTs' access to the IMM should not affect SDDTs' resilience because they are unlikely to use the IMM. The proposed simplified measure of derivative exposures for use in the LR and the LE limit would advance the PRA's primary objective of safety and soundness, as it would ensure these exposures would continue to be accounted for in the LR and the LE limit.

2.59 With regards to the PRA's secondary objective on competition, the PRA considers that the proposals for credit risk and operational risk set out in this section would facilitate effective competition by reducing barriers to growth for SDDTs, because SDDTs would not have to adapt to a new risk-weighting approaches to these risks if they move out of the SDDT regime. The proposals would also reduce the differences between standardised approach and IRB risk weights for residential mortgages.[43] Descoping SDDTs from capital requirements for CCR for derivatives and CVA risk, as well as market risk requirements associated with foreign exchange and commodity risk, could reduce compliance costs for SDDTs. Limiting SDDTs' access to the IMM should not affect SDDTs' costs because they are unlikely to use the IMM. The prices of banking services in the UK could decrease and the volume and variety of banking services could increase as a result if SDDTs pass on these

42 Article 92(1) of the CRR.
43 See **Bank Overground – Mind the (smaller) gap? Implications of the narrowing gap between modelled and standardised residential mortgage risk weights**.

lower costs to customers or because the lower costs encourage greater entry into the UK banking sector.

2.60 The proposals in this section also advance the PRA's secondary competitiveness and growth objective. By making Pillar 1 requirements for credit and operational risk more risk sensitive, the proposals could support an efficient allocation of capital between different types of borrowers, which could support the economy. By supporting effective competition, the proposals could lower the costs of financial intermediation and improve access to financial services in the economy. The proposals would reduce costs for SDDTs with foreign parents. Reduced costs could increase incentives for small foreign banks to establish banks in the UK.

Cost benefit analysis (CBA)

2.61 This section sets out the analysis of costs and benefits of the proposals in this chapter.

2.62 The costs and benefits of applying the CR SA and the OR SA to SDDTs are defined relative to the approaches that currently apply under the CRR. The costs and benefits of the disapplication of due diligence requirements in the CR SA, the simplifications to the market risk framework, the disapplication of capital requirements for CCR for derivatives and CVA risk, and consequential changes to the LR and the LE rules are defined relative to the capital framework that would apply outside of the SDDT regime. See Chapter 9 for more details about this approach to defining the baseline in the CBA.

Benefits

2.63 The proposed application of the CR SA means SDDTs would face Pillar 1 requirements that are more risk sensitive than CRR rules, which would support the resilience of SDDTs by setting appropriate incentives in place for various types of business. The CR SA would also narrow the gap between risk weights applied by smaller firms and larger firms who are more likely to be using IRB. This would improve the capacity of SDDTs to compete with IRB firms and increase competition in the UK banking sector.[44]

2.64 The proposal to exempt SDDTs from the CR SA due diligence requirements would remove a cost without affecting SDDTs' resilience relative to outside of the SDDT regime.

2.65 The proposed application of the OR SA would reduce the compliance costs for SDDTs relative to the existing CRR rules due to its simpler calculations and differentiation based on a firm's size and complexity.

[44] See footnote 43.

2.66 The PRA considers that the proposed simplifications to the market risk framework, and the disapplication of the CCR for derivatives (with some exceptions) and CVA capital requirements would reduce compliance costs for SDDTs compared to costs they would face outside of the SDDT regime.

2.67 The PRA considers that the resources saved by not facing these requirements could have additional benefits to safety and soundness if SDDTs diverted resources into risk management and because they could increase SDDT's capacity to build or conserve capital.

Costs

2.68 The proposed application of the CR SA and OR SA could change some SDDTs' capital requirements, in either direction. The PRA considers that applying Basel 3.1 CR SA and OR SA capital requirements would entail a one-off cost to SDDTs. See Chapter 9 for details.

2.69 The PRA considers that limiting SDDTs' access to the IMM should not generate any costs because SDDTs are unlikely to use the IMM. It might have benefits by making the Pillar 1 framework simpler for SDDTs.

'Have regards' analysis

2.70 In developing these proposals, the PRA has had regard to its framework of regulatory principles. The regulatory principles that the PRA considers are most material to the proposals are:

1. Proportionality:

The PRA considers that the proposed application of the Basel 3.1 CR SA and CRM, and OR SA would be proportionate for SDDTs as the Basel 3.1 standards are implemented by the PRA in a way that recognises differences in the operational capacity between the firms. While the CR SA could increase the complexity relative to the current requirements, the PRA considers that the benefits in terms of the greater risk sensitivity for safety and soundness should outweigh the costs of greater complexity.

The PRA has also considered where it can propose to simplify or disapply requirements deemed to be disproportionate for SDDTs. In particular:

- the due diligence requirements in the CR SA were deemed disproportionate as SDDTs may not have the operational capacity to challenge external credit ratings;
- the PRA considers that market risk exposures under the SDDT criteria would be small, so calculating capital requirements for SDDTs' small trading books using the CR SA and exempting SDDTs from maintaining capital against their small foreign-exchange exposures would be a more proportionate approach than SDDTs having

the option to use the market risk rules and having to hold capital against their foreign-exchange exposures;

- the PRA considers Pillar 1 requirements related to CCR for derivatives and CVA risk are disproportionately burdensome for SDDTs, as their trading activity is limited by the SDDT criteria. The PRA expects that redirecting operational capacity of SDDTs to focus on prudent CCR risk management practices would be more proportionate;
- the PRA considers limiting SDDTs' access to the IMM is proportionate because SDDTs are unlikely to use the IMM and the IMM is a complex exposure-value method; and
- the PRA considers its proposal to simplify the calculation of derivatives exposures in the LR and LE parts of the framework to be proportionate.

2. Recognition of difference between businesses:

The PRA recognises the potential differences between the business models of SDDTs and non-SDDTs because SDDTs' trading activities are limited by the SDDT criteria. The PRA proposes that capital requirements for SDDTs' small trading books would be calculated using the CR SA. SDDTs could have derivative positions related to hedging, but in the view of the PRA these risks could be mitigated more efficiently via prudent CCR risk management practices.

3. Encouraging economic growth in the interests of consumers and businesses, including: facilitating investment in productive assets, sustainable finance and the supply of long-term investment, better outcomes for consumers, and smart regulatory reform:

The PRA considers that the proposals to apply the Basel 3.1 CR SA and CRM, and OR SA to SDDTs should help to ensure that SDDTs' RWAs are sufficient given the risks to which they are exposed and that risk measurements are more consistent across firms. Other proposals simplify or disapply certain Pillar 1 requirements for SDDTs, which could reduce SDDTs' operational costs. The PRA considers that the proposals in this chapter would support a more efficient allocation of capital in the UK economy, which could support economic growth.

4. Promoting the government's strategy to promote competitiveness and its priorities, including: the Future Regulatory Framework Review, trade and inward investment into the UK, UK attractiveness for international financial services, and innovation:

The PRA considers that the proposals to simplify or disapply certain Pillar 1 requirements for SDDTs could reduce costs for SDDTs with foreign parents and increase the incentives of small foreign banks to establish banks in the UK.

5. Efficient use of PRA resources:

The PRA considers that the proposal to apply the CR SA and OR SA to SDDTs and non-SDDTs would ensure that risks are measured and supervised consistently across the firms, placing a lower burden on supervisors than if different approaches applied to SDDTs and non-SDDTs. The PRA considers the proposal to remove CCR for derivatives and the CVA requirements should lead to an efficient use of PRA resources by redirecting supervisory efforts from scrutinising the complex capital-requirement calculations for CCR for derivatives and CVA risk, which currently tend to result in low capital requirements, to assessing whether SDDTs manage their derivative exposures prudently, in line with the draft SDDT ICAAP SS.

2.71 The PRA has had regard to other factors as required. Where analysis has not been provided against a ‘have regard’ for this set of proposals, it is because the PRA considers that ‘have regard’ to not be a significant factor for this set of proposals.

3: Pillar 2A

Overview

3.1 This chapter sets out the PRA's proposals to simplify the Pillar 2A framework for SDDTs. It sets out the introduction of significant simplifications to the PRA's Pillar 2A methodologies for SDDTs. These would also simplify how an SDDT is expected to assess risks in its Internal Capital Adequacy Assessment Process (ICAAP), and so they would allow for corresponding simplifications to reporting requirements (see Chapter 7). Overall, the proposals seek to balance simplicity with strength, with a view to lowering SDDTs' costs of compliance without compromising their safety and soundness.

3.2 The proposals in this chapter (and other chapters) would introduce:

- a draft SoP – The PRA's methodologies for setting Pillar 2 capital for Small Domestic Deposit Takers ('draft SDDT Pillar 2 SoP').

3.3 Chapter 7 includes proposed changes to reporting that arise from the proposed changes set out below.

3.4 The PRA's Pillar 2 capital framework is intended to ensure that firms have adequate capital to support the relevant risks in their business, and that they have appropriate processes to ensure compliance with capital requirements. It is intended to encourage firms to develop and use better risk management techniques in monitoring and managing their risks. Pillar 2, therefore, acts to further the safety and soundness of firms, in line with the PRA's primary objective. The PRA's existing Pillar 2 capital framework consists of Pillar 2A and Pillar 2B. Pillar 2A addresses risks not already, or not sufficiently, captured by Pillar 1. Collectively, Pillar 1 and Pillar 2A form the regulatory minimum capital requirement, called the 'total capital requirement' (TCR), which firms must maintain at all times. Pillar 2B, also currently referred to as the PRA buffer, is an amount of capital a firm should maintain in addition to its TCR and the combined buffer to absorb losses that may arise under a severe but plausible stress (see Chapter 1, Chapter 2, and Chapter 4 respectively for further details on the overall capital framework and a proposed single capital buffer).

3.5 In accordance with the PRA's Internal Capital Adequacy Assessment (ICAA) rules, in conjunction with **SS31/15**, a firm must carry out an ICAAP to assess on an ongoing basis the amounts, types, and distribution of capital that it considers adequate to cover the level and nature of the risks to which it is, or might be, exposed. The PRA requires firms, in the first instance, to take responsibility for ensuring that the capital they have is adequate, with the ICAAP being an integral part of meeting this expectation. As part of the Capital Supervisory

Review and Evaluation Process (C-SREP), the PRA will review the firm's ICAAP to determine whether all the material risks for that firm have been identified and adequately capitalised.

3.6 The PRA sets Pillar 2A capital requirements using both the calculations included in a firm's ICAAP, the results of the PRA's own Pillar 2A methodologies and supervisory judgement. To assess the capital adequacy of a firm under Pillar 2A, the PRA has developed methodologies, as set out in 'The PRA's methodologies for setting Pillar 2 capital' (the 'existing Pillar 2 SoP'), for eight types of risk: credit risk, credit concentration risk (CCoR), operational risk, interest rate risk in the banking book (IRRBB), pension obligation risk, market risk, group risk, and counterparty credit risk. Firms are required to capitalise all risks to which they are exposed, including risks other than the eight types of risk.

3.7 A large majority of respondents to DP1/21 agreed that the current Pillar 2A approach was unduly burdensome for small firms. Some of the methodologies may be less relevant to the risks that small firms are exposed to, given their relatively simple and domestically focused business models. This complexity is exacerbated by two Pillar 2A 'adjustments' in relation to the refined methodology[45] and the CCyB.[46] These complex adjustments are aimed at ensuring firms' total amount of capital requirements and buffers do not exceed the amount necessary to ensure a sound management and coverage of its risks and take into account the increase in the level of the UK CCyB resting rate respectively.

3.8 These adjustments can make it difficult and time consuming for small firms to understand the final Pillar 2A requirement that is set. More generally, small firms often do not have the resources, capability, or data that larger firms have, and report that they would benefit from more guidance. The most frequent view offered by respondents to DP1/21 was that the Pillar 2A approach should be retained but simplified, provided that this did not increase overall capital requirements. This view received considerably more support than the alternative set

45 The PRA's Pillar 2A credit risk methodology was updated in 2017, updating the existing Pillar 2 SoP and SS31/15 as set out in PS22/17 – **Refining the PRA's Pillar 2A capital framework**, to allow some SA firms that meet specified criteria to compare their SA risk weights with those derived from typical IRB models. When making an overall assessment of the adequacy of their total capital requirements, the firm and the PRA can consider that comparison and assess whether there is any excess conservatism inherent in some aspects of the existing Pillar 1 SA.

46 In December 2019, the FPC increased the UK CCyB rate that it expects to set in a standard risk environment from in the region of 1% to in the region of 2%. Subsequently, the PRA reduced Pillar 2A capital requirements to reflect the additional resilience associated with higher macroprudential buffers in a standard risk environment. For firms whose minimum requirement for own funds and eligible liabilities (MREL) exceeds their TCR, the PRA reduced variable Pillar 2A capital requirements by 50% of the firm-specific increase in the UK CCyB pass-through rate in a standard risk environment. Firms are eligible for an additional reduction of 50% of the firm-specific UK CCyB pass-through rate if their MREL is equal to their TCR and if they are considered to have a low-risk profile by the PRA. See PS15/20 – **Pillar 2A: Reconciling capital requirements and macroprudential buffers**.

out in DP1/21 of reducing or eliminating the need for Pillar 2A capital requirements while toughening the calibration of Pillar 1 capital requirements.

3.9 The PRA considers that the prudential regime could be simplified significantly for SDDTs, while still maintaining their overall resilience, by streamlining existing Pillar 2A methodologies, consistent with the responses to DP1/21. In designing the proposed simplifications to the Pillar 2A methodologies for SDDTs, the PRA has taken a 'risk-by-risk approach'. This means that the PRA would continue to set out methodologies for each relevant type of Pillar 2A risk, but with simplifications to the calculations of certain risk types. The risk-by-risk approach preserves risk sensitivity in Pillar 2A capital requirements, while allowing for significant simplification of methodologies and a reduction in the associated data templates (see Chapter 7). Simplifying the Pillar 2A methodologies should increase the transparency for SDDTs over how their Pillar 2A requirements are set and lower the operational burden. Furthermore, the approach maintains the current benefits in relation to encouraging good risk management, by requiring SDDTs to explore in the ICAAP risks they are exposed to that are not well captured in Pillar 1 or buffers (see Chapter 5 for the PRA's proposals to simplify the ICAAP documentation).

3.10 It is important to note that the PRA's view of the risks to which SDDTs are exposed and its risk appetite have not changed. The proposals simplify how these risks are assessed, but they should not lead to significantly different capitalisation for SDDTs relative to the existing methodologies for the types of risk concerned. The calibration of Pillar 2A add-ons for SDDTs may be updated, subject to consultation, if there is a prudential case to do so in the future.

3.11 The risk-by-risk approach provides an avenue for the PRA to assess, as part of the C-SREP, whether SDDTs have identified all material risks, and whether their capital is sufficient to cover the nature and level of the risks to which they are exposed. In line with the PRA's existing approach, the PRA's proposed methodologies for SDDTs would not be fully mechanical. Rather, they would serve as a starting point that would inform the setting of Pillar 2A capital requirements, which are based on supervisory judgement and set on a firm-specific basis.

3.12 The PRA proposes to:

- substantially simplify the Pillar 2A approaches for credit risk, credit concentration risk and operational risk for SDDTs.[47] The current methodologies and expectations for these risk types are considered relevant but are less well-tailored to SDDTs, given their relatively simple and domestically focused business models. Consistent with that, respondents to DP1/21 most commonly highlighted these areas as those where the

[47] The firm-specific structural adjustments to Pillar 2A for SME and infrastructure exposures (see PS9/24 for details) would apply to SDDTs.

potential for simplification was the greatest. As a result of the proposed simplifications, four reporting templates would be removed and one streamlined (see Chapter 7 for further details). In addition, the draft SDDT Pillar 2 SoP and draft SDDT ICAAP SS would provide greater clarity and transparency on the PRA's methodologies and expectations for SDDTs;

- retain the existing Pillar 2A approach for IRRBB (with some clarifications), pension obligation risk, and counterparty credit risk for SDDTs as the PRA considers that its current Pillar 2A approaches are sufficiently simple and effective in capturing these risks;
- remove Pillar 2A methodologies and expectations for market risk and group risk for SDDTs as the PRA considers that these types of risk are generally not relevant to SDDTs; and
- eliminate the complex Pillar 2A adjustment for SDDTs in relation to the CCyB, in addition to the proposal to retire the refined methodology set out in CP9/24. The removal of these complex adjustments follows from the proposals in this CP to not apply the CCyB to SDDTs and to apply the Basel 3.1 standardised approach to credit risk to SDDTs, respectively. This would significantly simplify the capital framework for SDDTs and enhance its transparency.

3.13 The proposals set out in this chapter to simplify Pillar 2A methodologies would only apply to SDDTs. The PRA is planning to review its existing Pillar 2A methodologies after the finalisation of the PRA rules to implement the Basel 3.1 standards. The simplifications to the Pillar 2A methodologies and expectations for SDDTs proposed in this CP are not expected to fall within the scope of that review.

Credit risk

3.14 Credit risk is the risk of losses arising from a borrower or counterparty failing to meet its obligations as they fall due. Most of that risk is captured in Pillar 1 minimum requirements, but some might not be, and the PRA sets credit risk add-ons in those circumstances. As set out in the existing Pillar 2 SoP, the PRA's current Pillar 2A methodology for credit risk add-ons is based on a comparison of firms' standardised approach (SA) risk weights at a portfolio level to an internal ratings based (IRB) risk-weight benchmark (hereafter 'the benchmarking methodology'). The objective of this methodology is to increase the risk capture of minimum capital requirements for asset classes for which the PRA believes the SA underestimates the risk.

3.15 This benchmarking methodology applies to all firms using the SA and those portfolios capitalised using the SA by firms with IRB permissions. The determination of a firm's credit risk add-on is not a mechanical calculation but is also based on supervisory judgment, taking into account considerations such as the firm's own assessments. All firms using SA for credit risk are currently required under the Reporting Pillar 2 Part of the PRA Rulebook to complete the data items for wholesale and retail credit exposures under the SA (FSA076 and FSA077).

3.16 Currently, relatively few firms are subject to a credit risk add-on and this is also the case for SDDT-eligible firms. While the current supervisory expectations for all firms (SS31/15) do not specify how firms should conduct their proposals for credit risk add-ons, the PRA has observed that SDDT-eligible firms generally make reference to the benchmarking methodology set out in the existing Pillar 2 SoP. SDDT-eligible firms also make use of credit scenarios (eg thinking through the implications of a situation in which there was a reduction in property prices) to stress their credit portfolios to assess whether additional capital might be required. Several SDDT-eligible firms create their own proxy IRB modelling to estimate the equivalent risk-weight might be in a model based on the historical performance of their own credit portfolios, and then compare it with their Pillar 1 requirements to assess whether additional capital might be required. The PRA has observed that in most cases for SDDT-eligible firms, these assessments do not result in an additional add-on for credit risk.

3.17 With the proposal to apply the Basel 3.1 CR SA to SDDTs (see Chapter 2), some of the existing risk underestimation under the SA would be addressed, and therefore, the PRA considers that even fewer firms would require credit risk add-ons in the future.

3.18 At the same time, the PRA acknowledges that the Basel 3.1 CR SA framework is not catered to the riskiness of every specific asset (eg subprime loans) and as a result, there are idiosyncratic risks faced by specific firms for which they should continue to maintain additional capital. However, these idiosyncratic risks are not captured under the benchmarking methodology. Further, the benchmarking methodology will likely be inappropriate as an assessment for any risk underestimation under the SA[48], given changes proposed to be introduced as part of the Basel 3.1 standards – for example, the implementation of the output floor and the removal of modelling for certain asset classes.

3.19 Therefore, the PRA proposes to simplify the Pillar 2A methodology for credit risk as follows:

- remove the use of, and reliance on, the benchmarking methodology currently set out in the existing Pillar 2 SoP, and therefore also remove the requirements to submit FSA076 and FSA077 returns (See Chapter 7 for details);
- expect only SDDTs that meet certain criteria – such as those that are new and growing or engaged in higher risk lending, as set out below – to provide a detailed assessment of capital needed in relation to credit risk; and

48 The PRA will review the Pillar 2A credit risk methodology for other firms (ie non-SDDTs) more comprehensively in a Pillar 2A methodologies review.

- use credit scenarios as the core methodology for SDDTs that need to undertake a detailed assessment.

Proposed criteria for which SDDTs will need to undertake a detailed assessment

3.20 While all SDDTs would continue to be required under the ICAA Part of the PRA Rulebook to assess and maintain capital they consider adequate to cover all the risks – including credit risks – to which they are or might be exposed, the PRA considers that only some SDDTs would need a focused assessment in their ICAAPs of the capital needed to support their credit risk exposures, and propose credit risk add-ons (if any) over and above their Pillar 1 requirement. The PRA would then use such information to assess whether a credit risk add-on would need to be set for an SDDT.

3.21 The PRA proposes to require SDDTs to run this detailed assessment if they meet the criteria below, as set out in the draft SDDT Pillar 2 SoP and draft SDDT ICAAP SS:

- new and growing banks as defined under SS3/21 – **Non-systemic UK banks: The Prudential Regulation Authority's approach to new and growing banks**; or
- predominantly engaged in unsecured retail lending; or
- engaged in other higher-risk lending (eg sub-prime lending) where additional capital would be potentially required to ensure the SDDT is capitalised appropriately.

3.22 While SDDTs meeting these criteria are more likely to be under-capitalised from a credit risk perspective, because typically they have newer credit portfolios or are engaged in potentially higher-risk lending, they would not necessarily be subject to credit risk add-ons. Rather, the rationale of requiring SDDTs that meet the above criteria to conduct this assessment is to ensure that firms thoroughly understand and manage their own risks and are confident they are sufficiently capitalised. The PRA considers SDDTs would benefit from a more comprehensive assessment and monitoring to ensure their risk and capital management remain commensurate with their business needs. In cases where an SDDT falls outside the above criteria but considers it would be appropriate for the SDDT to conduct this assessment, the PRA expects the SDDT to include the assessment in its ICAAP (based on the core methodology and expectations set out below). This is in line with the ICAA Part of the PRA Rulebook that SDDTs must assess and maintain capital they consider adequate to cover all the risks and the PRA's expectation that SDDTs to take responsibility for ensuring that the capital they have is adequate.

3.23 Under this proposal, supervisors would make use of a firm's own assessment to review its risk profile and then assess whether a credit risk add-on would be required for a firm. In the cases of firms meeting the above criteria but not submitting an assessment, the PRA would assess a firm's credit risk add-on based on sufficiently conservative assumptions to ensure the capital required covers risks the firm may be exposed to.

3.24 The PRA considers that this proposal could significantly streamline and simplify both the ICAAP and C-SREP, as most SDDTs would not have a risk profile that would require a detailed assessment and/or propose credit risk add-ons in their ICAAP.

Proposed core methodology – credit scenarios

3.25 The PRA proposes that SDDTs meeting the above criteria (and any others who consider it appropriate) make use of credit scenarios as the core methodology to assess their exposure to credit risk. The PRA proposes that SDDTs should design their own scenarios which should focus on high-severity tail events, over a 12-month horizon, with particular focus on how these events may result in credit losses for higher risk lending which is not captured under Pillar 1.[49] The PRA proposes that SDDTs should ensure their own credit scenarios are more severe than the non-cyclical stress test scenarios published by the PRA (see paragraphs 4.34-4.37 for more details). The PRA considers credit scenarios would be an effective tool in capturing additional risk sensitivity that is otherwise not well captured by the SA framework, while providing flexibility for SDDTs (with a range of business models) to suitably address idiosyncratic risks. Credit scenarios are currently commonly adopted by SDDT-eligible firms for Pillar 2A assessments. The PRA proposes to provide supervisory expectations which would guide SDDTs in conducting their own analysis in the draft SDDT ICAAP SS. (Please refer to Appendix 6). This is to ensure the scenarios designed by SDDTs are proportionate and more consistent across firms.

3.26 The PRA also proposes to provide an option for SDDTs to conduct the assessment using proxy IRB models. However, the PRA has concerns about the over-reliance on non-approved models given that these models are not subject to comprehensive assessment, testing, and approval processes. Therefore, the PRA expects this option would be limited to exceptional cases. It is also the responsibility of the firm's board to ensure that the models used to assess capital requirements are robust and comprehensive.

Credit concentration risk (CCoR)

3.27 CCoR is the risk of losses arising from concentrations of exposures due to imperfect diversification. That can mean a certain shock may result in much higher losses in concentrated firms compared to firms that have more diversified portfolios. This imperfect diversification can arise from the small size of a portfolio or many exposures to specific obligors ('single-name concentration'), or from imperfect diversification with respect to economic sectors or geographical regions. Notwithstanding the changes to methodologies

---

49 This assessment aims to capture any under-capitalisation in Pillar 1 with the aim of ensuring minimum requirements provide sufficient capacity to absorb losses and additional costs incurred in a gone-concern scenario through exploring high-severity tail events over a 12-month horizon. This is different from the assessment of Pillar 2B (as set out in Chapter 4), which is intended to ensure that firms maintain sufficient capital to withstand a severe but plausible stress while continuing to meet TCR over a longer time horizon.

set out in this consultation, an SDDT should continue to ensure that its internal risk measurement system allows it to address and control all material sources of CCoR in compliance with Internal Capital Adequacy Assessment 6.1.

3.28 As set out in the existing Pillar 2 SoP, the PRA's current Pillar 2A methodology calculates a measure of CCoR, the Herfindahl-Hirschman Index (HHI), for all relevant portfolios (to identify concentration in single-names and pre-defined industry sectors and geographic regions). The HHI measure for single-name, sector, and geographic credit concentration is then mapped to capital add-on ranges. The PRA exercises judgement as to where within that range the capital add-on should be set. For the purposes of the current HHI methodology, only wholesale credit portfolios are considered for single-name and sector concentration risk.[50] This is because single-name and sector concentration risk are considered less relevant for retail portfolios, which tend to be more granular. In contrast, geographic concentration risk is considered relevant for both retail and wholesale credit portfolios. However, residential mortgage portfolios on the standardised approach for credit risk are not currently included in the HHI calculation for geographic concentration risk.

3.29 CCoR was one of the Pillar 2A risk area that received the most comments in the responses to DP1/21. Responses from firms suggested that using HHI to calculate CCoR is complex and unduly burdensome. This burden of HHI may be particularly felt by smaller firms as it requires them to calculate and report on concentration risk types that are less relevant due to their size, and so is considered to be disproportionate.

3.30 The PRA considers that its current Pillar 2A methodology for CCoR can be significantly simplified for SDDTs while still ensuring adequate capitalisation of this risk for these firms. The PRA's review found that the HHI methodology adds unnecessary complexity for this group of firms, which is relatively homogenous due to the SDDT criteria, particularly in terms of UK geographic concentration, as a firm must have, on average, at least 85% of its credit exposures in the UK to be eligible to be an SDDT. Instead, a simpler calculation could be applied to SDDTs' RWAs, which could be sourced from existing regulatory reporting rather than through a separate return.

3.31 The PRA proposes the following changes to achieve this simplification:

- to replace the HHI methodology with a simpler calculation of CCoR which is composed of a base add-on for CCoR, with separate components for retail and wholesale (as described in the draft SDDT Pillar 2 SoP); and
- to supplement this approach by periodically evaluating single-name and sector concentration risks, using data from the existing large exposure and stress testing

50 This excludes securitisation, intra-group exposures and non-performing loans.

frameworks respectively (as described in the 'Credit concentration risk' section of the draft SDDT ICAAP SS).

These simplifications would also allow for a reduction in reporting of related items by SDDTs to the PRA (see Chapter 7 for detail on reporting proposals).

Revisions to calculating Pillar 2A capital for credit concentration risk

3.32 For SDDTs, the PRA proposes to set Pillar 2A CCoR capital base add-ons based on wholesale exposures ('wholesale add-on') and retail exposures other than SA residential mortgage portfolios ('retail add-on'). The wholesale add-on would be calibrated to include risks from single-name, sector, and geographic concentration. The retail add-on would only cover geographic concentration risk, given the lower relevance of single-name and sector concentration risk for retail portfolios. The PRA considers that these two separate add-ons provide good, simple, proxies for measuring CCoR for SDDTs. The PRA considers that the assessment of CCoR using these two add-ons and the exclusions of different assets should deliver broadly the same outcome, in aggregate, as the current CCoR Pillar 2A requirements.

3.33 The wholesale add-on would apply to all credit RWAs excluding residential mortgages, unsecured retail, short-term liquid exposures to financial institutions and exposures in default.[51] The wholesale add-on would be set at 3.5% of relevant RWAs. The PRA's analysis has indicated that this level, when combined with the retail add-on, would broadly match the current range of CCoR add-ons for eligible SDDTs in aggregate. The retail add-on would apply to all credit RWAs, excluding wholesale RWAs, short-term liquid exposures to financial institutions, exposures in default, and residential mortgages.[52] Given the exclusions, the retail add-on is expected to primarily apply to unsecured retail assets. To be consistent with the current level and range of CCoR add-ons for eligible SDDTs, the retail add-on would be set at 1% of the relevant RWAs.

3.34 In developing this approach, the PRA focused on delivering simplification while maintaining risk sensitivity. The new approach does not reflect a change in PRA's risk appetite or view on CCoR risks for these firms. The PRA would keep these calibrations under review. Firm-specific assessment and supervisory judgement will play an important role in the

---

[51] For the purposes of calculating the 3.5% CCoR wholesale add-on, wholesale credit RWAs will be calculated as the cell OF 02.00S – R0040C0010 minus the following six cells: (a) OF 07.00S: retail exposures – R0010C0220, (b) OF 07.00S: real estate exposures – R0330C0220, (c) OF 07.00S: real estate exposures – R0351C0220, (d) OF 07.00S: real estate exposures – R0352C0220, (e) OF 07.00S: exposures to institutions – R0180C0220, and (f) OF 07.00S: exposures in default – R0010C0220. See Chapter 7 for further detail on the OF 02.00S and OF 07.00S templates.

[52] For the purposes of calculating the 1% CCoR retail add-on, retail credit RWAs will be calculated as the sum of the following cells: (a) OF 07.00S: retail exposures – R0010C0220, (b) OF 07.00S: real estate exposures – R0351C0220, (c) OF 07.00S: real estate exposures – R0352C0220. See Chapter 7 for further detail on the OF 02.00S and OF 07.00S templates.

setting of Pillar 2A CCoR add-ons for SDDTs, as it does for firms outside of the SDDT regime. The approach to this is described in more detail below.

3.35 For the purpose of setting the add-ons, the PRA would require no new reporting submissions from firms. The PRA has set out in the draft SDDT Pillar 2 SoP how it intends to make use of existing reporting to calculate the wholesale and retail RWAs. As a result of no longer applying the HHI to SDDTs, they would no longer be required to submit FSA078 and FSA079 (see Chapter 7 for detail on reporting proposals).

