



Discussion Paper | DP1/21

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

April 2021





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Responses are requested by Friday 9 July 2021.

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Foreword

The PRA regulates a diverse range of banks and building societies in the UK. These differ in size and the activities they do, but we currently seek to achieve PRA objectives by applying broadly the same prudential regime to all of them. This means smaller banks and building societies may face prudential requirements and expectations that are over-complex relative to what is actually needed to ensure their safety and soundness. This complexity may have negative effects on their costs, and thereby on their resilience and on effective competition in the UK banking sector. This is why we want to explore ways to simplify the prudential framework for smaller, non-systemic, banks and building societies, starting with the publication of this discussion paper.

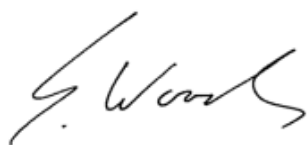
It is important that we simplify in the right way. We are aiming to simplify the prudential framework only in ways that will maintain the resilience of smaller banks and building societies. Simplicity should not be at the expense of safety and soundness of individual firms, nor should it undermine financial stability. This is why we refer to a 'strong and simple' prudential framework.

We also want to avoid the inadvertent creation of new barriers to growth. We want to implement a framework that supports a dynamic and diverse banking sector in the UK, in which successful banks and building societies can grow and less successful ones can contract and exit in an orderly fashion.

These trade-offs – between increasing simplicity, maintaining resilience, and avoiding further barriers to growth – are highlighted in the paper as different options for designing a strong and simple framework are discussed. The paper also builds on a number of recent PRA initiatives to support dynamism in the sectors we regulate, including the changes we have made to the prudential framework for credit unions and, most recently, our updated approach to supervising new and growing banks.

This paper aims to set out the different ways in which a strong and simple framework could be designed, because we want to engage widely and openly with stakeholders at an early stage rather than jumping straight to consulting on a single way forward.

We look forward to receiving your comments on the paper.

A handwritten signature in blue ink, appearing to read 'S. Woods', with a stylized flourish at the end.

Sam Woods

Deputy Governor, Prudential Regulation

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Executive summary

This Discussion Paper (DP) explores options for developing a simpler prudential framework for banks and building societies (hereafter ‘firms’) that are considered by the Prudential Regulation Authority (PRA) to be neither systemically important nor internationally active. The objective of this framework would be to maintain the resilience of those firms and of the UK financial sector while using simplified prudential regulation, thereby enabling a dynamic and diverse banking sector in the UK. The PRA therefore refers to it as the ‘strong and simple’ framework. Any changes to simplify prudential regulation for smaller firms should be balanced against the risk those changes may create barriers to growth, which could discourage or prevent smaller firms from becoming large enough to provide effective competitive challenge to larger firms. The intention is to develop a strong and simple framework that is fully consistent with the Basel Core Principles for Effective Banking Supervision,¹ but simpler than the Basel standards that apply to large and internationally active banks.

Since this would be a major change in prudential policy applying to banks and building societies in the UK, the PRA is seeking input first through this DP. The aim is to invite firms’ and other practitioners’ views on the various options, to help the PRA understand preferences and wider implications. Those comments will help as the PRA undertakes the detailed design work ahead of consultation and implementation of any proposals in the future.

Prudential regulation can exhibit a ‘complexity problem’ when the same requirements are applied to all firms. This problem exists if the costs of understanding, interpreting, and operationalising prudential requirements are higher relative to the associated public policy benefits for smaller firms than for larger firms. Public policy benefits here means the contributions that prudential requirements make to the safety and soundness of PRA-regulated firms. The complexity problem arises because there are economies of scale to understanding, interpreting, and operationalising prudential requirements, or because the factors driving smaller and larger firm distress are different, but the requirements have been designed with larger firms in mind. This problem could have adverse effects on PRA objectives because it could both reduce the resilience of small firms and diminish effective competition.

Steps to simplify prudential regulation would build on a number of recent PRA actions: for example, the simplified prudential regime for credit unions introduced in 2020² and the recent policy statement about the PRA’s approach to new and growing banks.³ It would also be consistent with the actions to simplify prudential regulation for small banks taken in other jurisdictions.

Given the diversity of sizes and business models of PRA-regulated firms that are not considered systemically important, it may not be possible to have one simple prudential regime that maintains the resilience of all those firms. The PRA’s long-term vision is of a strong and simple framework in which requirements expand and become more sophisticated as the size and/or complexity of firms increase. The PRA will also need to take into account the overall complexity of the strong and simple

¹ <https://www.bis.org/publ/bcbs230.pdf>.

² PRA Policy Statement (PS) 6/20 ‘Credit unions: review of the capital regime’, March 2020: <https://www.bankofengland.co.uk/prudential-regulation/publication/2019/credit-unions-review-of-the-capital-regime> and speech by Sam Woods, ‘Credit union meets robot’, October 2019: <https://www.bankofengland.co.uk/speech/2019/sam-woods-speech-at-mansion-house-london>.

³ PS8/21 ‘Non-systemic UK banks: The Prudential Regulation Authority’s approach to new and growing banks’, April 2021: <https://www.bankofengland.co.uk/prudential-regulation/publication/2020/new-and-growing-banks> and a speech by Sarah Breedon, ‘Climbing mountains safely’, July 2020: <https://www.bankofengland.co.uk/speech/2020/sarah-breedon-climbing-mountains-safely>.

framework. Many layers might make it harder for a firm to understand how prudential requirements would change, were it to grow or expand into new activities.

Developing a strong and simple framework along those lines would represent a significant shift in the design of prudential regulation of banks and building societies in the UK. For this reason, the PRA is considering starting by developing a simpler regime for the smallest firms; ie the firms that probably experience the complexity problem the most. Once proposals for this regime are developed, the PRA will look to build out the other layers of the strong and simple framework.

The PRA has identified options for determining which firms should be in scope of this first step of a strong and simple framework, including possible criteria based on geographical footprint, size, and activities and risk exposures. The criteria would be designed to identify those firms that are not internationally active and for which prudential regulation could be simplified without reducing their resilience. There could be a trade-off between the breadth of scope and the simplicity of this regime for the smallest firms: if the scope criteria were to exclude firms with activities and business models that bring risks that can only be captured adequately by complex prudential requirements (eg trading activity), requirements could be simplified to a greater extent. To reflect that small firms might have very different growth plans, an option would be to permit firms that meet the scope criteria to opt out of the simpler regime, where it would not suit them.

The PRA has considered the key options for determining the shape of prudential requirements under this first step of a strong and simple framework and identified two types of design approach that can be thought of as representing two ends of a spectrum. At one end is a 'streamlined' approach that takes the existing prudential framework as a starting point and modifies those elements that are over-complex for smaller firms. At the other is a 'focused' approach based on a much narrower but more conservatively calibrated set of prudential requirements. Each approach has advantages and disadvantages that will need to be weighed up when deciding whether the final simpler regime should be more streamlined or focused in approach. For example, a focused approach could go significantly further in simplifying prudential regulation, but it would probably reduce the risk-sensitivity and robustness of the regime and therefore need to be calibrated conservatively to maintain resilience and reflect any stronger risk-taking incentives arising under these requirements. Developing a more bespoke new regime for smaller firms would result in a greater disconnect between it and the prudential regime for larger firms, potentially increasing costs for those firms that wish to grow out of the simpler regime.

A fully focused approach to capital requirements could involve a simple standard capital requirement measure that is relatively risk insensitive but conservatively calibrated and setting a single micro-prudential buffer at the same level for all firms. Similarly, a fully focused approach could involve a single liquidity requirement, rather than the existing Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) requirements, again with conservative calibration. There may also be a need for supervisory judgement overlays to compensate for reduced risk-sensitivity of prudential requirements.

A fully streamlined approach would take the existing prudential framework as a starting point and modify those elements that appear over-complex for smaller firms – for example, elements that do not add significantly to overall resilience. For capital adequacy requirements, this might be achieved by simplifying the current Pillar 1 and Pillar 2A risk weighted capital requirements. Similarly, for liquidity requirements this could involve simplifying the LCR and NSFR requirements.

Some elements of the regime would need to apply equally under both approaches. There is evidence to demonstrate the importance of good governance in firms as a means of reducing likelihood of

firm failure,⁴ so there may be only limited scope for simplifying the existing prudential governance requirements. Similarly, operational resilience is as important for smaller as for larger firms. Proper recovery and resolution planning will continue to be expected and this paper contains a detailed box examining the importance of ‘ease of exit’ and the potential benefits of solvent wind down planning.⁵

This paper also discusses whether there may be scope to reduce mandatory prudential disclosures, such as under Pillar 3: the PRA is seeking views from users of those disclosures as well as the firms making them. The Bank of England’s (the Bank’s) recently published plan to transform regulatory data collection⁶ may be particularly beneficial for the smaller firms likely to be in scope of the simpler regime. Only once the overall shape of the simpler regime is clearer will the PRA be able to consider the implications for reporting requirements in full.

There are a number of operational considerations for the simpler regime that will need to be factored in. These include options for moving efficiently from the new simpler regime to one applying to larger firms, and vice versa, with an objective of avoiding abrupt and unpredictable changes in requirements while ensuring that material prudential risks remain fully addressed. More generally, recognising that frequent changes to a regulatory regime tend particularly to amplify compliance costs for smaller firms, the PRA has identified some options for minimising those costs, including by adopting a more predictable pattern of simpler regime updates.

Looking forward, the PRA’s ambition is to extend the strong and simple framework to larger, but still non-systemic domestic firms. There is a further trade-off to be made between the number of layers and the scale of change for firms that moving between layers of the framework would involve. Smaller steps could reduce barriers to growth, but only by spreading out changes over time; and having a higher number of layers would make the overall framework more complex for both firms and supervisors.

While this strong and simple framework is being developed, prudential regulation is still evolving, for example through the implementation of the finalised Basel reforms. In designing and implementing the simpler regime, the PRA’s aim is consider how those reforms can be introduced in a suitable way for small firms, and to minimise as far as possible the number of times prudential regulatory rules change for small firms. The framework will also need to reflect the outcomes of the Bank’s review of its approach to setting minimum requirements for own funds and eligible liabilities (MREL)⁷ and the Financial Policy Committee (FPC) and Prudential Regulation Committee’s (PRC) review of the UK leverage framework.⁸ The PRA will need to have in place the powers to implement such a simpler regime. The Financial Services Future Regulatory Framework, with its proposed delegation of additional rulemaking responsibilities to the PRA, that HM Treasury has recently consulted on would

⁴ See Box B.

⁵ See Box E.

⁶ <https://www.bankofengland.co.uk/paper/2021/transforming-data-collection-from-the-uk-financial-sector-a-plan-for-2021-and-beyond>.

⁷ Bank of England Discussion Paper ‘The Bank of England’s review of its approach to setting a minimum requirement for own funds and eligible liabilities (MREL)’, December 2020: <https://www.bankofengland.co.uk/paper/2020/boes-review-of-its-approach-to-setting-mrel>.

⁸ Bank of England Financial Stability Report, December 2019: <https://www.bankofengland.co.uk/financial-stability-report/2019/december-2019> and HM Treasury/Bank of England/PRA/Financial Conduct Authority, ‘Regulatory Initiatives Grid’, September 2020: <https://www.fca.org.uk/publication/corporate/regulatory-intitatives-grid-september-2020.pdf>.

allow the PRA to implement the simpler regime (and the strong and simple framework more broadly).⁹

The PRA welcomes comments on this DP, including answers to the questions laid out in it. Those comments, and other views that the PRA obtains as a result of interaction with PRA-regulated firms, trade bodies, and other stakeholders during the commenting period, will help the PRA consider how best to design and implement a strong and simple prudential framework. After the end of the period for receiving comments, the PRA plans to publish a summary of the comments received, in an anonymised way, to stimulate further debate.

As explained, the PRA is currently considering building the strong and simple framework by starting with a simpler regime for the smallest firms, and the next step would be to publish a consultation paper. This would set out the proposed prudential rules for defining whether a firm is in scope of the simpler regime (ie the scope criteria) and the proposed requirements under this regime. Design and implementation is likely to take a number of years to complete.

⁹ HM Treasury Consultation 'Financial Services Future Regulatory Framework Review Phase II Consultation', October 2020: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/927316/141020_Final_Phase_II_Condoc_For_Publication_for_print.pdf.

1 Introduction

1.1 The PRA is considering the appropriate prudential framework for smaller PRA-regulated banks and building societies ('firms') that are neither systemically important nor internationally active, with the intent to maintain their resilience while simplifying prudential regulation of those firms and supporting those among them wishing to grow.

1.2 This paper outlines the reasons why the prudential framework at present may be overly complex for smaller firms, and the implications of this for the PRA's objectives. It outlines a vision for how the prudential framework in the UK could be changed to mitigate the complexity problem while maintaining resilience and not creating further barriers to growth, and focuses on options for simplifying prudential regulation for the smallest firms.

1.3 This paper is about the prudential framework for banks and building societies only. A review of the Solvency II prudential regime for insurers is currently being carried out by the UK government. It is possible that review will include consideration of whether there is scope to simplify to some extent requirements for small insurers. That question would be addressed as part of the Solvency II review once responses to the call for evidence have been considered.

1.4 Simplifying prudential requirements must not come at the expense of PRA-regulated firms' resilience, nor broader financial stability in the UK. The policy options discussed in this paper are intended to lessen complexity in the existing prudential framework while maintaining resilience. This is why the long-term vision for prudential regulation of non-systemic firms is referred to here as a 'strong and simple' prudential framework.

1.5 Since this is a new direction for prudential policy in the UK, the PRA is seeking input first through this DP. In particular, the PRA would like stakeholders' views on the rationale for, and the shape of a strong and simple framework as considered in this paper. Those comments will help as the PRA undertakes the detailed design work ahead of consultation and implementation of any proposals in the future. To help structure comments, there are a series of questions throughout the paper.

1.6 While the strong and simple framework represents a new direction for prudential policy, it builds on a number of recent PRA actions. A simplified prudential regime for credit unions in the UK was introduced by the PRA in 2020, setting robust prudential requirements proportionate to their business models and activities.¹⁰ The PRA has introduced revisions to the Pillar 2 framework to address concerns about the higher risk weights for some lower risk assets under the standardised approach compared with internal ratings based approach. This supports smaller firms that are more likely to use the standardised approach.¹¹ The PRA has also recently finalised its approach to new and growing banks, which is designed to help these firms understand how and why PRA expectations increase as they grow and mature, as well as introducing a revised approach to setting PRA capital buffers for these firms in their first five years of existence.¹² This supports a diverse and resilient banking system in the UK. The FPC and PRC are also reviewing the UK's leverage ratio framework in

¹⁰ PS6/20 'Credit unions: review of the capital regime', March 2020: <https://www.bankofengland.co.uk/prudential-regulation/publication/2019/credit-unions-review-of-the-capital-regime> and a speech by Sam Woods, 'Credit union meets robot', October 2019: <https://www.bankofengland.co.uk/speech/2019/sam-woods-speech-at-mansion-house-london>.

¹¹ PS22/17 'Refining the PRA's Pillar 2A capital framework', October 2017: <https://www.bankofengland.co.uk/prudential-regulation/publication/2017/refining-the-pra-pillar-2a-capital-framework>.

¹² PS8/21 'Non-systemic UK banks: The Prudential Regulation Authority's approach to new and growing banks', April 2021: <https://www.bankofengland.co.uk/prudential-regulation/publication/2020/new-and-growing-banks> and a speech by Sarah Breedon, 'Climbing mountains safely', July 2020: <https://www.bankofengland.co.uk/speech/2020/sarah-breedon-climbing-mountains-safely>.

light of revised international standards¹³ (which could have implications for the prudential framework for non-systemic banks and building societies) and the Bank is reviewing its approach to setting MREL (which could have implications for mid-tier banks and building societies).¹⁴

1.7 The framework is also consistent with the direction in which prudential regulation is developing globally. A number of jurisdictions have recently designed prudential regimes for small banks.¹⁵ The latest generation of banking regulation in the European Union has incorporated enhanced measures to simplify prudential requirements for small and non-complex credit institutions.¹⁶ In developing ways to simplify UK prudential regulation of smaller firms, the PRA will seek to remain consistent with the Basel Core Principles for Effective Banking Supervision.¹⁷

Discussion paper structure

1.8 **Chapter 2** describes the existing prudential framework for small, non-systemic banks and building societies in the UK. It explains why the existing framework may be overly complex for these firms, and sets out the possible consequences of this for the PRA's objectives. It also highlights the risk that simplifying requirements could increase barriers to growth. The approaches to regulating small banks in several other jurisdictions are also described.

1.9 **Chapter 3** introduces a long-term vision for a strong and simple prudential framework for non-systemic firms in the UK. It then explains how the PRA could realise this vision over time, starting with the introduction of a materially simpler prudential regime for the smallest banks and building societies.

1.10 **Chapter 4** discusses options for how the simpler regime for these smallest firms could be designed. It discusses how firms in scope of the regime could be determined, possible prudential requirements under the regime, how the regime, once it is in place, might evolve over time, and arrangements for how firms could transition out of it.

1.11 **Chapter 5** discusses measures that might lower barriers to growth faced by non-systemic firms other than those operating under the simpler regime described in the previous chapter and the trade-offs involved. These are measures the PRA could consider as it builds out the strong and simple framework to cover a wider set of non-systemic firms.

