Q4 Regulatory Insights Newsletter – Banking

There were a number of regulatory developments in Q4 2022, including the launch of the consultation paper on Basel 3.1. This was followed by the publication of the 2023 priorities letter from the PRA in January 2023. In this update, we have discussed the key regulatory developments from Q4 2022, and also discussed the PRA priorities letter from Q1 2023.

The key developments that we have discussed in this update are as follows:

- The Edinburgh Reforms
- The PRA's future approach to policy
- Implementation of Basel 3.1 standards (CP 16/22)
- Implications of the Basel 3.1 on the Strong and Simple regime
- Banking priorities for 2023 (published in Q1 2023)

The Edinburgh reforms

In a written statement to parliament on 9 December 2022, the Chancellor of the Exchequer unveiled the Edinburgh Reforms: a package of modifications intended to boost growth and competitiveness in the financial services industry. The reform is motivated by the increased competition the UK is facing from cities such as New York, Frankfurt and Paris. The announcement is part of the wider government's ambition to make London the world's most innovative and competitive global financial centre.

The announcement of the Edinburgh reforms is a clear indication that the UK government is willing to take advantage of Brexit by amending existing regulatory frameworks and trying to bolster the competitiveness of the UK financial services sector. Simplifying regulatory frameworks may ensure banks are ready to compete for overseas business but can also result in negative outcomes. Critics of deregulation argue that a similar approach set the scene for the 2007-08 financial crisis.

To enable this a wide range of reforms are being proposed (the full list can be found here). This article focuses on three major amendments of the Edinburgh reforms; ring fencing, the SMCR and international competitiveness of UK regulators. It will seek to understand how these policy initiatives are perceived and interpreted by participants, as well as analyse the implications of these changes.

1. Reforming ring fencing regime for Banks

The UK government initially introduced ring fencing with the objective to separate core retail services from investment operations in large banking groups. This was done to protect depositors against the risk that losses in adjacent business lines may imperil the viability of the banking group, as occurred during the 2007-08 Financial Crisis. The ring-fencing regime was one of the centrepieces of the UK's post Financial Crisis regulatory reforms and was a personal project of the current PRA head Sam Woods.

However, while making the banking sector more resilient and prudent, critics have accused the capital requirements of harming smaller lenders under the scope of ringfencing. Some industry participants have warned that ring-fencing has triggered unfair competition products such as mortgages. This is because banks inside the ring-fence use their vast pools of deposits to gain greater market share via ultra-competitive lending.

As part of the Edinburgh Reforms, a new 2023 consultation plan aims to review the practicalities of matching the ring-fencing and resolution regimes. Currently, the main proposals include removing banks without major investment activities from the regime and raising the deposit threshold for being in scope of the requirements. Additionally, the government will review and update the list of activities which ring-fenced banks are restricted from carrying out. The intention of these reforms will be to release capital that was previously tied up in ring-fencing into the wider economy.

<u>What management should consider</u>

A loosening in ringfencing rules could increase competition in the market. Freed from the regulatory constraints associated with the £25 billion deposit cap, medium sized banks may be able to grow their balance sheets and utilised greater economies of scale to compete more effectively in UK consumer lending markets. Foreign banks, whose competitive position has been constrained by the requirement of having to hold separate capital in their UK entities under ringfencing could also take advantage of this relaxation. UK affiliate of foreign banks such as Goldman Sachs (through Marcus) and JPMorgan (through Chase) may seek increase their retail funding presence in the UK.

2. Reforming the Senior Managers & Certification Regime (SM&CR)

Q1 2023 is expected to see a review of the existing SM&CR. Along with regulators, the government is likely to review the effectiveness, scope and proportionality of the current Regime. The review could lead to change initiatives designed to enhance the accountability of senior managers and improve governance arrangements in systematically important banks. Currently, the most frequent SM&CR complains from industry are focused on the time taken by the PRA/FCA to approve senior management individuals and the framework behind the designation of staff requiring certification. The delay in future SMCR expansion to financial market infrastructure, payment, and e-money enterprises is expected to be the immediate effect of this declaration. It may also result in the postponement of SMCR-related efforts, such as the FCA's guidelines on non-financial misconduct.

