The Strong and Simple Framework: Liquidity and Disclosure requirements for Simpler-regime Firms

(Consultation Paper | CP4/23)
(February 2023)

Overview

As set out in Consultation Paper 5/22 'The Strong and Simple Framework: a definition of a Simpler-regime Firm' (**CP4/23**) and Discussion Paper 1/21 'A strong and simple prudential framework for non-systemic banks and building societies', the PRA is proposing simplifications to the prudential framework for Simpler-regime Firms. The changes seek to mitigate the 'complexity problem' that can arise for smaller banks and building societies, when the same prudential requirements are applied to all firms but the costs of understanding, interpreting and operationalizing those requirements are higher relative to the associated public policy benefits for smaller firms than larger firms. The PRA's strong and simple initiative seeks to simplify the prudential framework for small, domestic banks and building societies, while maintaining their resilience and reducing barriers to growth.

The combined objectives of this framework would be to maintain the resilience of those firms, and the stability of the UK financial sector, while using simplified prudential regulation by removing or adapting rules which offer little prudential value for firms in scope. This could enhance effective competition and enable a dynamic and diverse banking sector in the UK, without making the sector more fragile, thereby increasing the sector's efficiency and productivity, and contributing positively to its ability to facilitate the growth of the UK's economy.

Proposals

CP4/23 sets out the first phase of proposed simplifications that would apply to Simpler-regime Firms. These proposals consist of:

- new liquidity requirements for the application of the net stable funding ratio;
- revisions to the application of Pillar 2 liquidity add-ons;
- a new, streamlined Internal Liquidity Adequacy Assessment Process template;
- the removal of certain liquidity reporting templates;
- new Pillar 3 disclosure requirements for Simpler-regime Firms; and
- simplifications to certain proportionality approaches currently applicable in the PRA Rulebook.

The proposed second phase for the simpler regime will focus on the capital framework.

Structure of the Consultation Paper

This Consultation Paper sets out a number of simplified liquidity, disclosure and reporting measures that would address a number of the concerns respondents raised in response to DP 1/21 and could be introduced expeditiously in Phase 1. In addition, the PRA intends to consider possible further changes to liquidity reporting requirements as part of implementing the Bank of England's plan for transforming data collection. The PRA considers the proposals set out would advance firms' safety and soundness and make meaningful progress to reduce the complexity of the PRA approach, as well as improving its proportionality and consistency, by targeting prudential measures more precisely at the risks to which Simpler-regime Firms may be subject.

The proposals Consultation Paper (CP4/24) are structured as follows:

- **Scope and levels of application –** PRA's proposed scope and levels of application for the proposals in this Consultation Paper.
- **Net stable funding ratio –** PRA's proposals to apply the Net Stable Funding Ratio (NSFR) only to Simpler-regime Firms that are subject to relatively greater stable funding risk, as measured by a new retail deposit ratio (RDR), and to remove the simplified NSFR.
- **Pillar 2 liquidity –** PRA's proposals to generally not apply Pillar 2 liquidity guidance to Simpler-regime Firms, except where warranted in the case of a particularly material idiosyncratic risk or risks, and introduces a new ILAAP template for Simpler-regime Firms.
- **Liquidity reporting –** PRA's proposals to exclude Simpler-regime Firms from the requirement to report four of the five Additional Liquidity Monitoring Metrics (ALMM) returns and adjust the remaining ALMM return.
- **Disclosure (Pillar 3) –** PRA's proposals to streamline Pillar 3 disclosure requirements for firms with listed financial instruments and remove them for firms without listed financial instruments, and to remove the Small and Non-Complex Institution disclosure requirements.

Impact on Mutuals

FSMA requires that the PRA assess whether, in its opinion, the impact of the proposed rules on mutuals will be significantly different from the impact on other firms, and if so, provide details of the difference. The PRA expects the proposed definition would capture mutuals, which would benefit from a simpler prudential regime.

Interaction with other frameworks

In CP16/22, the PRA set out a proposal that firms that met the Simpler-regime criteria would not have to apply the proposed implementation of the Basel 3.1 standards. Instead, the PRA proposed that these firms could choose to enter a transitional regime based on current CRR provisions (the 'Transitional Capital Regime') during the interim period between the proposed implementation date for the Basel 3.1 standards and the future implementation date for a permanent risk-based capital regime for Simpler-regime Firms.

Implementation

The PRA plans to consult on other aspects of the simpler regime layer of the strong and simple framework, including the requirements that would apply under this regime, within the first half of 2023. The second set of proposals are likely to follow in 2024.

Further simplification proposals

PRA plans to publish proposals for simplified prudential requirements in distinct phases. The proposed second phase for the simpler regime will focus on the capital framework. The PRA is making the planning assumption that the Basel 3.1 Pillar 1 approach to credit risk would be the starting point for designing the simpler-regime risk-based capital framework. This is because the PRA considers the proposed Basel 3.1 Pillar 1 approach to credit risk to represent an improvement over the current capital rules; they would be more risk sensitive and would facilitate competition without compromising safety and soundness. The PRA intends in Phase 2 to focus on simplifications to Pillar 2 and buffer requirements for Simpler-regime Firms. These elements would be considered together to support the development of a coherent, simple, and proportionate risk-based capital framework for Simpler-regime Firms. The PRA expects to consult on Phase 2 measures in 1H2024.

