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Implementing PRA CP4/23: The Strong and Simple Framework

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Claire Trythall
Cumberland Building Society

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The Prudential Regulation Authority (PRA) has released *Consultation Paper CP4/23- The Strong and Simple Framework: Liquidity and Disclosure requirements for Simpler-regime Firms*. This represents the first phase of its "Strong and Simple" framework, which aims to address the "complexity problem" faced by smaller banks and building societies. This problem arises when smaller firms are required to comply with the same prudential requirements as larger firms, but the associated costs of implementing and understanding these requirements are proportionally higher.

This first phase relates to non-capital related prudential measures, while the second phase will deal with capital requirements and is due to be released early-2024. The rationale behind this phased approach is to allow for the early realisation of the benefits of implementing phase one, such as enhancing competitivity for smaller institutions by having less stringent requirements and thereby contributing to improving the overall efficiency and productivity of the banking sector.

The Consultation Paper (CP) describes proposals relating to:

- NSFR: New liquidity requirements
- Pillar 2 Liquidity: Revisions to Pillar 2 liquidity add-ons and a Simplified Internal Liquidity Adequacy Assessment Process (ILAAP) template
- Liquidity Reporting: Removal of certain liquidity reporting templates
- Pillar 3 Disclosures: Simplification of certain proportionality approaches applicable in the PRA rulebook.

The PRA has proposed that firms meeting the Simpler-regime criteria would have the option to enter a transitional regime based on current CRR provisions during the interim period between the proposed implementation date for Basel 3.1 standards, and the future implementation date for a permanent risk-based capital regime. Firms meeting the criteria could also choose to be subject to the proposed implementation of Basel 3.1 standards without delay. Under this proposal, organisations can make an informed decision whether to adhere to the Strong and Simple Framework or adopt Basel 3.1 regulation. If they opt for the Simpler-regime, a transitional regime based on current CRR provisions will be implemented during the interim period.

Through the implementation of the Strong and Simple Framework, the PRA intends to promote competition among smaller institutions by implementing less stringent requirements and enhancing efficiency and productivity in the banking sector. The approach will allow for organisations falling under the criteria of Simpler-regime Firms to benefit from the early realisation of reduced regulatory requirements, such as (in theory at least) giving firms more time and resources to be invested into growth and competitiveness.

The proposed date for implementing the simplifications outlined in this CP is expected to be in H2 2024.

Criteria of Simpler-Regime Firms

To qualify as a Simpler-regime Firm under the Strong and Simple Framework proposals, a bank or building society must meet either of the following criteria:

Average total asset value of under £4 billion, which is calculated based on a three-year average using the calculation outlined in the Strong and Simple framework proposals.

or

Average total asset value ranging between £4 billion and £20 billion and satisfying the following criteria:

i. The trading book business does not exceed £44 million and is less than 5% of the firm's total assets;
ii. Foreign exchange positions not exceeding 3.5% of own funds and at or under 2% of own funds on average;
iii. No positions relating to commodities;
iv. No provision of clearing, transaction settlement, custody, or correspondent banking services to UK or non-UK credit institutions, including acting as an intermediary for accessing certain specified facilities;
Unless these services are within their immediate group and in Pound Sterling (GBP).
v. The firm is not operating a payment system.

Through prioritising small firms most impacted by the complexity problem, the PRA intends to guarantee effective targeting of the new regulation. Additionally, this ensures that the PRA does not deviate from international standards by introducing the simpler regime only for domestically focused firms.

Net Stable Funding Ratio

The Net Stable Funding Ratio (NSFR) is a regulatory requirement introduced by the PRA on 1 January 2022 to demonstrate that firms maintain a stable funding profile and avoid excessive reliance on short-term wholesale funding. Although the NSFR applies to banks, building societies, and PRA-designated investment firms, smaller and non-complex institutions can choose to apply a simplified version.

The simplified NSFR (sNSFR) was introduced in January 2022 for small and non-complex firms to use as a simpler and less costly alternative to the NSFR. However, the PRA now proposes to remove the sNSFR from the Liquidity (CRR) Part of the PRA Rulebook, to avoid complexity and have a more proportionate approach to the NSFR.

The proposal is not to apply NSFR to Simpler-regime Firms when specific conditions related to their funding structure are met. Instead, there will be a new measure, the Retail Deposit Ratio (RDR), which aims to provide a simpler, more proportionate means of ensuring that smaller firms have sufficient stable funding in place to promote their safety and soundness.
RDR is given as:

RDR (%) = Total Retail Deposits / Total Funding

The proposal outlines the use definitions and data points from quarterly liquidity reporting that firms already submit to calculate the RDR. The PRA believes that this approach would be clear, prudent, and proportionate.