<u>What management should consider</u>

In the interim, banks should continue to ensure that statement of responsibilities for their SMFs remain all-encompassing; and that the design and delivery of such responsibilities are reviewed internally at least once a year. It is clear that the Edinburgh Reforms will warrant greater focus from regulators on this matter.

3. New remit letter for PRA and FCA

The government issued new remit letters to regulators to amend the Financial Services and Market Act (FSMA) and will look to introduce an additional secondary competition target for the FCA and PRA. The purpose of the remit letter is to deliver further suggestions and guidance with regards to regulators to facilitate international competitiveness and growth of the UK economy. Some of the priorities include:

1. swiftly implementing the outcomes of the FRF (Future Regulatory Framework) Review which focused on accountability, scrutiny, and stakeholder engagement;

2. promoting inward investment into the UK;
3. supporting innovation and new developments such as crypto, AI and machine learning; and
4. ensuring the UK is attractive to internationally active financial services firms and activities.
5. The implementation of these measures should be progressive and frequently assessed. If the implementation of those measures is uneven, banks that specialise in certain market sectors might be able to take advantage leading to unfair competition

These objectives add on to existing objective for both the PRA and FCA. The PRA element of this proposal is covered in our article below '**Vicky Saporta's speech on the PRA's future approach to policy**'.

What management should consider

Comparisons with the famous Thatcherite 'big bang' deregulation of City in the 1980s are obvious but lazy. There is debate over the significance of the proposed reforms, but early indications suggest that, overall, Edinburgh will provide an adjustment to the existing landscape rather than radically changing it. It will not be a total overhaul of how the UK approaches regulation of financial services that some were hoping to see.

Banks should review the SMCR regime. In particular, whether a more proportionate and streamlined approach may result in a relaxation of requirements for smaller firms.

Vicky Saporta's speech on the PRA's future approach to policy

Vicky Saporta, the Bank of England's Head of Prudential Policy, gave a speech to the Bank of International settlements covering the PRA's future approach to policy. The key theme of the speech was how the PRA can maintain financial resilience whilst simultaneously facilitating competitiveness in alignment with relevant international standards. This follows the UK governments announcement that it will be receiving a new secondary objective to facilitate the international competitiveness of the UK financial services sector (covered in the Q3 banking regulatory update under the title DP4/22 – the PRA's future approach to Policy).

The speech covers three main areas: the responsive approach, international competitiveness, and the balance of regulation to benefit innovation.

1. Responsive approach

Saporta discussed how good prudential regulation protects from threats and responds to new risks in a tailored manor. Existing examples given that illustrate this included; the building a Strong and Simple framework for small domestic banks and building societies for whom Basel standards were not designed (more on this later in the regulatory update); establishing a New Bank Start-Up Unit in 2013 to authorise new banks to take on incumbents; and considering a mobilisation regime for new insurers as part of the ongoing Solvency II review.

2. International Competitiveness

Saporta believes that facilitating competitiveness by aligning with international standards allows the PRA to review previously fixed legislation and areas of policy. Her view is that it will also allow the regulator to avoid inefficiencies from international firms having to comply with different rules. This will enable firms to benefit from so-called 'agglomeration effects' – self-reinforcing cost saving effects which naturally arise where businesses cluster together.

Termed as 'regulatory innovation', Saporta outlined that the PRA's new approach would protect and strengthen the regulator's reputation. The PRA hopes this will make it more likely for other regulators to allow other firms in their jurisdictions to operate in the UK. Existing examples of this, noted in a recent IMF review on the British regulatory landscape, include the UK regulators willingness to flexibly supervise banks with significant digital footprints and advanced technology stacks. Another factor that will support Saporta's position is the consensus that the PRA and FCA are well respected by international counterparts and heavily involved in international regulatory exercises and policy forums. However, these relationships will need to be maintained and enhanced to achieve the agglomeration effects that the PRA desires.