Review of single-name and sector concentration risks

3.36 The PRA considers that the new methodology described above would adequately capture CCoR for the majority of SDDTs. However, there may be SDDTs with single-name and sector concentration risks that are not fully reflected in the proposed simplified approach. In addition to supervisory engagement, the PRA proposes to review periodically, as part of a firm's C-SREP, single-name and sector concentration risk for SDDTs as explained below:

- **Single-name concentration**: The PRA proposes to review, as part of an SDDT's C-SREP, single-name concentration by considering the sum of an SDDT's large exposures, as defined in the Large Exposures (CRR) Part of the PRA Rulebook (1.2(b)), relative to its Tier 1 capital. This is sometimes known as a 'cluster limit' and would complement the existing Large Exposures (LE) requirements. As part of the C-SREP process, the PRA would review this measure and engage with SDDTs for which the sum of their LEs is above 300% of their Tier 1 capital. This engagement would focus on better understanding the firm's approach and management of single-name concentration risk, so that the PRA could form a view on whether the firm is sufficiently capitalised for this risk through the RWA-based CCoR add-on. The PRA intends to monitor this through the existing LE reporting within COREP as required by the Article 394 Reporting Requirements in Large Exposures (CRR) Part of the PRA Rulebook.
- **Sector concentration**: Under paragraph 3.13 of the existing SS31/15, for the purposes of stress testing, a firm should develop a range of scenarios relevant to the circumstances of the firm, including its business model, and the market(s) in which it operates. For SDDTs with significant wholesale exposures, the PRA would expect any sector concentration risks from these exposures to also be reflected in the design of these stress scenarios. As part of the C-SREP process, the PRA would engage with SDDTs to ensure they have sufficiently explored how their sector concentrations could crystallise losses in a severe but plausible stress. As in all cases, the PRA will maintain supervisory discretion to set additional capital add-ons if it judges an SDDT is not prudently monitoring or managing its sector concentration risk.

Operational risk

3.37 Operational risk (OR) is the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events, and includes legal risk. Calculating capital requirements for operational risk is a significant challenge. The loss distribution related to this risk is unusually 'fat-tailed', which means it is characterised by infrequent but very large losses. Moreover, as these events tend to happen infrequently, data to help assess the likelihood and impact of these risks crystallising can be difficult to obtain.

3.38 The PRA has considered how SDDT-eligible firms currently conduct their operational risk Pillar 2A assessments to identify ways to simplify the process. SDDT-eligible firms typically propose Pillar 2A add-ons for operational risk in their ICAAPs along with supporting evidence including scenario analysis. Often these firms base their approach on the methodology that is set out for Category 1 firms in the existing Pillar 2 SoP for operational risk. This methodology uses a combination of information on forecasts of expected losses, on historical losses, and from scenario assessments. The PRA considers that this methodology can be complex for SDDT-eligible firms, and particularly newer firms, as they often have limited data on historical losses and have difficulty with calibrating scenario analysis to a 1-in-1,000-year event which is included in the approach for the Category 1 firms.

3.39 As outlined in Chapter 2, the PRA proposes to apply the near-final Basel 3.1 SA for operational risk in Pillar 1 to SDDTs. The PRA considers the OR SA enhances the safety and soundness of firms and is proportionate both through its simplicity of calculation based on financial statement information and through its differentiation based on a firm's size and complexity. Nonetheless, the PRA considers that it continues to be important to assess operational risk as part of Pillar 2A. Pillar 2A assessments ensure operational risk capital requirements are adequate given the risks firms face, including any idiosyncratic risks that are not well captured in Pillar 1, and the relevance of the firm's past losses to their future operational risk, whilst remaining flexible and risk sensitive.

3.40 In developing its proposals for a simplified Pillar 2A operational risk methodology for SDDTs, the PRA has considered responses to DP1/21 that indicated small firms typically expend significant effort in assessing operational risk for Pillar 2A, and it is an area where small firms struggle to accurately calculate capital requirements. The feedback included that scenario analysis is the most developed and established way of assessing Pillar 2A operational risk as it takes a forward-looking approach, but it is reliant on too many assumptions, which can result in disparity in approaches. Responses also noted that the calibration of scenarios can be subjective and is an area that would benefit from a more standardised approach.

3.41 The PRA's proposed change is to articulate and streamline the methodology for setting operational risk Pillar 2A capital for SDDTs. As set out in the draft SDDT Pillar 2 SoP, the PRA proposes to use an SDDT's ICAAP to allocate it to one of three buckets, relating to its broad level of risk, which in combination with the firm's Pillar 1 operational risk requirement would then determine the level of Pillar 2A add-ons that the SDDT would be required to meet. The PRA considers that this proposal would simplify the capital setting process. This approach is set out in more detail below.

3.42 The PRA is also proposing to introduce clearer and more proportionate expectations for SDDTs undertaking their own Pillar 2A operational risk assessment. The PRA proposes to set an expectation in the draft SDDT ICAAP SS that all SDDTs should provide in their ICAAP document some operational risk scenario analysis, as well as information on their management of operational risk and any available data the firm has on any recent loss events and/or any expected losses in the next year. This is in line with observed current practices of SDDT-eligible firms. The draft SDDT ICAAP SS provides more transparency on the PRA's expectations for the scenario analysis than the existing expectations. The PRA has considered feedback from DP1/21 and has made its expectations in the draft SDDT ICAAP SS for the coverage of events and calibration of scenario analysis clearer and tailored to SDDTs.

The PRA's bucketing approach to operational risk capital

3.43 The PRA's proposal would use an approach in which firms are placed in one of three buckets, each consistent with a different level of operational risk. Each of the buckets would have a corresponding total operational risk capital requirement (Pillar 1 plus Pillar 2A) expressed as a share of the firm's total assets (as shown in Table 3). The PRA considers that having three buckets provides an appropriate balance between increasing simplicity and retaining risk sensitivity. And that the requirement applied within each bucket should apply to total assets, as that is an appropriate measure to scale operational risk, given that the size of a firm is a relevant factor in considering operational risk.

3.44 The proposed levels of capital for each bucket have been informed by existing operational risk capital requirements for SDDT-eligible firms and PRA judgement. The proposed approach does not reflect a change in PRA's risk appetite or view on operational risks for these firms. Consequently, this should result in a broadly similar outcome for total operational risk capital in aggregate relative to existing requirements, which is consistent with simplification while maintaining resilience. The PRA will keep the calibration levels for the buckets under review and adjust if there is a prudential case to do so in future.

3.45 Under the proposals, once the overall operational risk capital requirement has been determined, the Pillar 2A add-on would be the remaining capital after the Basel 3.1

operational risk Pillar 1 requirement has been accounted for. If the resulting capital requirement from the bucket is less than the firm's Pillar 1 operational risk requirement, there would be no Pillar 2A add-on. The PRA would also use supervisory judgement, as currently, to assess the Pillar 2A add-on, and may vary the approach on a case-by-case basis including setting an add-on above the Bucket 3 level if judged to be necessary. Once determined, the firm's Pillar 2A add-on would be converted into a percentage of RWAs, such that it is adjusted proportionately with RWAs in between C-SREPs, in line with the current approach and to maintain consistency with other Pillar 2A add-ons.

Table 3: Operational risk bucket levels

Bucket 1	Bucket 2	Bucket 3
0.3% of total assets	0.65% of total assets	1.25% of total assets

3.46 As part of the C-SREP, the PRA proposes to allocate an SDDT to a bucket using the information provided in its ICAAP and through supervisory knowledge of the SDDT. The PRA proposes that:

- Bucket 1 is for firms with simple business models and/or that are not significantly exposed to operational risk and/or demonstrate effective management of operational risk;
- Bucket 2 is for firms with more complex business models and/or some concerns on the exposure to or management of operational risk; and
- Bucket 3 is for firms with significantly complex business models and/or more material concerns on the exposure to or management of operational risk. Bucket 3 may also be considered for new firms – as these firms are typically fast growing – as these firms may be exposed to operational risk that is higher as a proportion of their assets.

Firm operational risk scenario analysis and additional operational risk information from the ICAAP

3.47 The PRA proposes to provide additional clarity on its expectations for SDDTs with regards to the ICAAP. The PRA considers SDDTs providing information in their ICAAP about any recent internal historical operational losses and any operational losses they expect in the next year is proportionate and broadly in line with what SDDT-eligible firms currently provide in their ICAAP. The PRA considers monitoring loss events to be an important part of risk management, and the PRA intends to give SDDTs flexibility on how they report this in their ICAAP. The PRA proposes to take a proportionate approach to this expectation as, while it expects SDDTs to collect and monitor their operational losses, the PRA recognises new firms may have limited data to share.

3.48 The PRA proposes to introduce clearer and proportionate expectations for SDDTs on the operational risk scenario analysis expected in the ICAAP. The PRA has balanced the benefits of providing guidance on its expectations and rules to improve transparency and guide firms' analysis, with retaining the ability for SDDTs to ensure their scenarios are tailored to their firm-specific risks. As set out in the draft SDDT ICAAP SS, this is done by being clearer on the information expected to be covered in each scenario but giving SDDTs the flexibility to adjust the scenario frequency – how often the event is estimated to occur – and severity levels – the estimated amount of operational loss – they consider.

3.49 As set out in rule 10.1 of the Internal Capital Adequacy Assessment Part of the PRA Rulebook, firms must implement policies and processes to evaluate and manage their exposure to operational risk, and to cover low-frequency and high severity events. The PRA considers that asking SDDTs to estimate losses for a number of scenarios is important so they can understand the scale of risks they may be exposed to, to inform their risk management and give the PRA information on the effectiveness of risk mitigations and controls. The PRA proposes that a proportionate way for SDDTs to explore low-frequency and high-severity events is to combine individual events together. For example, SDDTs could combine individual events such as a 1-in-40-year event exploring one Basel event type[53] and a 1-in-25-year event exploring another Basel event type.

Other types of risk considered relevant for SDDTs

3.50 IRRBB is the risk of losses arising from changes in the interest rates associated with banking book items. IRRBB is not captured in Pillar 1. Currently, smaller, and less complex firms are primarily subject to the 'standard' approach to IRRBB capital. Under this approach, the PRA uses a firm's own internal IRRBB policy limits – which define the maximum levels of risk it is willing to accept – as a basis to determine the capital add-on. A firm's assessment is informed by its economic value sensitivity to parallel up and down shifts in interest rates across the whole yield curve – with the size of the shift currently used by the PRA as a benchmark set at 200 basis points. If a firm has more complex IRRBB exposures, it may instead be subject to the 'comprehensive' approach, in which the PRA reviews duration risk, basis risk and, as necessary, optionality risk. Both approaches are subject to supervisory judgement and the PRA's assessment of the firm's risk management capabilities. As part of

53 Basel operational risk event type categories are set out in the PRA Rulebook and include internal fraud, external fraud, employment practices and workplace safety, clients, products and business practices, damage to physical assets, business disruption, and system failures.

this risk management assessment, firms are subject to expectations around the identification, measurement, monitoring, and control of IRRBB. These include having appropriate systems and processes, adequate oversight and approval of risk appetite and policy limits, and appropriate setting and documentation of behavioural and modelling assumptions.

3.51 The PRA considers the current approach to setting capital for IRRBB for small firms to be already both simple and risk sensitive, as it focuses on firms' own risk appetite. Several respondents to DP1/21 were supportive of retaining the IRRBB Pillar 2A approach and said that IRRBB was not an area of Pillar 2A that could be easily simplified. The PRA therefore proposes to retain the current approach to IRRBB for SDDTs. While the approach would remain the same, the PRA is proposing to make several changes to the text of the policy documents to enhance clarity and transparency. This includes having the IRRBB section of the draft SDDT Pillar 2 SoP focus on the 'standard' approach to IRRBB, as this is the approach that applies to most SDDT-eligible firms. However, if an SDDT has more complex IRRBB exposures, the PRA may instead apply the 'comprehensive' approach to IRRBB risk assessment. This is consistent with the current practice and would be applied in line with the comprehensive approach for large or more complex firms in the 'Interest rate risk in the banking book' section of the existing Pillar 2 SoP. In addition, the PRA proposes to clarify some of the text around the scope of application, methodology, and specific terms used in the draft SDDT Pillar 2 SoP and draft SDDT ICAAP SS. All of these changes are intended to clarify the existing policy and do not change the approach in practice. The PRA is simultaneously consulting on making similar clarifications in the existing Pillar 2 SoP and existing ICAAP SS in CP9/24.

3.52 Pension obligation risk refers to the risk a firm will need to make payments or other contributions to support existing pension schemes if guaranteed returns are not fully matched by underlying investments. The PRA is of the view that the current Pillar 2A approach is tailored to risks in a firm's specific pension scheme, which can be significant for some SDDT-eligible firms, and that the stress calculations necessary are already well-embedded. The PRA also takes into account responses to DP1/21, which indicated general support for retaining the current approach, as most firms considered it was not necessary or possible to simplify this risk further. The PRA therefore proposes to retain the current approach to pension obligation risk. For greater clarity and transparency, however, the PRA proposes to update a reference to the PRA Rulebook in the pension obligation risk section in the draft SDDT Pillar 2 SoP. The PRA is simultaneously consulting on making similar clarification in the existing Pillar 2 SoP in CP9/24.

3.53 Counterparty credit risk (CCR) is the risk that the counterparty to a derivative transaction could default before the final settlement of the transaction in cases where there is a bilateral risk of loss. The PRA considers that applying the Pillar 1 CCR framework, including generally complicated calculations, is not proportionate given the low level of CCR risks typically faced by SDDT-eligible firms. However, the materiality of CCR varies across firms, and the PRA expects SDDTs to monitor and adequately capitalise against the risks that they are exposed to. If an SDDT does not manage its CCR prudently, the PRA may expect the firm to hold additional capital under Pillar 2. This could take the form of a risk management and governance scalar, as set out in the draft SDDT Pillar 2 SoP, or a Pillar 2A add-on in line with the 'Counterparty credit risk' section of the draft SDDT Pillar 2 SoP – The PRA's methodologies for setting Pillar 2 capital.

Types of risk considered generally not relevant for SDDTs

3.54 SDDTs are typically not exposed to market risk (ie the risk of losses arising from movements in market prices) as the SDDT criteria exclude firms with significant exposures to this risk.[54] As far as group risk is concerned (ie the risk that the financial position of a firm may be adversely affected by its relationships with other entities in the same group), SDDT-eligible firms tend to be solo firms or part of relatively simple groups so they should not require a group risk add-on. As the PRA considers that these risks are generally not relevant for SDDTs, the PRA does not propose to set specific methodologies and expectations for market risk and group risk for SDDTs in the draft SDDT Pillar 2 SoP and draft SDDT ICAAP SS, respectively. The PRA also does not propose to include a section on ring-fenced bank (RFB) group risk (ie the risk that the financial position of a firm on a consolidated basis may be adversely affected by the minimum capital and buffers applicable at the level of the RFB sub-group) in the draft SDDT Pillar 2 SoP and draft SDDT ICAAP SS, as the PRA considers that SDDTs would not be exposed to RFB group risk by definition given the SDDT criteria.

3.55 Similarly, the PRA proposes not to set specific expectations for the following sections in the draft SDDT ICAAP SS, as it considers them generally not relevant for SDDTs:

- risk of excessive leverage; and
- foreign currency lending to unhedged retail and small and medium-sized enterprise (SME) borrowers.

3.56 To the extent that SDDTs are exposed to any of the above risks, the PRA proposes to continue to require SDDTs to ensure that they hold adequate capital for these risks as part of their ICAAP, in accordance with the Internal Capital Adequacy Assessment Part of the PRA Rulebook. The PRA would review SDDTs' self-assessments of these risks, and would exercise supervisory judgement to apply to them Pillar 2A methodologies and expectations, including those set out in the existing Pillar 2 SoP and existing ICAAP SS respectively.

54 See rule 2.1(3) of the SDDT Regime – General Application Part of the PRA Rulebook.

Pillar 2A adjustments to the capital stack

3.57 The PRA proposes to eliminate two complex Pillar 2A adjustments for SDDTs. The PRA is separately consulting on retiring the refined methodology set out in PS22/17 – **Refining the PRA's Pillar 2A capital framework** which considers one of these adjustments. The refined methodology was introduced to promote safety and soundness, as well as facilitating more effective competition, by addressing concerns at the time about the potentially conservative nature of the CRR Pillar 1 standardised approach to credit risk compared with the IRB approach. The PRA judges this adjustment will no longer be required once firms adopt the Basel 3.1 CR SA, so it is proposing to remove the Pillar 2A adjustment currently applied to some firms (including some SDDT-eligible firms[55]): see CP9/24 - **Streamlining the Pillar 2A capital framework and the capital communications process** for further details.

3.58 In addition, the PRA is proposing to remove the Pillar 2A adjustment that was applied following the FPC's decision to increase the level of the UK CCyB rate in a standard risk environment from 1% to 2% (henceforth the 'CCyB adjustment'), as set out in PS15/20 – **Pillar 2A: Reconciling capital requirements and macroprudential buffers**.[56] In summary, the PRA reduced Pillar 2A capital requirements to reflect the additional resilience associated with higher macroprudential buffers in a standard risk environment. The proposal to remove the CCyB adjustment would be consistent with the PRA's proposal to de-scope SDDTs from the CCyB (see Chapter 4 for further details).

3.59 The proposed removal of these two complex adjustments would significantly simplify the capital framework for SDDTs and enhance its transparency. The removal of these adjustments would generally result in somewhat higher Pillar 2A capital requirements for SDDTs relative to the current levels. But, given the aim for the Strong & Simple framework is to maintain the overall resilience of SDDTs, not increase capital, the overall capital framework for SDDTs has been calibrated such that total capital requirement and buffers are broadly similar on average to outside the SDDT regime (see Chapters 4 and 9).

PRA objectives analysis

3.60 The PRA considers that the proposals in this chapter would advance the PRA's primary objective of safety and soundness of firms by maintaining the resilience of SDDTs, while simplifying the Pillar 2A framework. The PRA proposes significant simplifications to the PRA's methodologies, requirements, and expectations for individual risk types, and

55 For SDDTs, the retirement of the refined methodology would take effect on different dates depending on whether they opted into the ICR. For ICR firms, the refined methodology would be retired at the same time when the proposals in this CP come into effect, ie 1 January 2027. For non-ICR firms, it would be retired on the implementation date for the Basel 3.1 standards, ie 1 January 2026.

56 For details on FPC decisions on the CCyB rate, and adjustments granted by the PRA, see footnote 46 in this chapter.

eliminates complex Pillar 2A adjustments to the capital framework. These are the areas small firms suggest that they find challenging and unduly burdensome. The proposals, as set out in the draft SDDT Pillar 2 SoP and draft SDDT ICAAP SS, would provide greater clarity and transparency in these areas, allowing firms to better understand the PRA's expectations and assess their Pillar 2A add-ons in a more consistent way. This, in turn, would allow both SDDTs and the PRA to focus their resources on risks that matter the most, so that they are managed and capitalised in a prudent manner. At the same time, the PRA considers that the simplified Pillar 2A framework would continue to require SDDTs to appropriately assess and adequately capitalise for all the risks they face, thus not compromising their safety and soundness. Moreover, the simplifications, alongside the reduction in associated data templates set out in Chapter 7, could lower SDDTs' compliance costs without adversely affecting the management of their risks. The reduction in costs for SDDTs could also improve safety and soundness if they used the cost savings to increase financial resilience via retained earnings.

3.61 The PRA considers that the proposals would advance the PRA's secondary competition objective as they would reduce the resources required by SDDTs to perform Pillar 2A assessments, potentially reducing SDDTs' costs. The prices of banking services in the UK could reduce and the volume and variety of banking services could increase as a result if SDDTs pass on lower costs to customers or if the lower costs encourage greater entry into the UK banking sector. Lower costs would also reduce barriers to entry for the UK banking sector. More generally, by simplifying the existing risk-by-risk approach, rather than reducing or eliminating the need for Pillar 2A capital requirements while toughening the calibration of Pillar 1 capital requirements, SDDTs would face lower barriers to growth should they wish to grow out of the SDDT regime.

3.62 The PRA considers that the proposals would also advance the PRA's secondary competitiveness and growth objective. By retaining a risk-by-risk approach to setting add-ons, Pillar 2A requirements would continue to be risk sensitive for SDDTs, which could support an efficient allocation of capital in the economy. By supporting effective competition, the proposals could reduce the cost of financial intermediation and improve access to financial services in the economy. The proposals could also reduce costs for SDDTs with foreign parents, potentially increasing incentives for small foreign banks to establish banks in the UK.

Cost benefit analysis (CBA)

3.63 This section sets out the analysis of the costs and benefits of the proposal to introduce the changes to Pillar 2A approach as part of the SDDT regime.

3.64 The baseline for comparison in this section is that the SDDT regime is not introduced, and SDDTs continue to follow existing PRA rules and supervisory expectations, as set out in the PRA rulebook, the existing Pillar 2 SoP and SS31/15. See Chapter 9 for the expected aggregate costs and benefits of implementing the proposals set out in this CP.

3.65 The PRA considers all SDDT-eligible firms would benefit from the proposed simplifications of Pillar 2A capital requirements and therefore the cost benefit analysis below applies to all SDDT-eligible firms (under the assumption they become SDDTs).

Benefits

3.66 The PRA considers that its proposals for simplifying the Pillar 2A framework would make capital requirements and expectations more certain and predictable for SDDTs. The simpler and more transparent Pillar 2A methodologies mean SDDTs would be able to predict with more certainty how their Pillar 2A requirements could change when their business and exposures change. Importantly, the removal of an existing complex capital stack adjustment would enhance transparency[57] and thus enable more efficient capital planning by SDDTs.

3.67 The PRA also considers that the proposals set out in this chapter would reduce the compliance costs faced by SDDTs while maintaining their overall resilience. By removing complex methodologies, expectations and complex adjustments, the PRA considers that there would be a meaningful reduction in compliance time and costs for SDDTs, which would be proportionate given their smaller size and less complex business models than larger firms. This reduction would be on an ongoing basis, which would allow SDDTs to focus resources on the risks that are most pertinent to their business.

3.68 The PRA also considers that the draft SDDT Pillar 2 SoP and draft SDDT ICAAP SS provide greater clarity and transparency on areas of regulation that SDDTs find challenging, by, for example, simplifying definitions and providing some best practice guidance for scenario analysis. This would reduce the time and resources SDDTs need to understand the PRA’s methodologies and meet its expectations concerning Pillar 2A capital requirements in a consistent way.

3.69 The PRA considers that the cost, time, and resource savings could improve operating efficiencies and may have additional benefits to safety and soundness if SDDTs use the cost savings to support risk management activities. Alternatively, reduced costs could help to enable SDDTs to strengthen their financial resilience through retained earnings.

3.70 The PRA considers that by focusing on simplifying the existing risk-by-risk approach rather than reducing or eliminating the need for Pillar 2A capital requirements while

57 The firm-specific structural adjustments to Pillar 2A for SME lending and infrastructure exposures (see PS9/24 for details) would apply to SDDTs.

toughening the calibration of Pillar 1 capital requirements, SDDTs would face lower barriers to growth should they wish to grow out of the SDDT regime. The reduction in costs and complexity associated with Pillar 2A capital requirements would also reduce potential barriers to entry to the UK banking sector, facilitating effective competition.

3.71 PRA considers that there also would be a positive resource impact on the PRA from these proposals. A consistent approach to simplifying Pillar 2A methodologies for SDDTs would allow the PRA to spend less time and effort setting capital requirements for SDDTs and explaining methodologies. This would enable to the PRA to focus its supervisory resources on SDDTs with the greatest risks so that these risks would be managed and capitalised in a prudent manner.

Costs

3.72 The PRA considers that there would be minimal costs to SDDTs from the simplifications proposed in relation to Pillar 2A requirements. Having considered the responses to DP1/21, the PRA proposes changes to the capital framework which make it simper and increase transparency, thus reducing the need for SDDTs to apply the PRA's methodologies that are not relevant to them in their ICAAP. There may be some additional costs for SDDTs associated with implementing new requirements, such as aligning their Pillar 2A assessments to the PRA's expectations. However, the PRA considers that these costs should be one-off and more than outweighed by the benefits associated with the removal of the current, more complex requirements. Similarly, the PRA considers that there would also be a small cost to the PRA associated with updating internal processes tailored for SDDTs. The PRA also considers that this cost should be one-off and minimal as the PRA's proposals are focused on clarifying, removing, and streamlining requirements and expectations associated with Pillar 2A capital setting rather than introducing new ones. The PRA judges this is more than outweighed by the safety and soundness benefits that the SDDT regime brings.

3.73 All else being equal, the removal of these adjustments would generally result in an increase in Pillar 2A capital requirements for SDDTs relative to the current levels. However, in line with the approach to maintain the overall resilience of SDDTs, the rest of the components of the capital framework are proposed to be calibrated such that the capital requirements and buffers an SDDT are expected to be on average broadly similar to what they would be outside of the SDDT regime (see Chapters 4 and 9). As a result, SDDTs would not, on average, have to raise or conserve capital under the regime relative to outside the SDDT regime.

'Have regards' analysis

3.74 In developing these proposals, the PRA has had regard to its framework of regulatory principles. The regulatory principles that the PRA considers are most material to the proposals are:

1. Proportionality:

The PRA adopts regulatory proportionality to ensure that the regulatory framework is appropriate for the size, complexity, and risk profile of different types of firms. This approach reduces the regulatory burden on smaller firms and encourages competition and innovation. The proposals in this chapter are designed to enhance proportionality of Pillar 2A capital requirements by:

- Maintaining a risk-by-risk approach to simplifying the PRA's methodologies and expectations for SDDTs, such that Pillar 2A capital requirements would be proportionate to the risk profile, scale, and complexity of SDDTs;
- Eliminating complex Pillar 2A adjustments to the capital stack, such that the overall design of the Pillar 2A component of the capital framework would become simpler and correspond more to the size, nature, and risk profile of SDDTs;
- Tailoring the Pillar 2A approach for credit risk, credit concentration risk, and operational risk for SDDTs, by affording greater recognition of the smaller scale and generally lower complexity of the activities of SDDTs, while maintaining their overall resilience;
- Particularly for credit risk, applying the PRA's methodologies on a more targeted basis such that SDDTs with the greatest risks would be subject to higher Pillar 2A capital requirements, relative to those with simpler business models;
- Minimising the operational burden on SDDTs by simplifying methodologies, enhancing clarity and transparency of expectations, and removing reporting templates, in a way that is commensurate to the risk profile, scale, and complexity of SDDTs; and
- Not setting specific Pillar 2A methodologies and expectations for market risk and group risk for SDDTs, as the PRA considers that these types of risk are generally not relevant for SDDTs.

2. Recognition of differences between businesses:

The proposals in this chapter were designed to recognise differences between types of firms by preserving risk sensitivity. By maintaining the existing risk-by-risk approach, the proposed Pillar 2A capital requirements would continue to be proportionate to the size, business model, and risk profile of SDDTs, which vary by firm. This would enable the PRA to continue to capture the different types of risks that may be more prevalent for different business models.

The proposed Pillar 2A methodologies would also enable the PRA to focus on SDDTs whose business model poses high or idiosyncratic risks so that these risks would be managed and capitalised in a prudent manner.

3. Encouraging economic growth in the interests of consumers and businesses, including: facilitating investment in productive assets, sustainable finance and the supply of long-term investment, better outcomes for consumers, and smart regulatory reform:

By lowering costs, the proposals could make SDDTs more robust and to some extent better able to support the economy by reallocation of capital that would otherwise be spend on disproportionate regulation. The PRA also considers that the proposals would maintain sufficient risk sensitivity to ensure that the capital held by SDDTs is appropriate for the risks they are exposed to, which would support sustainable growth.

4. Promoting the government’s strategy to promote competitiveness and its priorities, including: the Future Regulatory Framework Review, trade and inward investment into the UK, UK attractiveness for international financial services, and innovation:

The PRA considers that the proposals in this chapter would reduce the regulatory compliance costs for SDDTs with foreign parents and could increase incentives for small foreign banks to establish banks in the UK.

5. Transparency:

The PRA considers that the Pillar 2A proposals in this chapter would enhance the transparency of the regulatory regime for SDDTs by eliminating a complex Pillar 2A adjustment. In addition, the draft SDDT Pillar 2 SoP and draft SDDT ICAAP SS would be dedicated to SDDTs and would provide greater clarity and transparency on areas SDDTs find challenging. This would allow these SDDTs, with their lower resources available for compliance, to understand the PRA’s requirements and expectations more fully and consider their risks more consistently.

6. Efficient use of PRA resources:

The PRA considers that the proposals in this chapter would enhance the efficiency with which the PRA uses its resources to assess the Pillar 2A capital requirements of SDDTs. By adopting simplified Pillar 2A methodologies for SDDTs, the PRA would spend less time and effort setting capital requirements for SDDTs and explaining its methodologies. This would enable the PRA to reallocate its supervisory resources to SDDTs with the greatest risks so that they would be managed and capitalised in a prudent manner.

3.75 The PRA has had regard to other factors as required. Where analysis has not been provided against a 'have regard' for this set of proposals, it is because the PRA considers that 'have regard' to not be a significant factor for this set of proposals.

4: Capital buffer framework

Overview

4.1 This chapter sets out the PRA's proposals to simplify the capital buffers framework for SDDTs while maintaining their overall resilience. The PRA proposes to:

- introduce a Single Capital Buffer (SCB) for SDDTs to replace the current multiple buffers.[58] The new SCB would be implemented as part of the Pillar 2B capital framework and would be set at no less than 3.5% of RWAs;[59]
- replace the cyclical stress testing framework with a non-cyclical stress test to inform the setting of SDDTs' SCBs. The non-cyclical stress test would set a severity benchmark to support SDDTs' own stress scenarios as part of their ICAAPs;
- remove the automatic capital conservation measures currently associated with the usage of some buffers under the Maximum Distributable Amount (MDA) framework.
- provide guidance on the supervisory response to buffer usage; and
- introduce a specific methodology for calculating the SCB for new and growing banks.

4.2 The proposals in this chapter would amend:

- the Capital Buffers Part of the PRA Rulebook;
- the Disclosure (CRR) Part of the PRA Rulebook;
- Own Funds (CRR) Part of the PRA Rulebook;
- SS6/14 – Implementing capital buffers (Appendix 3);
- SS3/21 – Non-systemic UK banks: The Prudential Regulation Authority's approach to new and growing banks (Appendix 4); and
- SS16/16 – The minimum requirement for own funds and eligible liabilities (MREL) – buffers and Threshold Conditions (Appendix 5).

