Financial Services Regulatory Insights

The Strong and Simple Framework

Easing regulatory burden without compromising stability

HOT TOPIC

September 2024

Highlights

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Executive Summary

On 12 September, the PRA released the second near-final policy statement (PS9/24) and rules for implementing Basel 3.1 standards, covering credit risk, the output floor, and reporting and disclosure requirements. This announcement is particularly significant for all PRA-regulated banks, building societies, investment firms, and financial holding companies.

Alongside the Basel 3.1 standards the PRA published consultation paper CP7/24 "The Strong and Simple Framework". This framework aims to significantly simplify the capital regime for Small Domestic Deposit Takers (SDDTs) while maintaining their resilience. The new regime proposes simpler calculations for certain risk-weighted assets, Pillar 2 methodologies and capital buffers and less onerous reporting obligations. These changes are designed to foster a competitive, diverse, and sustainable banking sector in the UK. The PRA's initiative addresses long-standing concerns from smaller firms and sets the implementation date for the simplified capital regime to 1 January 2027, with the consultation period closing on 12 December 2024.

Key highlights

The framework is being implemented in two phases. Phase 1 addressed non-capital related aspects e.g. liquidity and disclosure requirements whereas Phase 2 proposes a simplified capital regime and additional liquidity simplifications. This includes a simplified capital stack and the revocation of the Interim Capital Regime (ICR).

Simplified Capital Stack

Pillar 1 Simplifications: The PRA proposes to apply Basel 3.1 standardised approaches to calculating risk-weighted assets (RWAs) for credit risk (but without due diligence requirements) and operational risk to SDDTs. Simplifications to the market risk framework and the disapplication of capital requirements for counterparty credit risk (CCR) for derivatives (with some exceptions) and credit valuation adjustment (CVA) risk are also proposed. The new framework aims to preserve the benefits of consistent and comparable Pillar 1 capital requirements across SDDTs and non-SDDTs, while avoiding barriers to entry and exit from the SDDT regime.

Credit Risk: SDDTs will use the Basel 3.1 standardised approach to credit risk (CR SA) and credit risk mitigation (CRM) methods set out in PS9/24. The CR SA introduces more granular requirements that better reflect the riskiness of firms' exposures, benefiting both small and large firms by delivering resilience aligned with Basel 3.1 standards.

CRM methods including on-balance sheet netting, financial collateral simple method (FCSM), financial collateral comprehensive method (FCCM), other funded credit protection (OFCP) method, and the risk weight substitution method will be optional for SDDTs allowing them to use these methods if the benefits of RWA reduction outweigh the costs of increased complexity.

Operational Risk: SDDTs will use the Basel 3.1 standardised approach to operational risk (OR SA) set out in PS17/23. The OR SA is proportionate, with a simple calculation method based on financial statement information and differentiation based on firm size and complexity. This approach avoids creating additional barriers to growth for SDDTs.

Market Risk: The Pillar 1 capital requirements for market risk will be calculated using the CR SA; however SDDTs will be exempt from calculating capital requirements for foreign exchange and commodity risks.

Pillar 2A Simplifications

The PRA aims to simplify the Pillar 2A framework commensurate with the operations and complexity of the small, domestic-focused banks and building societies. Key changes include the removal of the IRB benchmarking methodology for credit risk, a simplified credit concentration risk calculation and a bucket approach for operational risk with firms allocated to one of three risk levels, each with a corresponding capital requirement.

The current approaches for interest rate risk in the banking book and pension obligation risk will be retained, while SDDTs are expected to monitor and adequately capitalise for counterparty credit risk. Additionally, the refined methodology and CCyB (PS15/20) adjustments will be eliminated, simplifying the overall capital framework and maintaining the resilience of SDDTs.

Credit Risk: The PRA will simplify the Pillar 2A methodology for credit risk, removing the benchmarking methodology and requiring certain SDDTs (e.g. new and growing banks, those engaged in higher-risk lending) to conduct detailed assessments using credit scenarios. This approach aims to reduce the burden on most SDDTs while ensuring adequate capitalisation for higher-risk firms.

Credit Concentration Risk: The PRA will replace the Herfindahl-Hirschman Index (HHI) methodology with a simpler calculation for credit concentration risk, using a base add-on for wholesale and retail exposures. The new approach will be supplemented by periodic evaluations of single-name and sector concentration risks using existing large exposure and stress testing frameworks.

Operational Risk: The PRA will introduce a streamlined methodology for setting Pillar 2A capital for operational risk, using a bucketing approach to allocate firms to one of three buckets based on their risk levels. Each bucket will have a corresponding total operational risk capital requirement, expressed as a share of the firm's total assets (0.3%, 0.65%, or 1.25% of total assets). However, SDDTs will be required to provide operational risk scenario analysis, risk management information, and loss data in their ICAAP, with the PRA setting clearer and more proportionate expectations for these analyses and management practices.

Other risk types: For other types of risk, the current approach for interest rate risk in the banking book (IRRBB) will be retained, focusing on firms' own risk appetites and internal policy limits. Similarly, the current approach for pension obligation risk, tailored to specific pension schemes, will continue, as it is already well-embedded and supported by most firms. SDDTs are expected to monitor and adequately capitalise for counterparty credit risk (CCR), with the PRA applying additional capital under Pillar 2 if necessary.