3. Regulation to benefit innovation

Lastly, Saporta maintains strong regulation needs to be responsive to the needs of the UK whilst benefitting innovation. This is exemplified through the removal of legacy EU restrictions regarding when distributions taking firms into their capital buffers can be made; removing EU requirements for international groups to operate under a single intermediate parent and delivering a 15% reduction in reporting burden on insurers across the sector. Saporta states the PRA will "continue to delete unnecessary rules" and will choose options that facilitate growth and competitiveness.

What management should consider

As Saporta's speech further sets out, any post Brexit 'bonfire of regulations' appears unlikely. However, firms should be aware of the impact ongoing, piecemeal, post-Brexit adjustments to the UK regulatory framework that may, over time have a material impact on their organisation. To counter this senior management will need to understand and monitor the cumulative impact of the regulatory changes being made.

CP16/22 – Implementation of Basel 3.1 Standards

The PRA has recently published the CP16/22 **'Implementation of Basel 3.1 Standards'**[1] a response to the Basel Committee's final set of post 2007-08 Financial Crisis capital reforms.

The reforms seek to make 3 significant adjustments to the regulatory landscape. The first is an increase per unit of risk by raising the quantity of capital in the financial system. Second, to increase the amount of capital held by firms and the third is to improve the measurement of risk by firms. CP16/22 sets out the PRA's intention to apply Basel 3.1 standards over the coming years with an implementation date for the Basel 3.1 reforms of 1 January 2025 (with transitional arrangements in place for some elements of the reforms).

This article summarises the main changes associated with Basel 3.1 and highlight factors banks should give consideration to when interpreting the new regulations. This CP is targeted at the PRA-authorised banks, building societies, PRA-designated financial or mixed financial holding companies.

Overview

There are nine key elements of the CP that are important in setting the scene for Basel 3.1:

1. Overhaul of the **Standardised Approached (SA)**, providing more specific requirements to suit firm's own unique risk exposures.
2. Introduction of new measures that will establish robustness and consistency among firms when calculating their **Internal Ratings Based (IRB**) credit risk.
3. Introduction of **credit risk mitigation (CRM)** techniques.
4. Introduction of an **Output Floor** providing a limit on the extent to which firms using IRB can lower their risk-weighted assets (RWAs) compared to firms using the Standardised Approach (SA).
5. A new approach to **Operational Risk**, with all banks being required to follow the Standardised Op Risk approach (SA-OR). For smaller firms this means moving away from the simplistic Basic Indicator Approach (BIA).

[1] CP16/22 – Implementation of the Basel 3.1 standards | Bank of England

6. Removal of Internal Models for **credit valuation adjustment (CVA)** risk, implementing new standardised and basic approaches. With the new proposed prudential framework to capitalize for CVA, banks are now incentivized to hedge out the market risk arising from CVA. Overall, capital is still expected to increase although there are still outstanding questions such as whether the corporate exemption will be maintained.
7. A new approach to **Market Risk**, comprising of four elements:
    - For trading book allocation, there will be new requirements determining these positions
    - A simplified standardised approach (SSA) will be established along with the standardised approach (SA)
    - Introduction of advanced standardised approach (ASA) and internal model approach (IMA) as calculation methodologies

    Several large banks have communicated that they would not apply for the internal model approach under FRTB, the so-called FRTB-IMA. Institutions that are aiming to apply though are ramping up resources across quant, infrastructure and transformation to be able to deliver in line with the timelines communicated by the BoE. There are still uncertainty on the stability of the IMA as desks need to consistently pass statistical tests on an on-going basis, with the risk of falling back to the more punitive standardized approach.

8. Inclusion of the **2050 net-zero target in the Climate Change Act 2008** within the Basel 3.1 standards. The PRA are aiming to reduce any negative impacts there may be on the net-zero targets when allowing firms to use FIRB and AIRB approaches. In addition, the PRA proposes to introduce a specific risk weight for carbon emissions certificates.
9. The Basel 3.1 CP interacts with the **'strong and simple'** framework involving non-systematic banks and building societies. Firms that meet the Simpler-regime criteria will not be obliged to implement the Basel 3.1 standards as they are presented in the CP, instead these firms can enter 'Transitional Capital Regime' which is based on CRR provisions.