4.3 Chapter 7 includes proposed changes to reporting that arise from the proposed changes set out below.

4.4 The PRA considers that the proposals in this chapter would advance the PRA's primary safety and soundness objective, while simplifying the existing capital buffer framework materially. The proposals would maintain SDDTs' resilience by ensuring SDDTs hold

---

58 SDDT-eligible firms are currently subject to the combined buffer – ie, the Capital Conservation Buffer (CCoB) and the Countercyclical Capital Buffer (CCyB) – and the PRA buffer.

59 Under this proposal, the Pillar 2B capital framework would comprise two buffers with different scopes of application. The PRA buffer would apply to all firms outside the SDDT regime while the SCB would apply only to SDDTs.

sufficient buffers to withstand the impact of a severe but plausible stress, while continuing to meet minimum capital requirements.[60] The proposals in this chapter would simplify the capital buffer framework by reducing the number of buffers, removing complicated adjustments, and eliminating the current cyclicality in capital buffers which are together costly for SDDTs. Buffers would be more certain and predictable, and hence would reduce SDDTs' incentives to hold relatively large management buffers.

The new Single Capital Buffer for SDDTs

Current capital buffer framework for SDDT-eligible firms

4.5 The existing capital buffer framework is intended to supplement total capital requirements (TCRs), which firms are required to maintain at all times. While TCRs provide capacity to absorb losses and additional costs incurred in a gone-concern scenario, capital buffers aim to ensure that firms maintain sufficient capital to withstand a severe but plausible stress while continuing to meet TCRs. The existence of capital buffers reduces both the likelihood of a disruption to the credit supply and weakens firms' incentives to deleverage during stress events. Buffers also enhance firms' safety and soundness by building resilience against firm-specific risks.

4.6 Currently, the capital buffer framework consists of the combined buffer, which for SDDT-eligible firms comprises the CCoB and the CCyB,[61] and the PRA buffer, which sits on top of that. Figure 3 illustrates on the left-hand side the current capital stack for SDDT-eligible firms.

4.7 Each capital buffer is intended to serve a specific purpose. The CCoB is a fixed buffer of 2.5% of RWAs which applies to all firms and aims to establish a base level of capital buffer to absorb losses and reduce the risk of firms breaching their TCRs. The CCyB is a time-varying buffer set by the FPC in relation to credit exposures to the UK.[62] The CCyB builds resilience against the systemic risks that the financial cycle poses, with the aim of ensuring that the banking system can maintain a stable provision of financial services over the financial cycle. It is increased when vulnerabilities are judged to be building up, ensuring that firms have an additional cushion of capital to absorb potential losses when risks materialise. The PRA buffer is set by the PRA and aims to absorb losses that may arise under a severe stress scenario and from additional risks, such as significant risk management and governance

60 Minimum capital requirements are the sum of Pillar 1 and Pillar 2A and are also referred to as total capital requirements (TCRs).

61 The capital buffer framework in the UK includes also buffers for systemically important institutions. The PRA has not considered them in this document because SDDT-eligible firms are not in the scope of application of either the other systemically important institutions buffer (O-SII buffer) or the global systemically important institutions buffer (G-SII buffer).

62 Each firm must calculate its 'institution-specific' CCyB rate, defined as the weighted average of the CCyB rates in effect across the jurisdictions in which it has credit exposures. Each quarter the FPC sets the CCyB rate for UK exposures. This is the most relevant rate for SDDT-eligible firms as their credit exposures are primarily located in the UK.

(RMG) weaknesses, while avoiding duplication with the combined buffer. The PRA buffer is set on a firm-specific basis and is informed by stress test results to ensure that firms more at risk of losses than the system on average have additional buffer capital to reflect those idiosyncratic risks.

Complexity in the current capital buffer framework

4.8 The existing capital buffer framework is designed to be robust and transparent. However, the PRA recognises that having multiple buffers introduces complexity into the framework. The interaction between the CCoB, the CCyB, and the PRA buffer leads to complicated calculations and adjustments to avoid the double counting of risks. There is also a complex interaction between the capital buffers and the TCR, as the PRA applies the CCyB adjustment to Pillar 2A capital requirements (see paragraph 3.58 in Chapter 3). This capital buffer framework was designed for larger, more complex firms. However, the PRA recognises that these interactions and adjustments can make capital requirements and buffers unduly complex and uncertain for SDDTs.

4.9 The PRA also considered the responses to DP1/21 when identifying the complexities in the current buffer framework and designing the proposals to simplify it. Several respondents described challenges to raising new regulatory capital quickly in response to an increase in the CCyB because there is no deep market for their capital instruments, or because their access to external funding or opportunities to generate capital organically are limited. Therefore, the time variation in the CCyB appears to generate significant costs for SDDTs because it may lead them to maintain higher management buffers (ie ‘buffers on buffers’) above regulatory capital buffers than other firms in the financial system, rather than adjusting their capital ratios in response to changes in the CCyB rate.

The Single Capital Buffer

4.10 The PRA has reviewed the different elements of the current capital buffer framework for SDDTs. The PRA considers that one capital buffer calibrated at the firm-level to capture firm-specific exposures to common risks and idiosyncratic risks, including risk management and governance risks, and which does not vary over the financial cycle, would be a more targeted way to support SDDTs’ resilience and would address the complexity in the current capital buffer framework. It would also reduce SDDTs’ incentives to hold relatively large management buffers.

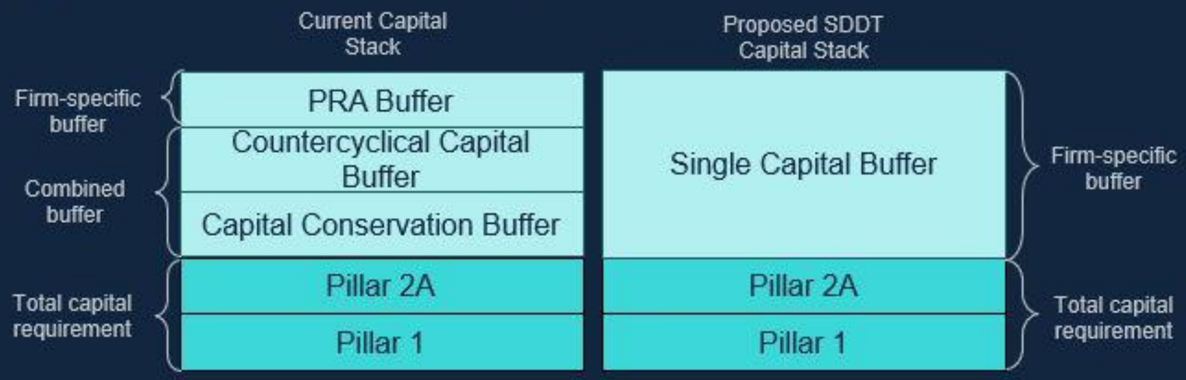
4.11 Therefore, the PRA proposes to replace the current framework based on multiple capital buffers with the SCB for SDDTs, which means that SDDTs would be:

a. descoped from the CCoB and the CCyB, and hence from the associated capital conservation measures (ie, MDA);[63] and

b. subject to the SCB which would be implemented as part of the Pillar 2B capital framework, replacing the PRA buffer. The SCB would be non-cyclical. It would be at least 3.5% of an SDDT's RWAs and may be higher depending on the risks to which the individual SDDT is exposed and/or how well the individual SDDT is risk managed and governed, to promote the SDDT's safety and soundness.

4.12 The PRA proposes that the SCB would be an amount of capital that an SDDT would be expected to maintain in addition to its TCR, and, because it would be implemented as part of the Pillar 2B framework, it would be set as a PRA expectation rather than in rules or as individual requirements. Under this proposal, the TCR plus the SCB would make up the PRA's capital stack for SDDTs, as illustrated in the right-hand side of Figure 3.

Figure 3: Current and proposed capital stacks for SDDTs



63 This proposal would imply descoping SDDTs from the Capital Buffers Part of the PRA Rulebook, which includes CCoB, CCyB and Capital Conservation measures. Appendix 14 contains the proposed changes to the PRA Rulebook.

4.13 By descoping SDDTs from the CCyB and designing the SCB as a non-cyclical buffer, the PRA intends to remove the costs coming from the time-varying elements of the current framework. The FPC, in its statement published alongside this CP, welcomes this proposal.[64]

4.14 By introducing the SCB, the PRA also intends to eliminate the unwarranted complexity stemming from the existence of multiple buffers, while ensuring that SDDTs maintain a sufficient buffer to withstand the impact of a severe but plausible stress and continue to meet minimum capital requirements. The PRA considers the SCB would reduce SDDTs' incentives to hold relatively large management buffers.

4.15 Section II of the draft SDDT Pillar 2 SoP in Appendix 2 sets out the design features the PRA proposes to adopt when setting the SCB.

Components

4.16 As is currently the case for the PRA buffer, the setting of the SCB would be informed by three key components of the assessment process:[65]

- Stress impact. The PRA proposes to set the SCB based on a range of factors including, but not limited to, firm-specific stress test results. The PRA considers that by looking at the impact of a stress on each SDDT's capital resources and capital requirements over a time horizon of three to five years,[66] the setting of the SCB would capture relevant firm-specific risks. And, as a result, SDDTs would be likely to be adequately capitalised in a severe but plausible stress.

- RMG assessment. Research suggests that weak risk management and governance helps to predict distress or failure of small firms.[67] Therefore, the PRA proposes to include an RMG scalar in the SCB for SDDTs with significantly weak risk management and governance. Setting this scalar would mean that a SCB would have capital reflecting the risks posed by these weaknesses until they are addressed.

- Supervisory judgement. The PRA proposes that supervisory judgement is applied during the assessment process. The PRA considers that adjustments to an SDDT's stress test results may be needed in cases of weaknesses in its stress testing processes and data quality, for example.

64 **Financial Policy Committee statement on SDDTs**.
65 The components listed below are already part of the PRA buffer and therefore familiar to SDDTs.
66 Capital resources are expected to reduce in a stress due to lower income and profitability and higher losses. Meanwhile, capital requirements are expected to change as a result of riskier balance sheets in a deteriorating economic environment.
67 Saunders A. and Willison M. (2021) **Measure for measure: evidence on the relative performance of regulatory requirements for small and large banks**, Staff Working Paper No. 922.

4.17 As is currently the case for the PRA buffer, all components of the SCB, including the RMG scalar, would need to be met by CET1 capital, the highest quality of regulatory capital, and the PRA would ordinarily set the SCB as a percentage of RWAs. The PRA would communicate the value of the SCB to each SDDT individually.

4.18 New and growing banks ('new banks') are currently subject to a different methodology for calculating capital buffers. The PRA's proposed SCB calculation for new banks that operate under the SDDT regime is set out in paragraphs 4.38-4.41.

Calibration

4.19 In view of the uncertainties flowing from the nature and extent of economic and financial cycles, unexpected shocks, the reliance of stress tests on models and judgements, and the frequency of the SREP cycles for SDDTs, the PRA proposes that the SCB would be set at no less than 3.5% of RWAs, before any RMG scalar is applied.

4.20 **Box A** provides details on why the PRA considers that setting the SCB at a level no lower than 3.5% of RWAs would support the resilience of SDDTs, on average across SDDTs and through the cycle. The PRA anticipates that some firms will have a SCB higher than 3.5% of RWAs where they are more exposed to idiosyncratic risks. This risk would be identified as part of firms' stress tests which in turn would be used to inform the SCB.

Box A. PRA's considerations around the 3.5% level

To inform the appropriate calibration of the SCB, the PRA examined the historical loss experience of SDDT-eligible firms (and firms of similar sizes and with similar business models) in both normal and crisis times. The results suggested that a buffer of no less than 3.5% of RWAs would provide a level of resilience such that, on average, SDDTs could withstand a severe but plausible stress without breaching their TCRs.

The PRA has also analysed historical stress test results, given the role of stress tests in informing buffers under the current Pillar 2B capital framework. The PRA found that setting the SCB at a level no less than 3.5% of RWAs would imply that stress testing would play a similar role in determining SDDTs' capital buffers as it would if these firms were not in the SDDT regime. A level higher than 3.5% would reduce the role of stress testing and, in turn, the risk sensitivity of the capital buffer framework for SDDTs.

Finally, the PRA estimates that setting the SCBs at no less than 3.5% of RWAs, as part of the overall package of proposals in this CP, would result in overall capital requirements plus buffers for SDDT-eligible firms being broadly similar, on average, in the SDDT regime to outside of it, ie under the Basel 3.1 standards in full, the current Pillar 2A methodologies, and the current buffer framework in a standard risk environment, thereby maintaining resilience for SDDTs while simplifying requirements (see Chapter 9 for further details on overall capital impacts).

4.21 The PRA proposes to align the frequency of assessing the SCB to an SDDT's ICAAP cycle, which typically takes place every 2-4 years. The draft SDDT ICAAP SS in Appendix 6 sets out key PRA's expectations over the ICAAP.

Non-cyclicality

4.22 The PRA proposes that the SCB would be designed as a non-cyclical buffer to avoid re-introducing the disproportionate costs that SDDT-eligible firms face in changing their capital positions in response to changes in the CCyB. Accordingly, the PRA proposes that, while values of SCBs could be different across SDDTs, for each SDDT, the SCB would remain constant through the economic cycle. This would make SCBs more certain, which would reduce SDDTs' incentives to hold relatively large management buffers.

4.23 To support the non-cyclicality of the SCB, the PRA proposes to replace the current cyclical stress testing framework with one based on a non-cyclical scenario that generates a constant impact across ICAAP/SREP cycles. The PRA proposal for a non-cyclical stress test scenario is set out in paragraphs 4.31-4.37.

Disclosure

4.24 As a result of setting the SCB as capital expectations, the PRA proposes that SDDTs should treat the SCB as confidential unless they are required to disclose it by law. This would be consistent with the approach taken to the PRA capital buffer for firms outside of the SDDT regime and would therefore avoid having two disclosure regimes under the Pillar 2B framework. The PRA also considers that confidentiality would promote the usability of the SCB in stress circumstances because the draw down of the SCB by an SDDT would not be disclosed, preventing unintended and disproportionate market reactions that could impair or delay the execution of an SDDT's capital restoration plan.

Level of application

4.25 The PRA proposes that the SCB would be applied at each level of consolidation which applies to the SDDT. This means:

a) where the SDDT is only required to meet capital requirements on an individual basis, the PRA proposes to set the SCB on an individual basis; and

b) where the SDDT is required to meet capital requirements on an individual basis and on a consolidated basis, the PRA proposes to set the SCB both on an individual basis and on a consolidated basis.

4.26 Where an SDDT is required to meet capital requirements on a consolidated basis, the PRA proposes to use the SCB assessment at the consolidated level as the starting point to calculate and set the SCB for the SDDT on an individual basis. The PRA considers that firm-specific factors may justify setting a different level for the SDDT's SCB on an individual basis to the SCB set on a consolidated basis. But in all cases, the SCB would be at least 3.5% of RWAs, in line with the proposals in this chapter. The draft SDDT Pillar 2 SoP in Appendix 2 sets out the approach that the PRA proposes to apply during the assessment of the SCB for SDDTs which must meet requirements on a consolidated basis.

4.27 The PRA considers that this proposed approach would promote the resilience of SDDTs, by ensuring an SDDT has enough capital buffer above TCR at all levels of consolidation, while maintaining the flexibility for the PRA to set the SCB at an individual level to incorporate specific factors appropriately.

The use of the Single Capital Buffer

4.28 The PRA considers that it is important for firms to have capital buffers that can be used in stressed circumstances. As part of its proposals to descope SDDTs from the combined buffer, the PRA would remove the associated capital conservation measures. These measures set out the maximum amounts that a firm can distribute as dividends and in other ways when it does not meet its combined buffer.[68] As a result, they help to ensure that firms can support the provision of financial services to the real economy during a stress. However, the PRA considers that this objective is less material for SDDTs than other firms, given their limited role in the supply of credit.

4.29 The PRA proposes to promote and encourage the usability of the SCB by removing automatic capital conservation measures, and by setting out details in the draft SDDT Pillar 2 SoP of its approach to an SDDT drawing down its SCB. These include the following proposals:

a) Using the whole amount or part of the SCB would not itself be considered a breach of capital requirements or threshold conditions.[69] The PRA would not expect or require SDDTs to finance themselves with more capital than the total of their capital requirements and buffers. However, SDDTs are not expected to use their SCBs in the

[68] Under the current capital buffer framework, a firm that does not meet its combined buffer must calculate an MDA as indicated in the Capital Buffers Part of the PRA Rulebook, and it must not distribute more than the calculated MDA. The MDA restrictions depend on how far the firm has gone into the combined buffer.

[69] This feature is shared with all capital buffers in the current PRA capital buffer framework.

normal course of business or enter into their SCBs as part of their base business plans.
b) SCB draw down would not automatically trigger the use by the PRA of any of the supervisory tools at its disposal. The supervisory reaction to buffer usage would be assessed on a case-by-case basis. The PRA considers that usability of the SCB would be better supported by supervisory actions based on judgement specific to the circumstances rather than by automatic capital conservation measures.

c) After drawing down its SCB, an SDDT would be given a reasonable period to rebuild its capital buffer in a gradual way, subject to an agreed capital restoration plan. When agreeing a capital restoration plan, the PRA proposes to consider how far the SDDT has run into its SCB, the expected duration of the stress, the drivers and context of that stress (whether specific to the SDDT or systemic), and macroeconomic and financial conditions.

4.30 The PRA proposes that, in a scenario where an SDDT has identified the need to draw down its SCB, the SDDT notifies the PRA as early as possible.[70] As set out in point b) above, the PRA's reaction to an SDDT's buffer notification would be centred around supervisory judgement, informed by prior engagement and supervisory activities. The Annex of the draft SDDT Pillar 2 SoP contains the 'Supervisory Approach to Single Capital Buffer Usage' and provides hypothetical case studies to illustrate how the PRA may react to notifications of buffer usage.

A new non-cyclical stress testing framework

Current framework for SDDT-eligible firms

4.31 Currently, the PRA publishes two stress scenarios each year for use by all firms that are not part of the annual concurrent stress testing (CST) exercise, including SDDT-eligible firms.[71] These scenarios serve as a template and severity benchmark for firms to support their own ICAAP stress testing scenario design processes. The results of firms' ICAAP stress tests form the basis of the buffer assessment undertaken by the PRA.

4.32 These scenarios are derived from the Annual Cyclical Scenario (ACS), which is the scenario used in the annual CST exercise comprising the largest UK deposit takers. The ACS is countercyclical, meaning its severity increases as risks build up and decreases as they abate. The severity reflects the FPC's assessment of the risks facing the banking

70 This is in line with the current framework and with Fundamental Rule 7, which requires that a firm must deal with its regulators in an open and cooperative way and must disclose to the PRA appropriately anything relating to the firm of which the PRA would reasonably expect notice.
71 The CST exercise targets only the largest UK firms and ring-fenced entities.

system globally and in the UK. Therefore, the scenarios currently published for all firms that are not part of the annual CST exercise vary each year and reflect countercyclical factors.

4.33 For firms not subject to the ACS, the PRA buffer is not expected to reflect the countercyclical factors embedded in the scenarios. Therefore, to avoid double counting the risks already covered by the CCyB, the PRA currently undertakes complex calculations when setting the PRA buffer. These calculations can make the setting of the PRA buffer opaque and in turn difficult to understand for SDDTs.

The proposal for SDDTs

4.34 In line with the proposed non-cyclicality of the SCB, the PRA proposes to publish annually two non-cyclical stress test scenarios, which SDDTs could use as a template and severity benchmark to support their own ICAAP stress testing scenario design processes. By publishing two different scenarios, the PRA aims to encourage SDDTs to consider the type, characteristics, and severity of stress that their business model is vulnerable to, when designing their own stress testing scenarios.

4.35 The PRA proposes that these scenarios are set so that as the economy moves through the economic and financial cycles, the SCB calculated for an SDDT would remain, on average, at a relatively constant level (if the SDDT's risk profile and balance sheet remained broadly unchanged). However, the calculated SCBs would vary across SDDTs, in accordance with differences in their risk profiles and business models. An SDDT's SCB may also, on rare occasions, be changed in response to material changes in the structure (ie, not related to the economic or financial cycle) of the economy or financial system that are relevant for SDDTs.

4.36 An SDDT would be required to meet the proposals on the stress testing framework in line with the ICAAP rules set out in Chapter 14 of the ICAA Part of the PRA Rulebook.

4.37 Under the proposal to move to a non-cyclical stress test scenario, the PRA considers that the buffer setting framework would be more transparent and simpler for SDDTs to understand and engage with. The PRA also considers that a non-cyclical stress testing framework would give SDDTs more certainty on the size of their buffers over time, and hence, reduce the disproportionate costs associated with the higher management buffers they currently maintain compared with other firms by reducing their incentives to hold relatively high management buffers.

Calculation of the Single Capital Buffer for new and growing banks under the SDDT regime

4.38 Under the current framework, the PRA subjects new banks to specific capital expectations, including a different methodology for calculating the PRA buffer than is applied to established firms.[72]

4.39 The PRA buffer is set for new banks by considering the forward projection of operating expenses rather than stress testing results.[73] These firms are currently subject to a capital buffer expectation equal to the CCyB plus the higher of the CCoB and a buffer set to cover six months of projected operating expenses.[74]

4.40 In line with the proposal to simplify the capital buffer framework for SDDTs, the PRA proposes to also introduce the new SCB under the Pillar 2B capital framework for new banks that are SDDTs. To make the SCB consistent with the PRA's capital expectations for new banks, the PRA proposes to set the SCB for new banks under the SDDT regime to cover six months of projected operating expenses, in line with the definition set out in SS3/21. But in all cases, the SCB for an SDDT that is a new bank would be at least 3.5% of RWAs, in line with the proposals in this chapter.

4.41 The PRA considers that these proposals would simplify the calculation of the buffer expectations for new banks which are SDDTs, in line with the other proposals in this chapter, while maintaining their resilience. The PRA also considers that the proposal reflects well the specific characteristics of new banks and thereby no further changes to the capital expectations for new banks under the SDDT regime are needed. The proposals in this section are set out in the updates to SS3/21 in Appendix 4.

Summary of PRA's proposed updated Pillar 2B framework

4.42 The proposals in this chapter would update the Pillar 2B framework, as summarised in Table 4. If the proposals in this chapter were implemented, the Pillar 2B framework would comprise the current PRA buffer, which would continue to apply to all firms outside the SDDT

72 The PRA defines new and growing banks as those banks which have been operating for five years or less since being authorised without restrictions and are yet to achieve a profit over a full year of trading. The PRA's expectations of new and growing banks are set out in SS3/21.

73 For new banks, the amount of capital needed to survive a stress test scenario would generally be very large, due to for instance the RWA growth associated with their continued business expansion. This could give rise to a disproportionate level of capital relative to the financial stability risks posed by new banks. For more details, see paragraph 4.6 in SS3/21.

74 Operating expenses are defined in SS3/21.

regime, and the SCB, which would apply only to SDDTs. Firms outside the SDDT regime would continue to be subject to the combined buffer in addition to the PRA buffer.

Table 4. The proposed updated Pillar 2B framework

	All PRA-regulated firms, except for SDDTs	SDDTs
Established firms	A **PRA buffer** informed by firm-specific cyclical stress testing results, on top of the combined buffer	An **SCB** informed by non-cyclical stress testing results and no lower than 3.5% of RWAs
New banks	A **PRA buffer** based on six months of projected operating expenses,[75] on top of the combined buffer	An **SCB** based on six months of projected operating expenses and no lower than 3.5% of RWAs

Consequential amendments

4.43 The PRA considers that the proposed descoping of SDDTs from the combined buffer requires some consequential amendments to certain provisions of the existing UK CRR which are being transferred to the PRA Rulebook or to existing PRA rules, as set out below.

Minority interests

4.44 The first proposed consequential amendment concerns the minority interest and qualifying AT1 and Tier 2 capital that can be recognised in the consolidated capital resources (together 'minority interests').[76] Currently, the CRR limits the amount of a subsidiary's minority interests that can be recognised in the consolidated capital resources at the group level. The minority interest calculation takes into account the surplus of capital of the subsidiary above its TCR plus combined buffer.[77]

4.45 As a consequence of the proposal to descope SDDTs from the combined buffer, the PRA proposes to amend the calculation of minority interests for SDDTs by removing the combined buffer from the calculation of the subsidiary's capital surplus.[78]

---

75 To avoid double counting between the buffers, the component of the PRA buffer that relates to operating expenses is calculated as the excess amount of capital required over and above the CCoB.

76 Minority interest is defined in Articles 4(120), 81, and 84 of the UK CRR. The PRA is consulting on rules that would set out the requirements for minority interest and qualifying AT1 and Tier 1 capital than can be recognised in the consolidated capital resources in Chapter 3, Own Funds (CRR) Part of the PRA Rulebook (see CP8/24).

77 The calculations are currently set out in Articles 81 to 88 of Part II Own Funds and Eligible Liabilities, Title II Minority Interest and Additional Tier 1 and Tier 2 Instruments Issued by Subsidiaries in the UK CRR.

78 Under this proposal, the minority interests of an SDDT consolidation entity would be calculated as the minority interests of the subsidiary less the subsidiary's surplus of capital above its TCR adjusted for the relative importance of minority interests for the subsidiary.

4.46 The PRA considers that under this proposal an SDDT would calculate minority interests based on only the TCR of the subsidiary, which would mean considering a lower total requirement compared to the current one (which includes the TCR plus combined buffer). Nevertheless, the PRA considers that this proposal would not have material impacts on SDDTs' current total capital resources, since most SDDTs currently do not report minority interests. The PRA also considers that this proposal would reduce the complexity of the capital framework.

Capital reduction permissions

4.47 The PRA requires firms to obtain a prior permission to reduce, redeem, repay, or repurchase any capital instruments (a CRR Article 77 permission).[79] In applying the CRR Article 77 permission, the PRA currently requires a firm to provide the relevant information to support its application, which include among others, the present and forward-looking impact of the reduction of capital instruments on its combined buffer.[80]

4.48 As a consequence of the proposal to descope SDDTs from the combined buffer, the PRA proposes to qualify the wording in Article 30(1)(d)(iii) of the Rules Supplementing the CRR with Regards to Own Funds Requirements (previously Regulation EU No 241/2014) so that the reference in that rule to the combined buffer would only apply 'where applicable to the firm concerned'. As it would not be applicable to SDDTs, these firms would not be required to supply information of the impact of a reduction in capital on the combined buffer.

Limitations on redemption of capital instruments

4.49 The CRR allows certain firms to limit their redemptions of CET1 instruments under the provisions governing the CET1 instrument.[81] In setting limitations on the redemption amounts, the PRA requires a firm to have regard for its combined buffer to calculate those limitations.[82]

4.50 As a consequence of the proposal to descope SDDTs from the combined buffer, the PRA proposes that the reference to the combined buffer in Article 10 (3)(c) of Chapter 4 of Rules Supplementing the CRR with Regards to Own Funds Requirements (previously EU No 241/2014) would only apply "where applicable to the firm concerned". As it would not be applicable to SDDTs, these firms would not need to have regard to the combined buffer when considering limitations on redemption.

---

79 Article 77, Chapter 4, Own Funds and Eligible Liabilities (CRR) Part of the PRA Rulebook.
80 Article 30, Chapter 4, Own Funds and Eligible Liabilities (CRR) Part of the PRA Rulebook.
81 The PRA proposes to maintain this requirement in draft Article 29, Chapter 3, Own Funds (CRR) Part of the PRA Rulebook (see CP8/24).
82 Article 10, Chapter 4, Own Funds and Eligible Liabilities (CRR) Part of the PRA Rulebook.

Disclosure of capital buffers

4.51 The last proposed amendment is to Article 433b(1)(b) of the Disclosure (CRR) Part of the PRA Rulebook, which would descope SDDTs from the requirement to disclose the combined buffer.

4.52 The PRA considers that the proposed consequential amendments would simplify the current framework for SDDTs, while maintaining their resilience.

PRA objectives analysis

4.53 The PRA considers that the proposals in this chapter would advance the PRA’s primary objective of safety and soundness by introducing a simpler capital buffer framework for SDDTs that ensures sufficient loss absorbing capacity during stress, while removing unnecessary complexity that is disproportionately costly for these firms. The PRA also considers that by removing the complex system of interactions and adjustments, the proposals would make the framework simpler to understand and manage. Furthermore, the PRA considers that the proposed non-cyclical buffer framework would provide greater certainty on the size of the buffer over the economic and financial cycles, which would aid SDDTs in their capital planning and reduce SDDTs’ incentives to hold relatively large management buffers. Both removing complexity and greater certainty are expected to advance SDDTs’ safety and soundness.

4.54 The PRA considers that the proposals in this chapter would improve the usability of the capital buffer framework for SDDTs, by removing the capital conservation measures of the current combined buffer, treating the SCB as a confidential buffer, and providing additional guidance on the supervisory response to buffer usage. The PRA considers that higher usability would have a positive second-order impact on SDDTs’ safety and soundness by increasing their ability to absorb shocks without implementing inefficient reactions, like fire selling assets, to remain above the regulatory buffer level.

4.55 The proposals in this chapter also advance the PRA’s secondary competition objective by reducing the complexity of the buffer framework and the associated compliance costs. This could result in lower prices and greater volume and variety of banking services in the UK if SDDTs pass on the lower costs to customers. By freeing up resources spent on capital planning, the proposals could increase SDDTs’ ability to innovate, which could help them compete. The proposals in this chapter could also increase competition by encouraging entry of SDDT-eligible firms into the UK banking sector.

4.56 Furthermore, the proposals in this chapter advance the PRA’s secondary competitiveness and growth objective. By reducing the complexity of the buffer framework and the associated compliance costs for SDDTs with foreign parents, the proposals could potentially increase incentives for small foreign banks to establish banks in the UK. Since buffers would reflect risks that SDDTs face, the proposals would support an efficient allocation of capital in the economy. By supporting effective competition, the proposals could lower costs of financial intermediation and improve access to financial services in the economy.

Cost benefits analysis (CBA)

4.57 This section sets out the analysis of the costs and benefits of the proposed simplifications to the capital buffer framework for SDDTs. Further details on aggregate costs and benefits of the proposals are set out in Chapter 9.

4.58 The baseline for comparison in this section assumes that SDDTs are subject to the current capital buffer framework. This baseline also incorporates the use of the two cyclical scenarios derived from the ACS, which are published annually by the Bank and the PRA, and which serve as severity benchmarks for firms to support their own ICAAP stress scenario design.

Benefits

4.59 The PRA considers that the proposal to replace multiple buffers with the SCB would reduce compliance costs and unwarranted complexity for SDDTs. By removing the complex calculations and adjustments underlying the current multiple buffers framework, the PRA estimates that there would be a meaningful cost reduction for SDDTs and the PRA during the buffer setting process.