A 50% RDR is considered as a suitable level for determining when a firm's funding structure shifts from being predominantly retail-focused to predominantly wholesale-focused. Applying the NSFR if a firm's RDR falls below 50% is deemed prudent by the PRA, as it helps to mitigate the risk of insufficient resiliency to future funding stress. Calculating the RDR using the moving average across four quarters would address the risk of fluctuation in and out of the NSFR scope for Simpler-regime Firms with an RDR near 50%.

These proposals apply to Simpler-regime Firms and Simpler-regime consolidation entities based on their consolidated situation. To avoid duplicating data for comparable reporting, organisations have the option of utilising data from the C68 return. The C68 return serves the dual purpose of calculating the RDR and serving as a means of liquidity reporting, with all liabilities submitted instead of just those with a concentration greater than 1%. This is anticipated to streamline the process by eliminating an additional calculation step, and the repurposing of this report will prove advantageous in both calculating the RDR and in liquidity reporting, which is further elaborated upon in the Liquidity Reporting section.

The PRA proposes to require firms with a four-quarter moving average RDR below 50% to implement the NSFR within one year, balancing the need to provide firms with sufficient time to implement the standard and mitigate any risks to safety and soundness. SS24/15 will be amended to clarify the implementation period and the PRA's power to require a shorter implementation period. The one-year implementation period would not apply to firms that applied the NSFR before the implementation of the Simpler-regime and did not meet the RDR condition on the latest remittance date. Simpler-regime Firms would cease to be subject to the NSFR after a moving average RDR of greater than or equal to 50% has been observed for four consecutive quarters.

Nearly all firms under the Simpler-Regime are expected to meet the RDR threshold, meaning they will no longer be required to submit an NSFR.

“Safety and soundness” in the system is thereby maintained by applying NSFR for firms with a higher stable funding risk (arising from a greater proportion of short-term wholesale funding), while providing a simpler alternative for Simpler-regime firms that are mainly funded by retail deposits. The RDR provides a straightforward approach to identify firms that face NSFR-related risks, and the resulting cost reductions for Simpler-regime Firms funded primarily through retail deposits could aid in enhancing their financial resilience.

Liquidity Reporting

The Prudential Regulation Authority (PRA) proposes excluding Simpler-regime Firms and Simpler-regime consolidation entities from certain requirements for liquidity reporting, including reduced Pillar 2 requirements, a simpler ILAAP template and removing the requirement to report four of the five additional liquidity monitoring metric (ALMM) returns.

The PRA’s Pillar 2 liquidity approach is designed to address liquidity risks that are not fully captured by LCR (“Pillar 1”) regulations. Firms are required to assess their own liquidity risks, including Pillar 2 risks, and take measures to manage them. If the PRA determines that a firm is exposed to such risks, it may apply individual guidance, such as adding further high quality liquid assets, to address the risks. However, the PRA’s Pillar 2 approach is proportionate to each firm’s business model and risk level, and Simpler-regime firms are generally considered to pose lower risk and may not require Pillar 2 guidance. The PRA will be removing the regulatory requirement for Pillar 2 measurement and management for Simpler-regime firms (although they will still be required to assess their own risks and determine the quantity of high-quality liquid assets they hold).

A simpler ILAAP template should reduce considerably what has hitherto been a time- and resource-consuming process. The PRA set out expectations for ILAAP documents eight years ago in SS24/15, which included an annual update and a template for firms to follow. To improve the consistency and proportionality of ILAAP expectations, the PRA proposes a new template for Simpler-regime Firms. This will be a simplified and proportionate template, providing specific guidance on how Simpler-regime Firms can conduct their risk assessment appropriately in the context of their own business model and size. This will help firms to better understand the PRA’s expectations and consider adaptations in approach regarding individual circumstances. Overall, the new template involves the merging of duplicate sections, places emphasis on stress testing, provides guidance on conducting risk assessments proportionate to the firm’s business model, and outlines the information that should be included in each section.

The PRA will be reducing the burden of current ALMM returns (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 net stable funding ratio (NSFR)). The PRA’s proposals aim to align with the Bank of England’s plan for transforming data collection, including integrated reporting, common data standards, and modernising reporting instructions.