Of these nine elements, four should be of particular consideration for banks when interpreting the new requirements:

1. Credit Risk: Standardised Approach

Basel 3.1 aims to increase the risk sensitivity and consistency in the Standardised Approach to ensure a robust RWA calculation. We have further detailed the two most significant changes to the SA approach:

External Credit Ratings: The BCBS believe that the over reliance on external credit ratings was a risk, with firms struggling to understand and represent the exposures associated with each risk. Consequently, the PRA proposes firms to use the credit ratings of their nominated external credit institutions (ECAIs) for each type of risk exposure they face. This reduces the likelihood of firms nominating ECAI ratings that would lower their RWAs, providing consistency and appropriate risk management measures.

Exposure for off-balance sheet items: To align with the Basel 3.1 proposals the PRA proposes two categories of off-balance sheet items, the first of which is issued off-balance sheet items to a third party, and the firm takes this risk exposure. Second, commitments to extend credit or issue off-balance sheet items at a future date.

<u>What management should consider</u>

- Firms should consider using credit ratings of their nominated external credit assessment institutions (ECAIs) for every risk exposure they identify unique to their organisation.
- Firms should consider doing extensive research on their counterparties' risk exposures to assess their financial positions in the market, benchmarking this against their own risk measurement and implement appropriate oversight measures associated with this.

2. Credit Risk: Internal Ratings Based Approach (IRB)

The Basel 3.1 reforms aim to alter the IRB approach due to the perceived disadvantages posed with the current calculation of risk-weighted assets (RWAs) when using internal models as inputs for determining credit risk. Such disadvantages include a lack of comparability between firms and increased complexity and variability when determining the RWAs.

To account for this Basel 3.1 standards aims to amend and introduce new measures that will establish robustness and consistency among firms when calculating their IRB credit risk. There are several steps the PRA are going to introduce to ensure these changes take place:

- Limit the amount of exposure categories under which the IRB approach can be utilised, and to restrict the type of models that can be used to reduce variability.
- Adopt input floors. Input floors are a risk parameter used in IRB modelling, measuring the probability of default (PD), loss given default (LGD) and exposure at default (EAD). This will reduce variability and increase comparability between firms in their computation of RWAs.
- Provide more information and regulatory guidance on parameter estimation to reduce the variability of RWAs.

What management should consider

- To familiarise themselves with the Basel 3.1 revisions banks should review their IRB models framework. When conducting this analysis the potential implications of other further regulatory change should be understood. Especially, the increased utilisation of automation IRB models set out by the PRA in DP 5/22 'Artificial Intelligence and Machine Learning'.
- Firms will need to conduct a gap analysis of their IRB approaches to understand whether they are able to continue applying them to different subsets of credit risk under Basel 3.1.

3. Operational Risk

Basel 3.1 proposes moving away from the Basic Indicator Approach to the snappily named Standardised Op Risk approach (SA-OR). The SA-OR will be calculated via the application of two elements, the Business Indicator Component and the Internal Loss Multiplier.

The Business Indicator (BI) is comprised of the sum 3 different components; leases and dividends component, services component and financial component. The latter covering bank's gross income. The Business indicator Component (BIC) is then calculated by the multiplication of the BI with coefficients depending on the size of the bank.

The Internal Loss Multiplier (ILM) ensures that a bank's internal operational risk loss experience affects the calculation of operational risk capital. This is calculated via a Loss Component (LC) which is defined as 15 times the average annual operational risk losses over the previous 10 years (with a minimum of five years during the transition to the SA). This component introduces some risk sensitivity into the approach. The ILM is then calculated from the LC and the BIC.

What management should consider

This will disproportionately impact smaller firms. Therefore, it is important that these firms begin to implement testing and training programs to their finance and risk departments so that individuals are well prepared to implement and understand the new approach and its capital implications.