4.60 The PRA considers that the proposed removal of SDDTs from the scope of application of the CCyB and the introduction of a non-cyclical capital buffer would make the framework for SDDTs more certain and predictable over time. Since SDDTs tend to have more limited ability to raise capital (through both internal and external channels) to accommodate changing capital requirements, the PRA expects these proposals to generate meaningful and cost savings for SDDTs. Smaller firms currently hold relatively larger management buffers compared to larger firms, in part to accommodate cyclical variation in the buffers. The PRA considers that a non-cyclical buffer would reduce SDDTs' incentives to maintain these relatively larger buffers.[83] That could have benefits for the firms, by allowing them to operate their businesses with lower levels of actual capital, and, at the margin, for the real economy.

4.61 Furthermore, the PRA considers that the proposals in this chapter would make the framework more targeted to the risks faced by SDDTs and make the framework simpler to

83 Building societies may have additional reasons – over and above the cyclicality and uncertainty of the size of capital requirements over time – to maintain relatively high voluntary management buffers, hence their management buffers may remain higher than for other firms under the SDDT regime.

understand and manage for them. The PRA considers that the proposed non-cyclical scenarios and the simplification of the ICAAP process (see Chapter 5) contribute to a simpler stress testing framework for SDDTs. The PRA estimates that this simplification will contribute to a reduction of regulatory costs for SDDTs on an ongoing basis.

Costs

4.62 The PRA considers that there would be implementation costs to both SDDTs and the PRA related to the transition from the current buffer framework to the proposed SCB. But these costs would be small given that the SCB is simpler compared to the current framework and includes several features of the existing PRA buffer. For example, the setting of the SCB is based on firms' stress testing exercises, which are already carried out as part of the regular ICAAP. The PRA estimates these one-off costs are outweighed by the ongoing cost savings associated with the simplification of the framework.

4.63 The PRA considers that there may be costs for SDDTs in adjusting or adapting internal methodologies to the new stress testing framework. However, the PRA considers that these costs would be relatively small because SDDTs already have experience in designing their own scenarios. The PRA also considers that these costs are outweighed by the savings associated with the non-cyclical capital buffer.

4.64 The PRA considers that the other features of the proposals in this chapter have no material bearing on costs and benefits.

'Have regards' analysis

4.65 In developing these proposals, the PRA has had regard to its framework of regulatory principles. The regulatory principles that the PRA considers are most material to the proposals are:

1. Proportionality:

The PRA considers that the proposals in this chapter are designed to enhance proportionality of the capital framework for SDDTs by:

- implementing a capital buffer and a stress testing framework which are more targeted to the risks SDDTs face;
- removing the cyclicality from the buffer framework for SDDTs, hence reducing the disproportionate costs for SDDTs of having to adjust their levels of capital over the economic and financial cycles given, for example, the limited role they play in the aggregate provision of financial services to UK households and corporates;

- reducing the complexity of the current buffer framework for SDDTs coming from the current multiple buffer structure, while maintaining resilience; and
- making the buffer framework easier to understand and manage for SDDTs.

2. Recognition of differences between businesses:

The PRA considers that the proposals in this chapter are designed to recognise differences between types of firms. By relying on stress testing to a substantial degree in the setting of the SCB, the PRA considers that the risks associated with different business models would flow through to the SCB.

The PRA considers that the proposals for new banks in the SDDT regime ensures that specific risks associated with those banks are captured by the new capital buffer framework for SDDTs.

3. Encouraging economic growth in the interests of consumers and businesses, including: facilitating investment in productive assets, sustainable finance and the supply of long-term investment, better outcomes for consumers, and smart regulatory reform:

By lowering costs, the proposals could make SDDTs more robust and to some extent better able to support the economy. The PRA also considers that the higher usability of the SCB compared to the current framework would enhance SDDTs' ability to lend and provide other critical financial services to the economy during idiosyncratic and systemic stress. However, these effects are expected to be marginal because SDDTs are small relative to the UK economy and financial system, including in terms of their share of lending and critical financial assets.

4. Promoting the government's strategy to promote competitiveness and its priorities, including: the Future Regulatory Framework Review, trade and inward investment into the UK, UK attractiveness for international financial services, and innovation:

The PRA considers that the proposed simplifications would lower the complexity of the capital buffer framework and the associated compliance costs for SDDTs, which should facilitate international competitiveness of the UK by lowering costs for SDDTs with foreign parents and increasing the incentives of small foreign banks to establish banks in the UK.

5. Transparency:

The PRA considers that the proposed simplifications set out in this chapter would increase the transparency of the buffer framework for SDDTs, allowing these firms to better understand the PRA's policies and expectations.

6. Efficient use of PRA resources:

The PRA estimates that some additional PRA resources would be required for the design of the proposed new non-cyclical scenarios, but that fewer resources would be allocated to understanding and setting the less complex capital buffer framework for SDDTs. On balance, the PRA considers that the proposals would make efficient and economic use of PRA resources.

4.66 The PRA has had regard to other factors as required. Where analysis has not been provided against a ‘have regard’ for this set of proposals, it is because the PRA considers that ‘have regard’ to not be a significant factor for this set of proposals.

5: The Internal Capital Adequacy Assessment Process (ICAAP)

Overview

5.1 This chapter sets out the PRA's proposed approach to simplifying the ICAAP, and the Reverse Stress Testing (RST) exercise within that, for SDDTs. In addition, this chapter sets out further simplifications to the ILAAP, building on the simplifications to liquidity requirements introduced in PS15/23.

5.2 The proposals in this chapter (and other chapters) would introduce:

- A draft SS – The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP) for Small Domestic Deposit Takers (SDDTs) ('draft SDDT ICAAP SS').

5.3 The proposals in this chapter would amend:

- Rule 15 of the Internal Capital Adequacy Assessment Part of the PRA Rulebook;
- Rules 11 and 13 of the Internal Liquidity Adequacy Assessment Part of the PRA Rulebook; and
- SS24/15 – The PRA's approach to supervising liquidity and funding risks (Appendix 7).

5.4 The PRA requires firms to take responsibility for maintaining an adequate level of capital, consistent with their safety and soundness, and taking into account the risks to which they are exposed.[84] The ICAAP is an important exercise that gives firms, and the PRA, a better understanding of their risks, and thus enables better risk management. As part of the ICAAP, firms are required to conduct RST, in which they carry out stress tests and scenario analyses that test their business plans to the point of failure. The PRA considers RST to be a crucial tool for enabling firms to manage their risks.

5.5 Similarly, the PRA requires firms to take responsibility for ensuring they can meet their liabilities as they fall due.[85] PRA rules require a firm to have in place robust strategies and systems to manage liquidity and funding risks, and to make a written record in its ILAAP as part of assessing and managing those risks.

5.6 While firms generally recognise the benefits of producing ICAAP and ILAAP documents, the PRA has received feedback from industry in response to DP1/21 and CP4/23 on the disproportionate cost of producing both documents for small firms. For example, a common suggestion in response to DP1/21 was that significant resource savings would be possible if

84 Rule 2.1 of the ICAA Part of the PRA Rulebook.
85 Rule 2.1 of the ILAA Part of the PRA Rulebook.

the frequency of review for both documents was reduced,[86] and that the PRA should reduce the duplication of material across the ICAAP and ILAAP documents, as well as recovery and resolution plans.

5.7 The PRA currently expects a firm to conduct ICAAP assessments, review its ICAAP and update its ICAAP document at least annually. [87] [88] A firm is required to review its ILAAP, and is expected to update its ILAAP document, at least annually.[89] In both cases, a firm is expected to do so more frequently in the event of changes to its business, strategy, or scale of activities, or if the operational environment suggests that the firm's current level of capital, liquidity, or funding profile are no longer adequate.[90] However, the PRA recognises that most SDDT-eligible firms have simple business models that do not change significantly from year to year, and, as a result, these expectations can be unduly burdensome relative to SDDT-eligible firms' risks. The PRA also considers that this process could be simplified for SDDTs; for example, some risks will be less applicable to these firms given the criteria that they must meet to be SDDTs, eg in relation to their business models.

5.8 Therefore, this chapter sets out proposals to simplify the ICAAP (both in terms of the process itself and the documentation of the process), based on the following principles:

- The ICAAP should remain an important tool within the firm and should not be simply a regulatory exercise. Instead, an SDDT should consider how the ICAAP can best be used as part of its risk management practices.
- An SDDT should only need to consider risks relevant to its business and size, and the ICAAP document should be tailored to the simpler business model of SDDT-eligible firms.
- PRA guidance on the ICAAP should be clear, and should enable an SDDT to produce, understand, and own its ICAAP document.

5.9 The PRA considers the proposals in this chapter should reduce the operational burdens SDDTs experience when preparing their ICAAP documents while not reducing the effectiveness of the ICAA, thus supporting the safety and soundness of these firms.

ICAAP document frequency

5.10 The PRA currently expects a firm to document and update an ICAAP at least annually, or more frequently if needed (see paragraph 5.7).

86 FS1/21.
87 The PRA has set out its requirements in the ICAA Part of the PRA Rulebook and expectations in SS31/15.
88 The PRA has set out its requirements in rule 15 of the ICAA Part of the PRA Rulebook and expectations in SS31/15.
89 The PRA has set out expectations of firms undertaking an ILAAP in SS24/15 and the requirements in the ILAA Part of the PRA Rulebook.
90 For example, because of material balance sheet growth, a change in business model (eg focus on higher loan to value (LTV) lending, change in product offering), or changes to market conditions or interest rates.

5.11 The PRA has observed that most elements of SDDT-eligible firms' ICAAP documents do not tend to change materially from year to year. It has also observed that producing the ICAAP document can be costly for SDDT-eligible firms. The PRA is therefore proposing to reduce the frequency with which SDDTs are expected to update and document the ICAAP to a minimum of every two years. However, the PRA considers that an exception to this is warranted for the Pillar 2A and Pillar 2B elements of the ICAAP document, for which it proposes continuing to expect updates at least annually.

5.12 Table 5 sets out the PRA's proposed frequency of updates of SDDTs' ICAAP documents.

Table 5: Frequency of updates to ICAAP document elements

Risk assessment	At least annually	At least every 2 years
Pillar 2A	✓	
Pillar 2B (including stress testing)	✓	
Reverse Stress Testing (RST)		✓
Full ICAAP Document [(a)]		✓

(a) See Annex 1 of the draft SDDT ICAAP SS for other information that a firm may choose to include in its ICAAP.

5.13 The PRA's proposed minimum frequency is a safeguard against SDDTs' ICAAP documents becoming outdated but, as is the case now, SDDTs must proactively ensure that more frequent updates occur if required, as set out in paragraph 5.7. Under this proposal, it would remain the responsibility of an SDDT to ensure its ICAAP document is relevant and current. Furthermore, to ensure that SDDT resilience is supported alongside the reduction in the expected frequency of the ICAAP document, the PRA would have the discretion to request an annual update from an SDDT if it judged it to be necessary. For example, if an SDDT's ICAAP document was of poor quality, supervisors could ask it to remediate issues in the next year and evidence this through submission of an updated ICAAP document. As is the case now, the PRA would have the discretion to use other supervisory tools (including but not limited to capital scalars) if it concluded there were concerns around ICAAP quality and governance of the ICAAP document.

5.14 The PRA also proposes to maintain its expectation that new banks[91] update and document their ICAAPs on an annual basis, as the business models of these firms often adjust quickly as they develop. The PRA expects to apply a higher degree of scrutiny to these banks to ensure governance and controls are appropriate and that banks understand the risks they are taking on.

Reducing elements of the ICAAP

5.15 In addition to the proposed reduction in the frequency of updates to elements of the ICAAP document, the PRA considers it appropriate to propose to introduce more proportionate expectations in relation to some of its components for SDDTs.

Referencing the ILAAP

5.16 Certain elements of the ICAAP can be duplicative of content of the ILAAP document. The PRA therefore proposes that an SDDT should be able to reference sections of the ILAAP when considering liquidity risk in their ICAAP document, rather than duplicating that material. If the ILAAP highlights liquidity risk concerns, the PRA would expect the ICAAP to build on this analysis to consider how liquidity risks could lead to potential losses and have capital adequacy implications. However, if there are no such concerns, the PRA would not expect firms to conduct deeper analysis in the ICAAP document beyond the material in the ILAAP. The PRA has set out its expectations in the draft SDDT ICAAP SS.

Reverse stress testing

5.17 The PRA recognises the costs SDDTs experience in annually updating and documenting reverse stress tests as set out in the PRA Rulebook and proposes to introduce more proportionate requirements on SDDTs in relation to RST. Since reverse stress tests tend not to change materially year on year for SDDTs, the PRA proposes to reduce the frequency with which SDDTs are expected to carry out and document the results of their RST from a minimum of annually to a minimum of every two years. This would introduce further proportionality without diminishing the importance of RST as a risk management tool. To ensure that safety and soundness is not diminished because of the reduction in the expected frequency of the RST component of the ICAAP document, the PRA would maintain the discretion to request RST more regularly, though only if necessary. An RST expectation

91 As defined in SS3/21.

would continue to exist in recovery planning to maintain the resilience of SDDTs but allow the PRA to offer simplifications to the ICAAP and ILAAP.[92]

5.18 As noted above, the PRA is not proposing to reduce the frequency of the Pillar 2B part of firms' ICAAP documents, including the stress scenario analysis conducted as part of that assessment. SDDTs often assess whether their Pillar 2B stress test scenarios are sufficiently severe by comparing them to their reverse stress test results. The PRA considers that SDDTs should be able to subject these scenarios to robust challenge to assess whether they are sufficiently severe in their own right, without needing to refer to the results of their RST. Reducing the frequency of RST from annually to every two years – and so decoupling it from the annual completion of Pillar 2B stress tests – would be consistent with this.

5.19 Smaller firms often lack the capabilities to run a full quantitative reverse stress test. Therefore, the PRA proposes to allow SDDTs to perform a more qualitative reverse stress test. The PRA would expect an SDDT to consider, for example, scenarios in which the failure of a major market participant or a significant market disruption would cause it to fail. And an SDDT should describe the scenario and the stress testing approach. However, the PRA would not expect quantitative analysis to be included in the ICAAP document. The PRA may still request that an SDDT quantify the level of financial losses that would place it in a situation of business failure should a scenario crystallise.

Optional ICAAP document structure

5.20 The PRA has also considered ways to improve SDDTs' ownership of their ICAAPs. As noted, the ICAAP can be costly for SDDTs, which sometimes means SDDTs rely on external and specialist resource to author their ICAAP documents. Consequently, the PRA proposes to create a new optional structure as a guide for SDDTs when producing their ICAAP documents. The PRA considers that this template would be particularly useful to new banks when developing their ICAAP documents.

5.21 This proposed structure, which can be found in Annex 1 of the draft SDDT ICAAP SS should:

- provide an example ICAAP document structure that an SDDT may choose to follow;
- highlight areas where other documents, such as the ILAAP document, can be referenced;
- illustrate how an SDDT can conduct its risk assessment proportionately in each component of the ICAAP; and

92 As set out in paragraph 2.58 of SS9/17 – **'Recovery planning'**, firms should define and justify its point of near failure and scenarios should be sufficiently severe to take the firm to this point, providing they are plausible. Firms are encouraged to make use of their most recent reverse stress testing exercises to do this.

- highlight the information that, at a minimum, should be covered in each ICAAP document component.

5.22 The proposed structure is high level, with a focus on the type of information the PRA would look for in the C-SREP of a firm with a simple business model. SDDTs would retain autonomy over how to conduct their risk assessment, how to design their stresses and scenarios, and how to justify the use of their chosen methodologies. The PRA considers that SDDTs should own and understand their ICAAP documents. Therefore, the PRA proposes that the structure should be an optional guide and it is not meant to be exhaustive.

ILAAP frequency

5.23 As with the ICAAP, the PRA recognises SDDTs' concerns that requirements and expectations on the frequency with which they review and document their ILAAP can be costly for them. Therefore, in addition to the simplifications to the ILAAP set out in PS15/23, the PRA proposes to reduce both the frequency with which SDDTs are required to review their ILAAP and the frequency with which SDDTs are expected to update their ILAAP document from at least annually to at least every two years.

5.24 Under this proposal, it would remain the responsibility of an SDDT to ensure its ILAAP document is relevant and current. The PRA intends the minimum frequency to be a safeguard against ILAAP documents becoming outdated and would expect an SDDT to proactively ensure that a more regular update is undertaken if necessary (for example in response to changes to the business model or funding profile of a firm, which affect the relevance of the ILAAP). Therefore, in line with current guidance, the PRA proposes to maintain the current provision that the ILAAP document should be updated more frequently if needed (see paragraph 5.7 and SS24/15 – **The PRA's Approach to Supervising Liquidity and Funding Risks**).

5.25 In addition, as with the reduction to the frequency of the ICAAP document, the PRA might request an updated ILAAP document from an SDDT if necessary. The PRA also proposes to maintain its expectation that new banks update and document their ILAAPs on an annual basis.

PRA objectives analysis

5.26 The PRA considers the proposals in this chapter support the PRA's primary objective of safety and soundness, as they should maintain SDDTs' resilience, while reducing regulatory burden. Since many SDDTs' business models do not tend to change materially from year to year, expecting SDDTs to review and update their ICAAP and ILAAP documents annually does not enhance their safety and soundness. Furthermore, these proposals could support the PRA's safety and soundness objective, as the lower costs associated with the proposed ICAAP simplifications could increase small firms' resilience by increasing their capacity to build and conserve capital.

5.27 In addition, the PRA's ability to request more regular reviews and updates to the ICAAP and ILAAP documents if necessary, and to require new banks to prepare these documents annually, should also support the safety and soundness objective.

5.28 The proposals in this chapter would advance the PRA's secondary competition objective. Firm feedback suggests firms desired a reduced review cycle for both documents. The proposed changes to the ICAAP and ILAAP should reduce SDDTs' costs. Lower costs for SDDTs could result in lower prices and increased volume and variety of banking services in the UK if SDDTs pass on the lower costs to customers, as well by encouraging greater entry into the UK banking sector.

5.29 With regards to the secondary objective on competitiveness and growth, the proposals could reduce costs for SDDTs with foreign parents and potentially increase incentives for small foreign banks to establish banks in the UK. By supporting effective competition, the proposals could lower the costs of financial intermediation and improve access to financial services in the economy. The proposals would support a supervisory approach that reflects the risks SDDTs face, which could support the efficient allocation of capital in the economy.

Cost benefit analysis (CBA)

5.30 This section sets out the analysis of the costs and benefits of introducing the proposed changes to the ICAAP, RST, and the ILAAP for SDDTs. The baseline for comparison in this section is the ICAAP and ILAAP policies and rules that would apply to SDDT-eligible firms outside of the SDDT regime at the point the Phase 2 package was implemented. These policies are those that all firms are currently subject to, set out in SS31/15, SS24/15, and in the draft SoP – The PRA's methodologies for setting Pillar 2 capital in Appendix 4 to CP9/24.

5.31 The PRA considers that the key benefit of the proposals in this chapter is that SDDTs should face lower costs associated with prudential regulation. The proposals should reduce the time and resources SDDTs must spend to produce their ICAAP and ILAAP documents, as well as the governance time required to review these documents. These cost savings could be re-allocated to higher-value activities.

5.32 The PRA considers that its proposals should have negligible costs for SDDTs. The PRA considers there may be a one-off cost to SDDTs choosing to adopt the optional ICAAP structure. However, the ongoing reduction in costs provided by the structure in terms of streamlining ICAAP documents and providing clarity on what is required should offset this. In addition, the optional structure could reduce SDDTs' reliance on external support creating their ICAAP documents, which would reduce ongoing costs associated with the ICAAP.

'Have regards' analysis

5.33 In developing these proposals, the PRA has had regard to its framework of regulatory principles. The regulatory principles that the PRA considers are most material to the proposals are:

1. Proportionality:

The PRA considers that the proposals in this chapter would introduce more proportionate requirements on SDDTs while maintaining their resilience. In particular, the PRA considers that reducing the frequency of the ILAAP and some elements of the ICAAP would reduce costs for SDDTs, and it is appropriate to do so, given that SDDTs' risks and exposures tend not to change significantly year to year.

2. Encouraging economic growth in the interests of consumers and businesses, including: facilitating investment in productive assets, sustainable finance and the supply of long-term investment, better outcomes for consumers, and smart regulatory reform:

The PRA considers the proposals in this chapter should reduce SDDTs' costs, which could support effective competition, which in turn could lower the costs of financial intermediation and improve access to financial services in the economy.

3. Promoting the government's strategy to promote competitiveness and its priorities, including: the Future Regulatory Framework Review, trade and inward investment into the UK, UK attractiveness for international financial services, and innovation:

The proposals may reduce costs for SDDTs with foreign parents and increase the incentives of small foreign banks to establish banks in the UK.

4. Transparency:

The proposal to introduce an optional ICAAP document structure would increase the transparency of the regime, enhancing clarity and guidance in areas with which SDDT-eligible firms currently struggle. This would assist SDDTs with less resources for compliance to better understand the requirements and expectations placed on them.

5.34 The PRA has had regard to other factors as required. Where analysis has not been provided against a ‘have regard’ for this set of proposals, it is because the PRA considers that ‘have regard’ to not be a significant factor for this set of proposals.

6: Simplified capital deductions

Overview

6.1 This chapter sets out the PRA's proposals to simplify capital deduction requirements for SDDTs when calculating regulatory capital resources.

6.2 The proposals in the chapter would amend:

- Own Funds (CRR) Part of the PRA Rulebook.

6.3 Chapter 7 includes proposed changes to reporting that arise from the proposed changes set out below.

Deductions from capital resources

6.4 Firms are required to deduct certain items when calculating their regulatory capital resources. For example, when calculating their Common Equity Tier 1 (CET1), firms are required to deduct items such as intangible assets, deferred tax assets (DTAs), and holdings of regulatory capital instruments in other financial sector entities.[93] These items are deducted because there is a high degree of uncertainty attached to their realisable value in a stress, which could mean there is less loss absorbing capital when it is most needed.

6.5 Some deductions are relatively simple to calculate, such as the requirement to deduct intangible assets, in full, from regulatory capital. But for certain items, the deduction is subject to thresholds whereby only amounts above certain threshold limits need to be deducted, which can make capital resources calculations complicated. These thresholds are intended to limit the amounts of items that can be recognised for regulatory capital purposes. They were developed for international standards following the global financial crisis and, in recognising differences between countries' existing practices, give rise to complexity for the following reasons.

- **There are thresholds at the individual item and aggregated levels, which have different calibrations:** For example, where a firm invests in other financial sector entities' CET1 instruments, where these are not significant (a 'non-significant investment' or 'NSI'), it must deduct any amount of that investment from regulatory capital which exceeds 10%[94] of its own CET1 capital post regulatory adjustments and non-threshold deductions. DTAs that are dependent on future profitability and arise

[93] See Article 36 of the Own Funds and Eligible Liabilities (CRR) Part of the PRA Rulebook.
[94] Article 46 of the UK CRR.

from temporary differences[95] and significant holdings of CET1 instruments in other financial sector entities (a 'significant investment' or 'SI'[96]), are subject to an individual threshold (10%) as well as an aggregate threshold (15%)[97] of the firm's adjusted CET1 capital.[98] Qualifying holdings outside the financial sector are subject to a separate threshold calculation.[99]

- **Each threshold is determined based on a different CET1 capital base:** For example, for NSIs, the 10% threshold is based on a firm's CET1 capital after certain regulatory adjustments and deductions that are not subject to a threshold calculation (adjusted CET1 capital). For DTAs that are dependent on future profitability and arise from temporary differences and SIs, the individual 10% threshold is based on the firm's adjusted CET1 capital reduced by the NSI deduction. The aggregate 15% threshold is then based on the firm's adjusted CET1 capital further reduced by all items subject to deductions in full (without applying the threshold exemptions).
- **Items are required to be deducted from different tiers of capital:** While most items must be deducted from CET1 capital, NSI and SI in holdings of AT1 and Tier 2 instruments of other financial sector entities are deducted from the corresponding tiers of capital.[100]

6.6 In addition, firms may choose between fully deducting certain items from capital or alternatively risk weighting them at 1250%.[101] These items include qualifying holdings outside of the financial sector (QH),[102] certain securitisation positions,[103] free deliveries,[104] and certain exposures under internal ratings based (IRB) (collectively referred to as 'specific items').[105]

6.7 The PRA considers these complex requirements to be unduly onerous and disproportionate to the size of SDDTs, which do not currently have significant amounts of these items. In addition, IRB-related specific items are not relevant for SDDTs.[106]

---

95 The term 'temporary differences' refers to the timing difference between the applicable accounting requirements and the tax rules. For instance, DTA could occur when expenses are recognised in the income statement but not yet deductible for tax purposes.
96 SI is as defined in Article 43 of the UK CRR.
97 Article 48(2)(b) of the UK CRR refers to 17.65%. As explained in paragraph 30.33 of CAP30 – Regulatory adjustments section of the Basel Framework, the recognition of the relevant items will be limited to 15% of CET1 capital, after the application of all deductions. 17.65% is applied to determine the maximum amount of the relevant items that can be recognised. This number is derived from the proportion of 15% to 85% (ie 15%/85% = 17.65%).
98 Article 48 of the UK CRR.
99 Article 89 of the UK CRR.
100 Articles 56(d) and 66(d) of the UK CRR.
101 Article 36(k) of the UK CRR.
102 Article 89 of the UK CRR.
103 Securitisation positions referred in point (b) of Article 244(1), point (b) of Article 245(1), and Article 253 of the UK CRR.
104 Article 379(3) of the UK CRR.
105 Article 153(8) of the UK CRR.
106 Firms using IRB models for credit risk cannot be SDDTs.

6.8 The PRA suggested in DP1/21 that capital deduction rules were an area of regulation that could be simplified. This was welcomed by respondents to DP1/21.

Proposed simplified capital deductions

6.9 The PRA therefore proposes to simplify the capital deduction requirements for SDDTs by removing:

- multiple deduction thresholds;
- different treatments between NSIs, DTAs, and SIs;
- the requirement to deduct NSIs and SIs from different tiers of capital; and
- the optionality between deduction and risk weighting for the specific items.

6.10 Instead, the PRA proposes to simplify the deduction requirements by requiring:

- **A single group**: all items subject to threshold calculations or optional risk weightings would be added together and considered as a single group for the purpose of the deduction calculation assessment. These items are: DTAs that are dependent on future profitability and arise from temporary differences; holdings in regulatory capital instruments of financial sector entities (including SI and NSI and combining CET1, AT1 and Tier 2); qualifying holdings outside the financial sector; certain securitisation positions;[107] and free deliveries;
- **A single threshold**: the aggregate amount of the items above would be assessed against a single threshold of 25% of the firm's net CET1 capital; and
- **One net CET1 basis:** the 25% threshold would be applied to one net CET1 capital amount.

6.11 Under these proposals, SDDTs would be required to deduct from their CET1 the aggregate amount of the items that exceeds the 25% threshold. The amount deducted would be apportioned across the respective items. The amounts below the 25% threshold would be risk weighted at 250% for NSI, SI and DTA items to further reduce the calculation complexity and 1250% for the other items.

6.12 The overall proposal and how it differs from the current rules is summarised in Tables 6A and 6B.

[107] Securitisation positions referred in point (b) of Article 244(1), point (b) of Article 245(1), and Article 253 of the UK CRR.

<table>
<tr><th colspan="5">Table 6A: Existing CRR Deduction Requirements</th></tr>
<tr><th>Subject to threshold deduction</th><th>Deduction category (a)(b)(c)</th><th colspan="2">Deduction threshold</th><th>Tier of capital from which deducted</th></tr>
<tr><td rowspan="5">Items subject to threshold deduction</td><td>Temporary DTAs</td><td>10% individual</td><td rowspan="2">15% aggregate</td><td>CET1</td></tr>
<tr><td>SI in CET1</td><td>10% individual</td><td>CET1</td></tr>
<tr><td>NSI in CET1</td><td colspan="2" rowspan="3">10% individual</td><td>CET1</td></tr>
<tr><td>NSI in AT1</td><td>AT1</td></tr>
<tr><td>NSI in Tier 2</td><td>Tier 2</td></tr>
<tr><td rowspan="2">SI not subject to threshold deduction</td><td>SI in AT1</td><td colspan="2" rowspan="2">Full deduction</td><td>AT1</td></tr>
<tr><td>SI in Tier 2</td><td>Tier 2</td></tr>
<tr><td rowspan="3">Specific items (d)</td><td>Qualifying holdings</td><td colspan="2">15% individual or 60% aggregate</td><td rowspan="3">Option to fully deduct from CET1 or risk weight at 1250%</td></tr>
<tr><td>Certain securitisation positions (e)</td><td colspan="2" rowspan="2">N/A</td></tr>
<tr><td>Free deliveries</td></tr>
</table>

<table>
<tr><th colspan="4">Table 6B: SDDT Deduction Requirements</th></tr>
<tr><th>Subject to threshold deduction</th><th>Deduction threshold</th><th>Tier of capital from which deducted</th><th>Risk weight for non-deducted amount</th></tr>
<tr><td>Items subject to threshold deduction</td><td>25% aggregate</td><td>CET1</td><td>250%</td></tr>
</table>

SI not subject to threshold deduction			
Specific items (d)			1250%

(a) Temporary DTAs refers to DTAs that are dependent on future profitability and arise from temporary differences.

(b) SI refers to significant investment.

(c) NSI refers to non-significant investment.

(d) Specific items also covers equity exposure under IRB and other IRB positions, but these are not relevant to SDDTs.

(e) Securitisation positions referred to in point (b) of Article 244(1), point (b) of Article 245(1), and Article 253 of the UK CRR.

6.13 The proposed 25% threshold allowance broadly seeks to maintain the same combined threshold as currently faced by firms (based on current individual threshold 10% CET1 for NSIs and, separately, a further aggregated threshold of 15% CET1 for DTAs that are dependent on future profitability and arise from temporary differences and SIs). In addition, the proposed changes make the deduction simpler and more robust by deducting the amounts exceeding the 25% threshold from CET1 only, compared to the current approach of deducting some items (ie NSI and SI) from corresponding tiers of capital. The PRA considers that the proposed 25% allowance will provide the right balance between supporting market liquidity in NSI and SI transactions and preventing significant concentration of certain items in SDDTs' regulatory capital. This is intended to avoid a materially negative impact on loss absorbency during a stress.

6.14 In addition, removing the choice between deduction and risk weighting would reduce complexity within the deduction rules to some extent, and would also achieve a consistent deduction requirement across all items for all SDDTs.

6.15 The PRA intends to achieve the proposed changes by making a new rule for SDDTs: see the proposed Article 45A in Chapter 3, Own Funds (CRR) Part of the PRA Rulebook. The PRA also proposes to make certain amendments to the existing own funds and reporting rules consequential to these changes.