1.12 **Chapter 6** discusses how the PRA could go about developing and implementing a strong and simple prudential framework for non-systemic firms in the UK.

1.13 **Chapter 7** summarises the key ideas in the paper.

1.14 **Chapter 8** collects together the questions set out in the paper.

¹³ See Bank of England Financial Stability Report, December 2019: <https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/2019/december-2019.pdf> and HM Treasury/Bank of England/PRA/Financial Conduct Authority, 'Regulatory Initiatives Grid', September 2020: <https://www.fca.org.uk/publication/corporate/regulatory-intitatives-grid-september-2020.pdf>.

¹⁴ See Bank of England Discussion Paper 'The Bank of England's review of its approach to setting a minimum requirement for own funds and eligible liabilities (MREL)', December 2020: <https://www.bankofengland.co.uk/-/media/boe/files/paper/2020/boes-review-of-its-approach-to-setting-mrel.pdf?la=en&hash=E91E4A0380DE04A1EA5F1AB678EE8006041A344D>.

¹⁵ See Box A below.

¹⁶ For an overview of how simplicity is achieved in prudential regulation in the European Union see the speech by Kerstin af Jochnick, 'Striking a balance: proportionality in European banking regulation and supervision', November 2019: https://www.bankingsupervision.europa.eu/press/speeches/date/2019/html/ssm.sp191112_2~7c13940c3b.en.html.

¹⁷ See Box C below.

2 The existing prudential framework for small banks and building societies

This chapter describes the existing prudential framework for small, non-systemic banks and building societies in the UK. It outlines the reasons why the framework may be overly complex for these firms and the possible consequences for PRA objectives.

The existing prudential approach

2.1 Under the existing set of PRA rules and the legislation that apply to PRA-regulated firms, core regulatory requirements are broadly the same for all firms.¹⁸ This approach reflects the evolution of prudential regulation over the past forty or so years.¹⁹ The Basel Framework sets out minimum global standards for prudential regulation that have been designed with internationally active banks in mind; these banks tend to be larger and more complex than smaller domestic-focused banks. In many jurisdictions, policymakers apply Basel-based requirements to large and internationally active banks, but simpler prudential requirements to smaller banks (Box A). The existing UK approach, which is based on the approach adopted in the European Union, broadly applies the same prudential requirements to all firms, irrespective of their size or activities, while simplifying certain prudential rules for small and non-complex credit institutions. As a result, while the UK's existing approach does allow certain prudential rules to be made simpler for smaller and less complex firms, it does this to a lesser extent than the approaches taken in some other jurisdictions.

The complexity problem

2.2 Applying the same prudential requirements to all firms can give rise to a 'complexity problem'.²⁰ This problem exists if costs to firms of understanding, interpreting, and operationalising a prudential requirement, or set of requirements, are higher relative to the associated public policy benefits for smaller firms than for larger firms.

2.3 One of the costs of setting a prudential requirement is that firms must spend resources to understand the requirement, interpret what it means for their businesses, and implement the requirement so that they operate in accordance with it. For example, operationalising a requirement might necessitate a firm maintaining internal systems so it knows that it is satisfying it.

2.4 Public policy benefits here mean the contributions that a requirement (or set of requirements) makes to the safety and soundness of PRA-regulated firms and the stability of the financial system in the UK. In other words, the contributions a requirement makes to the PRA meeting its general objectives. For example, a public policy benefit of a capital requirement is the resilience of PRA-regulated firms.²¹

¹⁸ Although when a firm becomes systemically important, prudential requirements increase to reflect the bigger impact its distress could have on financial stability. For how capital buffer requirements increase for systemically important banks, see Chart D.2 in Bank of England Financial Stability Report, December 2019: <https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/2019/december-2019.pdf>.

¹⁹ Goodhart, C (2011), *The Basel Committee on Banking Supervision: a history of the early years 1974-1997*, Cambridge University Press.

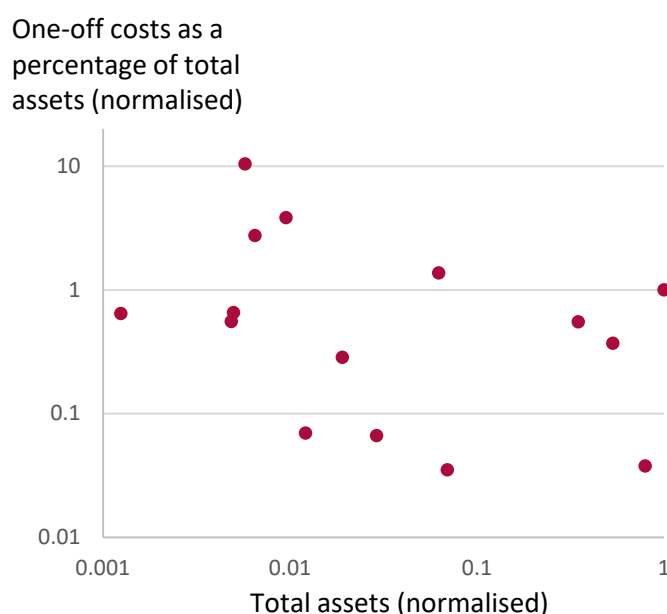
²⁰ This was referred to as a 'proportionality problem' in the speech by Sam Woods, 'Strong and Simple', November 2020: <https://www.bankofengland.co.uk/speech/2020/sam-woods-city-banquet>. Complexity problem is an equally accurate description of the problem set out here and in the speech.

²¹ On the role of capital requirements to ensure the resilience of banks and building societies, see Farag, M, Harland, D, and Nixon, D (2013), 'Bank capital and liquidity', *Bank of England Quarterly Bulletin*, 2013 Q3.

2.5 One reason for the complexity problem is that there is a fixed component to the costs of understanding, interpreting, and operationalising prudential requirements, which means that the average (or per-unit) costs are higher for smaller firms. In other words, there are economies of scale to understanding, interpreting, and operationalising prudential regulation (eg see Chart 1).²² This means it is possible that the costs associated with a requirement are higher relative to the public policy benefits for smaller firms than for larger firms.

2.6 Another potential reason is the public policy benefits of a prudential requirement might be relatively lower for smaller firms because the risk factors driving smaller and larger firm distress are different, but the requirement has been designed with larger firms' risk factors in mind. There is empirical evidence for this (Box B).

Chart 1: Comparison of average compliance costs with size (a)(b)(c)(d)



Source: Bank of England; Bank calculations

(a) The data were collected as part of a survey conducted for PRA Consultation Paper 5/13 'Strengthening capital standards: implementing CRD IV', August 2013: <https://www.bankofengland.co.uk/prudential-regulation/publication/2013/strengthening-capital-standards-implementing-crd-4>. The survey asked PRA-regulated firms for 'best efforts' estimates of the one-off and ongoing costs of complying with COREP and FINREP reporting requirements. Table 15.G in the consultation paper reports the estimated costs in aggregate for different sets of firms.

(b) This chart uses the data of one-off costs reported by small and mid-tier UK banks and building societies. One-off costs included costs associated with staff training, IT systems, and senior management time.

(c) The y-axis shows the ratio of one-off costs to total assets at the end of 2013 divided by the largest firm's corresponding ratio, shown in log-scale.

(d) The x-axis shows total assets divided by the total assets of the largest firm, shown in log-scale.

2.7 The complexity problem could be mitigated by changing prudential requirements to achieve the current level of resilience in simpler ways. Simplifying requirements would lower the costs of

²² See: Dahl, D, Meyer, A, and Neeley, M (2016), 'Bank size, compliance costs and compliance performance in community banking', *Mimeo*; Dolar, B and Dale, B (2020), 'The Dodd-Frank Act's non-uniform regulatory impact on the banking industry', *Journal of Banking Regulation*, Vol.21, pages 188-95; Elliehausen (1998), 'The cost of banking regulation: a review of the evidence', *Federal Reserve System Studies No.171*, pages 1-35; Feldman, R J, Schmidt, J, and Heinecke, K (2013), 'Quantifying the costs of additional regulation on community banking', *Federal Reserve Bank of Minneapolis Economic Policy Paper 13-3*.

understanding, interpreting, and operationalising prudential requirements (offsetting the scale economies effect) and reflect the specific risks smaller firms face.

Barriers to growth problem

2.8 Simplifying prudential regulation for smaller firms however risks adding to a ‘barriers to growth problem’. If prudential regulation is made less complex for smaller firms, by having different requirements for them compared with larger firms, a small firm wishing to become a large firm will need to adjust to a change in prudential requirements as it grows. The costs of this change may deter small firms from growing. Thus, there could be a trade-off between the two problems, if regulatory actions to make the prudential framework simpler for smaller firms create new and higher barriers for small firms wanting to grow.²³

Consequences for PRA objectives

2.9 The complexity problem could have adverse effects on PRA objectives. This could potentially happen via a number of different channels (Figure 1). For example, the higher average costs small firms might face due to the complexity problem could reduce their earnings, which might induce some small firms to increase their risk taking, thereby reducing their safety and soundness.²⁴ Compressed earnings could also deter new entrants, which could impede the PRA’s secondary competition objective. Changes that simplify the prudential framework for small firms could weaken these channels and hence be public policy beneficial.

2.10 Those benefits would need to be set against the consequences of any increase in barriers to growth that result from actions to make the prudential framework simpler for smaller firms (Figure 2). Deterring small firms from growing could reduce competition, which might make firms less efficient,²⁵ reducing their profits and hence making them less resilient in the long run. Barriers to growth could also prevent small firms from substituting for a large firm that gets into distress, which could increase the economic impact of large firms getting into distress.

2.11 The next chapter sets out a vision for how the prudential framework for non-systemic banks and building societies could be transformed to realise the public policy benefits of greater simplicity, while seeking to minimise any costs due to barriers to growth.

²³ The existing prudential framework might already generate some barriers to growth, as discussed in a speech by Sam Woods, ‘Credit union meets robot’, October 2019: <https://www.bankofengland.co.uk/speech/2019/sam-woods-speech-at-mansion-house-london>.

²⁴ Kim, R (2019), ‘Disproportionate costs of uncertainty: small bank hedging and Dodd-Frank’, *Mimeo*.

²⁵ Fisher, P and Grout, P A (2017), ‘Competition and prudential regulation’, *Bank of England Staff Working Paper No.675*.

Figure 1: Potential effects of the complexity problem

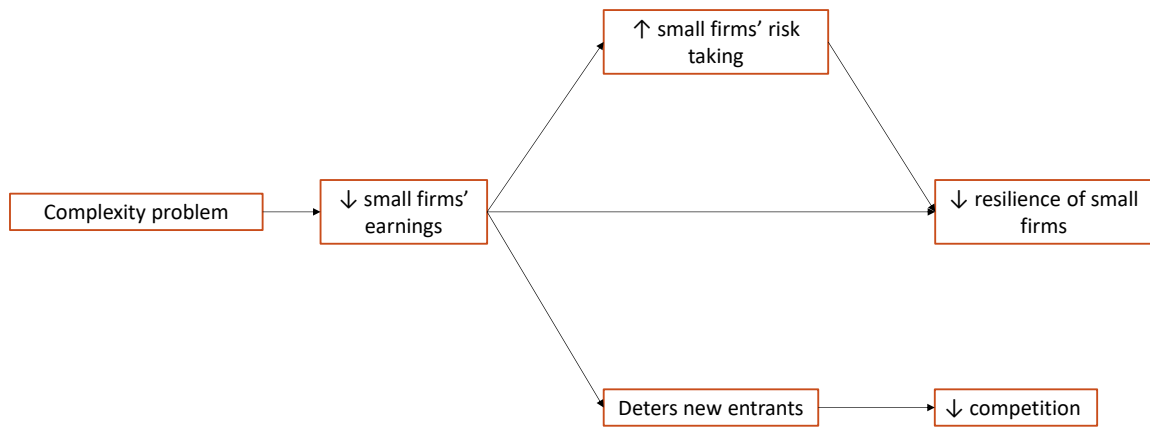
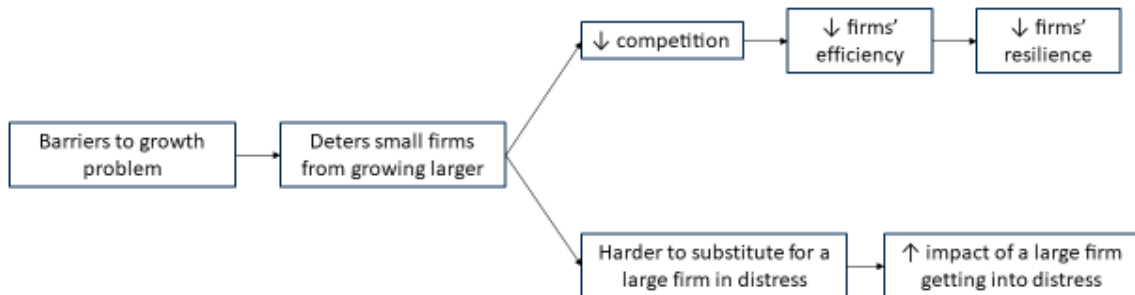


Figure 2: Potential effects of the barrier to growth problem



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

Box A: Prudential regulation of small banks in other jurisdictions

It is common for jurisdictions to incorporate proportionality measures into their prudential frameworks such as simplifying prudential requirements for a subset of banks (typically small and non-systemic banks). A majority of the jurisdictions that participated in a 2018 survey of proportionality practices by the Basel Committee on Banking Supervision indicated that they had proportionality measures in place.²⁶

This box focuses on the approaches taken in four jurisdictions (Australia, Canada, Switzerland, and the United States). These jurisdictions have recently introduced tailored prudential frameworks for their banking sectors. These frameworks have been motivated by a desire to reduce the burden associated with prudential regulation while maintaining the resilience of small banks²⁷ or to reflect how risks to small banks' resilience can be captured by simpler regulatory metrics given small banks have simpler balance sheets.²⁸

The precise approaches to simplifying prudential framework differ considerably across these jurisdictions, in terms of the types of firm that are subject to simpler prudential regulation and/or the types of prudential requirements that are simplified.

Table A summarises the main characteristics used to identify banks subject to simpler prudential requirements. There are differences in the metrics used by these jurisdictions to identify firms in scope of simpler requirements, although all of them use total assets as one of the metrics. Another difference is whether jurisdictions make a binary distinction between small and large banks or adopt a graduated regime in which regulatory requirements that banks face intensify and become more complex as they grow and/or undertake activities that are more complex. Australia and Switzerland follow the first approach, and Canada and the United States the second approach.

Table B outlines how these four jurisdictions have made prudential requirements simpler. There are significant differences across the jurisdictions. While Australia does not simplify requirements for liquidity, risk management and governance, Switzerland allows its smallest banks to be exempted from the NSFR and to benefit from reduced disclosure and risk management obligations. Canada and the United States, which both use a graduated regime, also make different choices regarding how to adjust prudential requirements to achieve greater simplicity. Where jurisdictions have exempted small banks from some requirements, they have at times calibrated the remaining requirements at relatively conservative levels. For example, Switzerland applies a simplified leverage ratio of at least 8%.

²⁶ See <https://www.bis.org/bcbs/publ/d460.pdf>.

²⁷ In the case of Switzerland, see a speech by Mark Branson, 'Innovative regulations for a diverse financial services industry', October 2017: <https://www.finma.ch/en/~media/finma/dokumente/dokumentencenter/myfinma/finma-publikationen/referate-und-artikel/20171002-rf-kleinbankensymposium-bnm.pdf?la=en>. In the case of Australia, see https://www.apra.gov.au/sites/default/files/response_to_submissions_-_revisions_to_the_capital_framework_for_adis_0.pdf.

²⁸ See <https://www.osfi-bsif.gc.ca/Eng/fi-if/rg-ro/gdn-ort/gl-ld/Pages/SMSB.aspx>

Table A: Determinants of which banks are in scope of simpler prudential requirements in four jurisdictions

	Scope metrics	Graduated regime
Australia ^(a)	Total assets; Trading activities Level of non-centrally cleared derivative exposures Provision of purchased payment facilities ^(b) ; Offshore funding	No
Canada ^(c)	Total assets Total loans	Yes
Switzerland ^(d)	Total assets; Assets under management Privileged deposits ^(e)	No
United States ^(f)	Total assets; Off balance sheet exposure Short-term wholesale funding Cross-jurisdictional activity; Non-bank assets	Yes

(a) See chapter 6 of https://www.apra.gov.au/sites/default/files/response_to_submissions_-_revisions_to_the_capital_framework_for_adis_0.pdf. A purchased payment facility is a facility under which a holder of stored value (ie an authorised deposit-taking institution) makes payment to another person on behalf of the user of the facility; see <https://www.apra.gov.au/licensing-guidelines-for-authorised-deposit-taking-institutions>.

(c) See <https://www.osfi-bsif.gc.ca/Eng/fi-if/rg-ro/gdn-ort/gl-ld/Pages/SMSB.aspx> published in March 2021 by the Office of the Superintendent of Financial Institutions (OSFI).

(d) See <https://www.finma.ch/en/supervision/banks-and-securities-firms/kleinbankenregime/>.

(e) Deposits totalling CHF 100,000 per client – the threshold of the Depositor Protection Scheme – are regarded as privileged deposits.

(f) See <https://www.federalreserve.gov/aboutthefed/boardmeetings/files/tailoring-rule-visual-20191010.pdf> and <https://www.fdic.gov/news/financial-institution-letters/2019/fil19066.html>.