Scope and Levels of Application

The PRA proposes to introduce a number of objective and transparent criteria for assessing whether a firm meets the definition of a Simpler-regime firm. The PRA proposes a firm must meet all of the scope criteria:

- A maximum size threshold of £15 billion of total assets, where total assets are as defined in the financial reporting framework and calculated using the average of the firm's total assets it was required to report during the previous 36 months in accordance with Rule 7.1 of the Regulatory Reporting Part of the PRA Rulebook.
- A firm must have an on-and off-balance sheet trading book business that would be equal to, or less than, both of the following thresholds: (i) 5% of the firm's total assets; and (ii) £44 million.
- The sum of a firm's overall net foreign exchange position, as defined in Article 351 in the Capital Requirements Regulation (CRR), must be equal to or less than 2% of the firm's own funds; and a firm must have no commodity positions.
- A firm must not have any internal ratings based (IRB) approvals to meet the definition of a Simpler-regime firm. Firms that wish to develop IRB models and submit an IRB application would be able to do so, while continuing to meet the Simpler-regime Firm definition. A firm would only cease to meet the definition when the model has regulatory approval, and hence will be using the model to calculate its capital requirements going forward.
- The firm's activity is primarily based in the UK, and focused on UK-based customers or counterparties. The PRA proposes that at least 85% of a firm's credit exposures must be to obligors located in the UK, where exposures means the exposures reported in COR001a, table C 09.04. In calculating these exposures to UK obligors and to obligors in all countries, a firm should use the geographical location of exposures reported in COR001a, table C 09.04, and exclude the exposure classes referred to in points (a) to (f) of Article 112 of the CRR.

Subsidiaries of large groups may be less likely to face the complexity problem than comparably sized standalone firms because they may be able to access group resources to help them understand, interpret, and operationalize prudential requirements. In those cases, the costs of understanding, interpreting, and operationalizing prudential requirements may be more likely to be proportionate to the public policy benefits. Therefore, to ensure firms meeting the Simpler-regime Firm definition advances the PRA's objectives, the PRA considers that the broader group should be taken into account when determining whether a firm meets the definition; i.e. the simpler regime would apply to small banks and building societies, not small units of large groups.

Net Stable Funding Ratio (NSFR)

The PRA introduced the NSFR on 1 January 2022. The NSFR is intended to help to ensure that firms maintain a stable funding profile in relation to the composition of their assets. It seeks to limit overreliance on short-term wholesale funding, encourage better assessment of funding risk across all on- and off- balance sheet items, and promote funding stability. A sustainable funding structure reduces the likelihood that disruptions to a firm's regular sources of funding could erode its liquidity position and increase the risk of its failure. Stability in a firm's longer-term funding enhances the safety and soundness of firms, in line with the PRA's objectives.

The PRA proposes to:

- apply to Simpler-regime Firms a new 'Retail Deposit Ratio' (RDR) to measure the extent of their use of relatively more stable retail funding;
- disapply the NSFR to a Simpler-regime Firm where the RDR condition is met (i.e. where the four-quarter moving average of its RDR is greater than or equal to 50% for four consecutive quarters); and
- otherwise apply the NSFR.

The Retail Deposit Ratio (RDR)

The PRA proposes to define the RDR as the ratio of a Simpler-regime Firm's retail funding to its non-capital funding:

Pillar 2 liquidity

The PRA's Pillar 2 liquidity approach is intended to complement the Pillar 1 regime by considering liquidity risks not captured, or not fully captured, under Pillar 1. The PRA's approach to assessing liquidity risks under Pillar 2 is set out in the PRA's SoP 'Pillar 2 liquidity'.

Liquidity reporting

The PRA proposes to exclude Simpler-regime Firms and Simpler-regime consolidation entities from certain requirements for liquidity reporting. The proposals would result in not requiring Simpler-regime Firms to report four of the five additional liquidity monitoring metric (ALMM) returns

Additional liquidity monitoring metrics (ALMM) returns

The ALMM returns are a set of liquidity risk monitoring tools that measure various dimensions of a firm's liquidity and funding risk profile that are not captured by the liquidity coverage ratio (LCR) or NSFR. The returns capture data related to firms' cash flows, funding and product concentrations, funding costs, and available unencumbered collateral. Submission of the returns is required on at least a quarterly basis.

Disclosures (Pillar 3)

The proposals would amend the Disclosure (CRR) Part of the PRA Rulebook

The proposals:

- for Simpler-regime Firms that have listed financial instruments ('listed Simper-regime Firms'), introducing a Pillar 3 disclosure requirement to disclose UK OV1 and UK KM1 templates;
- excluding Simpler-regime Firms without listed financial instruments ('non-listed Simper-regime Firms') from the requirement to disclose a Pillar 3 report; and
- removing the Pillar 3 rules applicable to small and non-complex institutions (SNCI) after a transitional period, after which SNCIs that are not Simpler-regime Firms will be subject to the disclosure requirements applicable to 'other' institutions in Article 433c of the Disclosure (CRR) Part of the rulebook.

How Pillar 4 can help

Pillar 4 works with aspiring SME banks and third country bank branches that we provide specialist services to. Speak to us for guidance on how this consultation might benefit your firm.