6.16 There are several CRR provisions related to certain securitisation provisions[108] and free deliveries provisions[109] that would also need to be amended in connection with these proposed changes. The draft rules in Appendix 14 do not include the proposed changes to these provisions as the PRA intends to consult on the relevant changes as part of its consultation on the proposed transfer of these provisions to the PRA Rulebook (a PRA consultation is scheduled for H2 2024).

PRA objectives analysis

6.17 The PRA considers that the proposals in this chapter would advance the PRA's primary objective of ensuring the safety and soundness of SDDTs by continuing to limit the amounts that can be included in SDDTs' CET1 capital for certain items that might not retain their value in stress. The proposals in the chapter would also simplify the way SDDTs calculate their regulatory capital resources while ensuring that the quality and quantity of SDDTs' regulatory capital remains strong.

6.18 The proposals would also support the PRA's secondary competition objective by reducing the complexity of the regulatory requirements and hence the resources SDDTs would need to comply with them. The savings in relation to compliance costs may improve SDDTs' operating efficiencies. Prices of banking services could fall and the volume and variety of banking services increase if SDDTs pass on those lower costs to customers or if the lower costs encourage greater entry into the UK banking sector.

6.19 The PRA considers that the proposals would also advance the PRA's secondary competitiveness and growth objective. The proposals could reduce compliance costs for SDDTs with foreign parents and could potentially increase incentives for small foreign banks to establish banks in the UK.

108 For example, Articles 244, 245 and 253 of the UK CRR.
109 Article 379 of the UK CRR.

6.20 By supporting effective competition, the proposals could lower the costs of financial intermediation and improve access to financial services in the economy.

Cost benefit analysis (CBA)

6.21 This section sets out the analysis of the costs and benefits of the proposal to change the way certain items are deducted for SDDTs. The PRA considers that all SDDTs could benefit from the proposed simplifications.

6.22 SDDTs do not currently have significant exposures to the relevant items subject to the proposal. Therefore, the PRA anticipates that the proposed changes will reduce regulatory compliance burden but would not have a significant impact on most SDDTs' capital resources. The PRA estimates the changes to CET1 and RWA are de minimis, and so the aggregated CET1 ratio for SDDTs in the financial sector would remain largely unchanged based on SDDTs' current assessment. As a result, the related costs for SDDTs should be very low.

6.23 The PRA considers that its proposals to simplify the deduction regime would significantly increase clarity and transparency on certain deduction requirements for SDDTs. The proposals would also reduce the regulatory compliance and reporting costs for SDDTs while maintaining their overall resilience.

6.24 The PRA considers that there also would be a positive resource impact on the PRA. The proposals would reduce the amount of time the PRA spends dealing with questions from firms about deduction calculations. The proposal should also provide the PRA with more consistent and comparative data across SDDTs, simplifying the assessment of any potential underlying risks across the sector.

'Have regards' analysis

6.25 In developing these proposals, the PRA has had regard to its framework of regulatory principles. The regulatory principles that the PRA considers are most material to the proposals are:

1. Proportionality:

The proposals in this chapter are designed to enhance the proportionality of the application of capital deduction requirements. SDDTs are not systemic firms and currently do not have significant amounts of the items subject to the threshold deductions. The proposals would simplify the deduction requirements for these firms without undermining their safety and soundness.

2. Recognition of differences between businesses:

The proposals recognise that SDDTs should have appropriate capital-deduction requirements that are commensurate to their size, risk profile, and the complexity of their businesses.

3. Promoting the government's strategy to promote competitiveness and its priorities, including: the Future Regulatory Framework Review, trade and inward investment into the UK, UK attractiveness for international financial services, and innovation:

The proposals could lower costs for SDDTs with foreign parents. Lower costs could increase incentives of small foreign banks to establish banks in the UK.

4. Transparency:

The PRA considers that the proposal to simplify the capital deduction rules for SDDTs would increase the transparency of the deduction requirements and would enable these firms to clearly understand the requirements.

5. Efficient use of PRA resources:

The PRA considers that the proposals to simplify the capital deduction regime for SDDTs would make it easier for supervisors to assess capital adequacy based on consistent and comparative data and enhance the PRA's risk-based supervisory approach, which is consistent with a more efficient use of the PRA resources.

6.26 The PRA has had regard to other factors as required. Where analysis has not been provided against a 'have regard' for this set of proposals, it is because the PRA considers that 'have regard' to not be a significant factor for this set of proposals.

7: Reporting

Overview

7.1 This chapter sets out the PRA's proposed changes to SDDTs' reporting to the PRA under the proposed simplified capital regime set out in this CP. The proposals in this chapter should be read in conjunction with Chapters 2 to 6 as they aim to reflect the proposed changes in the capital framework within the PRA's prudential reporting requirements.

7.2 The proposals in this chapter would amend:

- the Reporting (CRR) Part of the PRA Rulebook;
- the Regulatory Reporting Part of the PRA Rulebook;
- the Reporting Pillar 2 Part of the PRA Rulebook;
- the SDDT Regime – General Application Part of the PRA Rulebook;
- the Glossary Part of the PRA Rulebook;
- SS32/15 – Pillar 2 reporting, including instructions for completing data items FSA071 to FSA082, and PRA111 (Appendix 9); and
- SS34/15 – Guidelines for completing regulatory reports (Appendix 10).

7.3 In designing the proposals in this chapter, the PRA has sought to:

- make the minimum reporting changes necessary in light of the proposals set out in Chapters 2 to 6;
- maintain reporting that is necessary to enable the PRA to understand SDDTs' positions against the SDDT criteria in some areas; and
- introduce simplifications to the reporting framework for SDDTs through descoping them from a number of reporting templates and tailoring a number of templates and reporting instructions for them.

7.4 Overall, the PRA proposes to: descope SDDTs from 38 templates (a number of which will already not be relevant to many SDDTs, depending on their size and activities), replace most Counterparty Credit Risk (CCR) reporting with a simplified template, and amend 24 templates and instructions (of which six changes would be to reporting instructions only).

7.5 In line with the proposal in Chapter 2 to apply relevant Basel 3.1 risk-weighted Pillar 1 capital requirements to SDDTs, the PRA proposes to apply the related Basel 3.1 reporting changes set out in PS9/24 to SDDTs.[110] The PRA proposes to make the following further

[110] This would be achieved through the revocation of the Interim Capital Regime (ICR) which is proposed in this CP (see further detail in Chapter 2 and Chapter 8).

updates to Common Reporting (COREP), Capital+, Leverage and Pillar 2 reporting requirements for SDDTs to achieve the aims set out in paragraph 7.3 above:

- revisions to COREP templates and/or instructions for own funds and own funds requirements, and large exposures for SDDTs;
- descoping of SDDTs from having to report certain COREP templates;
- replacing most counterparty credit risk reporting for SDDTs with a new template, C34.XXS, to capture information on derivatives, securities financing and long settlement transactions of SDDTs;
- revisions to the Capital+ data items PRA113 and PRA114 and related instructions for SDDTs;
- changes to Leverage template LV 47.00 and the related instructions, and to the instructions for templates LV 41.00 and LV 44.00;
- changes to FSA data items FSA071 and PRA111 and the related instructions for SDDTs; and
- descoping of SDDTs from FSA data items FSA072 to FSA080.

7.6 The PRA has designed the proposals in this chapter on the basis that SDDTs would have their own tailored templates and reporting instructions for those reporting modules where the PRA considers it could significantly simplify reporting for SDDTs.[111] The PRA considers this to be the case for those templates which are part of the own funds and own funds requirements reporting module within COREP, data items which are part of the Capital+ reporting module, and the FSA071 data item. Under this approach, the PRA would:

- create new templates and instructions for SDDTs that are copies of the templates and instructions that would apply to all firms under Basel 3.1 reporting (set out in PS9/24);
- tailor those templates and instructions relating to the proposals set out in Chapters 2 to 6 for SDDTs where the PRA considers it could significantly simplify reporting for them;[112] and
- create a new tailored version of reporting modules for SDDTs where tailored templates are part of a reporting module.

7.7 The PRA has not applied this approach to the proposed changes affecting templates that are part of the Large Exposures reporting module within COREP, templates that are part of the Leverage Ratio reporting module or the proposed changes to PRA111 (which collects data on stress testing). This is because the PRA considers that the scale of the proposed changes to these templates and reporting instructions does not justify the creation of a

[111] A reporting module is a collection of reporting templates on a topic, for example Own Funds.
[112] For example, by adding new rows and/or columns to implement the underlying proposals set out in Chapters 2 to 6, deleting rows and/or columns no longer needed by SDDTs (eg those relating to IRB approaches) and further tailoring descriptions and instructions to SDDTs.

separate reporting module for SDDTs for these templates at this point. These amended templates would therefore be used both by SDDTs and non-SDDTs.

7.8 In line with the approach set out above, and to further simplify the reporting framework for SDDTs, the PRA is proposing to create a separate chapter in the Reporting (CRR) Part of the PRA Rulebook which specifies the format and frequency of reporting on own funds and own funds requirements for SDDTs. The PRA is also proposing to create SDDT-specific annexes with the templates and instructions for reporting of own funds and own funds requirements of SDDTs.

7.9 The PRA is not proposing any changes to reference dates, remittance dates or level of application for the reporting of templates.

7.10 Updated reporting requirements would enable the PRA to collect the necessary data to understand SDDTs' capital, large exposures, and leverage positions. They would also enable the PRA to understand SDDTs' positions against the SDDT criteria. The proposed reporting changes are important for the supervision of the broader proposals in this CP, and for monitoring across the industry.

7.11 The proposed reporting templates and instructions are attached to this CP (see Appendix 8), alongside proposed amendments to SS32/15 – Pillar 2 reporting, including instructions for completing data items FSA071 to FSA082, and PRA111 and SS34/15 – Guidelines for completing regulatory reports, and the draft rule instruments. The proposed changes to reporting templates and instructions arising from the proposals in this CP are shown relative to the templates and instructions that would apply to SDDTs assuming the reporting changes in PS9/24 have been implemented. Table 7 below summarises the proposals in this chapter.

Table 7: Summary of proposed reporting changes

Risk area	Relevant Basel 3.1 reporting changes	Further proposed reporting changes		
		Descope	New	Amend
Capital adequacy and group solvency COREP and Capital+	PS9/24 amended C 02.00, PRA102 and PRA103, and renamed these to OF 02.00, PRA113 and PRA114 respectively.	-	-	C 01.00, OF 02.00, C 04.00, C 06.01, C 06.02, PRA113, PRA114
Credit risk, counterparty	PS9/24 amended C 07.00 and C 09.01	C 34.01 to C 34.05,	C 34.XXS	OF 07.00, OF 09.01[a],

credit risk and securitisations COREP	and renamed these to OF 07.00 and OF 09.01 respectively	C 34.08 to C 34.11		C 09.04, C 13.01, C 14.00, C 14.01[(a)], C 33.00, C 34.06
Operational risk COREP	PS9/24 deleted C 16.00, C 17.01 and C 17.02 and replaced these with OF 16.00	-	-	-
Market risk COREP and FSA data items	PS9/24 deleted C 24.00 and FSA005, renamed C 18.00 to C 23.00 as OF 18.00 to OF 23.00, and introduced OF 24.01 to OF 24.03, and OF 90.00 to OF 91.10	OF 18.00 to OF 21.00, OF 24.01 to OF 24.03, OF 91.01 to OF 91.10	-	OF 22.00, OF 90.00
CVA COREP	PS9/24 deleted C 25.00 and introduced OF 25.01 to OF 25.03	OF 25.01 to OF 25.03	-	-
Large exposures COREP	-	-	-	C 28.00[(a)], C 29.00[(a)]
Leverage	-	-	-	LV 47.00, LV 41.00[(a)], LV 44.00[(a)]
Pillar 2 reporting	-	FSA072 to FSA080		FSA071, PRA111

(a) A change to instructions only.

7.12 In addition to the changes set out in Table 7, the PRA proposes to update the Reporting (CRR) Part of the PRA Rulebook and the related reporting instructions to make clear that certain templates relating to IRB approaches to credit (OF 08.01 to OF 08.07, OF 09.02, OF 34.07), Commodities (OF 23.00) and the output floor (OF 02.01) are not relevant to SDDTs.

7.13 The PRA considers that its proposed approach of tailoring certain templates and reporting instructions for SDDTs would have several benefits:

- it would allow for some simplification of reporting for SDDTs;
- it would mean non-SDDTs would not need to implement reporting changes that are being proposed for SDDTs now and, for any future changes to these templates, SDDTs and non-SDDTs would only need to implement reporting changes that apply to their respective versions of the templates and instructions;

- simplified templates and clarified instructions for SDDTs could reduce instances of misreporting by SDDTs;
- prospective SDDTs would find the reporting framework simpler and easier to understand when they are considering whether to become SDDTs; and
- it would facilitate future streamlining of reporting for SDDTs.

7.14 In line with the proposed implementation date set out in Chapter 1, the reporting changes set out in this chapter would come into effect on 1 January 2027. Reporting with a reference date before 1 January 2027 (for example, quarterly reporting with a reference date of 31 December 2026) would be submitted on the basis of the reporting requirements that apply on that reference date, even where the remittance date for the reporting is after 1 January 2027. Reporting with a reference date on or after 1 January 2027 would be made under the new reporting requirements for SDDTs.

7.15 The proposed new and tailored templates for SDDTs set out in this chapter and in the related appendices are titled with a temporary 'S' to indicate they are SDDT-specific templates. However, the names of these templates are subject to future change as the PRA finalises its policy on the proposals in this CP, and transitions away from the EBA authored taxonomy. For further detail on implementation see paragraphs 7.43 and 7.47 below.

7.16 Work on improving the collection of regulatory data is continuing under the Bank of England's plan for **Transforming Data Collection** and the PRA's **Banking Data Review**. These initiatives are aimed at bringing about more effective and efficient processes for data collections and reporting that are more proportionate to regulators' needs. Over time, this could result in further streamlining of reporting for SDDTs.

Capital adequacy and group solvency

7.17 As mentioned earlier in this chapter, the PRA proposes to apply Basel 3.1 reporting changes set out in PS9/24 to SDDTs. In relation to capital adequacy and group solvency, PS9/24 amends template C 02.00, PRA102 and PRA103 and renames these to OF 02.00, PRA113 and PRA114 respectively. The PRA proposes to make the following additional amendments to templates and related reporting instructions in relation to capital adequacy and group solvency for SDDTs:

- Template C 01.00 – Own funds
  - Create a copy of the template for SDDTs and rename it to 'C 01.00S – Own funds for SDDTs';
  - Delete, amend, and insert new rows and amend instructions in line with the new simplified capital deduction threshold calculation proposed in Chapter 6; and
  - Delete IRB-related rows.

- Template OF 02.00 – Own funds requirements
  - Create a copy of the template for SDDTs and rename it to 'OF 02.00S – Own funds requirements for SDDTs';
  - Delete rows related to market risk and credit valuation adjustment (CVA) in line with the proposals in Chapter 2 to descope SDDTs from market risk and CVA requirements;
  - Delete redundant rows/columns, for example those related to IRB and the output floor; and
  - Amend instructions to ask SDDTs not to report counterparty credit risk on certain derivatives, and to apply the new simplified capital deduction threshold calculation in line with proposals in Chapter 2 and Chapter 6 respectively.

- Template C 04.00 – Memorandum items
  - Create a copy of the template for SDDTs and rename it to 'C 04.00S – Memorandum items for SDDTs';
  - Delete rows related to complex capital deduction threshold calculations, and add rows and amend instructions for the new simplified capital deduction threshold calculation proposed in Chapter 6;
  - Delete rows for the combined buffer and add a row for the new Single Capital Buffer for SDDTs proposed in Chapter 4; and
  - Delete rows related to IRB.

- Templates C 06.01 and C06.02 – Group solvency: information on affiliates
  - Create a copy of the templates for SDDTs and rename them to 'C 06.01S and C 06.02S – Group solvency: information on affiliates of SDDTs';
  - Delete columns for risk weighted exposure amounts related to market risk of the group in line with the proposals in Chapter 2 to descope SDDTs from market risk;
  - Delete columns related to the combined buffer and add a column for the new Single Capital Buffer for SDDTs proposed in Chapter 4; and
  - Amend instructions to ask SDDTs not to report counterparty credit risk on certain derivatives, and to apply the new simplified capital deduction threshold calculation in line with proposals in Chapter 2 and Chapter 6 respectively.

- Data item PRA113 – Capital+ forecast semi-annual
  - Create a copy of the data item for SDDTs and rename it to 'PRA113S – Capital+ forecast semi-annual for SDDTs';
  - Make the same amendments as those set out above for C 01.00S, OF 02.00S, and C 04.00S, on which this return is largely based;
  - Delete additional rows related to the output floor;

  - Amend the PRA supplementary data section to reflect the new simplified capital deduction threshold calculation proposed in Chapter 6; and
  - Delete instructions related to the output floor, and update instructions relating to threshold deductions and the new treatment for certain capital deductions.

- Data item PRA114 – Capital+ forecast annual
  - Create a copy of the data item for SDDTs and rename it to 'PRA114S – Capital+ forecast annual for SDDTs';
  - Delete the row related to the output floor; and
  - Delete rows for the combined buffer and add a row for the new Single Capital Buffer for SDDTs proposed in Chapter 4.

Credit risk, counterparty credit risk and securitisations

7.18 As noted in Chapter 2, the PRA has proposed to descope SDDTs from the calculation of CCR requirements in relation to derivatives (with some exceptions). The PRA therefore considers that it is appropriate to significantly reduce the reporting requirements on SDDTs in relation to CCR. The PRA proposes to:

- descope SDDTs from the requirement to report templates C 34.01 to C 34.05 and C 34.08 to C 34.11;
- replace these with a simplified template for SDDTs (template C 34.XXS) to provide the PRA with some basic information on SDDTs' portfolios of derivatives, securities financing and long settlement transactions. This template is focused on collecting information on notional amounts and market values. The PRA proposes that this template is collected as part of other quarterly reporting by SDDTs, with the same quarterly reference and remittance dates, and at the same level of application; and
- retain a simplified version of the C 34.06 template (renamed to 'C 34.06S – Derivatives, securities financing and long settlement transactions of SDDTs: Top twenty counterparties') to collect information on an SDDT's top twenty counterparties in derivatives, SFTs, and long settlement transactions. The PRA proposes that this template will be reported quarterly.

7.19 The proposals above reflect the PRA's current view of its reporting needs. The Banking Data Review (see paragraph 7.16) is currently considering reporting requirements on CCR for all banking firms, and it is possible that further changes to reporting needs on CCR for SDDTs might result from that review, including as a result of taking into account responses to the reporting proposals in this CP. The PRA considered it would be useful to set out its current thinking on changes to CCR reporting by SDDTs in this CP for feedback.

7.20 In addition to minor updates to instructions related to updated rule referencing, the PRA proposes to make the additional amendments to templates and related instructions related to reporting of credit risk, counterparty credit risk, and securitisations set out below. Note that templates OF 07.00 and OF 09.01 were introduced by PS9/24 to replace templates C 07.00 and C 09.01 respectively.

- Template OF 07.00 – Credit and counterparty credit risks and free deliveries: standardised approach to capital requirements
    - Create a copy of this template for SDDTs and rename it to 'OF 07.00S – Credit and counterparty credit risks and free deliveries: standardised approach to capital requirements for SDDTs';
    - Delete IRB related rows;
    - Delete columns related to counterparty credit risk, and replace rows for counterparty credit risk in the breakdown of exposures by type with a single row to capture 'other' types of exposures; and
    - Amend instructions to ask SDDTs not to report counterparty credit risk on certain derivatives, and to apply the new simplified capital deduction threshold calculation in line with proposals in Chapter 2 and Chapter 6 respectively.

- Template OF 09.01 – Geographical breakdown of exposures by residence of the obligor: SA exposures
    - Amend instructions to ask SDDTs not to report counterparty credit risk on certain derivatives, and to apply the new simplified capital deduction threshold calculation in line with proposals in Chapter 2 and Chapter 6 respectively.

- Template C 13.01 – Credit risk: securitisations
    - Create a copy of the template for SDDTs and rename it to 'C 13.01S – Credit risk: securitisations for SDDTs';
    - Delete columns related to IRB; and
    - Amend instructions to ask SDDTs to calculate exposures under the new simplified capital deduction threshold calculation proposed in Chapter 6.

- Template C 14.00 – Detailed information on securitisations
    - Create a copy of the template for SDDTs and rename it to 'C 14.00S – Detailed information on securitisations for SDDTs'; and
    - Delete columns related to IRB.

- Template C 14.01 – Detailed information on securitisations
    - Amend instructions to ask SDDTs to calculate exposures under the new simplified capital deduction threshold calculation proposed in Chapter 6, and not to report under IRB approaches.

- Template C 33.00 – Exposures to general governments
  - Create a copy of the template for SDDTs and rename it to ‘C 33.00S – Exposures of SDDTs to general governments’;
  - Delete rows related to exposures under IRB; and
  - Delete rows/columns related to market risk and derivatives, in line with the proposals in Chapter 2.

7.21 In Chapter 4, the PRA is proposing to disapply the combined buffer (which for SDDT-eligible firms comprises the CCoB and the CCyB) and PRA buffer for SDDTs, and to replace these with the Single Capital Buffer as part of Pillar 2B. Although the CCyB would no longer apply to SDDTs, the PRA considers that it is appropriate to retain a simplified version of the C 09.04 template which monitors credit exposures by country because this return is used as part of the SDDT criteria. The PRA therefore proposes the following changes to C 09.04:

- Create a copy of the template for SDDTs and rename it to ‘C 09.04S – Breakdown of relevant credit exposures of SDDTs by country’;
- Delete redundant rows and columns for SDDTs (eg those related to IRB, trading book exposures, own funds requirements and rates for CCyB);
- Add rows for information related to SDDTs’ % UK exposures calculations; and
- Amend instructions to ask SDDTs not to report counterparty credit risk on certain derivatives, and to apply the new simplified capital deduction threshold calculation in line with proposals in Chapter 2 and Chapter 6 respectively, and to only report exposures for the UK and Total exposures (removing the need for SDDTs to report exposures for countries other than the UK).

7.22 Template C 09.04 is referenced in rule 2.4 and rule 2.5 of the SDDT Regime – General Application Part of the PRA Rulebook. In line with the proposal to introduce template C 09.04S for SDDTs, the PRA proposes to amend these rules to also refer to the proposed template.

Operational risk

7.23 In relation to operational risk, PS9/24 replaces templates C 16.00, C 17.00, and C 17.01 with template OF 16.00. The PRA has not proposed any changes in this CP to the way that Basel 3.1 operational risk requirements would apply to SDDTs, so it is not proposing any changes to the related Pillar 1 reporting for operational risk over and above those set out in PS9/24.

Market risk

7.24 In line with the proposal in Chapter 2 to descope SDDTs from having to calculate capital requirements for market risk, the PRA proposes to descope SDDTs from having to report market risk templates, other than amended versions of OF 22.00 and OF 90.00 which the PRA proposes to still require from SDDTs as follows:[113]

- Template OF 22.00 – Market risk: simplified standardised approaches for foreign exchange risk:
    - Create a copy of the template for SDDTs and rename it to 'OF 22.00S – Information on foreign exchange risk for SDDTs'; and
    - Delete rows and columns related to the own funds calculation for foreign exchange risk, and retain only those items related to foreign exchange positions.

- Template OF 90.00 – Market risk: authorisations
    - Create a copy of the template for SDDTs and rename it to 'OF 90.00S – Size of SDDTs' trading business'; and
    - Delete rows and columns other than those related to assessing the size of the trading book in line with the SDDT criteria.

7.25 The PRA considers it is appropriate to maintain amended versions of these two templates so that it receives some reporting by SDDTs on their positions against the SDDT criteria concerning their foreign exchange positions and the size of their trading businesses.

CVA

7.26 The PRA proposes to descope SDDTs from having to report CVA templates.[114] This proposal is in line with the proposal in Chapter 2 to descope SDDTs from Pillar 1 capital requirements for CVA.

Large exposures

7.27 As set out in Chapter 2, for Large Exposures purposes the PRA proposes to replace the calculation of CCR for derivatives by SDDTs with a simpler calculation where SDDTs'

113 PS9/24 renames template C 22.00 to OF 22.00 and introduces template OF 90.00.

114 In relation to CVA reporting, PS9/24 introduced templates OF 25.01 to OF 25.03 to replace template C 25.00. Under this proposal, SDDTs would not have to report any of these templates.

derivative exposures are calculated as 1.4 multiplied by the current market value of the derivative contract (with a floor of zero).

7.28 In line with this proposal, the PRA proposes not to make any changes to the existing Large Exposures templates, but to update the reporting instructions for Large Exposures templates C 28.00 and C 29.00 to instruct SDDTs to apply this simplified calculation for derivatives exposures when completing these templates. The PRA proposes to make these changes, directed only at SDDTs and not at non-SDDTs, to the Large Exposures reporting instructions which apply to all firms (ie both SDDTs and non-SDDTs). This is because the changes are modest and would not require reporting changes by non-SDDTs.

Leverage

7.29 Changes will also need to be made to Leverage reporting arising from the proposal mentioned in paragraph 7.27 above. In the case of Leverage reporting, the PRA proposes to:

- Add a row to template LV 47.00 to capture the proposed change in counterparty credit risk calculation for derivatives by SDDTs (see Chapter 2) and to make related changes to the reporting instructions for this template; and
- Make similar updates to the reporting instructions aimed at SDDTs for templates LV 41.00 and LV 44.00.

7.30 The PRA proposes to make these changes to the existing Leverage templates and reporting instructions which apply to all firms (ie both SDDTs and non-SDDTs) as the changes are modest and would require only a small update to the Leverage reporting module by non-SDDTs.

Pillar 2 reporting

7.31 In line with the proposals in Chapter 3 to adopt simplified methodologies for calculating SDDTs' Pillar 2A requirements, the PRA proposes the following changes to Pillar 2A reporting requirements for SDDTs:

- to descope SDDTs from the requirements to report data items FSA076 to FSA079 on credit risk and credit concentration risk;
- to clarify in SS32/15 – Pillar 2 reporting, including instructions for completing data items FSA071 to FSA082, and PRA111 that SDDTs are not considered to be 'significant firms' for the purposes of reporting operational risk, so they would not need to report data items FSA072 to FSA075 (the PRA would instead aim to source any data it requires to assess the Pillar 2A operational risk of SDDTs from the relevant firm's ICAAP, in line with the proposals set out in Chapter 3);

- to descope SDDTs from the requirements to report data item FSA080 concerning market risk arising on illiquid positions, which the PRA considers will not be significant for SDDTs given they are only permitted to have very small trading books; and
- to create a copy of data item FSA071 for SDDTs, to rename it to 'FSA071S – Firm information and Pillar 2 summary for SDDTs', and to delete rows no longer required by SDDTs (eg those related to breakdowns of operational risk, concentration risk and RFB group risk).

7.32 The PRA also proposes to amend data item PRA111 (which collects data on stress testing) to add a row to capture the new Single Capital Buffer for SDDTs, in line with the proposals in Chapter 4, and to make minor changes to the reporting instructions for this template. The PRA proposes to make these changes to the existing PRA111 data item and related instructions for all firms (ie both SDDTs and non-SDDTs) as the data item is Excel-based and so would require only minimal, if any, updates by non-SDDTs.

PRA objectives analysis

7.33 The PRA considers that the changes proposed in this chapter would result in reporting requirements and guidance for SDDTs that would support supervision of the policy proposals in Chapters 2 to 6. The proposed reporting changes would also introduce simplifications to reporting by SDDTs, facilitate future simplification of reporting for SDDTs (for example, as part of the Banking Data Review) and make the SDDT reporting framework simpler and easier to understand for SDDTs. The PRA considers that these proposals would therefore lower the risk of misreporting by SDDTs. The PRA also considers that these changes could help SDDTs to reduce their compliance costs, which could help them to build and conserve capital. The PRA considers that all of these potential impacts would advance the PRA's safety and soundness objective.

7.34 The proposals in this chapter would also advance the PRA's secondary competition objective. As noted above, the proposed changes should reduce SDDTs' compliance costs. This could result in lower prices for banking services if SDDTs pass on these lower costs to customers or the lower costs encourage greater entry into the UK banking sector.

7.35 By supporting effective competition, the proposals could lower the costs of financial intermediation and improve access to financial services in the economy. SDDTs with foreign parents would experience lower costs, which could increase small foreign banks' incentives to set up banks in the UK, thereby promoting the PRA's secondary competitiveness and growth objective.

Cost benefit analysis (CBA)

7.36 This section summarises the costs and benefits of the proposals in this chapter. Chapter 9 provides additional details.

Benefits

7.37 The proposed changes would deliver reporting requirements for SDDTs which are aligned to the proposed simplified capital regime set out in this CP and would therefore promote effective supervision under that regime. The proposal to apply the Basel 3.1 reporting changes set out in PS9/24 to SDDTs would support the proposal in Chapter 2 to apply the relevant Basel 3.1 risk-weighted Pillar 1 capital requirements to SDDTs. The proposals to further tailor and simplify reporting requirements for SDDTs would reduce compliance costs for them in gathering, processing, and reporting data. Further detail on the resultant cost savings can be found in Chapter 9.

7.38 The PRA considers there would be a further benefit related to timesaving as the proposals would free up resources for SDDTs, allowing them to improve the quality of the regulatory reporting they are required to complete. Improved quality of reporting would benefit the PRA by supporting the effective supervision of firms, thus promoting efficient use of PRA resources.

Costs

7.39 There would be a one-off implementation cost to SDDTs arising from the proposed changes to requirements and reporting instructions, especially in relation to the relevant changes set out in PS9/24 and the new CCR template. There will also be some cost to the PRA of implementing the proposed reporting changes.

7.40 The PRA's approach to developing these proposals should have minimal cost impact on non-SDDTs, because non-SDDTs would not need to consider, or make any adjustments for, the majority of changes proposed for SDDTs. In relation to the proposed changes to templates and reporting instructions for Leverage, Large Exposures, and the PRA111 which will affect all firms, there is only likely to be a small cost for non-SDDTs who would need to review the changes and potentially make small updates to the relevant reporting modules.

'Have regards' analysis

7.41 In developing these proposals, the PRA has had regard to its framework of regulatory principles. The regulatory principles that the PRA considers are most material to the proposals are:

1. Proportionality:

In developing the proposals in this chapter, the PRA has sought to implement the minimum reporting changes necessary to align with the proposals set out in Chapters 2 to 6, while maintaining some reporting to enable the PRA to understand SDDTs' positions against the SDDT criteria in some areas. The proposals aim to simplify reporting for SDDTs. The proposed approach of tailoring most of the templates and reporting instructions for SDDTs means they will be descoped from having to report a number of templates, and certain rows or columns within templates, resulting in a more proportionate set of reporting requirements for them. The proposed approach also facilitates future tailoring of returns for SDDTs, which could result in further proportionate changes to requirements to their reporting in future.

