Moving mountains: How the PRA expects new UK banks to move beyond base camp

24 July 2020

Going from challenger bank to established player is like climbing a mountain, according to the PRA. New draft guidance is intended to help new and growing banks plot a safe path as they scale. The PRA has also hinted at a new UK regime to give smaller banks “a simpler mountain” after Brexit.

**Scaling the mountain: Rising regulatory expectations as new banks grow**

As trailed in its latest business plan, the PRA has launched a consultation on a new supervisory statement setting out its approach to overseeing new and growing UK banks.

In the statement the PRA reiterates that it does not expect banks to meet all its expectations of established banks at the time of authorisation. However, within five years of authorisation the PRA expects banks to have:

> **“Mature” controls:** Banks should expect to make significant investment in controls in their early years of operation. The PRA wants to avoid banks retrospectively investing in control functions after outgrowing their control environment. We cover the regulatory priorities for fast growing firms in our Challenger Bank video series.

> **A clear path to profitability:** Banks should focus on reaching profitability within a reasonable period following authorisation and how they will meet all relevant loss-absorbing requirements. We discuss the drive to profitability and the associated regulatory compliance challenges in a recent Challenger Bank webinar.

> **“Best practice” governance:** At authorisation, banks should have a clear plan for how their boards will develop and they should update this plan as their business grows. They should regularly review the skills and composition of their boards to ensure they
remain appropriate for the changing business. Notably, the number of independent non-executive directors should ratchet up over the first five years.

> **Forward-looking risk management:** New and growing banks should also (i) implement appropriate measures to identify, monitor and manage potential conflicts of interest, (ii) regularly assess their risk management framework, and (iii) ensure they have sufficient governance and oversight of outsourcing arrangements.

**Smoothing the path: Revised capital buffers for new and growing banks**

New banks, like larger banks, are generally required to maintain enough capital resources to meet their capital requirements comprising both Pillar 1 requirements and discretionary Pillar 2 buffers. The consultation proposes that for new banks the discretionary PRA buffer (known as Pillar 2B) should be equal to six months’ operating expenses rather than being calculated based on stress testing. New banks should move to a Pillar 2B buffer set on a stress-test basis either five years after authorisation or when they reach profitability, whichever is sooner, and should monitor the difference between the two in the meantime.

Despite some flexibility on that buffer, the draft approach holds the line in other important areas.

In relation to quality of CET1 capital, the PRA reiterates its expectation for simple, plain vanilla structures comprising only one class of share that is fully subordinated to all other capital and debt and has full voting rights and equal rights across all shares with respect to dividends and rights in liquidation. The PRA wants firms (including small banks) to refrain from features that may be ineffective (or less effective) in absorbing losses, such as those involving several legs or side agreements.

On loss absorbency, the PRA expects new banks to meet their CET1 and MREL requirements (without double-counting any capital resources). The PRA also warns banks to expect it to investigate whether any firm in breach or likely breach of its MREL is failing, or likely to fail, to satisfy the Threshold Conditions (which include the requirement to have an appropriate amount and quality of capital and liquidity).

The PRA also notes the importance of prudent forward-looking assessments, given concerns about the speed of capital depletion that is often experienced by new and growing banks. It expects banks to act quickly and decisively when they are at the point of entering their buffers (which is not itself a breach). The PRA will undertake more intensive supervision if it becomes clear that a bank does not have a sufficiently forward-looking approach to capital management.
A safe descent: Recovery and resolvability

The PRA recognises that banks should be able to, if necessary, fail in an orderly manner. According to the draft supervisory statement, new and growing banks should have:

> credible recovery plans which are sufficiently detailed, practical and useable in a stress scenario;

> a board-approved solvent wind-down plan in place at the point of authorisation or exit from mobilisation which should be kept up to date and may form part of the bank’s recovery plan; and

> a single customer view and exclusions file which is available to the PRA or FSCS within 24 hours of a request.

In a separate consultation, the PRA has also proposed applying simplified obligations for recovery and resolution planning under BRRD to new and growing non-systemic banks. Previously the PRA had not formally applied simplified obligations under BRRD to smaller firms, preferring instead to apply recovery planning rules proportionately. For new banks, these proposals seek to reduce the minimum number of scenarios considered in recovery planning to two, and disapply specific reporting templates.

Getting a foothold: Defining new and growing banks

“New banks” are those in mobilisation or have been authorised in the last year. “Growing banks” are typically between one and five years post-authorisation. According to the PRA, common characteristics of growing banks are: rapid growth; loss-making; reliance on regular capital injections; significant and rapid changes in strategy and business model; and immature controls.

The broader landscape: Background to the consultation

The draft supervisory statement is a response to the PRA’s concerns that many new and growing banks are too focused on initial authorisation and lose the longer-term focus of becoming a sustainable business or fail to appreciate the ongoing need to invest in systems and controls.

In a speech accompanying the consultation, Sarah Breeden (Executive Director at the PRA) notes that a common problem with new banks is their failure to anticipate, and put in place steps to mitigate, the risks they face. The speech also emphasises two factors that contribute to a bank’s success: the quality of its governance, and the strength of its relationship with the PRA.
What happens next?
The consultation on the PRA’s supervisory approach to new and growing banks closes on 14 October 2020 and the PRA intends to finalise its approach in H1 2021.

The consultation on simplified obligations for recovery planning closes on 23 October 2020 and the PRA intends to publish a policy statement, and notify eligible firms, in H2 2020.

The PRA is also considering introducing a new regime for smaller banks after the end of the Brexit transition period which would be intended to increase competition within the UK banking industry. However, any such regime would have to be compatible with any international agreements the Government enters into as part of leaving the EU.

Meanwhile, the PRA wants to hear from firms about what aspects of the current regime they find most problematic.