Table B: Measures to make prudential requirements simpler for small banks in four jurisdictions^(a)

	Capital	Liquidity	Disclosure/ Reporting	Risk management control
Australia	<ul style="list-style-type: none"> • Simplified capital requirements for operational risk: flat rate capital add-on of 10% of risk-weighted assets (RWAs) • Exemption from capital requirements for counterparty credit risk • Exemption from a leverage ratio requirement 		<ul style="list-style-type: none"> • Reduced disclosure requirement 	
Canada	<ul style="list-style-type: none"> • A gradually simplifying approach for calculating capital requirements for credit risk and operational risk approaches • Smallest banks subject to a simplified risk-based total regulatory capital requirement of 10.5% 	<ul style="list-style-type: none"> • Smallest banks exempted from the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) but subject to a simpler liquidity requirement 		
Switzerland	<ul style="list-style-type: none"> • Exemption from risk-weighted capital requirements • No capital buffer and sectoral countercyclical capital buffer requirements • Simplified leverage ratio of at least 8% 	<ul style="list-style-type: none"> • Average (12 month) LCR of at least 110% • Exemption from the NSFR 	<ul style="list-style-type: none"> • Reduced disclosure obligations 	<ul style="list-style-type: none"> • Reduced risk control requirements. • Lower frequency of comprehensive risk assessment by internal audit
United States	<ul style="list-style-type: none"> • A gradually simplifying risk-based capital requirement • Exemption from the countercyclical capital buffer • Smallest banks subject to a leverage ratio^(b) of 9% and exempted from other capital requirements 	<ul style="list-style-type: none"> • Gradual introduction and increase in the LCR and NSFR. 		<ul style="list-style-type: none"> • Reduced frequency of company-run and supervisory stress testing
(a) See notes for Table A.				
(b) The definition of this leverage ratio is specific to this regime. It is not the definition of the leverage ratio in the Basel standards.				

Box B: Drivers of distress in small and large banks

To help assess the need for setting different prudential requirements for small banks and building societies, the PRA has tested how well some of the metrics in the existing prudential framework would have performed if they had been used in 2007 – that is, prior to the Global Financial Crisis – to identify large and small firms at risk of becoming distressed. This analysis uses a technique from previous Bank research that found using combinations of regulatory constraints based on the Basel standards could provide an efficient signal of distress.²⁹ The PRA has extended this analysis by testing whether the strength of this signal differs for large and for small firms.³⁰

Regulatory data from 2007 for 118 UK-focused banks and building societies were used. For each firm, its leverage ratio, risk weighted capital ratio, and an estimate of what its net stable funding ratio would have been were calculated (based on information about its assets and liabilities).³¹ The analysis identified which of these firms subsequently became distressed using six different measures. These were derived from a combination of supervisors' risk assessments at the time and our judgement about which firms would have defaulted in the absence of government support or mergers undertaken under stressed conditions.³² Using six different definitions allows one to test how sensitive the results are to choices about how to define distress.

The analysis made predictions by applying minimum thresholds set for each of the leverage, risk weighted capital, and net stable funding ratios. Distress is predicted for any firm that in 2007 would have failed to meet at least one of the thresholds being tested. When these thresholds are applied to the sample, good predictions yield high 'hit rates' (ie they correctly identify firms which became distressed) and low 'false alarm' rates (ie they do not incorrectly predict distress for firms which did not become distressed). The thresholds can be calibrated to target a specified hit rate (eg 75%, which would mean that three quarters of distressed firms are correctly identified). Having set this target, the combination of thresholds is found that achieves the targeted hit rate while producing the lowest possible false alarm rate. The analysis made predictions using all three ratios to target every possible hit rate. This included using each ratio on its own, using the three possible pairs of ratios, and using all three ratios at the same time. This allowed the analysis to map all the pairs of hit rates and minimum false alarm rates that could be achieved using the three ratios.

This exercise was undertaken for samples of small firms and samples of large firms. A small firm was defined as one with total assets of no more than £1 billion or, alternatively, as one with total assets of no more than £5 billion. The analysis found that when either size threshold is used alongside each of the six definitions of distress, the distribution of false alarm rates for large firms is different from that for small firms (Chart A). When hit rates of over 50% are achieved (that is to say, when a majority of the distressed firms are correctly identified), false alarm rates tend to be lower for large firms. These findings therefore suggest that the regulatory ratios used in this analysis are better suited to predicting distress for large firms than for small ones.

²⁹ See Aikman, D, Haldane, A G, Hinterschweiger, M, and Kapadia, S (2018), 'Rethinking financial stability', *Bank of England Staff Working Paper No.712* and Buckman, M, Gallego Marquez, P, Gimpelewicz, M, Kapadia, S, and Rismanchi, K (2021), 'The more the merrier? Evidence from the global financial crisis on the value of multiple requirements in bank regulation', *Bank of England Staff Working Paper No.905*.

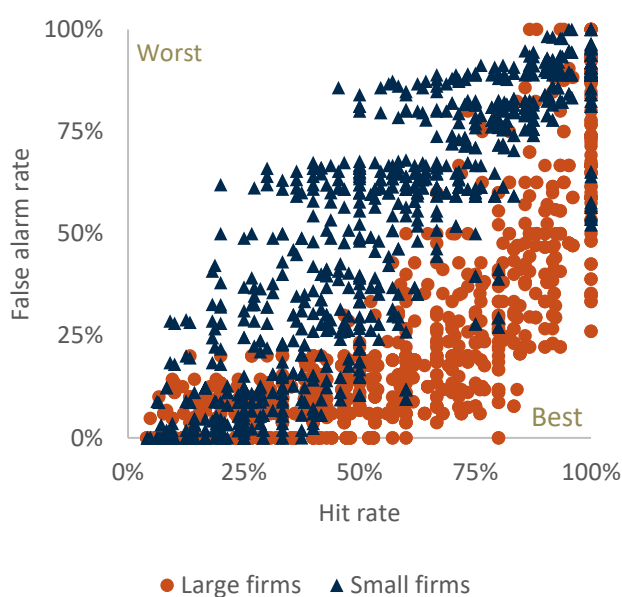
³⁰ See Saunders, A and Willison, M (2021), 'Measure for measure: evidence on the relative performance of regulatory requirements for small and large banks', *Bank of England Staff Working Paper*, Forthcoming.

³¹ Balance sheet data are from historical regulatory returns (see de-Ramon, S J A, Francis, W B, and Milonas, K (2017), 'An overview of the UK banking sector since the Basel Accord: insights from a new regulatory database', *Bank of England Staff Working Paper No.652*).

³² Data on supervisory ratings are from historic FSA records (see Suss, J and Treitel, H (2019), 'Predicting bank distress in the UK with machine learning', *Bank of England Staff Working Paper No.831*). Our six definitions of distress are: definition 1 = receiving the worst possible supervisory risk rating at any time between 2007 and 2008; definition 2 = any instance of default, receipt of state aid, or merger with or acquisition by another firm under stressed conditions during the same period; definition 3 = meeting either of the first two conditions; definitions 4 to 6 are the same as 1 to 3, but for the period between 2007 and 2009.

It is possible that other measures rather than the three regulatory ratios used in this analysis could make better predictions for small firms. To test whether the quality of small firms' governance might be one such measure, the experiment was repeated having added supervisors' judgements about the quality of firms' governance as an additional metric (supervisors' judgements were recorded on a scale of one to 10, allowing the analysis to specify numeric thresholds). Adding judgements about governance reduced false alarm rates more often – and by more – for small firms than for large ones (Chart B). This does not mean that governance is not important for the resilience of large firms, but it does mean that, when added to other metrics, judgements about governance provide more predictive information about the vulnerability of small firms than they do about the vulnerability of large firms. Such judgements are, therefore, especially important to supervisors of small banks and building societies.

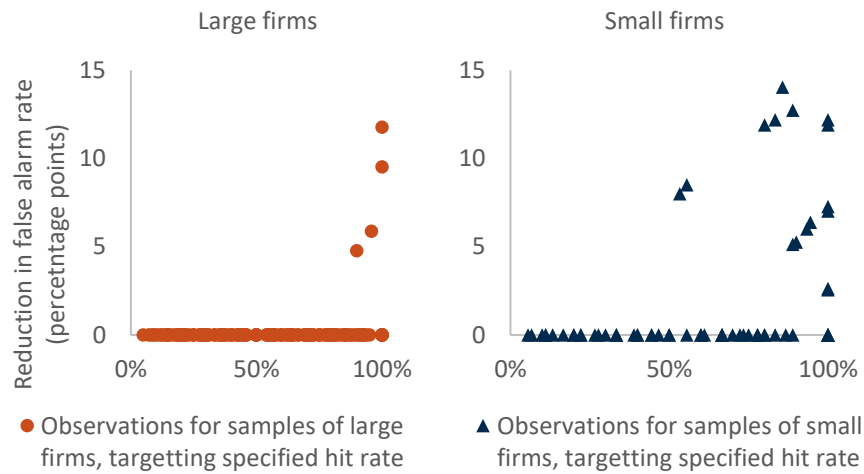
Chart A: Predicting distress using regulatory ratios



Source: Bank of England and Bank calculations.

Notes: For a description of the methodology, see Aikman, D, Haldane, A G, Hinterschweiger, M, and Kapadia, S (2018), 'Rethinking financial stability', *Bank of England Staff Working Paper No.712* and Buckman, M, Gallego Marquez, P, Gimpelewicz, M, Kapadia, S, and Rismanchi, K (2021), 'The more the merrier? Evidence from the global financial crisis on the value of multiple requirements in bank regulation', *Bank of England Staff Working Paper No.905*. Balance sheet data are from historical regulatory returns (see de-Ramon, S J A, Francis, W B, and Milonas, K (2017), 'An overview of the UK banking sector since the Basel Accord: insights from a new regulatory database', *Bank of England Staff Working Paper No.652*). Results are shown for two definitions of 'Large' (total assets over £1 billion and total assets over £5 billion), and using six definitions of distress: definition 1 = receiving the worst possible supervisory risk rating at any time between 2007 and 2008; definition 2 = any instance of default, receipt of state aid, or merger with or acquisition by another firm under stressed conditions during the same period; definition 3 = meeting either of the first two conditions; definitions 4 to 6 are the same as 1 to 3, but for the period between 2007 and 2009. Data on supervisory ratings are from historic FSA records (see Suss, J and Treitel, H (2019), 'Predicting bank distress in the UK with machine learning', *Bank of England Staff Working Paper No.831*).

Chart B: Improvements in performance after adding governance scores



Source: Bank of England and Bank calculations.

Notes: Balance sheet data are from historical regulatory returns, as of July 2007. Supervisors' scores for Governance are from historic FSA records (see Suss, J and Treitel, H (2019), 'Predicting bank distress in the UK with machine learning', *Bank of England Staff Working Paper No.831*). Each panel combines results obtained using two definitions of 'Large' (total assets over £1 billion and total assets over £5 billion), and using six definitions of distress: definition 1 = receiving the worst possible supervisory risk rating at any time between 2007 and 2008; definition 2 = any instance of default, receipt of state aid, or merger with or acquisition by another firm under stressed conditions during the same period; definition 3 = meeting either of the first two conditions; definitions 4 to 6 are the same as 1 to 3, but for the period between 2007 and 2009.

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

This chapter outlines a long-term vision for a strong and simple prudential framework for non-systemic firms in the UK and explains how the PRA could realise this vision over time.

A long-term vision

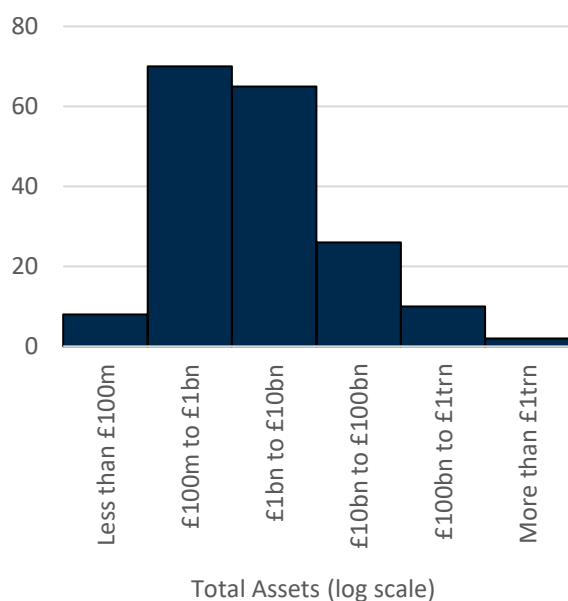
3.1 The PRA is considering moving over the long term to a prudential framework for non-systemic and non-internationally active firms that simplifies prudential regulation for these firms while maintaining their resilience and not increasing the barriers to growth these firms face. The overarching objective of this 'strong and simple' framework would be to enable a dynamic and diverse banking sector in the UK in which successful firms can grow as other less successful ones contract and exit, while maintaining the resilience of PRA-regulated firms. The framework should be flexible enough to accommodate different business models, including models that could emerge in the future. Such a framework should be designed so that it supports firms' safety and soundness, and hence supports UK financial stability, while also furthering the PRA's secondary competition objective.

3.2 A key principle for the design of the prudential framework for non-systemic and non-internationally active firms is that the UK continues to meet the Basel Core Principles for Effective Bank Supervision (Box C). Simplifying prudential requirements means that the framework could differ from the regulatory standards set out in the Basel standards in certain areas, but the UK would still comply with the Basel Framework because the PRA would continue to apply Basel standards to internationally active banks.

3.3 The set of PRA-regulated firms that are not considered systemically important is very diverse. In terms of size, the smallest firm has total assets of £17 million, while the largest firm not designated as an 'other systemically important institution' (O-SII) has assets of close to £90 billion. Most firms have total assets below £10 billion (Chart 2). These firms also differ in terms of the breadth and complexity of activities.

3.4 These facts suggest it is unlikely to be feasible to have a single set of strong and simple prudential rules applying to all non-systemic firms while maintaining their resilience. Given the range of activities of these firms, if there was only a single set of rules, it is unlikely those rules could be simplified significantly while also ensuring the resilience of all of those firms. Instead, it would seem more appropriate to have requirements that expand and become more sophisticated as the size and/or complexity of firms increase. That way, requirements would be aligned with the activities, and associated risks, firms undertake. When firms reach a certain size or begin undertaking a sufficient range of complex activities, the prudential requirements would converge on the requirements for large firms (including the full Basel standards). In other words, the strong and simple framework could eventually comprise a number of layered regimes.

3.5 While tethered to the Basel standards at one end, this graduated strong and simple framework would be anchored at the other end by a prudential regime for the smallest and least complex firms; these firms are the most likely to experience the complexity problem. This DP refers to this strong and simpler prudential regime for brevity as the 'simpler regime'.

Chart 2: Size distribution of PRA-regulated banks and building societies^(a)

Source: Bank of England and Bank calculations.

(a) The chart shows the distribution of total assets for all PRA-regulated deposit takers except credit unions. Data are from regulatory returns submitted in September 2020.

3.6 Figure 3 provides a stylised illustration of the possible overall strong and simple framework, with firms positioned according to their size and the complexity of their activities. A small and relatively non-complex firm, firm A, would be in scope of the simpler regime. Firm B, which is bigger, and firm C, which does more-complex activities, would not be in scope of the simpler regime, but would be in a higher layer of the strong and simple framework. Firm D is sufficiently large that it would be subject to the Basel standards.

3.7 As discussed above, having prudential requirements that change as firms grow larger or undertake more complex activities could create further barriers to growth. A strong and simple framework would therefore need to be designed so that requirements change gradually, without significant jumps, to reduce the risk of this happening. Nonetheless, in developing proposals for the framework, the PRA may need to make trade-offs between simplifying prudential regulation in a prudent ways and the number or height of ‘cliff edges’.

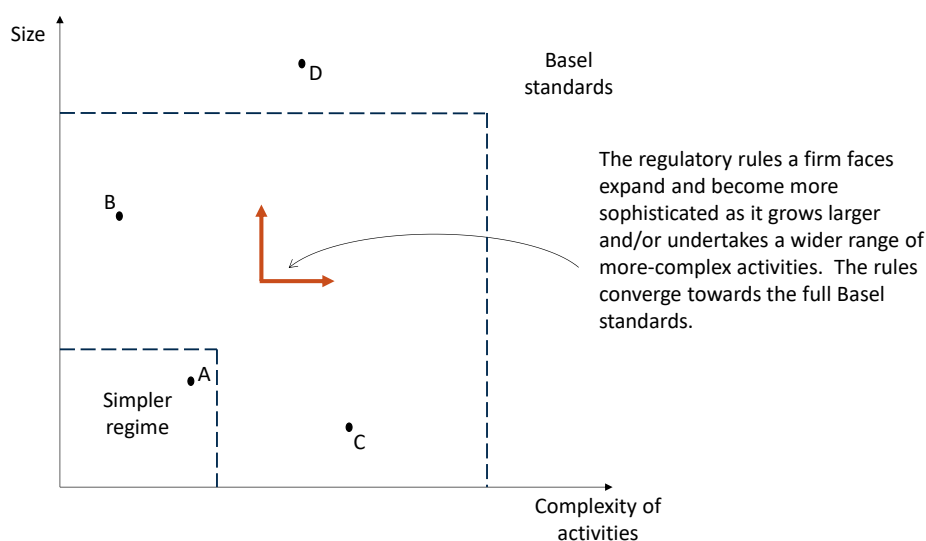
3.8 Another potential downside to this vision of a strong and simple prudential framework is that, taken as a whole, it might end up being more complex than the existing framework. While prudential requirements for an individual firm, especially a small firm, could be simpler, understanding the entire framework could become a more complicated task. This might make it harder for a firm to understand how prudential requirements would change were it to grow or expand into new activities, and this could act as a barrier to growth. A more complex overall framework could also make it less transparent to external stakeholders, inhibiting their ability to assess how well the PRA is fulfilling its mandate, and potentially undermining accountability

mechanisms in place.³³ This DP will return to these issues, and the issues highlighted in the previous paragraph, in Chapter 5.