The proposed approach also means non-SDDTs would not need to consider, or make any adjustments to modules for, the majority of changes proposed for SDDTs.

2. Recognition of differences between businesses:

The PRA considers that the proposals in this chapter recognise different types of business models of firms. The proposed approach would result in reporting requirements for SDDTs which are more closely tailored to the business models of these firms, for example, by descoping of some reporting data not relevant to them. The proposals also mean the majority of reporting templates and reporting instructions for non-SDDTs would be unaffected by the proposals aimed at SDDTs.

3. Transparency:

The PRA considers that the proposed changes in this chapter, together with the additional draft material in the Appendices, would ensure SDDTs are clear on reporting requirements which apply to them. Overall, the proposals would not only promote consistency with the underlying proposals set out in Chapters 2 to 6, but also result in simpler and clearer reporting requirements and instructions for SDDTs.

4. Efficient use of PRA resources:

The PRA considers that the proposed reporting changes in this chapter would promote more efficient use of PRA resources. This is because the proposals are limited to those reporting changes considered necessary to implement the underlying proposals set out in Chapters 2 to 6, and to maintain a limited amount of reporting in relation to the SDDT criteria. The proposals also make use of existing reporting templates and instructions as the basis for changes. Together, this means the scale of the changes to be implemented by the PRA should be less than it otherwise would be, promoting more efficient use of PRA resources. The PRA also considers that the proposals would result in simpler reporting requirements and instructions for SDDTs, which could result in reduced reporting errors. This in turn would require the PRA to devote fewer resources to reviewing and addressing such reporting errors.

7.42 The PRA has had regard to other factors as required. Where analysis has not been provided against a 'have regard' for this set of proposals, it is because the PRA considers that 'have regard' to not be a significant factor for this set of proposals.

Implementation

7.43 The PRA currently collects banking data using two different taxonomies. COREP is reported to the PRA using the European Banking Authority (EBA) authored taxonomy (version 3.0). The Bank of England Banking Taxonomy (version 3.5.1) is used to report other banking reporting including certain PRA, FSA, and ring-fenced body (RFB) titled data items.

7.44 The reporting proposals in this chapter would need to be implemented within a taxonomy authored by the Bank of England. For COREP, this approach would mean that SDDTs would no longer report own funds and own funds requirements (eg COR001a) to the PRA using an EBA authored taxonomy from the PRA's proposed implementation date (see Chapter 1). As this CP does not propose any changes to the existing Large Exposures templates, reporting of these would continue using EBA taxonomy version 3.0.

7.45 The PRA intends to publish the public working draft taxonomy following this CP for comments on the data modelling and overall technical implementation. This will outline the proposed reporting changes for own funds and own funds requirements, Capital+, and Leverage.

7.46 Data items FSA071 to FSA082 and PRA111 are not collected via a taxonomy, and revised data items will be provided once the PRA finalises its policy on the proposals in this CP. The PRA is not proposing changes to the data collection system or the format of reporting used for any of the data items referenced in this CP.

7.47 The PRA has set out temporary names for the proposed reporting templates set out in this CP. These template names may be subject to future change as the PRA finalises its policy on the proposals in this CP.

8: Operating the SDDT Regime

Overview

8.1 This chapter sets out the PRA's proposals as to how it would operate the SDDT prudential regime upon the implementation of the Phase 2 measures, which include the capital simplifications for SDDTs. This includes the PRA's proposals to revoke the Interim Capital Regime (ICR) and the related Statement of Policy to achieve the full implementation of the SDDT regime.

8.2 The proposals in this chapter would introduce:

- A new PRA Rulebook Part: SDDT Regime – Interim Capital Regime (Transitional Provisions).

8.3 The proposals in this chapter would amend:

- the SDDT Regime – General Application Part of the PRA Rulebook; and
- SoP – Operating the Small Domestic Deposit Taker (SDDT) regime (the 'SDDT Operationalisation SoP') (Appendix 11), which was published previously in PS15/23. As outlined in Chapter 1, the PRA proposes that the changes to this SoP would take effect upon the publication date of the PS.

8.4 The proposals in this chapter would revoke:

- The SDDT Regime – Interim Capital Regime (CRR) Part of the PRA Rulebook when Phase 2 of the SDDT regime is implemented.

8.5 The proposals in this chapter would delete:

- SoP – Operating the Interim Capital Regime (Appendix 15) upon the end of the ICR, when Phase 2 of the SDDT regime is implemented.

8.6 As in the rest of this CP, for the purposes of this chapter, any references in relation to an ICR firm should, where appropriate, be treated as applicable to both an ICR firm and an ICR consolidation entity.

8.7 As this chapter sets out the PRA's proposed approach to implementing the proposals outlined in this CP, it should be read in conjunction with the preceding chapters.

Phase 2 implementation: revocation of the ICR and migration of ICR permissions

Revocation of the ICR

8.8 In **PS17/23**, the PRA set out its near-final policy to implement the ICR, a temporary regime that will allow SDDT-eligible firms to choose (via a Modification by Consent ('MbC')) to remain subject to requirements equivalent to the existing Capital Requirements Regulation (CRR) capital rules until the implementation date of the simplified capital regime for SDDTs. The first iteration of near-final ICR rules relating to market and operational risk and near-final ICR SoP are also included in PS17/23. In PS9/24 , the PRA has updated the near-final ICR rule instrument with the second iteration of near-final rules, including those relating to credit risk.

8.9 The ICR avoids the need for SDDT-eligible firms to have to implement the full Basel 3.1 standards and subsequently move onto the simplified capital regime for SDDTs. It also avoids the PRA having to reset Pillar 2 items for these firms twice – first for the implementation of the full Basel 3.1 standards, and again for the implementation of the simplified capital regime for SDDTs.

8.10 The ICR is intended to be in place during the interim period between the implementation date for the full Basel 3.1 standards (1 January 2026) and the proposed implementation date for the simplified capital regime for SDDTs (1 January 2027). The PRA therefore proposes that the ICR will cease to apply upon the implementation date of the simplified capital regime for SDDTs.

8.11 To achieve this aim, the PRA proposes to revoke the rules that give effect to the ICR when the simplified capital regime for SDDTs comes into force. The MbCs held by ICR firms would also end because of the revocation.

8.12 Under these proposals, once the ICR has been revoked, firms that operated under the ICR (ICR firms) and have taken up the SDDT MbC would immediately move onto the simplified capital regime for SDDTs, while ICR firms that have not taken up the SDDT MbC would immediately move onto full Basel 3.1 standards.

8.13 As proposed in Chapter 2, at the point of the ICR's revocation, all firms that had been operating under the ICR would be required to apply Basel 3.1 standardised approaches to credit risk (with the exception of the due diligence requirements in the case of SDDTs) and operational risk, regardless of whether they had opted into the SDDT regime. This is because, as set out in Chapter 2, the PRA proposes to also implement the Basel 3.1 Pillar 1 standardised approaches to credit risk (with the exception of the due diligence requirements) and operational risk in the simplified capital regime for SDDTs.

Migration of ICR permissions

8.14 To facilitate the move of SDDT-eligible firms and consolidation entities from the ICR to their chosen prudential framework (the full Basel 3.1 standards or the SDDT regime), the PRA will need to migrate permissions relating to provisions in the ICR rules where appropriate to equivalent permissions in relation to the provisions for their chosen framework. The PRA proposes to achieve this migration by implementing transitional rules.

8.15 A firm may wish to leave the ICR before the implementation date of the simplified capital regime for SDDTs. In such circumstances, under these proposals, the firm would need to request that the PRA revokes its ICR MbC. The PRA would then consider whether to revoke the firm's ICR MbC, and if so, when. The firm would be subject to the full Basel 3.1 prudential standards at the point its ICR MbC has been revoked, and any incidental matters such as the treatment of existing permissions would need to be considered and addressed. A firm's decision to leave the ICR is separate and distinct from the decision to enter or leave the SDDT regime, which requires a firm to consent to, or request the PRA to revoke, its SDDT MbC.

Accessing the SDDT regime

SDDT-eligible firms' access to Phase 2 measures

8.16 As of 1 January 2024, SDDT-eligible firms have been able to consent to the SDDT MbC to become an SDDT. The Phase 1 measures (which focused on disclosure and liquidity simplifications for SDDTs) in the SDDT regime were implemented with effect from 1 January 2024 for the disclosure simplifications and 1 July 2024 for the liquidity simplifications.

8.17 In CP4/23, the PRA set out its intention to later consult on and apply further simplifications for SDDTs after the Phase 1 measures, without the need to consent to additional modifications. In line with this intention, the PRA proposes that at the point at which the Phase 2 measures are implemented, they would automatically apply to all SDDTs. Firms would need to consent only once to an MbC to become an SDDT (and CRR consolidation entities would need to consent only once to an MbC to become an SDDT consolidation entity) to opt into the regime and access all the simplifications for SDDTs.

8.18 The PRA considers that this proposed approach would simplify the opt-in process, as well as facilitate a straightforward and efficient implementation of the SDDT regime. It would also reduce the administrative burden on SDDT-eligible firms that want to operate under the SDDT regime.[115]

[115] Please note that the MbCs for the SDDT regime and ICR are separate; a firm will need to consent to an ICR MbC to enter the ICR.

SDDT-eligible firms' engagement with the PRA prior to taking up the SDDT MbC

8.19 The SDDT Operationalisation SoP notes that the PRA is prepared to offer SDDT-eligible firms an MbC by which these firms could choose to operate under the SDDT regime by consenting to the MbC.

8.20 The PRA proposes to update the SDDT Operationalisation SoP to provide further details on this process, including that:

- a firm that wishes to become an SDDT would be expected to engage with its supervisors early prior to taking up the SDDT MbC;
- once an SDDT-eligible firm has notified the PRA of its intention to consent to the SDDT MbC, the PRA would consider several practical matters, such as when and how to update the firm's Pillar 2A requirements and its expectations of the capital the firm should maintain under the SCB. The PRA would then coordinate with the SDDT-eligible firm on timings for the firm to formally consent to the SDDT MbC; and
- where an SDDT-eligible firm has not coordinated closely with the PRA on its process and timeline to become an SDDT, the PRA will need more time to plan for the relevant changes to its processes prior to issuing the modification direction.

8.21 The PRA considers it important to set out these details explicitly in the SDDT Operationalisation SoP so that SDDT-eligible firms have a clear understanding of the process for becoming an SDDT. It is also important that firms understand the PRA's expectation that SDDT-eligible firms should engage with their supervisors early to facilitate the firm's smooth transition to the SDDT regime.

8.22 The PRA also proposes to make similar amendments to the SDDT Operationalisation SoP in relation to firms leaving the SDDT regime and moving to the prudential regime that applies to other firms.

PRA review of firms' Pillar 2 requirements prior to the Phase 2 implementation date

8.23 As set out in Chapter 2, the PRA proposes to apply the PRA's implementation of the Basel 3.1 standards for the calculation of Pillar 1 risk weighted assets (RWAs) for credit risk (except the due diligence requirements for SDDTs) and operational risk to SDDTs. In PS17/23 and PS9/24, the PRA set out how Pillar 2 requirements and expectations will need to be updated as necessary ahead of implementing the Basel 3.1 standards to address potential double counting or any unwarranted higher (or lower) requirements as a result of changes to RWAs.

8.24 To do this, as set out in Chapter 6 of PS17/23, the PRA set out its plan to conduct an off-cycle review of firm-specific Pillar 2 capital requirements ahead of the Basel 3.1 implementation date (ie the Basel 3.1 Pillar 2 off-cycle review). The PRA also plans to apply firm-specific structural adjustments to Pillar 2A to ensure that the removal of the SME and infrastructure support factors under Pillar 1 do not result in an increase in overall capital requirements for SME and infrastructure exposures (the 'SME lending adjustment' and the 'infrastructure lending adjustment', respectively) as part of this off-cycle review. ICR firms and ICR consolidation entities would not be subject to the Basel 3.1 Pillar 2 off-cycle review.

8.25 Ahead of the implementation date of the simplified capital regime for SDDTs, the PRA proposes to conduct a similar off-cycle review of firm-specific Pillar 2 capital requirements for ICR firms, as well as non-ICR firms that have consented to the SDDT MbC. The off-cycle review for these firms would aim to adjust a firm's Pillar 2 requirements and buffers in accordance with the prudential framework the firm has chosen to move to once the Phase 2 measures have been implemented (ie the Basel 3.1 standards or the SDDT regime). The PRA would also apply a SME lending adjustment and infrastructure lending adjustment to ensure that overall capital requirements for SME and infrastructure exposures do not increase as part of this off-cycle review.

8.26 For ICR firms that would move on to the Basel 3.1 standards, the off-cycle review would be conducted in line with the PRA's plan set out in PS17/23 and PS9/24, together with the proposal to retire the refined methodology which is currently being consulted in CP9/24. In addition to the PRA's plan set out in PS17/23 and PS9/24 and the proposal to retire the refined methodology, the off-cycle review for firms that have opted to move on to the SDDT regime would also calculate the firm's SCB and remove the CCyB adjustment based on a firm's most recent ICAAP and C-SREP.

8.27 The PRA plans to communicate to firms the adjusted Pillar 2 requirements and expectations (ie the outcome of this off-cycle review) ahead of the implementation date for the proposals in this CP, so that firm-specific requirements would be updated at the same time that the chosen prudential framework is implemented. The PRA proposes to conduct a data collection exercise for ICR firms, and non-ICR firms that have consented to the SDDT MbC, to inform these adjustments, with further details to be set out in due course. The PRA does not plan to reset firms' Pillar 2 capital requirements fully through a full C-SREP process before the implementation date. This is because the reset to a firm's Pillar 2 capital requirements using the proposed simplified Pillar 2A methodologies and non-cyclical stress test would occur over time in line with the firm's C-SREP cycle.

Timeline for SDDT MbCs prior to the Phase 2 implementation date

8.28 In PS15/23, the PRA stated that SDDT-eligible firms will be able to consent to the SDDT MbC at any time. While this will remain the case, firms looking to operate under the simplified capital regime for SDDTs on the implementation date for the proposals in this CP would need to opt in to the SDDT regime (by consenting to the SDDT MbC) in advance of the implementation date.

8.29 This is because the PRA would need time to update its processes in accordance with the regime a firm would operate under upon the implementation date for the simplified capital regime for SDDTs. For example, the PRA would need to adjust a firm's Pillar 2A requirements and its expectations of the capital the firm should maintain under the SCB, as part of the off-cycle review discussed above. Equally, firms would need sufficient time to be compliant with their chosen prudential framework upon the implementation date of the simplified capital regime for SDDTs.

8.30 The PRA therefore plans to set out a deadline for SDDT-eligible firms which have not already consented to become SDDTs to consent, or inform the PRA of their intent to consent, to the SDDT MbC if they want to be subject to the SDDT regime on the proposed implementation date of the Phase 2 measures. If a firm has not informed the PRA of its intention by the deadline set, the PRA would then assume that the firm wishes to be subject to the full Basel 3.1 standards from the implementation date of the Phase 2 measures.

8.31 The following considerations would be taken into account by the PRA in determining the deadline for firms to consent, or inform the PRA of their intent to consent, to the SDDT MbC:

- the time firms need to carry out necessary preparations for their chosen prudential framework upon the implementation date for the proposals in this CP; and
- PRA resourcing considerations for making the necessary implementation changes outlined in paragraph 8.25-8.26.

8.32 The PRA therefore plans to communicate timings for when SDDT-eligible firms wishing to join the SDDT regime will need to have taken up the SDDT MbC or will need to have informed the PRA of their intention to do so. The PRA’s proposed deadline for SDDT MbCs is specifically for SDDT-eligible firms which have not already consented to become SDDTs but want to immediately transition onto the simplified capital regime for SDDTs upon the proposed implementation date in this CP. An SDDT-eligible firm will be able to consent to the SDDT MbC at any point after the deadline, but it would be subject to the full Basel 3.1 standards before moving onto the SDDT regime.

Leaving the SDDT regime

Approach to a firm leaving the SDDT regime

8.33 The PRA set out its approach to a firm leaving the SDDT regime in the SDDT Operationalisation SoP. In the SoP, the PRA notes that if a firm ceases to meet the SDDT criteria it must notify the PRA and should expect the PRA will then decide to revoke its modification direction so it is no longer an SDDT.[116] The SoP explains further that, in many cases, such a firm will be able to prepare for ceasing to meet the SDDT criteria and should therefore be able to comply almost immediately with the measures that will apply to it when it ceases to be an SDDT (for instance, the full Basel 3.1 standards). The SoP also notes that in some circumstances, a firm might reasonably need some further time to prepare for

[116] If a firm ceases to meet the SDDT criteria, they must notify the PRA of the fact within 14 days. See rule 3.4 of the SDDT Regime – General Application Part of the PRA Rulebook.

complying with those measures, and that the PRA will consider these factors when deciding when to revoke the firm’s modification direction.

8.34 In the SDDT Operationalisation SoP, a firm ceasing to meet the SDDT criteria is the only reason referenced for why a firm may leave the SDDT regime. The PRA also recognises that a firm may choose to leave the SDDT regime of its own accord. The PRA therefore proposes to amend the SDDT Operationalisation SoP to include this as a circumstance for a firm leaving the SDDT regime.

8.35 The PRA considers that it is appropriate to provide SDDTs with further guidance on the process for leaving the SDDT regime. The PRA therefore proposes to update the SDDT Operationalisation SoP to clarify that:

- An SDDT that wishes to leave the regime should engage with its supervisors to discuss its plans and explain its reasons for seeking to leave at the earliest opportunity before requesting that the PRA revokes its modification;
- An SDDT in this position will generally be able to prepare for leaving the SDDT regime so that by the time it requests the revocation of its modification direction it will be able to comply almost immediately with the measures that will apply to it if it ceases to be an SDDT;
- Early engagement with the PRA will allow the time needed for the firm and the PRA itself to prepare for any necessary changes associated with a request to leave the SDDT regime. Such steps would need to be completed before the PRA would be able to accede to a request for revocation of a modification direction;
- That when considering when to revoke a firm’s modification direction, in addition to considering the time a firm would need to comply with the measures that would apply to it when it ceases to be an SDDT, the PRA will also consider the time needed by the PRA to make any necessary changes, and any information needed from the SDDT.

Approach to an SDDT that wishes to opt out of the Phase 2 measures

8.36 In CP4/23, the PRA noted that a firm that had chosen to adopt the Phase 1 measures could decide not to be subject to the further simplifications introduced in Phase 2, and therefore request to withdraw from the SDDT regime. In the CP, the PRA set out its intention to consult on transitional arrangements for firms moving from the SDDT regime to other prudential frameworks.

8.37 The PRA does not propose to develop a specific transitional arrangement for firms that choose to leave the SDDT regime upon seeing the final measures for the simplified capital regime for SDDTs. This is because the PRA considers that firms will have sufficient time after reviewing the finalised measures for the simplified capital regime for SDDTs to move away from the Phase 1 simplifications to liquidity and disclosure requirements prior to the implementation date of the simplified capital regime for SDDTs.

8.38 In line with the PRA's proposed general approach to firms seeking to leave the regime, an SDDT that sees the final Phase 2 measures and wants to leave the regime before they are implemented would be encouraged to engage early with its supervisors to discuss its plans before requesting that the PRA revoke its modification direction. As the PRA will need time to update its processes in accordance with the regime a firm will operate under upon the Phase 2 implementation date, the firm will need to inform the PRA of its intent to leave the SDDT regime by the deadline for SDDT-eligible firms to consent, or inform the PRA of their intent to consent, to the SDDT MbC (see paragraph 8.30).

8.39 Early engagement with the PRA will also allow time for the SDDT and the PRA itself to prepare for any necessary changes associated with a request to leave the SDDT regime. An SDDT in this position will generally be able to prepare for leaving the SDDT regime so that by the time it requests the revocation of its modification direction it will be able to comply almost immediately with the measures that will apply to it if it ceases to be an SDDT. The PRA would consider on a case-by-case basis whether a firm may reasonably need further time to prepare to meet the prudential framework that will apply to it when it leaves the SDDT regime.

Re-entering the SDDT regime

8.40 As set out in PS15/23, the SDDT regime operates on an opt-in basis, rather than as the default regime for SDDT-eligible firms. A firm that has previously had its MbC revoked (ie because it ceased to meet the SDDT criteria, or because it requested revocation despite continuing to meet the SDDT criteria) could therefore seek to re-enter the SDDT regime provided it meets the SDDT criteria. Such a firm would need to consent to a further modification. The PRA would also expect these firms to discuss their intention to re-enter the SDDT regime and their rationale for doing so with supervisors in the first instance.

8.41 In practice, the cost to a firm of repeatedly and/or frequently changing the prudential regime under which it operates (the SDDT regime or the regime that applies to other firms) could be high and would likely deter a firm from seeking to do this.

8.42 Therefore, the PRA proposes not to introduce specific measures to prohibit a firm from making multiple changes to the prudential regime it chooses to operate under, but instead proposes to amend the SDDT Operationalisation SoP to set out that the PRA would not expect firms to frequently exit and re-enter the SDDT regime. To this end, the PRA would remain alert to any firm attempting to take advantage of short-term changes in capital requirements and buffers in the SDDT regime versus outside the regime.

8.43 Furthermore, as noted in the SDDT Operationalisation SoP, the PRA has discretion to remove a firm from the SDDT regime by revoking its MbC if the PRA considers the firm's inclusion in the regime does not advance the PRA's statutory objectives.

PRA objectives analysis

8.44 The PRA has assessed the proposals in this chapter and considers the approach proposed for operating the SDDT regime would best advance its primary and secondary objectives.

8.45 PRA considers the proposals in this chapter advance the primary objective of promoting the safety and soundness of firms by facilitating an orderly end to the ICR and a straightforward transition for ICR firms and non-ICR firms that have taken up the SDDT MbC to their chosen prudential framework. The proposals intend to ensure firms are appropriately moved and subject to their new PRA requirements under their chosen regime without causing undue impact on smaller firms.

8.46 The proposals in this chapter help to advance the PRA's secondary competition objective. This is because the proposals would not create a disproportionate compliance burden on firms, as firms would not have to consent to additional modifications aside from the already available SDDT MbC. This avoids a cost which, if it was incurred by SDDTs, could increase SDDTs' costs. Higher costs for SDDTs could increase the prices of or reduce the volume and variety of banking services in the UK if SDDTs passed on those increased costs to customers.

8.47 The PRA considers that the proposals for accessing (and leaving) the SDDT regime are simple and proportionate and would facilitate a smooth transition for firms moving to the new simplified capital regime for SDDTs. The proposals in this chapter may also support the PRA's secondary competitiveness and growth objective. The simplicity of the process for joining the SDDT regime may potentially increase incentives for small foreign banks to establish banks in the UK.

Cost benefit analysis (CBA)

8.48 This section sets out the analysis of the costs and benefits associated with the proposals set out in the chapter.

8.49 The costs and benefits of revoking the ICR upon the proposed implementation date of the simplified capital regime for SDDTs are defined relative to not revoking the ICR upon the proposed implementation date of the simplified capital regime for SDDTs. The cost and benefits of revoking the ICR by way of transitional rules are defined relative to the alternative of revoking the MbCs granted under the ICR individually. The costs and benefits of using a single MbC to join the SDDT regime are defined relative to introducing a requirement for SDDT-eligible firms to consent to an additional MbC to access the simplified capital regime for SDDTs.

Benefits

8.50 The ICR's proposed revocation would facilitate the implementation of the proposed simplified capital regime for SDDTs. The SDDT regime and the regime that applies to non-SDDTs require firms to apply the Basel 3.1 standardised approaches to credit risk (with the exception of the due diligence requirements for SDDTs) and operational risk, which is more risk sensitive than the UK CRR-equivalent rules under the ICR. The end of the ICR would result in all firms that were under the ICR moving to a more robust prudential framework (the SDDT regime or the full Basel 3.1 standards), improving the safety and soundness of all these firms.

8.51 The proposed revocation of the ICR (to fulfil its role as an interim regime) would also deliver a benefit by avoiding the need for the PRA to incur additional costs of operationalising the ICR in addition to the full Basel 3.1 standards and the SDDT regime.

8.52 The proposal for a single MbC to enter the SDDT regime would enable SDDT-eligible firms to benefit from the SDDT regime in a straightforward way and would minimise these firms' regulatory costs.

8.53 The proposed updates to the SDDT Operationalisation SoP would provide SDDTs and SDDT-eligible firms with additional guidance on how the process and timings would work for firms seeking to enter or leave the SDDT regime.

Costs

8.54 The PRA would incur costs relating to the processing of SDDT MbC applications for firms entering the SDDT regime, and the off-cycle review of firm-specific Pillar 2 requirements and buffers ahead of the implementation date for the proposals in this CP.

8.55 Firms under the ICR as well as non-ICR firms that have consented to the SDDT MbC would also face the cost of preparing their submission for the PRA's data collection exercise for the off-cycle review of firm-specific Pillar 2 requirements and buffers. This is likely to be a similar cost to that incurred by firms which are non-ICR firms as part of the Basel 3.1 Pillar 2 off-cycle review. Non-ICR firms that have consented to the SDDT MbC would need to incur the cost of undergoing an off-cycle review to move from the non-SDDT regime to the SDDT regime. It should be noted that, as part of the implementation of Basel 3.1 and the SDDT capital regime, all firms would be subject to an off-cycle review regardless of whether they move to the full Basel 3.1 standards or the simplified capital regime for SDDTs. This is because both regimes require firms to apply the Basel 3.1 standardised approaches to credit risk (with the exception of the due diligence requirements for SDDTs) and operational risk.

8.56 The PRA considers that the other proposals in this chapter have no material bearing on the CBA analysis. Overall, the PRA considers that these costs are outweighed by the benefits derived from the proposals set out in this CP (see Chapter 9).

‘Have regards’ analysis

8.57 In developing these proposals, the PRA has had regard to its framework of regulatory principles. The regulatory principles that the PRA considers are most material to the proposals are:

1. Proportionality:

The PRA considers the proposal for a single modification to access the SDDT regime would reduce the unnecessary regulatory burden for SDDTs of having to consent to additional modifications to access the simplified capital regime for SDDTs. This would facilitate a straightforward process to joining the SDDT regime.

The PRA considers the proposal for the use of transitional rules where appropriate to migrate permissions relating to provisions in the ICR rules to be proportionate. For ICR firms, the migration of permissions relating to provisions in the ICR rules where appropriate to equivalent permissions in relation to the provisions for their chosen framework would avoid the need for those firms to reapply for permissions.

2. Transparency:

The PRA considers that the proposed amendments to the statement of policy – Operating the Small Domestic Deposit Takers (SDDT) regime clarify the process for entering and exiting the SDDT regime in practice. Separately, the PRA considers that the proposal for a single MbC to operate under the SDDT regime would simplify the joining process and enhance the general transparency of requirements to access the SDDT regime.

3. Efficient use of PRA resources:

The PRA considers that these proposals would make efficient and economic use of PRA resources, as it would mean that the PRA would not have to process additional modifications by consent for firms that are already SDDTs. The proposed revocation of the ICR would also avoid the need for PRA resources to be used to operate another regime in addition to the SDDT regime and the Basel 3.1 standards.

Likewise, the proposal for the ICR to be revoked by transitional rules would support the efficient and economic use of the PRA’s resources as this would avoid the PRA having to undergo the operationally intensive task of revoking all the MbCs granted under the ICR individually.

8.58 The PRA has had regard to other factors as required. Where analysis has not been provided against a 'have regard' for this set of proposals, it is because the PRA considers that 'have regard' to not be a significant factor for this set of proposals.

9: Aggregated cost benefit analysis

Overview

9.1 This chapter sets out the PRA's impact analysis of the expected aggregate costs and benefits of implementing the proposals set out in this CP.

9.2 The aggregated CBA brings together the expected costs and benefits discussed in the preceding policy chapters. This chapter should, therefore, be read in conjunction with Chapters 2-8.

9.3 The chapter is structured as follows:

- **Case for action**: the rationale for the Strong & Simple Framework and how the proposals in this CP would contribute to advancing PRA objectives;
- **Overall approach to the CBA**: approach to the use of quantitative and qualitative information, key assumptions including about the baseline for comparison, and the presentation of the quantitative estimates;
- **Benefits and costs of applying elements of the Basel 3.1 standardised approaches to SDDTs**: a description of the expected benefits and costs for PRA-regulated firms and the PRA of this aspect of the proposals set out in this CP;
- **Benefits of the other parts of the proposals**: a description of the expected benefits for PRA-regulated firms and the PRA of the proposals set out in this CP apart from the application of elements of the Basel 3.1 standardised approaches;
- **Costs of the other parts of the proposals**: a description of the expected costs for PRA-regulated firms and the PRA of the proposals set out in this CP apart from the application of elements of the Basel 3.1 standardised approaches;
- **Impact on overall capital requirements and buffers**: analysis of the impact of applying elements of the Basel 3.1 standardised approaches to SDDTs and the other parts of the proposals on SDDTs' capital requirements and buffers, including analysis of the extent to which SDDTs would need to raise or conserve capital under the proposals in this CP; and
- **Summary of the costs and benefits**: summary of the expected benefits and costs in Part 2, and sensitivity analysis.

9.4 Overall, the PRA assesses that the proposals in this CP would generate positive net benefits. There are several other significant benefits which it was not feasible to quantify, implying the net benefit estimate presented here could be a lower bound on the true value.

Case for action

9.5 The PRA proposes changes to prudential policies where appropriate if it identifies risks to its primary objectives.[117] When it determines general policies in a way that advances its primary objectives, the PRA must act in way that advances its secondary objectives, so far as is reasonably possible.[118]

9.6 The PRA considers there is a case for changing prudential regulation for SDDTs because the way prudential polices have been implemented historically for small, domestic-focused banks and building societies has created a 'complexity problem', which, if mitigated, would advance the PRA's primary and secondary objectives.

9.7 This problem exists when the costs of understanding, interpreting, and operationalising prudential requirements and expectations are higher relative to the associated benefits for smaller firms than for larger firms.[119,120] One reason for the complexity problem is that there is a fixed component to the costs of understanding, interpreting, and operationalising prudential requirements and expectations, which means these costs can be proportionately higher for smaller firms. Another reason is the benefits might be relatively lower for smaller firms because the risk factors driving smaller and larger firm distress are different, but requirements and expectations have been designed with larger firms' risk factors in mind.

9.8 In DP1/21, the PRA set out the adverse effects associated with the complexity problem.[121] First, lower profits due to the complexity problem could induce small firms to increase risk taking, which could reduce small firms' resilience. Second, lower profits could lower their capacity to build and conserve capital. Third, lower profits could deter new entrants that otherwise could have increased competition in the banking sector.

9.9 Therefore, simplifying prudential regulation for SDDTs, but in a way that maintains resilience for SDDTs,[122] could advance the PRA's primary and secondary objectives by reducing these adverse effects associated with the complexity problem. The PRA considers that the proposals set out in this CP would achieve this outcome.