Elimination of Complex Adjustments: The PRA is proposing to retire the refined methodology, under which SA firms were able to seek an offset for “overcapitalisation” of credit risk under Pillar 1 against capital held for other Pillar 2A risks, on the basis that the Basel 3.1 CR SA changes render this adjustment largely redundant. In addition, the PRA proposes to remove the CCyB adjustment in Pillar 2A, as set out in PS15/20, simplifying the capital framework. This would generally result in somewhat higher Pillar 2A capital requirements for SDDTs, essentially reversing the previous shift of 1% of RWAs from buffers into the Pillar 2A requirement, balanced by the overall calibration of the capital framework to maintain resilience (i.e. lower buffers).

Buffers and Capital Framework

The new Single Capital Buffer (SCB) will replace the current multiple buffers, including the Capital Conservation Buffer (CCoB) and Countercyclical Capital Buffer (CCyB). The SCB will be set at no less than 3.5% of RWAs but may be higher based on individual firm risks and management. The SCB will be non-cyclical, reducing the complexity and cost associated with adjusting buffers in response to cyclical changes in the economy.

The SCB will be informed by firm-specific non-cyclical stress test results, risk management and governance assessments, and supervisory judgement. The SCB will ensure SDDTs maintain sufficient capital to withstand severe but plausible stress scenarios while reducing the complexity and unpredictability of current buffers.

Simplified Capital Deduction Requirements

The PRA proposes to simplify capital deduction requirements by removing multiple deduction thresholds, different treatments for non-significant investments (NSIs), deferred tax assets (DTAs), and significant investments (SIs), and the requirement to deduct NSIs and SIs from different tiers of capital. Under the new framework, all items subject to threshold calculations or optional risk weightings will be considered as a single group, with a single threshold of 25% of the firm's net CET1 capital. Amounts exceeding this threshold will be deducted from CET1, with non-deducted amounts risk-weighted at 250% for NSI, SI, and DTA items, and 1250% for specific items like certain securitisation positions and free deliveries.

Reduced Reporting Requirements

The PRA proposes to descope SDDTs from 38 reporting templates, replacing most CCR reporting with a simplified template and amending 24 templates and instructions. New tailored templates will be created for SDDTs, including copies of existing templates with amendments to reflect the simplified capital regime. Changes include the deletion of rows and columns related to IRB approaches, counterparty credit risk, and market risk, and the addition of rows for the new SCB.

Less Frequent ICAAP and ILAAP

The PRA proposes to reduce the frequency of SDDT firms' ICAAP and ILAAP reviews and updates from at least annually to at least every two years for most components, except for ICAAP Pillar 2A and Pillar 2B elements which will still require annual updates. This change aims to ease the operational burden on SDDTs, allowing them to focus resources on more critical risk management activities. Additionally, the PRA will introduce an optional structure for the ICAAP document, providing a high-level example of how SDDTs can conduct their risk assessments proportionately. This structure aims to help SDDTs produce and understand their ICAAP documents better, reducing reliance on external resources.

Implementation and Next Steps

The proposed implementation date for the changes is 1 January 2027, with the consultation period closing on 12 December 2024. SDDT-eligible firms are encouraged to engage with the PRA early if they intend to opt into the SDDT regime. The PRA will conduct an off-cycle review of firm-specific Pillar 2 capital requirements ahead of the implementation date to ensure a smooth transition. Firms will automatically transition to the new regime upon implementation if they have taken up the SDDT Modification by Consent (MbC).

What does this mean for firms?

Strategic Decisions

- Firms need to make a strategic decision whether to opt in to the Strong and Simple framework or to prepare for the "full version" of Basel 3.1, now that they have a full (near-final) picture of both regimes.
- The simplicity benefits of the framework may well outweigh the seemingly limited strength costs for firms that anticipate meeting the SDDT criteria over the medium to long term.

Maintain Resilience

- Although compliance is expected to be simpler and less costly, firms must transition to new but robust processes and controls framework for the simplified requirements.
- Firms need to ensure they remain as resilient under the simplified framework as under Basel 3.1 standards which may require enhanced oversight by senior management.

Technology Enable Processes and Reporting

- Firms should utilise the simplification opportunity to strategically update their technology infrastructure and automate processes to design an optimal and efficient system.
- Simplification increases the emphasis on process and controls to ensure the accuracy and completeness of PRA returns.
- Firms must stay informed about the ongoing wider data review by UK regulators, which may change how data is collected and the required data items and frequency.

Transition and Change management

- Firms need to address data challenges and finalise a range of judgements and interpretations in line with the new rules.
- One-off costs for system updates, staff training, and process adjustments may be required; however, potential cost savings should follow given reduced ongoing compliance requirements.
- Firms need to be aware of planning resources and engagement with the PRA for the off-cycle review of firm-specific Pillar 2 capital requirements.
- Firms need to adjust capital management strategies to align with new buffer requirements.
- Recalibration of ICAAP and non-cyclical stress-testing processes.

Increased reliance on Internal Risk Management

- The reduced frequency of assessments like ICAAP and ILAAP and increased supervisory judgement in setting the SCB could lead to less frequent but potentially more comprehensive reviews, requiring robust internal processes and risk management frameworks.
- Firms should assess the impact on their current governance, processes, systems and controls across all risk types.

Impact on Growth Plans

- Firms that grow beyond the SDDT criteria or are expected to do so in the near term will need to transition out of the simplified regime, potentially facing higher compliance costs and more complex regulatory requirements. Firms will need to factor that into their strategic growth plans and necessitate careful planning to manage the transition.

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