Simpler-regime Firms are proposed to be excluded from the requirement to report the following ALMM returns:

- C67 – Concentration of funding by counterparty;
- C69 – Prices for various lengths of funding;
- C70 – Roll-over of funding; and
- C71 – Concentration of counterbalancing capacity.

In addition, it is proposed that firms report liabilities arising from all relevant product types, not just those comprising 1% or more of liabilities, to reduce complexity in separating liabilities by concentration.
The PRA proposes to introduce a three-year transition period in which small and non-complex institutions that meet all of the conditions set out in point (145) of Article 4(1) of the CRR as at the implementation date in 2024 H2, but are not eligible for the simpler regime, would be able to continue to report all information on additional liquidity monitoring metrics with a quarterly frequency, to facilitate a smooth transition to monthly reporting. The PRA would continue to assess the risks that the ALMM returns are intended to capture, both on an ongoing basis and during L-SREP reviews.

Pillar 3 Disclosures

The PRA believes that public disclosures made by firms are important for the effective functioning of the financial system. Such disclosures help to reduce information asymmetry, facilitate market discipline and allow stakeholders to monitor firms they invest in. However, disclosures must be focused on valuable information to be effective in promoting market discipline. The PRA mandates content and presentation of disclosures to minimise coordination failure among firms and ensure consistency.

The PRA has determined that non-listed Simpler-regime Firms have limited ability to utilise disclosed information to exert discipline, and as a result, the loss of prudential benefits related to safety and soundness is unlikely to be significant. This conclusion is based on the feedback received in response to DP1/21, which suggested that non-listed Simpler-regime Firms do not frequently use disclosures. While Simpler-regime Firms may incur costs due to reduced disclosure, the option to voluntarily provide additional information to secure funding and reassure lenders remains. The proposed disclosure requirements serve as a minimum standard, but firms may choose to disclose additional information voluntarily.

The proposals outline that Simpler-regime Firms with listed financial instruments ('listed Simpler-regime Firms') must disclose UK OV1 and UK KM1 templates, while non-listed Simpler-regime Firms are not obliged to disclose a Pillar 3 report. Moreover, listed Simpler-regime Firms are expected to disclose essential regulatory metrics, such as risk-weighted assets, capital, leverage, and liquidity ratios, whereas non-listed Simpler-regime Firms are exempt from these disclosure requirements.

After a transitional period, the PRA plans to remove the Pillar 3 rules that apply to small and non-complex institutions, and those that are not classified as Simpler-regime Firms will be subject to the disclosure requirements outlined in Article 433c of the Disclosure (CRR) Part of the rulebook.

It is anticipated that cost savings derived from reduced disclosure requirements will benefit both listed and non-listed Simpler-regime Firms, due to reductions in templates and governance processes associated with disclosures. Although the PRA acknowledges that reduced disclosure may result in less publicly disclosed information about these firms, it considers that continuing disclosure requirements should be sufficient to satisfy market demand.

Summary and Conclusions

The release of Consultation Paper CP4/23 outlines proposals for a Strong and Simple Framework for the liquidity and disclosure requirements for Simpler-regime Firms. There will be a simplified liquidity, disclosure, and reporting regime, including a new measure, the Retail Deposit Ratio (RDR), removing the need to report NSFR (a metric once described by Professor Moorad Choudhry as "a set of assumptions divided by another set of assumptions"). The RDR measure is indeed strong and simple, and without an assumption in sight. Nonetheless, reporting its value will enable bank stakeholders to determine that they still have sufficient stable funding to ensure their liquidity risk safety and soundness.

The PRA also proposes to remove certain liquidity reporting templates and to amend the Pillar 2 and Pillar 3 disclosure requirements for Simpler-regime Firms, increasing proportionality and focusing disclosures on valuable information for investors and market participants.

The implementation date for the simplifications outlined in CP4/23 is expected to be in early H2 2024, to allow eligible firms sufficient time to consent to a rule modification that enables them to become Simpler-regime Firms and implement the simplifications. Additionally, the PRA wants to ensure that subsidiaries of non-UK groups, which meet the Simpler-regime criteria, have enough time to apply for the necessary modification.

We believe that the introduction of the new framework offers numerous advantages for smaller banks and building societies. Reducing regulatory burden and complexity not only results in time savings and a reduction in administrative processing requirement, it also contributes to cost savings, as there is now a lesser need for resources required to comply with more onerous regulation. Moreover, the decrease in resource requirement enables, at least in theory, the deployment of more resources to customer-facing and balance sheet origination business. This is to the benefit of the industry and all stakeholders.

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