---

117 Section 2B of FSMA 2000.

118 The secondary objectives are facilitating effective competition in the markets for services provided by PRA-authorised persons in carrying on regulated activities and facilitating, subject to aligning with relevant international standards, the international competitiveness of the UK economy (including in particular the financial services sector through the contribution of PRA-authorised persons) and the growth of the UK economy in the medium to long term. See sections 2H(1), (1A), and (1B) of FSMA 2000.

119 See paragraphs 2.2-2.6 in DP1/21.

120 This does not mean that the costs exceed the benefits for smaller firms, rather it means the (positive) net benefits may be lower for smaller firms than for larger firms.

121 See Figure 1 in DP1/21.

122 That is, does not increase the risk of SDDT failure.

9.10 The PRA considers it would not be advancing its primary objective if it simplified prudential regulation for SDDTs in ways that reduced SDDTs' resilience. If SDDTs' levels of resilience were reduced, it would heighten the risk of failure of SDDTs, and so could lead to a loss of confidence in SDDTs. This could also have a negative effect on effective competition if customers were deterred from using SDDTs because they perceived those firms to be less resilient than larger firms. This could increase the price, or reduce the quantity or quality, of banking services available to customers.

9.11 A potential disadvantage to creating a simpler prudential regime for SDDTs is that it could increase barriers to growth for firms in the regime.[123] An SDDT that ceases to meet any of the SDDT criteria – for instance, because it has grown so large it no longer meets the size criterion – would have to adjust to the prudential regime that applies to firms outside of the SDDT regime. The adjustment costs for the firm could be higher if the differences in design between the requirements and policies inside and outside the SDDT regime are greater.

9.12 The PRA considers that such adjustment costs could be low because it has used a 'streamlined' approach[124] to designing the SDDT regime, including the proposals in this CP. Under the streamlined approach, the PRA has taken the regime that applies to larger firms and sought to modify those elements of the regime that are overly complex or less relevant to the risks faced by SDDTs. This means that, while the resulting regime would be different from that of larger firms, there would continue to be links and common features between the SDDT regime and that outside of it. If the PRA had designed a completely new, much simpler prudential regime for SDDTs (what was called a 'focused' approach in DP1/21[125]), the PRA considers the adjustment costs would have been higher and the increase in barriers to growth larger.

Overall approach to the CBA

9.13 Where it is reasonable to do so, the PRA has produced quantitative estimates of costs and benefits associated with the proposals set out in this CP. As permitted under FSMA, costs and benefits have not been estimated (ie quantified) where they cannot reasonably be estimated or where it is not reasonably practicable to do so. In making these judgements, the PRA has considered factors including the reliability of any resulting estimates, proportionality (in relation to the costs of sourcing necessary data from firms) and the need to use its resources economically and efficiently.[126] Where the PRA considers it would not be reasonable or practicable to quantify certain costs and benefits, the CP describes those costs

123 See Figure 2 in DP1/21 for a description of the potential effects of barriers to growth.
124 See paragraph 4.25 in DP1/21.
125 See paragraph 4.25 in DP1/21.
126 Section 138J(8) requires a cost benefit analysis to include a statement of the PRA's opinion and an explanation of why costs or benefit cannot reasonably be estimated or it is not reasonably practicable to produce estimates.

and benefits qualitatively. In some cases, the CP presents quantitative facts to support the qualitative descriptions of costs and benefits.

9.14 Where the CBA uses balance sheet data from regulatory returns, data from end-2022 are used.

9.15 The costs and benefits are defined relative to a **baseline** (or counterfactual); ie the regulatory framework SDDT-eligible firms would face if the proposals in this CP were not made. The wider risk-based capital framework is going to change significantly between now and the implementation date for the proposals in this CP because the PRA will be implementing Basel 3.1 during this period.[127] Reflecting this, and to ensure transparency, the PRA has divided its CBA of the proposals in this CP into **two parts**.

9.16 In the first part, the costs and benefits of applying the Basel 3.1 standardised approaches to credit risk and operational risk, and ending the ICR, are defined relative to the Pillar 1 standardised approaches to credit and operational risk that currently apply to firms under the CRR (**Part 1**). The costs and benefits are calculated for all SDDT-eligible firms.

9.17 Part 1 reflects that the approaches which currently apply to firms will be maintained until the implementation date for the proposals in this CP under the ICR, for SDDT-eligible firms that choose to enter the ICR. When SDDTs that were on the ICR move to the SDDT capital regime, they would realise the costs and benefits of the Basel 3.1 standardised approaches to credit risk and operational risk relative to the Pillar 1 standardised approaches that currently apply to firms. These costs and benefits would also be realised by other SDDT-eligible firms that were in the ICR but chose not to become SDDTs, since those firms would become subject to Basel 3.1 in full when the ICR ends.[128] Part 1 provides transparency over the costs and benefits of the PRA's proposal to apply the Basel 3.1 CR SA and OR SA to SDDTs and end the ICR.

9.18 In the second part, the costs and benefits of the other parts of the proposals in this CP are defined relative to the capital regime that would apply outside of the SDDT regime (**Part 2**). By 'the capital regime that would apply outside of the SDDT regime', the PRA means the capital framework that would apply on 1 January 2027 (ie the proposed implementation date for the proposals in this CP) to a firm that was not an SDDT – which would be the full Basel 3.1 standards and the existing Pillar 2A methodologies[129] and the current capital buffer

---

127 See PS17/23 and PS9/24.

128 There is a third possible scenario, which is that an SDDT-eligible firm chooses to implement Basel 3.1 in full prior to the implementation date for the proposals set out in the CP. This could be a firm that adopted Basel 3.1 from the Basel 3.1 implementation date or a firm that initially entered the ICR but then had its ICR modification revoked, at which point it would have moved onto Basel 3.1 in full. The CBA is constructed under the assumption that this scenario would not arise; see paragraph 9.20.

129 Except for the refined methodology in Pillar 2A, but including firm-specific structural adjustments to Pillar 2A for SME lending and infrastructure exposures.

framework. These costs and benefits would be incurred by SDDTs, but not by other eligible firms that chose not to become SDDTs even if they were in the ICR. This part of the CBA is particularly relevant to helping firms understand the impact a decision to become an SDDT would have on them.

9.19 The PRA has used this approach to defining the baselines to make sure the costs and benefits associated with all the proposals in the CP are captured in the CBA. If the PRA only used the capital regime that would apply outside of the SDDT regime as the baseline, the costs and benefits arising from SDDT-eligible firms' move from the current standardised approaches to credit and operational risk to the Basel 3.1 standardised approaches to these risks would not be captured in the CBA. If the PRA only used the current capital regime as the baseline, the impact of a firm choosing to be in the SDDT capital regime versus outside of the regime would not be captured.

9.20 The CBA assumes that all SDDT-eligible firms enter the ICR and remain in it until the implementation date for the proposals in this CP.[130,131] This means the costs and benefits considered in **Part 1** have been applied to **all SDDT-eligible firms**. The CBA also assesses the proposals considered in **Part 2** in relation to their application to **all SDDT-eligible firms**. In other words, the CBA does not make any assumptions about which SDDT-eligible firms would choose to become an SDDT by the implementation date for the proposals in this CP or incorporate firms' incentives to be SDDTs. The CBA includes as part of its assessment firms that are members of foreign groups that the PRA estimates could become SDDTs.[132] The PRA estimates 80 firms would be SDDT-eligible based on data from end-2022.[133] The estimates of benefits and costs have been calculated based on those 80 firms.[134]

9.21 Since eligible firms choose whether to become SDDTs, it could be considered that firms' net benefits of the proposals considered in Part 2 must be positive. This is assuming that the only firms that would choose to become SDDTs, and hence subject to the SDDT capital regime, would be those for which the benefits of the proposals exceed the costs. This feature of the SDDT regime makes it more likely that the proposals considered in Part 2 would be net

130 Under this assumption, there would be no SDDT-eligible firms that would incur the costs and benefits of moving from the current Pillar 1 standardised approaches to credit and operational risks to the Basel 3.1 standardised approaches to credit and operational risks at the Basel 3.1 implementation date, or in the period between the Basel 3.1 implementation date and the implementation date for the proposals in this CP.

131 Under this assumption, there would be no SDDT-eligible firms that incur the costs and benefits of moving from the current Pillar 1 to the Basel 3.1 approaches for the risks apart from credit and operational risk.

132 As set out in SoP – **Operating the Small Domestic Deposit Taker (SDDT) regime**, the PRA considers that it is likely to be the case that a firm that a member of a foreign group should be able to become an SDDT when the firm can demonstrate that the group's total assets do not exceed £20 billion when calculated on the basis comparable to the measure of total assets in the size criterion in the SDDT criteria.

133 Therefore, the cohort does not include firms that may have become banks since the beginning of 2023 and meet the SDDT criteria. The analysis the PRA conducted to support the development of the proposals in this CP used this cohort of firms.

134 The 80 firms are made up of 30 banks, 36 building societies, and 14 'new banks', where a new bank is a firm in scope of SS3/21.

beneficial, but it is does not guarantee it because there may be costs associated with the proposals that SDDT-eligible firms do not internalise.[135,136] The aggregated CBA in this chapter includes costs that SDDT-eligible firms would not necessarily internalise (eg costs for the PRA).

9.22 Although the CBA is constructed under the assumption that all eligible firms are subject to the proposals, the PRA recognises that not all SDDT-eligible firms may choose to enter the SDDT regime (eg because they intend to grow quickly).[137] The PRA has considered the implications of some SDDT-eligible firms not entering the regime by undertaking a sensitivity analysis of the costs and benefits in Part 2 (see paragraph 9.74).[138]

9.23 Table 8 shows what the areas of regulation covered in the policy chapters look like in the two baselines as well as under the proposals.

Table 8: Areas of regulation under the proposals and in the baselines

	Proposal	**Baseline**
Part 1: CBA of the application of Basel 3.1 CR SA and OR SA relative to current requirements.	• Basel 3.1 CR SA and OR SA as set out in PS9/24 and PS17/23, including the SME lending adjustment and infrastructure lending adjustment to Pillar 2A (as set out PS9/24), and the retirement of the refined methodology and other changes to Pillar 2 set out in CP9/24 (see Chapter 2 of this CP).	• Current standardised approach to credit risk and approaches to operational risk under CRR.[139]

135 Ie it is possible that the proposals would be net beneficial for each SDDT-eligible firm, but the sum of the costs for firms and the PRA exceed the sum of the benefits for firms and the PRA.

136 Another possibility is that firms would be willing to be SDDTs even if the proposals were net costly for them because the benefits from the simplifications for SDDTs that the PRA has already introduced are large enough to make it worthwhile for them to be SDDTs.

137 Those firms would 'opt out' by simply not consenting to the SDDT modification. See paragraph 2.23 in CP4/23 – **The Strong and Simple Framework: Liquidity and Disclosure requirements for Simpler-regime Firms**.

138 The costs and benefits in Part 1 would not vary with firms' decisions about whether to become SDDTs because all SDDT-eligible firms would be subject to the Basel 3.1 standardised approaches to credit risk and operational risk (see paragraph 9.17).

139 The ICR will not be compulsory for SDDT-eligible firms. SDDT-eligible firms that chose not to be in the ICR would experience the costs and benefits from the application of the Basel 3.1 standardised approaches to credit risk and operational risk when Basel 3.1 is implemented rather than when the proposals in this CP are implemented.

Part 2: CBA of other parts of the Phase 2 package relative to outside of the SDDT regime.	• The Basel 3.1 Pillar 1 framework with the disapplication of the due diligence requirements in the standardised approach to credit risk, simplifications to the market risk framework, the disapplication of capital requirements for counterparty credit risk for derivatives (with some exceptions) and credit valuation adjustment (CVA) risk, consequential changes to the LR and LE rules (see Chapter 2 of this CP). • Simplified Pillar 2A methodologies for credit risk, operational risk, and credit concentration risk (see Chapter 3 of this CP). • A SCB framework, including a non-cyclical stress testing framework and removal of the CCyB adjustment (see Chapter 4 of this CP). • A simplified ICAAP and less frequent ILAAP (see Chapter 5 of this CP). • Simplified capital deduction rules (see Chapter 6 of this CP). • Simplified reporting requirements (see Chapter 7).	• The Basel 3.1 Pillar 1 framework in full, as set out in PS17/23 and PS9/24. • The LR as set out in SS45/15 – **The UK leverage ratio framework** and LE rules as set out in Large Exposures (CRR) Part of the PRA Rulebook. • The current Pillar 2A methodologies, inclusive of proposed changes to Pillar 2 set out in CP9/24[140] and the SME lending adjustment and the infrastructure lending adjustment to Pillar 2A (as set out in PS9/24). • The current capital buffers framework, as set out in the CRR and SS6/14, SS31/15, SS16/16, and SS3/21. • Current capital deduction rules under CRR. • Current reporting requirements.

9.24 The CBA includes costs and benefits for both SDDTs and the PRA. The costs and benefits that have been quantified have been presented in the following ways. The ongoing

140 Ie the amended SS31/15 – The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP) and Statement of Policy – The PRA's methodologies for setting Pillar 2 capital that are proposed in CP9/24.

costs and benefits of individual proposals are shown on a per-year, per-firm basis. One-off costs and benefits that could be realised when the measures set out in this CP are implemented are shown separately, and per-firm in the case when benefits or costs would be realised by SDDTs.[141] Where appropriate, quantitative estimates have been shown as ranges to reflect uncertainty about the estimates. The present values of the total costs and benefits are shown in the summaries in each part. The present values of ongoing costs and benefits are calculated assuming they last 10 years using a discount rate of 3.5%, in line with current HM Government guidelines.[142,143]

Part 1: Benefits and costs of the Basel 3.1 standardised approaches

9.25 The PRA considers that the Basel 3.1 CR SA (including the approach to CRM) and OR SA would generate both benefits and costs for SDDT-eligible firms compared to the standardised approaches that apply currently (and would continue to apply under the ICR).

9.26 The benefits and costs associated with the PRA's proposed implementation of these approaches were discussed in the CBA in CP16/22 – **Implementation of the Basel 3.1 standards**. The benefits and costs associated with the post-consultation changes to the approach to credit risk are discussed in PS9/24. The analysis of these parts of the proposals in this CP draws upon these discussions.

9.27 The requirement to use the Basel 3.1 CR SA and OR SA would create several material benefits for SDDT-eligible firms compared to the approaches to these risks that apply currently. As discussed in Appendix 7 to CP16/22, the primary benefits of the Basel 3.1 CR SA and OR SA arise from how they advance the PRA's objectives and 'have regards'. In particular, the PRA's primary objective to promote safety and soundness would be supported by the improvements the proposals would make to the capture of risk by firms. This is because accurate and appropriate risk measurement and capture help ensure firms have levels of capital commensurate to the risks they face. Additionally, improvements to the risk sensitivity in the CR SA help limit the extent to which measurement of RWAs diverges between IRB and standardised approach firms[144], improving competition and supporting the PRA's secondary competition objective.

141 One-off costs and benefits are assumed to occur when the proposals are implemented. In practice, one-off costs and benefits might be incurred over two to three years around the implementation date.
142 See HM Treasury's **The Green Book (2022)**.
143 In the present-value calculations, the CBA assumes 'Year 1' starts at the point the proposals in this CP are implemented. One-off costs and benefits are assumed to occur in Year 1.
144 See **Bank Overground – Mind the (smaller) gap? Implications of the narrowing gap between modelled and standardised residential mortgage risk weights**, February 2023.

9.28 The requirement to apply the Basel 3.1 CR SA and OR SA could generate costs for SDDT-eligible firms. CP16/22 detailed the potential operational compliance costs to firms across the whole package for different groups of firms, based on data from a survey of firms.[145] The costs of implementing the CR SA and OR SA for small and medium firms were included in these aggregated numbers but are also broken out in Table 9 for transparency. Table 9 shows that these costs are small for SDDTs (for instance, the one-off costs are around 0.3% of the average annual administrative expenses for SDDT banks and building societies at the end of 2022).

Table 9: Per-firm costs for SDDT-eligible firms of implementing the Basel 3.1 standardised approaches to credit risk and operational risk [(a)]

	One-off (£)		Annual ongoing (£)	
	Average [(b)]	Interquartile range	Average [(b)]	Interquartile range
Per-firm cost	98,000	20,000-133,000	16,000	0-24,000

Source: The PRA's survey of affected firms, the PRA analysis and calculations.

(a) The estimates are based on data from a survey to estimate the operational compliance costs of the proposals in CP16/22 (see Table 2 in Appendix 7 to CP16/22). The estimates have been rounded to the nearest thousand.

(b) The average is the arithmetic mean of the survey responses excluding the highest and lowest responses.

9.29 As discussed in CP16/22, there is uncertainty around these estimates for several reasons. First, there was only a limited sample available to the PRA to estimate the costs, and they can vary considerably depending on assumptions made. Second, the survey asked firms to report estimates of costs before the details of the proposals in CP16/22 were known. It is likely that firms reported conservative estimates of the costs, and therefore the results may over-estimate the likely size of the operational costs to the industry of these proposals.

9.30 As set out in Chapter 8, the PRA proposes to conduct an off-cycle review of firm-specific Pillar 2 capital requirements for firms that have been operating under the ICR ahead of the implementation date for the proposals in this CP. This would not entail a full C-SREP or new ICAAPs. As part of the review, the PRA would conduct a data collection exercise to inform the adjustments in the light of the application of the Basel 3.1 CR SA and OR SA and the retirement of the refined methodology, and invite firms to provide the necessary data to inform the calibration of the SME lending adjustment and infrastructure lending adjustment

[145] Tables 3 and 4 of Appendix 7 to CP16/22.

set out in PS9/24[146], and communicate to firms their adjusted Pillar 2 requirements ahead of the implementation date for the proposals in this CP. As part of that exercise, the PRA would also reflect the simplifications to Pillar 1 set out in Chapter 2 and set SCBs. Since it is difficult to split up the costs of the review between its different components, the PRA has accounted for the costs of the whole exercise in Part 2 (see paragraph 9.58).

9.31 CP16/22 also estimated capital and balance sheet costs to firms. The PRA has conducted an updated analysis of these costs to SDDT-eligible firms for the post-consultation CR SA and OR SA, which are discussed in the section 'Impact on overall capital requirements and buffers' below.

9.32 The proposal in CP9/24 to retire the refined methodology from the Pillar 2A framework could generate costs and benefits for SDDTs. See CP9/24 for the relevant cost benefit analysis.

Summary of costs and benefits

9.33 The total one-off costs and annual ongoing costs of implementing the Basel 3.1 CR SA and OR SA would be around £7.9 million and £1.3 million, respectively, if the average costs in Table 9 are multiplied by the estimated number of SDDT-eligible firms.[147] The present value of those costs is around £19 million. The present value of the aggregate net benefits is the present value of the ongoing benefits of the more accurate risk capture under the CR SA and OR SA, as discussed in paragraph 9.27, minus the present value of the implementation costs.

Part 2: Benefits of the other proposals

9.34 The PRA considers that the other proposals set out in this CP (ie the proposals apart from the application of the Basel 3.1 CR SA and OR SA) would produce several benefits for SDDTs and the PRA compared with the capital regime outside of the SDDT regime.[148] These are grouped into several themes below.

Capital requirements that are more certain

---

146 The PRA plans to apply firm-specific adjustments to Pillar 2A to ensure that the removal of the SME and infrastructure support factors under Pillar 1 do not result in increases in overall capital requirements for SME and infrastructure exposures.

147 Based on the 25th percentiles of the one-off and ongoing costs reported in Table 2, the aggregate costs would be £1.6 million and £0, respectively. Based on the 75th percentiles, the aggregate costs would be £10.7 million and £1.9 million, respectively.

148 See paragraph 9.18 for a definition of what is meant by outside the SDDT regime.

9.35 The proposals for simpler Pillar 2A methodologies and the SCB would make capital requirements and expectations more certain and predictable for SDDTs.

9.36 The simpler and more transparent Pillar 2A methodologies mean SDDTs would be able to predict with more certainty how their Pillar 2A requirements could change when their businesses and exposures change. For example, under the proposals in this CP, the approach to determining Pillar 2A requirements for operational risk would be more transparent than the approach in the Pillar 2A framework outside of the SDDT regime because the current published methodology focuses on Category 1 firms.

9.37 The SCB would make buffers more certain for three reasons. First, buffers would no longer depend on the interaction between the CCyB and the PRA buffer; the interaction would be a complex and potentially opaque part of the determination of buffers outside of the SDDT regime. Second, SDDTs would not face buffers that vary with CCyB rates.[149] Third, the stress test that helps to inform an SDDT's SCB would be based on a constant severity stress scenario rather than a scenario that changes with the economic cycle.

9.38 The PRA considers there would be several benefits from applying more predictable and certain capital requirements and expectations to SDDTs.

9.39 The first two benefits are related to the impact of a more predictable and certain capital framework for SDDTs on their capital and business planning.

9.40 First, SDDTs could invest fewer resources into making capital and business planning decisions. The PRA estimates that an SDDT could spend around 0.5 full time equivalents (FTEs) per annum understanding the complex interaction between the CCyB and its PRA buffer under the buffer framework outside of the SDDT regime. Under the SCB proposals, those FTEs could be reallocated to higher-value activities or taken as a cost saving. If taken as a cost saving, the PRA considers it could correspond to around £78,000 per firm per year. To estimate these cost savings, the PRA conducted desk-based analysis using the FTE estimate along with salary data from the 2023 Robert Walters Salary Guide[150] on key staff and job roles expected to be involved in capital and business planning decisions in SDDTs.[151]

149 Both the UK CCyB rate and the CCyB rates of other jurisdictions to which SDDTs have relevant credit exposures.
150 **Salary Survey UK 2024**.
151 The PRA adjusted the salary data upwards by 30% to capture overhead costs. This is a broad estimate and should be treated as such. This method of estimating cost effects was used in the CBA in CP10/23 – **Solvent exit planning for non-systemic banks and building societies** (see paragraph 2.21).

9.41 Second, if SDDTs were more certain about the levels of their capital requirements and buffers in the future, there could be effects on SDDTs' incentives to hold management capital buffers[152] and on SDDTs' lending capacity.

9.42 Responses to DP1/21 described how small firms find it more costly than larger firms to raise capital at short notice. This might lead small SDDTs to maintain high management capital buffers as a form of insurance against potential increases in buffers in the future. Past research has shown smaller banks and building societies in the UK tend to hold relatively bigger management buffers than larger firms.[153] More certain capital requirements and buffers could lead some SDDTs to reduce these 'buffers on buffers', which could reduce those SDDTs' funding costs. This would be consistent with research that shows that banks facing higher uncertainty maintain higher capital surpluses over regulatory requirements.[154]

9.43 These 'buffers on buffers' cannot be easily observed, but the sizes of SDDTs' current management buffers give an indication of the capacity SDDTs may have to reduce 'buffers on buffers'. The PRA assumes that SDDTs would still choose to maintain a level of management buffer to protect against the risk of falling under their SCBs. However, SDDTs could see a potential cost saving if greater certainty about buffers meant they felt able to reduce their management buffers compared with outside of the SDDT regime. A significant number of SDDT-eligible firms have a capital surplus over buffers of more than three percentage points of RWAs, with over a quarter of them having a surplus of more than five percentage points of RWAs.[155] The level of cost saving per firm would depend on their business models and future business plans. For example, on average, building societies currently have higher capital surpluses than banks, which is probably due to the restrictions building societies face on raising and distributing capital. The PRA considers that SDDTs with low management buffers are less likely to lower their capital surplus and thus are less likely to realise cost savings from being able to lower 'buffers on buffers'.

9.44 More certainty about capital requirements and buffers might also lead SDDTs to increase lending relative to the level they would do outside of the SDDT regime. This would

---

152 Management capital buffer refers to the difference between a firm's level of capital as a percentage of RWAs and its capital requirements plus buffers expressed as a percentage of RWAs.

153 See de-Ramon, Francis, and Harris (2022), 'Bank-specific capital requirements and capital management from 1989-2013: Further evidence from the UK', Journal of Banking & Finance, Vol.138, and Francis and Osborne (2012), 'Capital requirements and bank behavior in the UK: Are there lessons for international capital standards?', Journal of Banking & Finance, Vol.36, pages 803-816.

154 See Valencia (2016), 'Bank capital and uncertainty', Journal of Banking & Finance, Vol.69, pages 51-59.

155 These calculations are based on regulatory returns by banks and building societies but excluding banks in scope of SS3/21 ('new banks'). New banks' capital surpluses may not reflect their desire to hold 'buffers on buffers'. Their surpluses might reflect the initial injections of capital they have received and initially low RWAs.

be consistent with research showing a negative association between policy uncertainty and bank lending.[156]

Simplified capital stack

9.45 Simpler methodologies for determining SDDTs' **Pillar 2A requirements** could generate cost savings for SDDTs and the PRA. The simplifications to the methodologies for operational risk and credit concentration risk mean an SDDT would have to spend less time and effort understanding how those risks contribute to its Pillar 2A requirements than it would outside of the SDDT regime. In addition, the PRA would have to spend less time and effort dealing with questions from firms about those methodologies, allowing it to focus on the risks that matter most for SDDTs. The simplifications to the methodology for credit risk mean that for the majority of SDDTs, the PRA would probably no longer have to calculate a Pillar 2A add-on for credit risk nor have to require SDDTs to conduct focused credit scenario assessments in the ICAAP as set out in the proposed methodology. The PRA estimates only around 30% of SDDTs would need to conduct credit risk scenario assessments for Pillar 2A in the ICAAP because they meet the criteria set out in Chapter 3.

9.46 By contributing to a simplified capital stack for SDDTs, the SCB could also generate cost savings for SDDTs and the PRA. To determine a firm's PRA buffer under the framework outside the SDDT regime, there is a complex adjustment in relation to the CCyB rate. This means that each time there is a change to the CCyB a firm would incur costs in determining its PRA buffer. The complexity in the buffer calculation also creates a risk that buffers are miscalculated. If miscalculations occur, there can be costs both to firms and the PRA.[157]

9.47 The simpler calculation of **deductions from regulatory capital** that is proposed in this CP could generate cost savings for firms and reduce the risk of firms making mistakes in calculating capital resources. An accurate measure of capital resources means SDDTs' capital ratios will be more accurate measures of the resilience of these firms. The PRA has estimated that the proposal would not change the capital resources for the vast majority of SDDTs, although a few SDDTs would see a small increase in their ratios of regulatory capital to RWAs.

9.48 The proposed **Pillar 1 requirements** for SDDTs could reduce SDDTs' costs compared to outside of the SDDT regime. SDDTs would not incur the costs of meeting the due diligence requirements in the Basel 3.1 CR SA. SDDTs would not have to incur the costs of calculating

[156] Berger, Guedhami, Kim, and Li (2022), 'Economic policy uncertainty and bank liquidity hoarding', Journal of Financial Intermediation, Vol.49(C), pages 1-15, Bordo MD, Duca J, Koch C (2016), 'Economic policy uncertainty and the credit channel: Aggregate and bank level U.S. evidence over several decades', Journal of Financial Stability, Vol. 26(C), pages 90-106, and Gissler, S, Oldfather, J, Ruffino, D (2016). 'Lending on hold: Regulatory uncertainty and bank lending', Journal of Monetary Economics, Vol.81, pages 89-101.

[157] The PRA has not quantified this benefit because it is difficult to estimate the probability of this event occurring.

the relatively complex Pillar 1 capital requirements for counterparty credit risk for derivatives (with some exceptions) and CVA risk.[158] Since SDDTs would use the CR SA instead of the complex market risk rules, calculating Pillar 1 requirements related to trading activities could be less costly than outside of the regime. However, this benefit may be small because outside of the regime SDDTs would be in scope of Article 94 of the Trading Book (CRR) Part of the PRA Rulebook.[159]

9.49 At the same time, the PRA considers the proposed simplifications to Pillar 1 for SDDTs would not generate costs by making SDDTs less resilient than in the baseline: see Chapter 2 for reasons for this.

Reduced reporting requirements and simpler supervisory processes

9.50 In this CP, the PRA is proposing to disapply or simplify several **reporting** templates relative to what would be collected under the baseline. The PRA would no longer need from SDDTs all the information collected via these templates to set and monitor SDDTs' capital requirements and buffers given the proposed simplifications to Pillar 1, Pillar 2A, the definition of capital, and buffers.

9.51 These changes to reporting mean an SDDT would have to fill in fewer cells on a quarterly basis and when it submits an ICAAP. The PRA has used data collected as part of the Basel 3.1 compliance cost survey conducted in 2021 to inform estimates of the ongoing costs of completing a cell in a reporting template. Those data suggest a per-year cost of completing a cell of £5 to £10. Considering whether an SDDT-eligible firm would be likely in practice to fill in specific cells outside of the SDDT regime, the PRA estimates the reductions in reporting under the Phase 2 proposals could generate an annual cost saving of between around £7,000 and £15,000, per SDDT. See Table 10 for more details. However, these estimates may understate the cost savings because of the greater the amount of work that a firm potentially needs to do complete the cells in some of the templates (for instance, the templates related to Pillar 2). The cost savings could be greater for those SDDTs which submit reporting templates at a consolidated level as well as at an individual firm level.

[158] Costs could be lowered by the consequential simplifications to exposure measures in the LR and LE frameworks.

[159] Article 94 of the Trading Book (CRR) Part of the PRA Rulebook allows a firm that meets the thresholds set out in the article to use the CR SA to calculate capital requirements for their trading book business.

Table 10: Cost savings from reduced reporting requirements

Area	Effective difference between the number of cells an SDDT would report compared to outside the SDDT regime [(a)]	Comment
Capital adequacy and group solvency	-152	Cells related to IRB are not included in the count since SDDTs would not complete these cells outside of the SDDT regime because one of the SDDT criteria is that a firm does not use an IRB model for credit risk to calculate RWAs.
Credit risk, counterparty credit risk, and securitisations	-896	Cells related to IRB are not included (see above). Cells related to IMM models are also excluded because SDDTs are unlikely to have IMM model permissions.
Market risk	-224	Cells that SDDTs do not currently report or are related to the ASA approach are not included in the count.
CVA risk	-43	Cells that SDDTs do not currently report are not included in the count.
Leverage ratio	2	New rows added for SDDTs.
Pillar 2 [(b)]	-467	Cells in templates that firms submit when they submit their ICAAPs, which will be simplified under the Pillar 2 proposals in this CP. The amount of work a firm needs

		to do to complete cells in these templates may be higher than the amount of work it needs to do to complete cells in the other templates, hence the cost savings from simplifications to these templates may be higher than the estimates indicate.
Cost saving (per SDDT, per annum) (c)	£7,000 to £15,000	

Source: PRA regulatory returns, PRA analysis and calculations.