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

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

Figure 3: Illustration of the long-term vision for a strong and simple prudential framework



The approach to implementing the vision

3.9 Developing the strong and simple prudential framework would represent a significant shift in the design of prudential regulation of firms in the UK. It would be a major undertaking, taking a number of years to develop and implement.

3.10 For this reason, the PRA is considering building the strong and simple framework by starting with the simpler regime for the smallest firms. Once proposals for the simpler regime have been developed, the PRA would look to begin work to build out the other layers of the strong and simple framework.

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

³³ On the importance of mandates and accountability mechanisms for prudential regulators, see a speech by Vicky Saporta, 'The ideal post-EU regulatory framework', March 2020: <https://www.bankofengland.co.uk/speech/2020/victoria-saporta-speech-at-international-business-and-diplomatic-exchange-london>.

Box C: The Basel Core Principles for Effective Banking Supervision

Basel Core Principles for Effective Banking Supervision (BCPs) are a voluntary framework of minimum global standards for sound supervisory practices of banks. The BCPs are comprised of 29 Core Principles and are accompanied by criteria against which jurisdictions' compliance are assessed. BCPs are used as a benchmark in evaluating the quality of countries' supervisory frameworks, for example by the International Monetary Fund (IMF) and the World Bank (WB) in their Financial Sector Assessment Program (FSAP) reviews.³⁴

BCPs are split into two broad categories: expectations towards supervisors and standards applied to banks.³⁵ 16 BCPs on bank standards set key principles for the prudential regulation of banks' capital and liquidity adequacy and risk management practices (including requirements on credit, market, concentration, interest rate, and operational risk). They also set out minimum standards for requirements on banks' corporate governance, internal and external audit, financial reporting, disclosures, and transparency. 13 BCPs on supervision cover areas such as supervisors' powers and responsibilities, resourcing, the legal/institutional framework in which they operate, and requirements for supervisory approaches and tools.

Unlike the Basel standards for prudential requirements, which apply to internationally active banks, BCPs are expected to be applied to the whole banking sector, including the smallest domestic-focused banks. To reflect the variety of jurisdictions and firms to which they apply, at the same time BCPs allow proportionality in their application in both banking supervision and regulation. The BCPs are designed so there is scope to implement a tailored regulatory framework for smaller firms in line with those firms' risk profiles and systemic importance. Therefore, there is scope for the PRA to simplify prudential regulation of small firms while remaining compliant with the BCPs.

Figure A: Illustration of the Basel Core Principles for Effective Banking Supervision



³⁴ <https://www.bis.org/publ/bcbs230.pdf>.

³⁵ The two areas are entitled 'Supervisory powers, responsibilities and functions' and 'Prudential regulations and requirements', respectively.

4 A simpler prudential regime for small banks and building societies

This chapter discusses options for how the simpler regime for the smallest banks and building societies could be designed. It discusses how firms in scope of the regime could be determined, prudential requirements under the regime, arrangements for how firms could transition out of it, and how the regime once it is in place might evolve over time.

Scope

4.1 The first key design choice is how to determine which firms should be in scope of the simpler regime. The basis for determining whether a firm is in scope would ideally be simple, objective, and transparent. This would help firms to understand whether they are in or out of scope of the simpler regime and to predict whether their business plans could alter their status. It would also help to explain to other stakeholders how the PRA has arrived at choices about which firms are subject to a simpler set of prudential requirements.

4.2 The simpler regime would be designed for small firms that are not internationally active, for which the complexity problem is pronounced, and with activities and business models such that their resilience could be assured under a relatively simple set of prudential rules. Objective criteria for determining whether a firm is in scope of the simpler regime should reflect these characteristics.³⁶

Defining domestic firms

4.3 As explained before, internationally active banks are subject to the Basel standards and hence cannot be in scope of a simpler regime that differs from those standards. The Basel Committee does not provide a definition of an internationally active bank. Instead, it gives national jurisdictions discretion to determine which of their banks are active across borders.³⁷ Thus, the PRA would need to develop its own criteria to identify domestic firms.

4.4 In designing these criteria, one could begin by identifying what types and magnitude of cross-border activity would imply that a firm is internationally active and hence should be subject to the Basel standards. A criterion for a PRA-regulated firm being domestic could be comprised of two components: a measure (or measures) of its activity outside of the UK; and an upper bound (or bounds) on those measures for a firm to be considered domestic.

4.5 International activity could be defined and measured from a 'balance sheet' perspective, using data on the location of a firm's assets or liabilities. Additionally, it could be defined and measured from a 'legal form' perspective, using information about the jurisdictions in which firms or their groups have banking subsidiaries or branches.³⁸ Designing any criteria will involve a number of

³⁶ Even if specified criteria could be used to determine whether a firm is in scope of the simpler regime, the PRA might want to reserve the power to exclude a firm from the regime if it considered it inappropriate for it to be in scope for reasons that the objective criteria do not pick up. The small banks regime in Australia has this feature (see https://www.apra.gov.au/sites/default/files/response_to_submissions_-_revisions_to_the_capital_framework_for_adis_0.pdf).

³⁷ Hohl, S, Sison, M C, Stastny, T, and Zamil, R (2018), 'The Basel framework in 100 jurisdictions: implementation status and proportionality practices', *Financial Stability Institute Insights on policy implementation No.11*. The Basel Committee also does not specify whether its standards are intended for internationally active groups or solo entities (although Basel standards apply at the group consolidated level, as well as at lower levels in the group, see https://www.bis.org/basel_framework/chapter/SCO/10.htm?inforce=20191215&published=20191215).

³⁸ For instance, to determine whether a bank can be subject to simplified prudential regulation, Japan defines a bank as internationally active if it has at least one branch or subsidiary abroad (Carvalho, A P C, Hohl, S, Raskopf, R, and Ruhmau, S (2017), 'Proportionality in banking regulation: a cross-country comparison', *Financial Stability Institute Insights on policy implementation No.1*).

technical definitional questions; it may be possible for the PRA to use existing definitions of cross-border activities (eg the definitions used in the international banking statistics collected by the Bank of England).³⁹ The PRA would also need to determine how any criteria would be applied to PRA-regulated solo entities versus groups.

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

Identifying the firms facing the complexity problem

4.6 Chapter 2 highlighted the types of firms for which the complexity problem is more pronounced and argued that smaller firms tend to face higher average costs of understanding, interpreting, and operationalising prudential regulation. Since the simpler regime is intended for those firms that experience the complexity problem most acutely, there could be a size criterion specifying that only firms of size £X or less can be in scope of the simpler regime, where X would cover the firms that experience the complexity problem most.

4.7 A definition of total assets might be the most straightforward size measure available.⁴⁰ Firms should be able to calculate it easily given its use for certain requirements or for reporting purposes. It would not treat firms differently depending on the composition of their balance sheets, but a total assets threshold could result in relatively large but non-complex firms being out of scope of the simpler regime. If it were deemed appropriate for those firms to be in scope, while excluding other firms of comparable asset size, a single criterion based on total assets would not be suitable. Possible alternative size criteria that could deal with those cases could include ones based on total assets minus high-quality liquid assets, or on total retail deposits.

Activities and risk exposures

4.8 In order to ensure the safety and soundness of PRA-regulated firms and support UK financial stability, prudential requirements must capture the risks to which firms are exposed and reflect the risks to the rest of the financial system and the wider economy posed by firms were they to get into distress. To achieve this for some of types of risk and activities, prudential rules, and related supervisory processes, will need to be longer and more complex. Thus, there could be a trade-off between the breadth of scope and the simplicity of a simpler regime. For instance, if small firms doing relatively complex activities were in scope, it could limit opportunities to simplify prudential rules while maintaining resilience of all firms in scope.

4.9 If the PRA chose to put more emphasis on simplification, one set of firms that might have to be placed out of scope would be those that use an internal model to determine Pillar 1 capital requirements. Under the internal ratings based (IRB) approach to credit risk, a firm goes through a process in which it must demonstrate the robustness of its models. A prudential regime that allows for internal modelling of requirements will be more complicated (see Table 1).

³⁹ See <https://www.bankofengland.co.uk/statistics/details/further-details-about-consolidated-worldwide-claims-data>.

⁴⁰ For instance, an accounting measure of total assets or the total exposure measure used to calculate the leverage ratio.

Table 1: Incremental impact of IRB on the complexity of the existing prudential framework ^(a)

	Increase when IRB-related parts are taken into account (%) ^(b)		
	Number of words	Number of unique words	Number of conditional words ^(d)
Prudential rules ^(c)	49	45	64
Technical standards ^(c)	152	79	184
Total	71	51	84

Source: Bank calculations.

(a) For details on the methodology used, see Amadjarif, Z, Brookes, J, Garbarino, N, Patel, R, and Walczak, E (2019), 'The language of rules: textual complexity in banking reforms', *Bank of England Staff Working Paper No.834*.

(b) The figure in the cell (Prudential rules, Number of words) shows the number of words in the parts of the rules related to the internal ratings based approach to credit risk expressed as a percentage of the number of words in the parts related to the standardised approach to credit risk. The figures in the other cells are defined analogously.

(c) Prudential rules refers to the Capital Requirements Regulation (CRR) as of 2013. Technical standards refers to the EBA technical standards that accompany the CRR. PRA supervisory statements and other guidance are not included in the sample. Also not included are the sections of the PRA Rulebook on fees, reporting, and ICAAPs.

(d) Conditional words are words that indicate a condition such as 'if', 'except', and 'unless'.

4.10 Another activity that is subject to relatively complex prudential requirements is trading. These requirements need to capture the range of financial instruments that banks might trade, different factors affecting the value of a position (eg specific market risk versus general market risk), and the nature of a position (eg residual maturity, whether it is short or long). The parts of the prudential rules and technical standards related to capital requirements for market risk contain 16% and 12% respectively of the unique and conditional words in all parts of the rules and standards related to capital requirements.⁴¹ Therefore, if the PRA wanted to emphasise simplification it might be appropriate for only firms with no or minimal trading books to be in scope of the simpler regime. This approach could also apply for firms that take positions for non-trading purposes in financial instruments that are more usually held in the trading book (eg derivative positions that are not for hedging purposes⁴²) or that have significant open foreign exchange positions.

4.11 Firms that undertake highly risky forms of business activity, eg, firms focused on lending to high-risk borrowers, may also have to be excluded if the regime is to be kept simple. If firms of this sort were in scope, prudential requirements under the regime would have to be designed to capture the particular risks to which they are exposed, which might make it harder to have a simple, standardised, approach to setting capital requirements for all small firms. This DP will return to this issue in the next section when discussing Pillar 1 and 2A capital requirements.

4.12 The inclusion of firms involved in the provision of certain types of service to the rest of the financial system or to the wider economy may also limit the extent to which prudential requirements could be simplified, eg providing clearing and settlement services to other financial firms. If a firm that is a key provider of such services were to get into distress, it could create spillovers to the rest of the financial system and wider economy. If not excluded, the simpler regime would need to incorporate more complex measures to control those risks.

⁴¹ Prudential rules refers to the Capital Requirements Regulation (CRR) as of 2013 and the technical standards to the EBA technical standards that accompany the CRR. See Amadjarif, Z, Brookes, J, Garbarino, N, Patel, R, and Walczak, E (2019), 'The language of rules: textual complexity in banking reforms', *Bank of England Staff Working Paper No.834* for details about the methodology used to derive these numbers.

⁴² Excluding those firms would be akin to restrictions found in building societies legislation (see section 9A of the Building Societies Act 1986) or the ring-fencing legislation (see Part 2 of The Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014).

4.13 Provision of ‘critical functions’⁴³ also affects the strategy for resolving a firm, were it to get into difficulties. Firms that are significant providers of critical functions are generally set a preferred bail-in resolution strategy. If the simpler regime was unsuitable for firms providing critical functions to the economy, maybe only firms that are capable of exiting the market in an orderly way, by way of a Bank or Building Society Insolvency Procedure (BIP/BSIP), should be in scope of the regime. More generally, ensuring firms can exit in an orderly way would support a dynamic and competitive banking sector (Box E).

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

Optionality

4.14 Small firms might have very different growth plans. A long-established small firm, with a mature business model, might plan to operate under the simpler regime for the long term. In contrast, a recent entrant intending to grow very quickly could prefer to operate under the prudential rules for larger banks, rather than spending a period operating under the simpler regime.

4.15 The PRA would not necessarily be able to identify the firms that are likely to want to grow rapidly. Given that, the simpler regime could incorporate a mechanism for firms to choose whether to operate under the simpler regime, even though they meet the scope criteria. This ‘optionality’ feature could be delivered by in-scope firms having to opt in to the simpler regime (eg by seeking approval from the PRA to be subject to those rules). Alternatively, firms in scope could opt out (eg by requesting a waiver).

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

Other issues

4.16 In applying the scope criteria, the PRA will have to choose how firms within wider groups will be treated. Firms could be assessed against the scope criteria for the simpler regime on a standalone entity basis or alternatively, where applicable, with the rest of the broader banking group to which they belong. The former approach might be simpler, but the complexity problem outlined above would not necessarily apply to small subsidiaries within a larger group, since these subsidiaries should be able to share the fixed cost of understanding, interpreting, and operationalising prudential rules with the rest of their groups, whereas standalone firms of comparable size cannot.

4.17 In addition to determining how the scope criteria would apply to groups, there will be a need to define at which consolidation levels within groups the prudential requirements under the simpler regime should apply. The PRA’s approach to groups is that firms must maintain appropriate financial resources to capture all of the risks that the group of which a firm is a member is exposed to, and that those resources are allocated within the group close to the risks to ensure all entities within a group can absorb losses and meet liabilities as they fall due.⁴⁴ Firms must meet prudential requirements for capital and liquidity on a consolidated basis to achieve the former and on an individual basis to achieve the latter. The PRA may want to consider whether there could be simpler ways to apply that approach to firms in scope of the simpler regime.

⁴³ Supervisory Statement (SS) 19/13 ‘Resolution planning’, June 2018: <https://www.bankofengland.co.uk/prudential-regulation/publication/2013/resolution-planning-ss>.

⁴⁴ PS9/18 ‘Groups policy and double leverage’, April 2018: <https://www.bankofengland.co.uk/prudential-regulation/publication/2017/groups-policy-and-double-leverage>.

4.18 Some UK subsidiaries of foreign banks might fall within the scope of the simpler regime as many have simple business models and are small. The following are key considerations that would have to be made to determine whether those entities should be able to operate under the simpler regime.

4.19 The first is the extent to which foreign bank subsidiaries are affected by the problems that the simpler regime is intended to mitigate. Similar to subsidiaries of groups headquartered in the UK, if a foreign bank's UK subsidiary is able to share the costs of understanding, interpreting, and operationalising prudential rules with the wider group, it may not suffer from the complexity problem in the way a standalone UK bank or building society of comparable size does. The PRA may need to take into account the size of the wider group to determine whether a foreign bank's UK subsidiary is likely to suffer from the complexity problem.

4.20 A second consideration is whether the simpler regime is consistent with controlling risks that foreign banks pose to PRA objectives. The PRA is open to hosting overseas firms where accompanied by financial and operational resilience.⁴⁵ This means that the PRA is open to foreign banks being active in the UK as long as those firms are resilient, controlled and governed appropriately, and the PRA has sufficient information about and influence over necessary supervisory outcomes through supervisory cooperation with the home authority.⁴⁶ The PRA would also ensure that its treatment of foreign banks under the simpler regime is consistent with the UK's commitments under international trade agreements.

4.21 Another important factor when setting the scope criteria will be any impact of the simpler regime on the risk of small firms being 'systemic as a herd'.⁴⁷ A group of small firms, each individually not systemically important, might be considered systemic as a herd if there would be widespread negative effects on the financial system and wider economy were they to fail simultaneously and the likelihood that they fail simultaneously is significant. Given the simpler regime would be designed to maintain small firms' resilience, the introduction of the regime might increase the systemic-as-a-herd risk if it increased the correlation between failures of in-scope firms. This could happen, for instance, if the simpler regime created incentives for in-scope firm to choose assets that are more similar, resulting in loss experience becoming more correlated. The systemic-as-a-herd risk could be reduced by choosing tighter scope criteria, so fewer firms were in scope (eg setting a low size criterion), or by designing the prudential requirements under the simpler regime in ways that would not cause firms to choose more-similar assets.

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

⁴⁵ PRA Consultation Paper 2/21 'International banks: the PRA's approach to branch and subsidiary supervision', January 2021: <https://www.bankofengland.co.uk/prudential-regulation/publication/2021/january/international-banks-branch-and-subsi-dary-supervision>.

⁴⁶ See a speech by David Bailey, 'Responsible openness: the PRA's approach to supervising banks', January 2021: <https://www.bankofengland.co.uk/speech/2021/january/david-bailey-boe-afb-afme-webinar-on-a-forthcoming-consultation>.