(a) This column shows the count of the effective difference between the number of cells an SDDT would have to complete in the SDDT regime and the number it could have to complete outside of the regime. A negative (positive) value indicates that an SDDT would have to fill in fewer (more) cells in the SDDT regime than outside the regime. Cells that an SDDT would be likely to leave blank or enter a non-zero number outside of the SDDT regime are excluded from the count; see the 'Comment' column for further details about these cases. In the case of templates which require firms to submit data for exposures to individual countries or currencies, the counts are based on the assumption that the number of countries or currencies for which an SDDT submits data equal the averages of the numbers of countries or currencies SDDT-eligible for firms currently report in those templates.

(b) The Pillar 2 templates are templates that firms submit when they submit their ICAAP to the PRA. To reflect the frequency by which SDDTs would complete these templates, the cost saving estimate of the difference in the number of cells multiplied by the per-cell cost is further multiplied by 1/3 to generate the per-year cost saving.

(c) The cost saving equals the per-cell annual cost of filling in a cell multiplied by the sum of the effective differences between the number of cells an SDDT would report in the SDDT regime and outside of the regime in the different areas, where the number for Pillar 2 templates is multiplied by 1/3 (see note (b)). The lower value uses the annual per-cell cost of £5 and the higher value uses the annual per-cell cost of £10. The cost saving estimates are rounded to the nearest thousand.

9.52 An additional benefit of reducing reporting for SDDTs is that they may be able to put more resources into the regulatory reporting they continue to do, which may increase the quality of that reporting. Better quality reporting submissions should help the PRA's supervision of SDDTs, which supports SDDTs' safety and soundness.

9.53 The PRA considers that proposed changes to the **ICAAP** and **ILAAP** would generate several benefits for SDDTs. The reduced frequency of running ICAAP assessments, and as a result updates to parts of the ICAAP document (ie the ICAAP modules apart from the modules for Pillar 2A and Pillar 2B) and reviews requiring updates to the ILAAP document mean that an SDDT, unless it is a new bank[160], would have to incur the costs of making these updates every other year, rather than every year. The simplifications to the ICAAP template reduce duplicative elements and hence would reduce costs for SDDTs. The PRA estimates the cost savings from the reduced frequency of reviews, assessments, and consequential updates to the ICAAP and ILAAP documents could be between £43,000 and £171,000 over a two-year period. To produce these estimates, the PRA has assumed that the review of the processes, running the processes and the resultant preparation of an ICAAP or ILAAP document takes an SDDT between 50 and 200 days a year. The desk-based analysis described in paragraph 9.40 has been used to calculate the corresponding costs of those days for an SDDT. For the cost savings related to the ICAAP proposals, the estimated cost saving from the desk-based analysis is multiplied by the proportion of SDDTs' ICAAP documents that SDDTs could update less frequently under the proposals in this CP, which are any elements other than the Pillar 2 elements. For the purposes of the CBA, it is assumed 80% of the work to put together the ICAAP is related to Pillar 2 elements.

Other benefits

9.54 The PRA considers that the proposals set out in this CP could benefit new entrants to the UK banking system because it means new entrants that meet the SDDT criteria could go onto a regime that is simpler and less costly than the regime they would otherwise face. This may encourage greater entry, which could support effective competition in the UK banking sector, which could lead to lower prices and increased volume or variety of banking services in the UK. These new entrants could be UK banks set up by small foreign banking groups.

9.55 The PRA considers that the benefits associated with the proposals set out in this CP would not have large macroeconomic effects because SDDTs are small relative to the UK economy, both individually and collectively. SDDTs' share of lending by banks and building societies is 3-4%.[161] SDDTs' shares of mortgage, commercial real estate and private non-financial corporation loans are 2% or less, while their share of the stock of consumer credit advanced by banks and building societies is estimated to be around 15%. In spite of SDDTs' more material role in some types of lending, the buffers proposals would imply SDDTs would have capital buffers large enough to overcome a stress. Therefore, the PRA has not included in the CBA macroeconomic effects arising from the benefits of the proposals.

---

160 SDDTs that are new banks, ie in scope of SS3/21, are not in scope of these proposed simplifications: see paragraphs 5.13 and 5.24 in Chapter 5.

161 This share is based on data reported by SDDTs. Some SDDTs are below the reporting threshold so are not included in the calculation of this share or other shares shown in this paragraph.

Part 2: Costs of the other proposals

Implementation costs

9.56 The proposals set out in this CP, if implemented, would significantly change the way capital requirements and buffers are set for SDDTs. This change could generate one-off implementation costs for firms and the PRA.

9.57 SDDTs may incur costs to understanding and implementing the proposed simplified Pillar 2A methodologies and the SCB.

9.58 There are several tasks the PRA would need to do to implement the proposals which it would not need to do in the baseline. The PRA would have to provide training to supervisors of SDDTs about the new rules and policies. As part of the off-cycle review referred to in Chapter 8, the PRA would have to assess the impact of the Pillar 1 framework on SDDTs' RWAs and work out the implications for SDDTs' Pillar 2A requirements. The PRA would have to set SDDTs' SCBs as part of the same review. The Bank would have to design the non-cyclical scenario. The PRA would also have to make technology changes to allow for the changes to SDDTs' reporting submissions under the proposals. The PRA estimates the total cost of these tasks would be just over £4 million, which would be incurred over a period of three years around the implementation date for the proposals in this CP.

New reporting requirements

9.59 Under the proposals set out in this CP, SDDTs would be required to submit several amended reporting templates that they would not face outside of the SDDT regime. Firms could incur one-off costs of implementing these amended templates. However, these costs are likely to be low. The PRA has estimated these one-off costs for an SDDT assuming these costs would equal the number of new cells in the templates multiplied by £5 or £10 (ie the same per-cell costs used to calculate the ongoing cost savings from the proposed reporting changes). The PRA estimates the one-off costs of the proposed new reporting requirements could be just over £800 to just over £1,600 per SDDT.

Other costs

9.60 The PRA considers that descoping SDDTs from the CCyB would not lower the efficacy of the CCyB framework because SDDTs are small relative to the UK economy and financial system (see paragraph 9.55) and the proposals in this CP would maintain the resilience of SDDTs (see the section below). Therefore, the PRA has not included in the CBA any financial stability costs associated with the descoping of SDDTs from the CCyB.

9.61 The impact that the proposals set out in this CP could have on SDDTs could in turn affect banks and building societies outside of the SDDT regime. If SDDTs have lower costs due to the proposals and SDDTs pass those cost reductions onto customers, this could induce non-SDDTs with which SDDTs compete to reduce the prices of their banking services. This reaction from non-SDDTs could affect non-SDDTs' resilience; for instance, lower margins could reduce non-SDDTs' capacity to build, and conserve, capital. However, the small size of SDDTs (both in terms of their current size and their potential size given that the SDDT criteria limit their growth) means the effects on non-SDDTs may not be very large. If the effects did arise, the PRA could use its supervisory and regulatory tools to mitigate the impact on non-SDDTs' resilience.

Impact on overall capital requirements and buffers

9.62 The proposals for the SCB and simpler Pillar 2A methodologies have been calibrated so the level of SDDTs' overall capital requirements and buffers remain broadly unchanged. The impact of proposals on the levels of capital requirements and buffers and the extent to which individual SDDTs may need to raise new capital or conserve capital is discussed in this section.

9.63 The PRA has modelled the impact of the proposals set out in this CP on SDDT-eligible firms' capital requirements and buffers (where capital means total regulatory capital). This covers the impacts which relate to both the Basel 3.1 CR SA and OR SA versus the current standardised approaches / ICR (Part 1) and the impacts of the other proposals in this CP versus outside of the SDDT regime (Part 2).

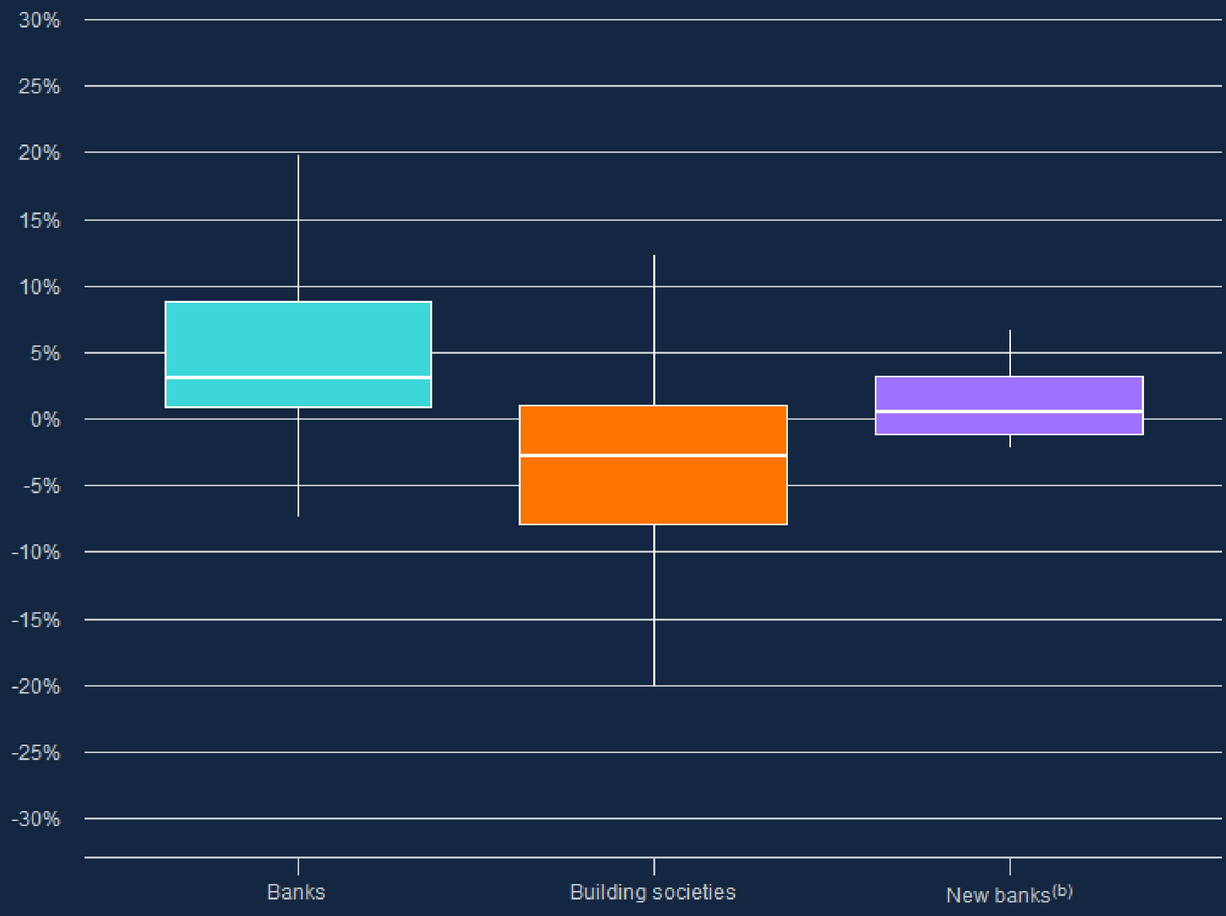
9.64 Minimum capital requirements and buffers together make up a firm's 'capital stack'. The 'top of the stack' refers to the sum of a firm's capital requirements and buffers. This section discusses the PRA's estimates of the impact of the proposals on the top of the capital stack.

9.65 The analysis in this section assumes SDDTs would not change the composition of their assets in response to the proposals in this CP or the implementation of Basel 3.1 standards outside of the SDDT regime. If SDDTs changed the composition of their assets to lessen the effect of these regulatory changes, the impact of the proposals may be lower than the estimates shown in Chart 1 below. The impact estimates use available regulatory data from firms, which may lack the granularity required for a precise assessment of the impacts. The estimates assume Basel 3.1 standards are fully phased in.

9.66 **Chart 1** shows the distribution of the impacts of the application of the Basel 3.1 CR SA and OR SA (and the retirement of the refined methodology in Pillar 2A, as set out in CP9/24) on the top of the SDDT-eligible firms' stacks. The chart shows the distributions for banks, building societies, and 'new banks' (which are SDDT-eligible firms in scope of SS3/21). The impact is measured by the estimated percentage difference between the top of the stack (expressed in pounds) when the CR SA and OR SA are applied to SDDT-eligible firms and the top of the stack under current rules (expressed in pounds). In other words, this chart shows the impact on the top of the stack in **Part 1**.

9.67 Chart 1 shows that the application of the CR SA and OR SA to SDDT-eligible firms tends to increase the top of the stack for banks and new banks and decreases the top of the stack for building societies. The median impacts are just over 3% for banks, around 0.5% for new banks, and close to -3% for building societies. The differences between banks and building societies reflect the differences in the composition of their assets combined with the changes to risk weights for different asset classes under the CR SA. For example, firms for which low loan-to-value owner-occupied mortgages are a larger share of assets – many of which are building societies – would see a reduction in RWAs. Firms, which are typically banks, that have a significant share of residential mortgages where the borrower's ability to repay is materially dependent on the cash flow from the property, especially when the mortgage has a high loan-to-value ratio, may see an increase in RWAs. In each of these examples, the effects on RWAs would happen because the CR SA is more risk sensitive than current Pillar 1 requirements.

Chart 1: Estimated impact of the application of the Basel 3.1 standardised approaches to credit and operational risk on the tops of the capital stacks for SDDT-eligible firms(a)



Source: PRA regulatory returns, PRA analysis and calculations.

(a) The boxplots show for banks, building societies, and new banks the distributions of estimated percentage differences between the top of the capital stack (expressed in pounds) when the CR SA and OR SA are applied and the top of the stack under current rules (expressed in pounds). For each box, the whisker on top is drawn up to the highest estimate within 1.5*interquartile range of the 75th percentile and the whisker below is drawn down to the lowest estimate within 1.5*interquartile range of the 25th percentile.

(b) New banks are those firms among the estimated population of SDDT-eligible firms that are in scope of SS3/21.

9.68 **Chart 2** shows the impact on the top of the stack of the other parts of the proposed package. Impact is measured by the percentage difference between the top of the stack under the proposals in this CP (expressed in pounds) and the top of the stack outside of the

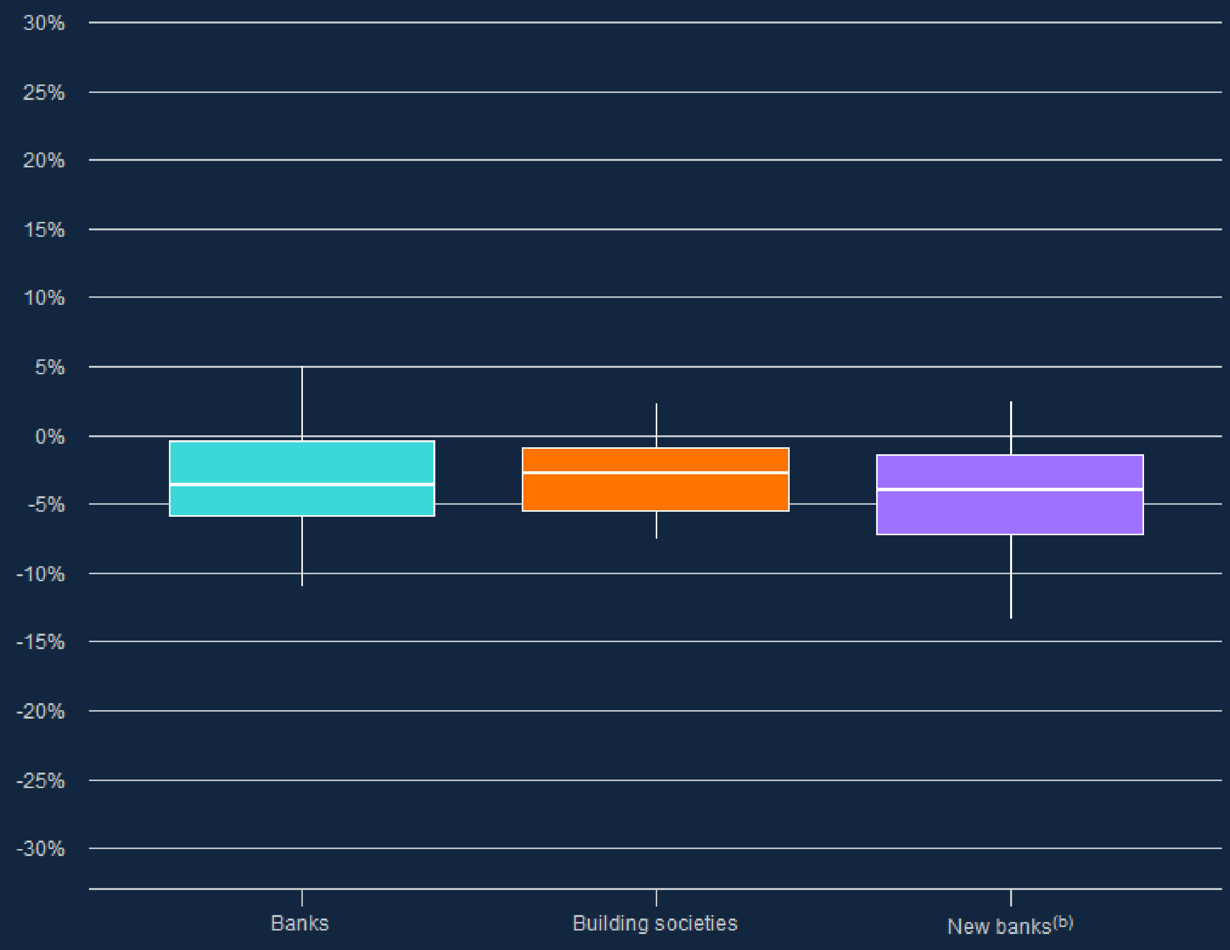
SDDT regime (expressed in pounds). In other words, this chart shows the impact on the top of the stack in **Part 2**.

9.69 Chart 2 shows the top of the stack tends to be lower compared with outside of the SDDT regime for banks, building societies, and new banks. Since the CR SA and OR SA apply inside and outside of the SDDT regime, the impacts reflect the effects of the proposals apart from the application of Basel 3.1 CR SA and OR SA (and the retirement of the refined methodology in Pillar 2A). The impacts reflect two opposing effects. The first effect is that the SCBs are lower than the combined buffers outside of the SDDT regime, on average. This effect pushes down the tops of the stacks under the proposals compared with the tops of the stacks outside of the SDDT regime. The second effect is due to the removal of the CCyB adjustment to Pillar 2A, which increases SDDTs' Pillar 2A requirements compared with outside the SDDT regime, on average. This effect pushes up the tops of the stacks under the proposals compared with the tops of the stacks outside of the SDDT regime. The PRA's modelling indicates that, on average, the first effect exceeds the second effect.

9.70 Chart 2 shows that the impacts on banks and building societies are more similar in Part 2 than in Part 1. This reflects the fact that banks and building societies are affected similarly by the proposals in this CP apart from the application of Basel 3.1 CR SA and OR SA. There is more variation in the impact of the proposals between banks than there is between building societies. This is because building societies, as a cohort, tend to have similar business models and therefore the proposals in this CP would affect them in similar ways. It is harder to model the impact on fast-growing new banks, so the estimated impacts on new banks are more uncertain.[162]

[162] When a firm is growing fast, the balance sheet used to estimate its Pillar 2A requirements under the proposals in this CP may differ significantly from the balance sheet at the time of the firm's most recent ICAAP prior to Q4 2022, which is the basis for modelling the firm's Pillar 2A requirement outside of the SDDT regime. This difference in the balance sheet tends to increase the estimated difference between the tops of the capital stacks inside and outside the SDDT regime for new banks.

Chart 2: Estimated impact of the other parts of the proposals on the tops of the capital stacks for SDDT-eligible firms[(a)]



Source: PRA regulatory returns, PRA analysis and calculations.

(a) The boxplots show for banks, building societies, and new banks the distributions of estimated percentage differences between the top of the stack under the proposals in this CP (expressed in pounds) and the top of the stack outside of the SDDT regime (expressed in pounds). For each box, the whisker on top is drawn up to the highest estimate within 1.5*interquartile range of the 75th percentile and the whisker below is drawn down to the lowest estimate within 1.5*interquartile range of the 25th percentile.

(b) New banks are those firms among the estimated population of SDDT-eligible firms that are in scope of SS3/21.

9.71 Chart 2 shows that the top of the stack is estimated to be higher under the proposals in this CP than outside of the SDDT regime for 17 SDDTs. The PRA has estimated the difference in capital costs in the SDDT regime and outside the regime.[163] The PRA estimates the total capital costs per annum would be between £3.9 million and £13.5 million lower in the SDDT regime than outside.[164]

Implications for resilience

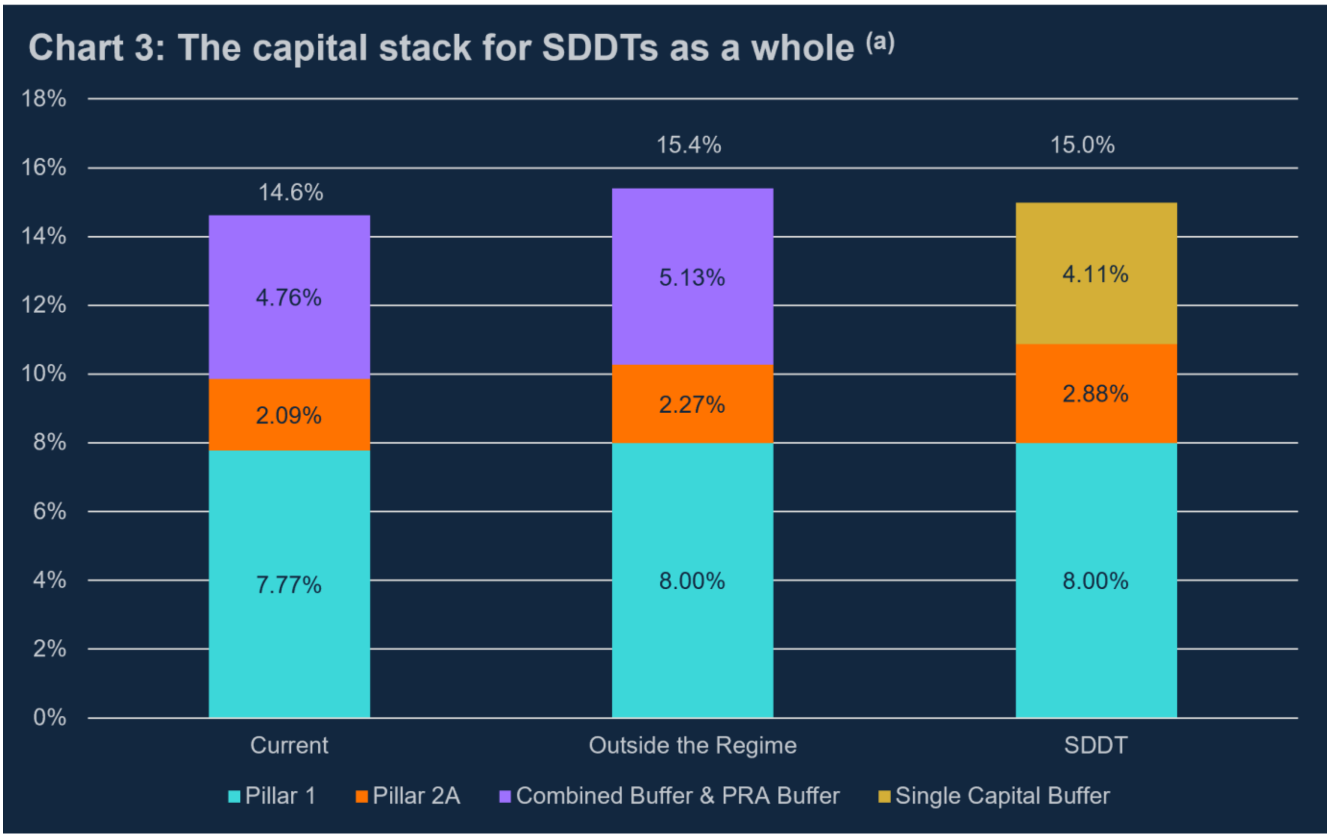
9.72 Chart 3 compares the weighted-average capital stacks[165] for SDDTs under the current rules and expectations, outside of the SDDT regime, and under the proposals in this CP. The stacks are shown as percentages of estimates of RWAs under the Basel 3.1 standards (‘Basel 3.1 RWAs’).[166] It shows the top of the stack under the proposals would be a little above the current stack (the difference is just below 40 basis points of Basel 3.1 RWAs). The difference reflects that RWAs are more risk sensitive under the CR SA. Greater risk sensitivity should improve resilience. The top of the stack under the proposals is slightly below the stack outside of the SDDT regime (the difference is around -40 basis points of Basel 3.1 RWAs). Although there are differences in the top of the stacks, the PRA considers the differences are small and hence the proposals in this CP would maintain the resilience among SDDTs, individually and as a cohort, both relative to now and to outside of the SDDT regime.

163 The cost difference is calculated as follows: calculate the cost difference for each firm using the equation $m\phi(\gamma_{equity} - \gamma_{debt})(C_{SDDT} - C_{outside})$, where m reflects the degree to which cost of equity and debt vary with the level of capital (ie, the Modigliani-Miller effect), ϕ reflects the sensitivity of levels of capital to the level of capital requirements plus buffers, γ_{equity} is the cost of equity, γ_{debt} is the cost of debt (taking into account the tax deductibility of debt interest), C_{SDDT} is the top of the capital stack under the SDDT proposals, and $C_{outside}$ is the top of the stack outside of the SDDT regime; sum the firms’ cost differences. The calculation applies the cost of equity to all forms of regulatory capital that SDDTs may use to meet regulatory requirements.

164 The lower bound of the range is based on the following parameter values: $\phi = 50\%$, $\gamma_{equity} = 9\%$, $\gamma_{debt} = 4\%$, and $m = 50\%$. The upper bound of the range is based on the following parameter values: $\phi = 80\%$, $\gamma_{equity} = 15\%$, $\gamma_{debt} = 4\%$, and $m = 50\%$.

165 The weight placed on firm i's capital requirements plus buffers is firm i's estimated RWA under the Basel 3.1 standards divided by the sum of SDDTs’ estimated RWAs under the Basel 3.1 standards.

166 The stacks are shown in terms of the same measure of RWAs so they are comparable. This means the values in the stack for current rules and expectations differ from the values of the requirements and buffers as stated in current requirements and expectations. For instance, although the current Pillar 1 capital requirement in the CRR is 8% of RWA, the Pillar 1 requirement in the current stack in the chart is less than 8%. The difference reflects the increase in RWAs on average resulting from Basel 3.1.



Source: PRA regulatory returns, PRA analysis and calculations.

(a) The bars show the weighted average capital stack for SDDT-eligible firms under current rules, outside of the SDDT regime, and under the proposals in this CP, respectively. Firms are weighted by their RWAs under the Basel 3.1 standards (ie to calculate the average value of a component of the stack, the weight placed on firm i's value for the component is firm i's estimated RWA under the Basel 3.1 standards divided by the sum of SDDTs' estimated RWAs under the Basel 3.1 standards).

Summary of the costs and benefits in Part 2

9.73 Table 11 shows quantitative estimates of the aggregate ongoing benefits and aggregate ongoing and one-off costs in Part 2. Table 11 also shows the present values of the benefits and costs and the overall net benefit in Part 2. Some of the values are shown as ranges to reflect uncertainty about the estimates. The table shows that the proposals would have positive net benefits based on the costs and benefits that have been quantified. The total benefits of the proposals may be higher because the benefits arising from the simplified capital stack have not been quantified. The costs may be somewhat higher because any costs that SDDTs might incur from implementing the new rules and have not been quantified (apart from the costs of implementing changes to reporting requirements). The costs and benefits for SDDTs shown in the table could help SDDT-eligible firms understand how the proposals in this CP could affect whether they would be better off in the SDDT regime.

Table 11: Expected aggregate direct costs and benefits of the proposals in Part 2

	Net benefit (£ million)	Type
More predictable and certain capital framework	6.27	Ongoing
A simplified capital stack	Not quantified	
Changes to reporting requirements	0.59 to 1.17	Ongoing
Implementing new reporting requirements	-0.07 to -0.13	One-off
Less frequent ILAAP and ICAAP (a)	2.86 to 11.45	Ongoing
PRA implementation costs	-4.08	One-off
SDDTs' implementation costs (apart from those related to reporting)	Not quantified	
Capital costs (b)	3.92 to 13.45	Ongoing
Total (Present value, £ million) (c)(d)	101 to 226	

Source: PRA regulatory returns, PRA analysis and calculations.

(a) This ongoing benefit would be realised over a two-year period.

(b) The difference between capital costs in the SDDT regime versus outside the regime. A positive (negative) value indicates that capital costs are lower (higher) in the SDDT regime versus outside.

(c) The present value is calculated using a 10-year horizon and a discount rate of 3.5%, and assuming benefits and costs are realised at the beginning of the year. The value is rounded to the nearest million.

(d) The bottom (top) of the range is calculated using the lower (higher) values for the positive net benefits in the rows above and the higher (lower) values for the negative net benefits in the rows above. The values are rounded to the nearest million.

9.74 The PRA considers that SDDT-eligible firms that intend to grow fast may be less likely to choose to become SDDTs, and hence be subject to the proposals in this CP, because they would expect to only be eligible for a short period, which might mean the costs of moving onto the SDDT regime could exceed any benefits of doing so. The PRA also considers that firms that would see higher capital requirements plus buffers in the SDDT capital regime than outside of the SDDT regime may be less likely to become SDDTs (ie firms above the zero line in Chart 2). If these firms were not SDDTs, the present value of the net benefit is between £81 million and £191 million based on the costs and benefits that have been quantified. The individual net benefits for these firms show that a relatively small number of these firms (around 3-4 firms) would need to be subject to the proposals for the combined net benefits for SDDTs to exceed the PRA implementation costs, and hence for the overall net benefit to be positive, based on the costs and benefits that have been quantified.[167, 168, 169]

Question 2: Do you have any comments on the aggregated CBA? Do you have any quantitative data or other information relevant to the assessment of the costs and benefits of the proposals set out in this CP

[167] The number of firms that would need to be subject to the proposals for the overall net benefit to be positive was derived in the following way: take the firms with positive net benefits (in present value terms) and list them in ascending order based on those net benefits (ie so the firm with the lowest positive net benefit is first in the list); starting from the beginning of the list, count how many firms would need to be subject to the proposals for the firms' total net benefits to exceed the PRA implementation costs.

[168] The range was derived by conducting the analysis described in footnote 167 for the lower and higher values of the net benefits.

[169] If firms deriving higher net benefits from the proposals had a greater propensity to become SDDTs, fewer firms would need to be subject to the proposals for the overall net benefit to be positive.