⁴⁷ For a definition of the concept of systemic as a herd see Adrian, T and Brunnermeier, M K (2016), 'CoVaR', *American Economic Review*, Vol.106(7), pages 1705-41.

Simpler prudential requirements

4.22 Given the objectives for a simpler regime set out in Chapter 2, the PRA has identified a number of key design choices that will be especially important for determining the shape of a simpler prudential regime. These are:

- how different the simpler regime should be from the existing prudential framework;
- the extent to which the resilience of small firms can be maintained with a standardised approach to determining capital requirements;
- what liquidity requirements should apply to small firms;
- whether regulatory-mandated disclosures contribute to the resilience of small firms; and
- what other requirements and expectations are necessary to ensure the resilience of small firms.

4.23 In the following sections, this DP expands on these key design choices, setting out possible options and the potential pros and cons of those options.

4.24 The prudential regulation of small firms forms part of a wider framework that includes the bank resolution and insolvency regime, the Financial Services Compensation Scheme, the PRA and FCA's respective processes for authorising new firms, the ongoing supervision and monitoring of PRA-regulated firms, and the macroprudential regime. In addition to the choices discussed below, the design of the simpler regime would need to take into account any future changes to that framework.

Overall approach

4.25 In arriving at a new prudential regime, for each element there are options that sit on a spectrum between:

- a fully 'streamlined' approach that takes the existing prudential framework as a starting point and modifies those elements that appear to be over-complex for smaller firms; or
- a fully 'focused' approach based on a narrower but more conservatively calibrated set of prudential requirements, as seen in some other jurisdictions (see Box A).

4.26 Each approach has advantages and disadvantages, as set out in Table 2. Two important trade-offs emerge:

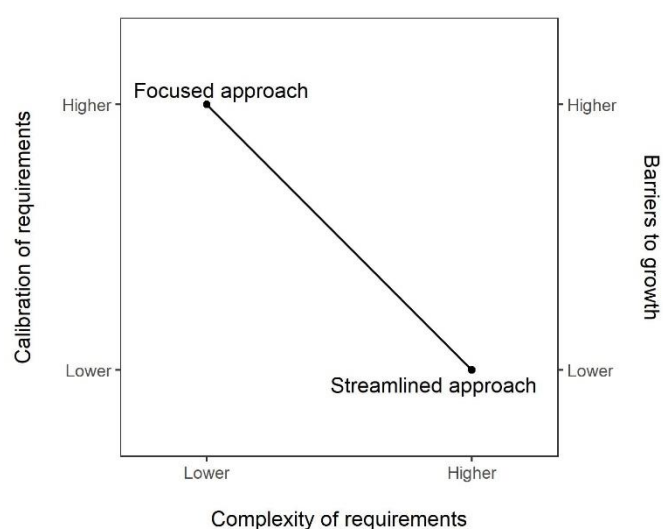
- between reducing the number of requirements, and not increasing their level of calibration;
- between reducing the number of requirements, and minimising barriers to growth for firms graduating to higher layers of the strong and simple framework.

Table 2: Potential advantages and disadvantages of a focused and a streamlined approach to designing a simpler prudential regime

Approach	Advantages	Disadvantages
Streamlined	Calibration of requirements may be lower than the focused approach would require Greater consistency with the wider prudential framework minimises new barriers to growth	Wide range of requirements are retained, meaning less simplification.
Focused	Maximises simplification by reducing the prudential rules to a small set of core requirements	Calibration of requirements may have to be very conservative. Significant differences to the wider prudential framework create new barriers to growth.

4.27 Wherever the outcome lies on the spectrum of options, the PRA will ensure calibrations do not go beyond what is necessary to maintain resilience of small firms. In doing this, the PRA will take into account how simpler requirements capture the risks to which firms are exposed, including how small firms' risk-taking and the distribution of risk in the banking system might change in response to those requirements (see Box D). This means that while a fully 'focused' approach would impose as few requirements as possible, those that were applied might have to be conservatively calibrated in order to maintain resilience. In contrast, a fully 'streamlined' approach would involve a greater number of less conservatively calibrated requirements compared with a fully focused approach. There would also be implications for supervision as a more focused approach may require more judgment based supervisory overlays.

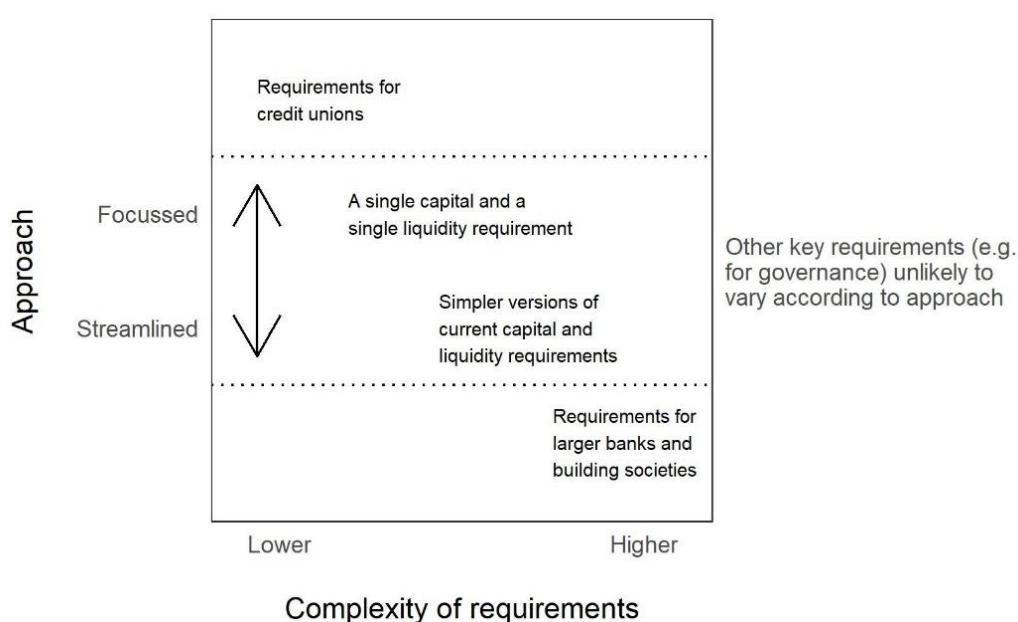
4.28 Figure 4 illustrates how the different approaches would manage some of these trade-offs.

Figure 4: Illustration of the characteristics of a 'focused' and a 'streamlined' approach

4.29 The rest of this chapter discusses the spectrum of design choices between a fully streamlined and a fully focused approach, beginning with capital and liquidity requirements. For these requirements, a ‘focused’ approach would lead to a smaller number of requirements than a streamlined approach. The chapter then discusses other requirements that the PRA consider would probably be the same under either approach. This is because they address risks which could not be mitigated by increasing the calibration of other requirements, meaning that streamlined requirements would also be the most simplified possible even under a focused approach.

4.30 Figure 5 illustrates how a focused and streamlined approach relate to each other, and to requirements for credit unions and for larger banks and building societies. The more ‘focused’ or the more ‘streamlined’ requirements are overall, the more they would resemble requirements for credit unions or for larger banks and building societies, respectively.

Figure 5: Illustration of how a ‘focused’ and a ‘streamlined’ approach would relate to each other and to requirements for larger banks and building societies



Minimum capital requirements

4.31 Minimum capital requirements play an important role in ensuring the resilience of PRA-regulated firms of all sizes and business models. The need for regulators to set prudent capital adequacy requirements is recognised in the Basel Core Principles.⁴⁸ The question is whether it would be possible to simplify aspects of capital requirements without weakening the associated public policy benefits of those requirements for small firms. This DP begins by considering the definition of the numerator of a regulatory capital to risk-weighted assets ratio, before considering the denominator of the ratio.

Capital quality requirements

4.32 There are a number of potential options for simplifying capital quality requirements for small firms, including adjusting the tiers of regulatory capital, reducing the complexity of eligible capital

⁴⁸ See Principle 16 in <https://www.bis.org/publ/bcbs230.pdf>.

instrument types, and simplifying adjustments made to regulatory capital. These could be relevant under both a focused and a streamlined approach.

4.33 A simpler capital structure for smaller firms could be based on ‘plain vanilla’ Common Equity Tier 1 (CET1) capital instruments and Tier 2 only. Other capital instruments, such as Additional Tier 1 (AT1), can add complexity to the capital structure. Under a focused approach, a Tier 1 capital structure based only on CET1 instruments could also offset risks to resilience arising from other simplifications in the simpler regime.⁴⁹ The impact of this could be limited as only a small minority of smaller firms currently have AT1 (including legacy Tier 1 instruments) in their capital structures. Conversely, it could also increase the cost of capital for any small firms that do want to issue AT1 and could cause some firms to opt out of the regime.

4.34 On the other hand, Tier 2 subordinated debt could be retained as it is less complex than AT1 and more frequently used by firms that are likely to be in scope of the simpler regime. Tier 2 capital complements CET1 capital by providing capacity to absorb losses in a gone-concern scenario and hence can play a role in supporting an orderly exit of firms.⁵⁰

4.35 Other aspects of the capital quality requirements could be modified in a simpler regime. For example, in order to simplify calculations, some of the capital deduction rules could possibly be amended (eg simplifying the deduction threshold for equity instruments of financial entities).

4.36 Under a **streamlined approach**, the treatment of ‘growth’ shares⁵¹ that may be used by new firms as part of management incentive packages could be reviewed. If these could be time limited and included within a capital structure without undermining resilience, use of them could support firms that wish to grow, which could in turn lead to competition benefits through encouraging more entry into the banking sector.

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

Risk weighted requirements

4.37 Under a **focused approach**, the current Pillar 1 and 2A capital requirements could be replaced with a single, simple, capital requirement. For instance, they could be replaced with a capital to risk-weighted assets requirement where the risk-weighted assets are calculated by allocating assets to a limited number of buckets (eg fewer buckets than in the current standardised approach to credit risk). Because the resulting requirement would be less risk sensitive, a **significantly** more conservative calibration of risk weights or of the minimum requirement would probably be necessary to maintain the resilience of firms in scope of the simpler regime. This would be the case even if some risks could be controlled by choosing tighter scope criteria, as discussed earlier. Therefore, while a capital requirement under the focused approach would be much simpler to calculate, the calibrations would likely have to be significantly higher to ensure the regime is both strong and simple.

⁴⁹ Alternatively, AT1 could still count towards Tier 1 capital but the ways an AT1 instrument can be structured could be narrowed to make the rules simpler.

⁵⁰ See https://www.bis.org/basel_framework/chapter/CAP/10.htm?inforce=20191215&published=20200605.

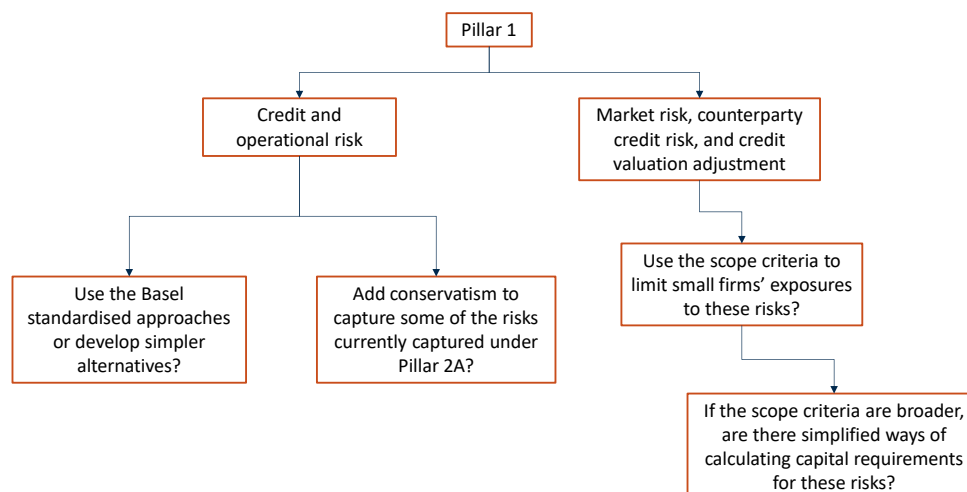
⁵¹ Growth shares are designed to accrete only future value from the point of issue (see https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/458580/HMRC_research_report_375_ERS.pdf). They are not plain vanilla instruments, so specific measures to enable their inclusion would be at odds with implementing a simpler capital structure.

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

Pillar 1 risk-weighted requirements

4.38 Figure 6 sets out some of the design choices that might be considered for Pillar 1 risk weighted requirements in a simpler regime.

Figure 6: Potential ways Pillar 1 risk weighted requirements might be simplified for small firms under a streamlined approach



4.39 A **streamlined approach** would suggest retaining risk-weighted Pillar 1 capital requirements, but potentially simplifying elements within it. Taking the elements of Pillar 1 requirements in turn:

- Credit risk and operational risk.* One option for both these types of risk would be to use the standardised approaches in the Basel standards; for instance, going forward, this could be the current Basel 3 standardised approaches or the more risk-sensitive standardised approaches introduced in the latest Basel 3.1 standards.⁵² This would ensure firms face capital requirements that reflect exposures to credit and operational risk and imply continuity for firms transitioning out of the simpler regime. In the case of credit risk, it would also be consistent with any decision to exclude firms that use the IRB approach from the regime. An alternative option would be to seek to develop simplified standardised approaches; eg have fewer risk weight buckets for credit risk, or a simpler calculation for operational risk. A third option would be to add some additional conservatism into Pillar 1 requirements to reduce the level of Pillar 2A requirements for risks not captured in Pillar 1; eg, by creating additional risk-weight buckets for high-risk lending (unless this is controlled through the scope criteria instead), or increasing the calibration of operational risk capital requirements.

⁵² For a high-level summary of Basel III reforms, see: https://www.bis.org/bcbs/publ/d424_hlsummary.pdf.

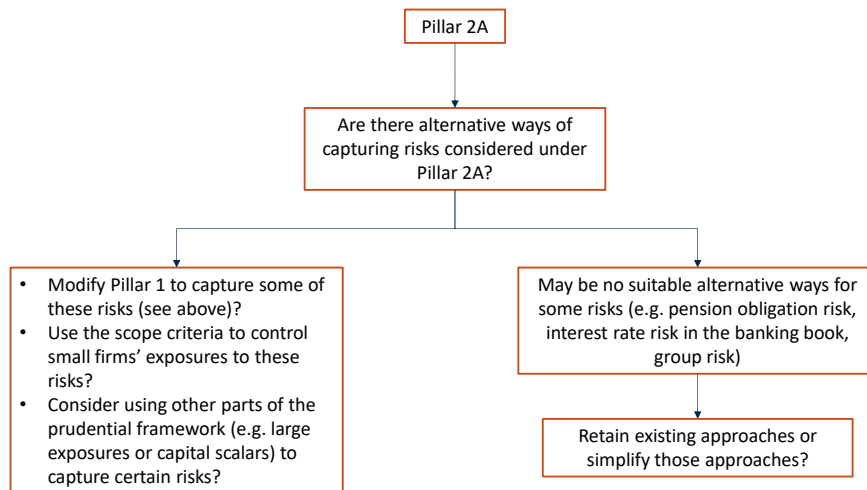
- *Market risk, counterparty credit risk, and credit valuation adjustment:* If firms with trading books and market activities were to be excluded from the simpler regime, as discussed above, there would be reduced or no need for Pillar 1 requirements for these types of risk in the simpler regime. If such firms were in scope, then requirements for these risks would need to be part of the regime to maintain those firms' resilience (eg the simplified approaches to counterparty credit risk in the existing framework and in the forthcoming Basel 3.1 reforms).⁵³ Thus, there is potentially a choice between using the scope criteria to set 'quantity' limits on small firms' exposures to these types of risk, and including potentially complex prudential requirements in the regime to ensure small firms have adequate capital against these risks.

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

Pillar 2A requirements

4.40 One feature of the existing prudential framework is that not all risks to which firms are exposed are captured by Pillar 1 minimum capital requirements. This has led to the introduction of the Pillar 2A approach in the UK to cover a range of additional risks to which firms may be exposed.⁵⁴ The prudential regime for small firms could be simplified significantly if there were ways to reduce or eliminate the need for Pillar 2A capital requirements, while still maintaining the overall resilience of firms. Figure 7 sets out some of the design choices that might be considered for Pillar 2A requirements in a simpler regime.

Figure 7: Potential ways Pillar 2A requirements might be simplified for small firms under a streamlined approach



4.41 One way to reduce or eliminate the need for Pillar 2A capital requirements, while still maintaining the overall resilience of firms, could be to toughen the calibration of Pillar 1 capital

⁵³ Paragraphs 8.18-8.24 of Consultation Paper (CP) 5/21 'Implementation of Basel standards', February 2021: <https://www.bankofengland.co.uk/prudential-regulation/publication/2021/february/implementation-of-basel-standards>.

⁵⁴ See PRA Statement of Policy 'The PRA's methodologies for setting Pillar 2 capital', April 2021: <https://www.bankofengland.co.uk/prudential-regulation/publication/2015/the-pras-methodologies-for-setting-pillar-2-capital>.

requirement; eg through changes to Pillar 1 to improve capture of high-risk lending, as discussed above. Another would be to rely on other elements of the simpler regime to limit small firms' exposures to the types of risk captured under Pillar 2A. For instance, there could be no need for Pillar 2A capital add-ons for high-risk credit portfolios, market risk, and counterparty credit risk if the scope criteria were designed to exclude small firms with significant exposures to these types of risk.

4.42 In the case of concentration risk, it may be possible to replace the current assessment (based on calculating the Herfindahl-Hirshman Index) by using instead large exposures regulation to control small firms' exposures to this risk – for example by setting a 'cluster limit' requirement that the sum of all large exposures to single counterparties and groups of connected counterparties should not exceed a specified multiple of capital.⁵⁵

4.43 If supervisors judge that operational risk is unduly high at or poorly managed by a firm, a capital scalar could be applied to capital buffer requirements, rather than calibrating a specific Pillar 2A add-on (see below).

4.44 For some types of risk, however, there may be no suitable alternative to retaining Pillar 2A requirements.⁵⁶ For example, it may be necessary to retain the existing approach to pension obligation risk as exposures to this risk can be significant for some small firms and the stress calculations necessary are already well embedded. Similarly, for interest rate risk in the banking book (IRRBB), the economic value risk may need to be captured in Pillar 2A, but there may be ways of developing a simpler alternative approach to that set out in the Basel standards for IRRBB⁵⁷ (eg based on fewer scenarios and principal cash flows only). Capital add-ons for group risk might also be needed in some cases.

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

Leverage ratio

4.45 The leverage ratio is designed to act as a guardrail against potential under-capitalisation of risk in the risk-weighting approach.⁵⁸ A leverage ratio is also the primary regulatory requirements for credit unions.⁵⁹ There is an ongoing review of the leverage ratio.⁶⁰ The conclusions of that review will be reflected on as the PRA designs the simpler regime.

Capital buffers

4.46 The role of a microprudential capital buffer requirement is to ensure firms have enough capital to absorb losses in stress conditions while continuing to meet minimum capital requirements. To fulfil that purpose, a buffer would need to be calibrated to reflect the scale of losses that a small firm

⁵⁵ Large exposures regulation in the past included a limit on the sum of a firm's large exposures; see former FSA Handbook rule BIPRU 10.5.8R at <https://www.handbook.fca.org.uk/handbook/BIPRU/10/5.html?date=2007-10-31>.

⁵⁶ The PRA's refined approach to setting Pillar 2A requirements (see <https://www.bankofengland.co.uk/prudential-regulation/publication/2017/refining-the-pra-pillar-2a-capital-framework>) could still apply in respect of any remaining variable elements of Pillar 2A.

⁵⁷ See <https://www.bis.org/bcbs/publ/d368.pdf>.

⁵⁸ See Bank of England, 'The Financial Policy Committee's review of the leverage ratio', October 2014: <https://www.bankofengland.co.uk/-/media/boe/files/paper/2014/the-fpc-review-of-the-leverage-ratio-october-2014>.

⁵⁹ See PRA Policy Statement 6/20 'Credit unions: review of the capital regime', March 2020:

<https://www.bankofengland.co.uk/prudential-regulation/publication/2019/credit-unions-review-of-the-capital-regime>.

⁶⁰ See Bank of England Financial Stability Report, December 2019: <https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/2019/december-2019.pdf> and HM Treasury/Bank of England/PRA/Financial Conduct Authority, 'Regulatory Initiatives Grid', September 2020: <https://www.fca.org.uk/publication/corporate/regulatory-intitatives-grid-september-2020.pdf>.

might incur under stress conditions. Small firms currently face two capital buffers: the 2.5% Capital Conservation Buffer (CCoB) and the firm-specific PRA Buffer (PRAB).

4.47 Under a **focused approach**, there could be no buffer requirement. This would not necessarily mean that firms would have no capacity to absorb losses without breaching minimum capital requirements because firms could choose to hold voluntary buffers above a minimum requirement. Alternatively, there could be a common buffer requirement, calibrated conservatively to ensure that in-scope firms can absorb losses in stress conditions and continue to meet minimum capital requirements.

4.48 Under a **streamlined** approach, the simpler regime could continue with the existing approach, where both the CCoB and PRAB may apply. Possible alternatives would be setting a single standard CCoB requirement that is calibrated to be conservative enough for all small firms' risk profiles (which could be potentially higher than the current CCoB); or setting only firm-specific buffers based on an assessment of each firm's risk profile.⁶¹

4.49 The benefit of the first alternative option is that it would be simpler. The disadvantage is that it could increase the capital buffer requirements for relatively safe small firms, as well as discouraging small firms from investing in their own stress-testing capabilities. The latter might create a barrier to growth for small firms wanting to transition out of the simpler regime, since internal stress testing is a key component of the prudential framework for larger firms. The second alternative should produce a better match of buffers to risks, but maintains the need for more sophisticated internal stress-testing capabilities at firms, and the absence of a 'backstop' would potentially increase the need for supervisory intervention to ensure the adequacy of buffer calculations.

4.50 The option for supervisors of applying a scalar to capital buffer requirements could be maintained in the simpler regime, under both the focused and streamlined approaches.⁶² It would also be way for a supervisor to mitigate risks arising from poor management and governance within a firm; see Box B for evidence suggesting governance can be an important risk factor for small firms.

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

Internal Capital Adequacy Assessment Process

4.51 There may be some scope to simplify the Internal Capital Adequacy Assessment Process (ICAAP) and Capital Supervisory Review and Evaluation (C-SREP). Simplification of ICAAP expectations in the simpler regime could be beneficial if it enables both small firms' boards and supervisors to focus on the key issues. Possible ways this could be achieved are for the PRA to develop updated guidance on the expected content of an ICAAP submission or to create a standard ICAAP submission template that contains all the relevant information for the C-SREP, as an alternative to each firm developing its own ICAAP format. The degree of simplification of the ICAAP process could be greater under a focused approach than a streamlined approach because there could be no Pillar 2A requirements under a focused approach.

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

⁶¹ There are also particular arrangements for new firms within the first five years of authorisation, for which historical business-model performance data are not available; PS8/21 'Non-systemic UK banks: The Prudential Regulation Authority's approach to new and growing banks', April 2021: <https://www.bankofengland.co.uk/prudential-regulation/publication/2020/new-and-growing-banks>.

⁶² See paragraphs 9.34-9.37 of PRA Statement of Policy 'The PRA's methodologies for setting Pillar 2 capital', April 2021: <https://www.bankofengland.co.uk/prudential-regulation/publication/2015/the-pras-methodologies-for-setting-pillar-2-capital>.

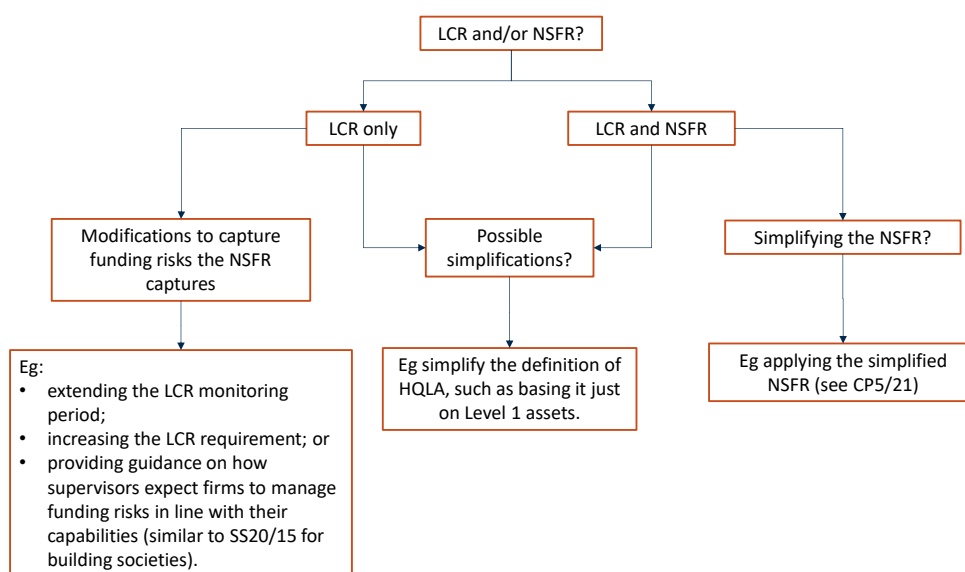
Liquidity and funding

4.52 The key design choice for liquidity requirements under the simpler regime is whether to base them on the existing Liquidity Coverage Ratio (LCR) and the proposed Net Stable Funding Ratio (NSFR) (ie a streamlined approach) or on a simpler liquidity measure (such as a required minimum level of liquid assets as a percentage of funding liabilities⁶³) (ie a focused approach).

4.53 The trade-off between the two options would be similar to that for capital requirements. Basing requirements on the LCR and NSFR would minimise barriers to growth for firms moving out of the simpler regime, as well as preserving investment in existing liquidity management and reporting systems. A new measure could be simpler to calculate and monitor, but would potentially need to be calibrated more conservatively to cover those business models with high liquidity or funding risks, and would be less risk-sensitive.

4.54 If the decision were to adopt a streamlined approach, the subsequent key design choices would be whether both the LCR and NSFR should be applied (recognising that NSFR is intended as a complement to the LCR) and whether the LCR and/or NSFR could be simplified for small firms.⁶⁴ Figure 8 sets out some of the design choices that might be considered for a simpler regime.

Figure 8: Potential ways liquidity requirements might be simplified for small firms under a streamlined approach



4.55 The existing Pillar 2 liquidity approach is already designed so it is applied in a proportionate way, reflecting firms' business models and the risks firms pose to PRA objectives.⁶⁵ If the scope criteria excluded firms conducting high levels of interbank activity or undertaking trading activities,

⁶³ This could be similar to the quantitative element of the liquidity requirements building societies use to face; see chapter 5 of Financial Services Authority Discussion Paper 07/7, 'Review of the liquidity requirements for banks and building societies': https://webarchive.nationalarchives.gov.uk/20081231024216/http://www.fsa.gov.uk/pubs/discussion/dp07_07.pdf.

⁶⁴ The PRA has consulted on a simplified NSFR; see PRA Consultation Paper 5/21 'Implementation of Basel standards', February 2021: <https://www.bankofengland.co.uk/prudential-regulation/publication/2021/february/implementation-of-basel-standards>.

⁶⁵ See PRA Statement of Policy 'Pillar 2 liquidity', June 2019: <https://www.bankofengland.co.uk/prudential-regulation/publication/2016/pillar-2-liquidity>.

Pillar 2 liquidity policy would have limited application in the simpler regime, and it might be possible to simplify the rules to focus just on the relevant elements.

4.56 For smaller firms, intraday risk would be the main type of liquidity risk that would not be captured by other prudential requirements. Simpler approaches to ensuring intraday risks can be covered by liquid assets may be possible.⁶⁶

4.57 It may also be possible, as part of the simpler regime, to clarify aspects of the rules and supervisory expectations relating to LCR reporting so that firms can more easily understand what is required; eg providing a clearer definition of ‘operational deposits’.

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

Internal Liquidity Adequacy Assessment Process

4.58 As with the ICAAP, there may be scope to simplify the Internal Liquidity Adequacy Assessment Process (ILAAP) and Liquidity Supervisory Review and Evaluation (L-SREP). Under a focused approach, the level of analysis needed may be lower to reflect a simple liquidity stock requirement. Under a streamlined approach, simplification of ILAAP expectations could be beneficial if it enables both small firms’ boards and supervisors to focus on the key issues. This could possibly be achieved by the PRA outlining a simpler set requirements and expectations for small firms. For example, it might not be necessary for firms with simple business models to have funds transfer pricing systems and elements relating to management of currency. One possibility would be to revert to an approach more like the Individual Liquidity Systems Assessment (ILSA), which was a simplified version of its Individual Liquidity Adequacy Assessment that the Financial Services Authority applied.⁶⁷

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

Other requirements

4.59 Other prudential requirements are likely to continue to play an important role in the simpler regime under either a focused or a streamlined approach because they address risks that cannot be covered adequately by changing the calibration or design of the requirements discussed above. The DP will now discuss how these requirements could be simplified while maintaining the resilience of small firms.

Large exposures

4.60 Given smaller firms might be more susceptible to having concentrated exposures to individual counterparties, large exposures rules play an important role in maintaining their resilience. The contribution large exposure limits make to resilience is recognised in the Basel Core Principles.⁶⁸ There may be a case for strengthening the large exposure rules that apply to small firms; eg setting a large exposure limit that is a percentage of CET1 rather than Tier 1;⁶⁹ or reducing the threshold

⁶⁶ This assumes the scope of the simpler regime excludes firms undertaking clearing and settlement activity.

⁶⁷ See former FSA rule BIPRU 12.6.21: <https://www.handbook.fca.org.uk/handbook/BIPRU/12/?view=chapter>.

⁶⁸ See Principle 19 in <https://www.bis.org/publ/bcbs230.pdf>.

⁶⁹ PRA Consultation Paper 5/21 ‘Implementation of Basel standards’, February 2021 proposes basing Large Exposure calculation on Tier 1 capital: <https://www.bankofengland.co.uk/prudential-regulation/publication/2021/february/implementation-of-basel-standards>. Moving to a CET1 basis would follow naturally if it were decided to centre Tier 1 capital quality requirements on CET1, as discussed earlier.

defining a large exposure, so supervisors receive more information about small firms' exposures to single counterparties and groups of connected counterparties.

Recovery and resolution planning

4.61 As set out earlier in this chapter, only firms set a Bank Insolvency Procedure (BIP) resolution strategy, or its building society equivalent (BSIP), by the Bank of England (as the resolution authority) might be within the simpler regime. If so, the simpler regime would incorporate the existing expectations for BIP/BSIP firms to take appropriate steps to remove any barriers to their orderly insolvency and to maintain and regularly test their capabilities to produce single customer view (SCV) files.

4.62 There are already elements that make the existing approach to recovery and resolution planning simpler for smaller firms: the PRA expects that smaller firms have fewer recovery indicators, a more limited range of recovery options, and simpler governance arrangements.⁷⁰ Furthermore, they are not subject to the requirements of the Bank's resolvability assessment framework, including to maintain financial resources beyond the PRA's prudential requirements.⁷¹ However, possible further simplification options could include:

- applying 'Simplified Obligations' for recovery planning to in-scope firms, were it the case only firms with a BIP/BSIP resolution strategy are within the regime.⁷² This would permit use of fewer planning scenarios and exempt firms from completing the template required of larger firms; and
- providing additional guidance on the PRA's recovery planning expectations to help focus small firm on having an up to date and prioritised set of recovery options ready to respond to periods of financial stress, to stabilise their financial position and to recover from financial losses.

Solvent wind-down planning

4.63 The PRA has recently published its final Supervisory Statement on its supervisory approach to new and growing banks,⁷³ which includes an expectation that new and growing banks should have board-approved solvent wind-down (SWD) plans in place at the point of authorisation, and should maintain these plans, regularly updating them to ensure they remain appropriate as the business develops. The Supervisory Statement expects new and growing banks to maintain their SWD plans until they are subject to a PRA buffer set on a stress-test basis.

4.64 So that the simpler regime supports a dynamic and resilient banking sector, and to maintain the overall strength of the regime while being simpler, an option would to extend the role of SWD planning to all firms in scope. If recovery options prove to be ineffective, solvent wind-down could allow firms to exit the market in an orderly manner, without entering an insolvency procedure. The benefits and practicalities of SWD planning are set out in Box E. To help small firms develop SWD plans, the PRA could potentially develop guidance on the contents of a SWD plan (eg a list of key issues to be addressed that might not form part of a recovery plan).

⁷⁰ PS25/20 'Simplified Obligations for recovery planning', December 2020: <https://www.bankofengland.co.uk/prudential-regulation/publication/2020/simplified-obligations-recovery-planning>.

⁷¹ Bank of England Policy Statement 'The Bank of England's approach to assessing resolvability', July 2019: <https://www.bankofengland.co.uk/paper/2019/the-boes-approach-to-assessing-resolvability>.

⁷² PS25/20 'Simplified Obligations for recovery planning', December 2020: <https://www.bankofengland.co.uk/prudential-regulation/publication/2020/simplified-obligations-recovery-planning>.

⁷³ PS8/21 'Non-systemic UK banks: The Prudential Regulation Authority's approach to new and growing banks', April 2021: <https://www.bankofengland.co.uk/prudential-regulation/publication/2020/new-and-growing-banks>.

4.65 To reduce the burden on small firms of undertaking SWD planning alongside recovery planning, the simpler regime could embed flexibility in the timing and depth of reviews; eg recovery and SWD planning alternating between years or alternating between major and minor plan reviews.⁷⁴ However, it would remain important that boards of small firms are cognisant that their plans need to remain up to date and usable.

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

Governance, remuneration, and risk management

4.66 The quality of governance and risk management is especially important for maintaining the resilience of small firms (see Box B). The Basel Core Principles expect a supervisor to determine that firms have robust governance policies and processes.⁷⁵ Thus, under a simpler regime, there would be no intention to cut back on the PRA's general expectations of the boards and management teams of in-scope firms given the objective of a simpler regime. Two possible relevant areas where the existing set of requirements covering governance could be streamlined would be the Senior Managers and Certification Regime (SM&CR) and rules covering remuneration.

4.67 The prudential aspects of SM&CR⁷⁶ could be varied in two dimensions: reducing the number of required senior manager roles and cutting back the number of prescribed responsibilities. Possible drawbacks of these options are, respectively, that having a smaller number of role holders but retaining robustness simply concentrates responsibilities rather than spreading them, and reformulating the wording of responsibilities would just mean grouping together sets of the existing prescribed responsibilities without removing the need to ensure these are still covered. Actual simplification would therefore be limited under either option, and the concentration of responsibilities on fewer individuals could be counterproductive.

4.68 There could be simplification benefits from streamlining the process of obtaining SM&CR approval, to reduce the elapsed time between job offer and approval. Greater use of time-limited approvals might be a means of achieving this. The PRA's recent evaluation report on the SM&CR identifies this and other ideas for potential improvements.⁷⁷

4.69 The smallest firms are exempt from some of the remuneration rules requirements, and subject to proportionate requirements for others.⁷⁸ However, there may be options for further exemption or simplicity, for example by applying remuneration requirements to narrower categories of staff, and/or reducing recording/reporting requirements, while still ensuring individual incentives support the safety and soundness of small firms.

⁷⁴ Both measures would be compatible with PRA Supervisory Statement 9/17 'Recovery planning', December 2020: <https://www.bankofengland.co.uk/prudential-regulation/publication/2017/recovery-planning-ss>.

⁷⁵ See Principle 14 in <https://www.bis.org/publ/bcbs230.pdf>.

⁷⁶ SM&CR policy is the joint responsibility of the PRA and FCA. Any changes would therefore need to be co-ordinated between the two authorities.

⁷⁷ PRA Report 'Evaluation of the Senior Managers and Certification Regime', December 2020: <https://www.bankofengland.co.uk/prudential-regulation/publication/2020/evaluation-of-the-senior-managers-and-certification-regime>.

⁷⁸ SS2/17 'Remuneration', December 2020: <https://www.bankofengland.co.uk/prudential-regulation/publication/2017/remuneration-ss>.

4.70 Our existing approach is that risk management arrangements in smaller firms should be proportionate to the scale and complexity of the business operated⁷⁹, so there is no required model for risk management arrangements. However, there is existing PRA guidance for building societies on aligning risk management capabilities with risk appetite⁸⁰, which could be adapted and extended to smaller banks as well. This could provide a means of gaining improved supervisor assurance on risk controls in firms with more risky business models, possibly as an alternative to a more conservative calibration of the simpler regime for all in-scope firms. It would also provide more clarity on the PRA's expectations for firms' risk appetite and management, and potentially simplify discussions with supervisors.

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

Operational resilience

4.71 Operational resilience is important for all firms, including smaller ones. Thus, a simpler regime would need to continue to incorporate requirements related to operational resilience. The PRA has recently published statements on its expectations for operational resilience⁸¹ and on outsourcing and third party risk management.⁸² In developing these statements, the PRA has, where possible, provided further clarity on the expected application of the policies to smaller and less complex firms. These policies do not come into effect until 2022 and it is therefore too early to determine whether there is further scope for simplification of our approach for smaller firms.

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

Disclosure

4.72 The argument for disclosure of information related to firms' safety and soundness is that placing information in the public domain will facilitate market discipline.⁸³ However, for firms that could be in scope of a simpler regime, it is possible that Pillar 3 and other similar disclosures attract less attention, eg because these firms tend not to be listed on stock exchanges or issue no or minimal amounts of wholesale debt. Retail customers may have little incentive to view disclosures that can be complex to interpret without specialist knowledge of the underlying regulations.

4.73 A design option for the simpler regime could be to cut back or eliminate Pillar 3 disclosures and just rely on those disclosures already included in annual accounts. The PRA would welcome comments from users of prudential disclosures made by small banks and building societies so the PRA can gain a better sense of their use and importance.

⁷⁹ See paragraph 58 of PRA's approach to banking supervision, October 2018: <https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/approach/banking-approach-2018.pdf>.

⁸⁰ SS20/15 'Supervisory building societies' treasury and lending activities', January 2021: <https://www.bankofengland.co.uk/prudential-regulation/publication/2015/supervising-building-societies-treasury-and-lending-activities-ss>.

⁸¹ PS6/21 'Operational resilience: Impact tolerances for important business services', March 2021: <https://www.bankofengland.co.uk/prudential-regulation/publication/2018/building-the-uk-financial-sectors-operational-resilience-discussion-paper>.

⁸² SS2/21 'Outsourcing and third party risk management': <https://www.bankofengland.co.uk/prudential-regulation/publication/2021/march/outourcing-and-third-party-risk-management-ss>.

⁸³ See Basel Committee (1988), 'Enhancing Bank Transparency (September 1998)': <https://www.bis.org/publ/bcbcs141.pdf>, and Mann, F (2017), 'Market discipline and UK bank bondholders', *Bank of England Quarterly Bulletin*, 2017 Q1 and Sowerbutts, R, Zimmerman, P, and Zer, I (2013), 'Banks' disclosure and financial stability', *Bank of England Quarterly Bulletin*, 2013 Q4.

4.74 Cutting back on Pillar 3 disclosures could create space for smaller firms to apply more resource to newer or wider disclosure requirements outside of the Pillar 3 framework, such as those covering climate-change risks, that might be of greater interest to customers and the wider market.

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

Summary

4.75 This chapter has sought to cover the key design choices for the PRA as it develops a simpler prudential regime for small firms. Nevertheless, the PRA would welcome views on any areas of the prudential framework not covered here that the PRA should consider as it develops the simpler regime. The PRA would also welcome views on whether, taken together, these options would have a significant impact on the complexity of prudential regulation for small firms were they introduced.

4.76 Table 3 summarises the options described above by illustrating what a ‘focused’ and what a ‘streamlined’ approach might look like.

Table 3: Summary of key options illustrating spectrum of ‘focused’ and ‘streamlined’ approaches

	Possible ‘focused’ approach	Possible ‘streamlined’ approach
Capital	A single capital requirement No buffer requirement, or a single buffer set at the same level for all firms.	Simpler versions of current Pillar 1 and Pillar 2A risk weighted capital requirements Single buffer requirement set on a firm-by-firm basis.
Liquidity	A single liquidity requirement	Simpler versions of current liquidity requirements
Other key requirements (eg on governance)	Unlikely to vary according to approach	

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

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

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

Regulatory reporting

4.77 In developing a simpler regime, the PRA will need to review its regulatory data collections from small firms so that they are tailored to the prudential requirements under the regime, and to the risks inherent to the business models of firms in scope of the regime. Reporting requirements under the simpler regime will ultimately depend upon the requirements under the regime, so detailed definitions of regulatory returns will not be available until the rules and requirements for the regime are nearer finalisation. The PRA appreciates that the running costs and complexity of submitting regulatory data can be a significant issue for small firms, and that there are material costs, and long

lead times, associated with introducing new reporting formats. These overheads will be factored into our approach.

4.78 The PRA embeds simplicity and proportionality into reporting requirements.⁸⁴ It has already taken steps to reduce duplicative reporting, and will continue to seek to avoid new duplication arising from future changes in reporting requirements: this might be especially beneficial for smaller firms.⁸⁵ Further steps to simplify reporting requirements – eg reducing reporting frequency and content – could have benefits for small firms (eg fewer resources needed to sign off data reported), but also drawbacks (eg necessitate changes to IT systems). However, the PRA would need to ensure it is receiving the data needed in a timely enough manner to be able to supervise firms in scope of the simpler regime effectively; this might mean small firms submitting more rather than less data in the future.

4.79 The Bank has also recently published a plan for transforming data collection.⁸⁶ The plan proposes three high level reforms: integrated reporting, common data standards, and modernising reporting instructions. Based on industry engagement to develop the plan, the Bank expects work on modernising reporting instructions to be particularly beneficial to smaller banks and building societies.

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

Evolution of the simpler regime

4.80 Prudential regulations need to change over time to address new risks and the unintended consequences of existing rules.⁸⁷ However, regulatory change imposes costs on firms: firms must spend resources on understanding new rules and may be required to make changes to their compliance and reporting systems. While these change costs should be set against the social costs from risk-taking that prudential regulation forces firms to internalise, over-frequent regulatory changes may be disproportionate to the risks they address.

4.81 Firms eligible for the simpler regime will have simpler businesses, which makes a simpler regulatory regime appropriate. The design of the simpler regime will nevertheless need to change over time to address new risks and unintended consequences, as well as to make sure calibrations remain appropriate.⁸⁸ New risks and unintended consequences, however, might emerge on average more slowly for simpler business models, and the systemic vulnerabilities these create will be lower because the firms are not systemically important.

4.82 An appropriate approach to regulatory changes to the simpler regime may therefore involve consolidating changes within a predictable cycle of updates (for example, an annual update) alongside a longer cycle of more fundamental reviews to ensure the regime remains fit for purpose.

⁸⁴ Eg see Rule 2.3 of the Reporting Pillar 2 part of the PRA Rulebook: <https://www.prarulebook.co.uk/rulebook/Content/Part/302460>.

⁸⁵ See Appendix 22 of PS29/20 'Capital Requirements Directive V (CRD V): Final policy', December 2020:

<https://www.bankofengland.co.uk/prudential-regulation/publication/2020/capital-requirements-directive-v-further-implementation>

⁸⁶ <https://www.bankofengland.co.uk/paper/2021/transforming-data-collection-from-the-uk-financial-sector-a-plan-for-2021-and-beyond>

⁸⁷ Speech by Vicky Saporta 'Prudential bank regulation: present and future', July 2018:

<https://www.bankofengland.co.uk/speech/2018/victoria-saporta-speech-at-the-westminster-business-forum-keynote-seminar>.

⁸⁸ For instance, if some of the scope criteria were based on thresholds expressed in nominal monetary amounts, these might need to be updated periodically to reflect wider economic change.

Notwithstanding this approach, extraordinary updates might still be needed from time to time to address particularly material and urgent new risks.

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

Transitioning in and out of the simpler regime

4.83 It is desirable that firms within the simpler regime are not discouraged from changing their businesses in ways that would make them no longer eligible for the regime, for example by growing their balance sheets or entering into more complex activities. In these circumstances, they will need to transition from the simpler regime to another prudential regime.⁸⁹ Conversely, some firms may in the future enter the simpler regime (for example a firm that contracts its balance sheet). Arrangements will therefore be needed for firms transitioning both out of and into the simpler regime (including new banks exiting the ‘mobilisation’ phase after authorisation, and banks currently considered to be Small Specialist Banks⁹⁰).

4.84 These arrangements must be consistent with the optionality features of the simpler regime (see above for how this feature might work). They must also allow firms to manage transitions efficiently (abrupt and unpredictable changes in requirements should be avoided where possible) but without leaving material prudential risks unaddressed.

4.85 This might be achieved by specifying intermediate requirements to bridge gaps between the simpler regime and that to which a firm is transitioning. Alternatively, there could be a simple cutover from one set of requirements to another. In either case, it might be desirable for the PRA to be able to waive some of the scope criteria for the simpler regime before a firm meets all the requirements of the other regime they will become subject to. On the other hand, the PRA might require firms to complete their transition to an alternative regime before they will be allowed to grow or to engage in activities beyond the simpler regime’s scope criteria. Finally, there is the question of what arrangements should be in place for a firm which unexpectedly become ineligible for the simpler regime (eg because of an unexpected inflow of deposits that takes its balance sheet over a size criterion) without being able to immediately meet all the requirements of an applicable alternative regime.

Q26: How should transition arrangements be designed?

⁸⁹ In the long run, this would be a higher layer of the overall strong and simple framework.

⁹⁰ See paragraph 8 in ‘A review of requirements for firms entering into or expanding in the banking sector: one year on’ <https://www.bankofengland.co.uk/prudential-regulation/publication/2014/review-of-requirements-for-firms-entering-into-banking-sector>.

Box D: Prudential requirements and risk-taking incentives

Firms' risk-taking incentives can be shaped by the design of prudential regulation, in particular, by the sensitivity of prudential requirements to risk. For instance, a capital requirement that is less sensitive to the riskiness of a firm's assets could encourage a firm to choose riskier assets; ie to engage in so-called risk-shifting behaviour.

There is substantial evidence of prudential regulation shaping firms' behaviour, including how risk-insensitive requirements can cause firms to risk shift.^{91, 92}

Under Basel I capital requirements, assets were assigned to a relatively small number of risk-weight buckets.⁹³ For instance, all corporate exposures received the same risk weight, which meant a firm could make riskier corporate loans without affecting its capital to risk-weighted assets ratio. Firms exploited regulatory arbitrage opportunities that existed because some risks were not captured fully.⁹⁴ The perception that Basel I was insufficiently risk sensitive led to the development of the Basel II capital standards.⁹⁵

Basel II introduced two, more granular, approaches to determining capital requirements for credit risk: the standardised approach and the internal ratings based (IRB) approach. For example, risk weights for residential mortgages depended on loan to value ratios under Basel II, particularly for firms using the IRB approach, whereas all mortgages had received the same risk weight under Basel I. Evidence from the UK mortgage market suggests firms reversed previous risk-shifting behaviour when Basel II was introduced.⁹⁶

However, the differences in the risk weights under the standardised and IRB approaches might have caused shifts in risk between firms, which pushed firms using the relatively less risk-sensitive standardised approach towards riskier lending. Risk weights for low risk mortgages tend to be lower under the IRB approach than under the standardised approach.⁹⁷ In the UK residential mortgage market, large firms that used the IRB approach increased the share of lower risk mortgages in their portfolios, while smaller firms using the standardised approach did the opposite.⁹⁸

The PRA has refined the Pillar 2A framework to address concerns about differences in risk weights under the standardised and IRB approaches, including the differences for lower risk mortgages.⁹⁹ The policy weakens the risk-taking incentives of firms using the standardised approach: eligible firms had an increased propensity to make lower risk mortgages following the publication of the related policy statement.¹⁰⁰

⁹¹ Referring here to what is referred to as *ex-ante risk sensitivity* in Basel Committee on Banking Supervision (2013), 'The regulatory framework: balancing risk sensitivity, simplicity and comparability': a risk-sensitive prudential requirement as one that makes fine distinctions according to the characteristics of exposures or transactions.

⁹² See Hinterschweiger, M, Neumann, T, and Saporta, V (2018), 'Risk sensitivity and risk shifting in banking regulation', *Bank of England Financial Stability Paper No.44* for a detailed discussion of this issue and a review of the literature.

⁹³ <https://www.bis.org/publ/bcbs04a.pdf>.

⁹⁴ For instance, because of the way securitisations were treated; see Jackson, P (1999), 'Capital requirements and bank behaviour: the impact of the Basle Accord', *Basel Committee on Banking Supervision Working Papers No.1*.

⁹⁵ <https://www.bis.org/publ/bcbs107.htm>.

⁹⁶ Box 1 in Hinterschweiger, M, Neumann, T, and Saporta, V (2018), 'Risk sensitivity and risk shifting in banking regulation', *Bank of England Financial Stability Paper No.44*.

⁹⁷ Table A1 in PRA Statement of Policy 'The PRA's methodologies for setting Pillar 2 capital', April 2021:

<https://www.bankofengland.co.uk/prudential-regulation/publication/2015/the-pras-methodologies-for-setting-pillar-2-capital>.

⁹⁸ See Benetton, M, Eckley, P, Garbarino, N, Kirwin, L, and Latsi, G (2020), 'Capital requirements and mortgage pricing: evidence from Basel II', *Journal of Financial Intermediation*, Forthcoming.

⁹⁹ PS22/17 'Refining the PRA's Pillar 2A capital framework', October 2017: <https://www.bankofengland.co.uk/prudential-regulation/publication/2017/refining-the-pra-pillar-2a-capital-framework>.

¹⁰⁰ See Arnould, G, Guin, B, Ongena, S, and Siciliani, P (2020), '(When) do banks react to anticipated capital reliefs?', *Bank of England Staff Working Paper No.889*.

Box E: Ease of exit

Consistent with its statutory objectives, a key principle of the PRA's approach to supervision is that it does not seek to operate a zero-failure regime for firms. Rather, and working with the Bank of England as the UK resolution authority where required, the PRA seeks to ensure that any firms that fail do so in an orderly manner.¹⁰¹ This approach is in line with the development of a strong and simple framework.

The PRA's Fundamental Rule 8 requires that all firms must prepare for resolution so that, if the need arises, they can be resolved in an orderly manner with a minimum disruption of critical services. The PRA's Threshold Conditions also require firms to have appropriate financial and non-financial resources in place in order to be permitted to carry out the regulated activities in which they engage.¹⁰²

In order to reduce the impacts of disorderly exits, the PRA recently published a Supervisory Statement on our supervisory approach to new and growing banks.¹⁰³ This contains an expectation that new and growing banks should have board-approved SWD plans in place at the point of authorisation.

Approach

The PRA and Bank are developing further proposals to build on our supervisory approach and the existing framework to further increase the likelihood that firms are able to exit the market in an orderly way. This includes considering ways in which firms and supervisors could:

- a) Better prepare for their potential exit from the market (for example through SWD, or a sale in going concern);
- b) Explore ways to make resolution – which is the backstop to all recovery options – more orderly by identifying and removing existing barriers.

This is likely to include measures to make credible SWD planning a more integral part of firms' recovery planning. Our considerations include but are not limited to the following:

Determining the scope of firms affected¹⁰⁴⁽⁴⁾

For non-systemic firms, their less complex business models would be more easily accommodated within a SWD plan, and their withdrawal from the market under such a plan should not affect the PRA's (or the Bank as resolution authority's) statutory objectives. SWD may be a preferable form of exit for such firms, as it may reduce reputational costs for firms' boards and management. It may

¹⁰¹ See PRA 'The Prudential Regulation Authority's approach to banking supervision', October 2018: <https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/approach/banking-approach-2018.pdf?la=en&hash=3445FD6B39A2576ACCE8B4F9692B05EE04D0CFE3>. Considering the impact of firm failure, and acting pre-emptively to ensure either recovery or orderly resolution, is a core aspect of the PRA's supervisory approach and the PRA works to deliver this, with the rest of the Bank, through its supervisory strategy for individual firms. The PRA's ability to ensure firm failure is orderly depends on both the efficacy of the UK's statutory resolution regime and ensuring firms are structured, and operate, in a way that is compatible with the Bank's preferred resolution strategy under UK resolution powers. See also the PRA's approach to insurance supervision. In the event that an insurer's financial position comes under stress, policyholders can be protected through mechanisms by which insurers can exit the market in an orderly way, eg through the removal of permission to undertake new business, and orderly run-off of existing business. Under our prudential regulation regime, insurers must maintain a certain level of resilience against failure. This is essential to ensuring confidence in general in the resilience of the insurers that the PRA supervises for the PRA to deliver on its objectives.

¹⁰² See PRA 'The Prudential Regulation Authority's approach to banking supervision', October 2018: <https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/approach/banking-approach-2018.pdf?la=en&hash=3445FD6B39A2576ACCE8B4F9692B05EE04D0CFE3>.

¹⁰³ PRA Policy Statement 8/21 'Non-systemic UK banks: The Prudential Regulation Authority's approach to new and growing banks', April 2021: <https://www.bankofengland.co.uk/prudential-regulation/publication/2020/new-and-growing-banks>.

¹⁰⁴ While this box focuses on SWD plans for deposit takers, the PRA's work includes orderly exit for insurers.

also eliminate costs to creditors and, via the FSCS levy, to the wider banking sector, that might be incurred in a resolution. In addition to being capable of recovery, firms must ensure they continue to be able to demonstrate that they are resolvable as per their resolution strategy if all recovery options – including SWD – are exhausted. Firms should also factor into their capital plans possible MREL requirements further down the line, with a sufficient planning horizon.

Proportionality

Any SWD planning requirements or expectations for in-scope firms will be proportionate, with a focus particularly on planning capabilities and options, rather than on detailed financial forecasts. The aim would be to ensure that firms have thought in advance about the issues that could arise in a SWD, are able to produce credible and detailed SWD plans in short order if required, and have put in place the necessary steps to be able to implement such plans effectively. A key consideration underpinning our expectations of specific firms will be assessing the risks that a firm's exit, if disorderly, would pose to depositors and policyholders, and the wider UK financial system.

SWD plans

The PRA could potentially develop more detailed guidance on the contents of a SWD plan (eg, a list of key issues to be addressed that might not form part of a recovery plan). This could aid firms and supervisors in the creation and review of SWD plans to ensure that they are credible and effective.

The PRA intends to provide more detail on our overall proposals and engage with industry and other stakeholders in due course.

How will increasing 'ease of exit' contribute to the PRA's objectives?

Work on ease of exit will support the PRA's safety and soundness and competition objectives. One of the ways the PRA pursues its primary objective is working 'to minimise adverse effects that the failure of ... firms we regulate could have on financial stability'.

The PRA considers that effective competition involves the least efficient firms being able to exit the market in an orderly way. This opens up space for new entrants, or for more-efficient existing firms to grow. Our proposed initiatives on going concern exit will, over time, increase firms' ability to exit the market if they are not viable. A higher turnover of inefficient firms exiting in a way which does not adversely affect the PRA's objectives will lead to a more dynamic and competitive market.

5 Measures to lower barriers to growth

This chapter discusses possible measures to lower barriers to growth faced by non-systemic firms that would not be operating under the simpler regime. It highlights actions that might be taken as the PRA builds out the strong and simple framework to cover a wider set of non-systemic firms, and the trade-offs involved.

5.1 As explained in Chapter 3, the long-term vision for prudential regulation for non-systemic banks and building societies in the UK is to have a graduated framework in which prudential requirements and expectations increase and/or become more sophisticated as firms grow bigger and/or undertake a wider range of complex activities. This means there would be a series of thresholds that define when requirements and expectations change for a firm in a graduated framework.

5.2 Introducing a graduated prudential framework in order to achieve more simplicity could potentially increase the number of thresholds and hence potentially make the barriers to growth problem worse.

5.3 In Chapter 4, possible ways to help small firms transition out of the simpler regime were discussed. This chapter will expand on this by discussing measures the PRA could take to lower barriers to growth for other non-systemic banks and building societies.

5.4 The focus is on ways the structure of the strong and simple framework could be designed to lower barriers to growth. The chapter will not discuss how specific prudential policies could be designed to lower barriers to growth or reduce complexity for non-systemic firms. This reflects the fact there are ongoing reviews of MREL¹⁰⁵ and the leverage ratio¹⁰⁶ that could have implications for the direction of the design of the strong and simple framework. The PRA will reflect on the conclusions of those reviews as it develops further layers of the strong and simple prudential framework.

Metrics

5.5 As with the simpler regime, the thresholds for further layers of the strong and simple framework would ideally be based on simple, objective, and transparent criteria. Some of the criteria might be based on similar metrics; eg total assets as a measure of size. As the PRA builds out the strong and simple prudential framework, it could commit to using a relatively small set of metrics; eg a single definition of total assets. Using multiple definitions could make it harder for a firm to predict when it will transition between layers of the strong and simple framework, and hence to develop its business plans. This might discourage a firm from growing, increasing barriers to growth.

¹⁰⁵ See Bank of England Discussion Paper 'The Bank of England's review of its approach to setting a minimum requirement for own funds and eligible liabilities (MREL)', December 2020: <https://www.bankofengland.co.uk/-/media/boe/files/paper/2020/boes-review-of-its-approach-to-setting-mrel.pdf?la=en&hash=E91E4A0380DE04A1EA5F1AB678EE8006041A344D>.

¹⁰⁶ See Bank of England Financial Stability Report, December 2019: <https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/2019/december-2019.pdf> and HM Treasury/Bank of England/PRA/Financial Conduct Authority, 'Regulatory Initiatives Grid', September 2020: <https://www.fca.org.uk/publication/corporate/regulatory-intitatives-grid-september-2020.pdf>.

Layers

5.6 Whether thresholds deter firms from growing, in size or in breadth of activities, will also depend on the extent to which requirements and expectations change for firms crossing thresholds; ie on the 'height' of the 'cliff edges'. For example, if the prudential rules become significantly more complex when a firm crosses a threshold it is probably more likely the threshold acts as a barrier to growth. However, reducing the height of the cliff-edges, to avoid exacerbating the barriers to growth problem, could constrain how much one could simplify prudential regulation. Figure 9 illustrates in a stylised way the trade-off between the complexity and barriers to growth problems. The steps are smaller in the case shown in Panel B than in the one in Panel A, but this is achieved by doing less to simplify the prudential rules for the smallest firms.

5.7 The trade-off could be improved by having a greater number of layers in the strong and simple framework. This is illustrated in Panel C of Figure 9. Overall, the strong and simple framework as a result looks more complex: more layers also mean a growing firm would have to understand and operationalise changes to regulation more frequently, which means incurring the costs associated with regulatory change more often. Thus, there could be a trilemma between the complexity problem, the barriers to growth problem, and the overall complexity of the framework/frequency of regulatory change for a growing firm.

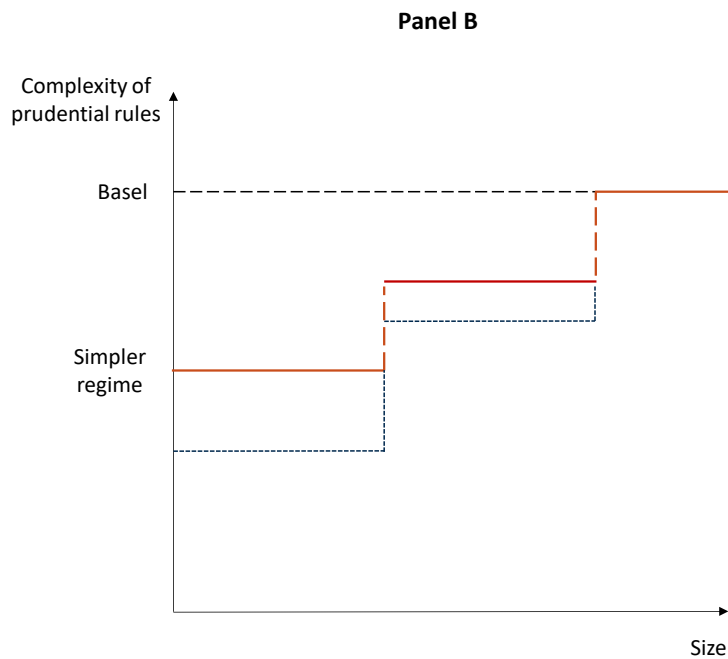
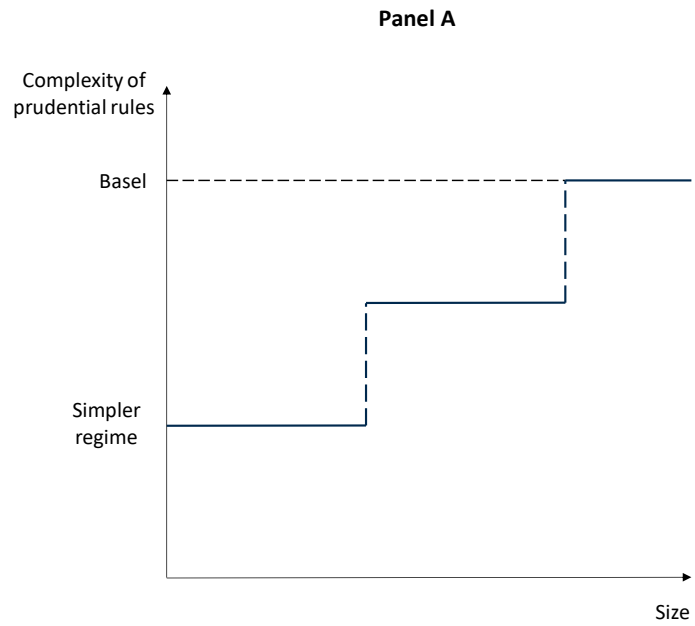
Transition arrangements and optionality

5.8 Another way of mitigating the barriers to growth problem would be to adopt the transition arrangements and the optionality feature discussed previously in relation to the simpler regime. That is, a firm could have a period to transition towards implementing changes in requirements and have the option to choose to be subject to requirements that are intended for larger and/or more complex firms. If there are multiple layers in the graduated framework, it might be possible for a firm to have the option to choose to be subject to the rules for any layer above the one for which it meets the scope criteria (including being able to choose to be subject to the full Basel standards).

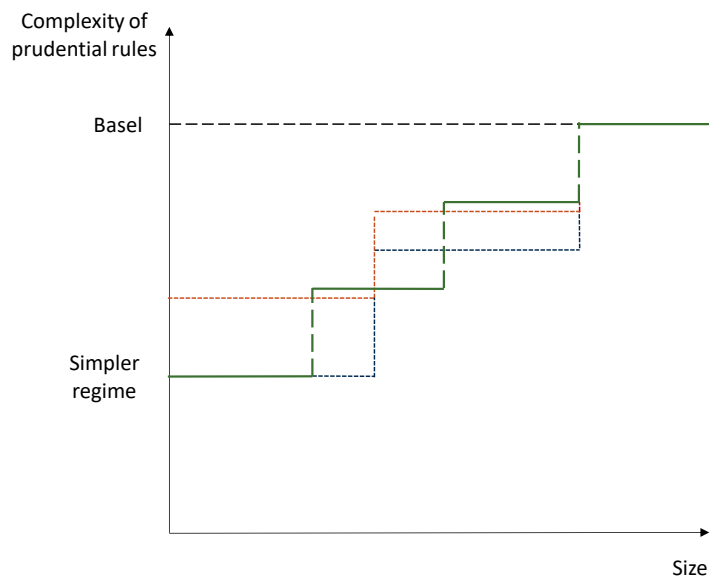
Q27: Would it be preferable to have few or many layers in a strong and simple framework for non-systemic banks and building societies?

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

Figure 9: Illustration of the choice of number of layers, complexity, and barriers to growth



Panel C



Increase the number of layers in order to improve the trade off between simplicity and barriers to growth

6 Future plans for the strong and simple framework

This chapter discusses how the PRA could go about developing and implementing a strong and simple prudential framework for non-systemic banks and building societies in the UK.

6.1 The purpose of this DP is to collect comments on the merits of introducing a strong and simple prudential framework for non-systemic banks and building societies in the UK and on what that framework could look like. The PRA will use those comments to develop proposals for the shape of any future framework. It would then publish those proposals for consultation on the different elements of the framework.

Implementing a simpler regime for small firms

6.2 As explained in Chapter 3, the PRA is considering building the strong and simple framework by starting with the simpler regime for the smallest firms. If the PRA decides to follow that approach, it would consult on proposed prudential rules for defining whether a firm is in scope of the simpler regime (ie the scope criteria) and for the requirements under this regime. Design and implementation is likely to take a number of years to complete.

6.3 In designing and implementing the simpler regime, the PRA will need to take into account other changes to prudential regulation that are planned. In particular, the PRA will be introducing the final set of reforms to implement Basel standards (ie the Basel 3.1 reforms) using the powers that are anticipated to be conferred on the PRA through the Financial Services Bill.¹⁰⁷ The PRA will consider how those reforms should be introduced for small firms. It will also seek to minimise as far as possible the number of times prudential regulatory rules change for small firms.

6.4 Implementing a simpler framework may necessitate changes to existing elements of the PRA Rulebook and expectations. It may require changes to prudential rules that are within legislation. HM Treasury has recently published a consultation paper setting out a Financial Services Future Regulatory Framework in which government and Parliament set out the policy framework while regulators design and implement regulatory requirements, with accompanying scrutiny and public engagement arrangements to ensure regulators are accountable.¹⁰⁸ This framework would enable the PRA to implement the simpler regime (and the strong and simple framework more broadly).

Building out the strong and simple framework

6.5 While the PRA moves forward with designing and implementing the simpler regime for the smallest non-systemic firms, it intends to start considering policy options for higher layers of the strong and simple framework. That is, the PRA intends to start to consider options for the prudential regimes that would apply to non-systemic firms that would not meet the criteria to be in scope of the simpler regime or might choose not to be subject to it. The PRA may decide to issue further discussion papers focused on these policy options, to gather views, before proceeding to issue proposed rules and expectations for consultation.

¹⁰⁷ See HM Treasury Policy Statement 'Prudential standards in the Financial Services Bill', March 2020: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/871680/Final_Budget_policy_statement_-_Basel_and_prudential_measures.pdf.

¹⁰⁸ See HM Treasury Consultation 'Financial Services Future Regulatory Framework Review Phase II Consultation', October 2020: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/927316/141020_Final_Phase_II_Condoc_For_Publication_for_print.pdf.

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

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

7 Conclusions

7.1 This paper has set out a number of considerations regarding how the prudential framework for non-systemic firms might be changed to make it simpler while maintaining the resilience of all firms and minimising the risk of creating higher barriers to growth.

7.2 The ideas set out in the paper were they introduced would represent a significant change to the prudential framework for non-systemic firms in the UK. This is why the PRA has decided to write a discussion paper rather than proceeding straightaway to publishing proposals for consultation.

7.3 The argument for simplifying PRA's prudential rules and expectations for smaller firms is that the cost of understanding, interpreting, and operationalising prudential regulation falls more heavily upon smaller firms. Those costs could also have negative effects on the PRA's objectives. The aim is to simplify regulation in ways that reduce those costs while still ensuring all PRA-regulated firms face prudential rules and expectations that maintain their safety and soundness.

7.4 This is why the PRA wants to introduce a strong and simple prudential framework. This framework would support the stability of the banking sector in the UK, but in doing so enable a dynamic and diverse banking sector in which successful firms can grow as other less successful ones contract and exit the sector.

7.5 The diversity of the UK's banking sector implies that a single set of rules and expectations for non-systemic firms is unlikely to achieve the objective of simplifying while also ensuring resilience. This is why this DP suggests the framework is likely to involve a series of layers, where prudential requirements and expectations increase in line with a firm's size and complexity of activities.

7.6 A graduated framework is likely to take a number of years to introduce. This DP has explained that the PRA is considering building the strong and simple framework by starting with a materially simpler prudential regime for the smallest banks and building societies, which are the firms that are likely to experience the complexity problem most acutely. This DP has set out ideas for what that simpler regime might look like, including the possible approaches to identifying firms in scope, the possible requirements under the regime, and ways in which firms might transition in and out of the regime. It has highlighted the key design choices and trade-offs the PRA will need to consider when designing and implementing the simpler regime.

Response and next steps

7.7 The PRA would welcome views on this discussion paper, including answers to the questions. The PRA will use those comments as it considers how to design and implement a strong and simple prudential framework in the UK. After the end of the period for receiving comments, the PRA will publish a summary of the comments it has received in an anonymised way to further encourage debate.

8 Questions

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Q26: How should transition arrangements be designed?

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

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

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

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