4. Output Floor

The Basel 3.1 introduces an output floor to ensure closer alignment between IRB approach firms and their SA counterparts. The output floor, which sets a lower bound of 72.5% capital estimated under IRB approaches versus standardised requirements, will ensure the classification of standardised risk weights becomes more significant larger firms as it becomes the binding constraint on their overall capital requirements.

What management should consider

Banks following advanced approaches to credit risk will need to reassess their Standardised risk weights and, consequently, are likely to have to increase the number of procedures, controls, and oversight in place.

Strong and Simple – Implications of Basel 3.1

For the past 24 months senior figures at the Bank of England have been signalling their intention to develop a "strong and simple" regime for less systemically important banks that the PRA does not consider to be systemically important or internationally active, reducing regulatory burdens and levelling the playing field in the process.

After a slow start it appears work is picking up speed, with a consultation paper published in April 2022 which seeks to define definition of a 'Simpler-regime Firm' and disclosures around the PRA and FCA's the new competition objectives.

Further detail has been promised on how the Strong and Simple regime will work in practice from a capital (expected 2024) and everything else (expected 2023) perspective.

Mazars are developing a new **Strong and Simple Hub** which will seek to become a one-stop-shop for all clients and market participants who want to remain abreast of regulatory developments in this space as they gradually unfold.

While waiting for further detail from the Bank of England, there are already some insights we are starting to gather on what the regulator may be looking to implement in the future. For many in the market one of the most interesting possibilities is associated with the restructuring of the capital adequacy framework for small and medium sized UK banks. Given the recent publication of the Basel 3.1 consultation paper, which covers similar ground, we thought it would be interesting to look how the two could align.

Implications of Basel 3.1 on Strong and Simple – a positive outlook

Basel 3.1 might be belated, but its implementation timeline aligns neatly with the timelines associated with the Strong and Simple workstream and it stands to reason that the Bank of England will seek to incorporate elements of the former into the latter.

The PRA has already disclosed that it is considering whether the proposed revised approaches for credit risk SA and credit risk mitigation under Basel 3.1 would be the appropriate starting point for designing the simpler regime's risk-based capital framework. As outlined below, it does appear as though a number of proposals under Basel 3.1 would, in fact, naturally align with the objectives of the Strong and Simple regime.

1. Credit Risk

A significant amount of the Basel revisions are more directly applicable to larger firms. For example, the introduction of the concept of an output floor (72.5% capital as a base versus standardised requirements), attempting to account for model risk and bring about closer alignment between the Standardised and IRB approaches. However, this has a knock-on effect for Strong and Simple firms, reduces the divergence in capital treatment between the two regimes.

Reform could provide additional impetus for a second look at the underlying risk weights associated with the Standardised Approach. As part of this the PRA could consider application of greater risk weight granularity for a small group of low risk, but financially significant, products such as mortgages. This could be to the advantage of small and larger firms.

2. **Operational Risk**

Operational Risk is another element of Pillar 1 that is expected to change. Basel 3.1 proposes moving away from the Basic Indicator Approach to the snappily named Standardised Op Risk approach (SA-OR). For smaller firms this will be calculated via the application of two elements, the Business Indicator and the Business Indicator Component. This is covered earlier in our article **CP16/22 – Implementation of Basel 3.1 Standards**

This will likely have a negative impact smaller firms in the short term because the new approach is more complex than the simplistic Basic Indicator Approach. However, moving all banks onto a standardised approach for Operational Risk capital means that, again, the application of the revised Basel 3.1 approach looks like it will have the effect of levelling the playing field in terms of requirements. This is because Basel 3.1 promotes closer alignment of the capital calculation methodologies for Operational Risk across the sector.

What management should consider

It can be reasonably argued that Basel 3.1 reforms have the potential to be a positive for Strong and Simple firms. They are likely to bring closer alignment in the capital requirements for all UK banks. Although smaller firms should note that the reforms are also likely to add complexity to the Pillar 1 capital framework, via the revised calculation of Operational Risk. As a result it seems plausible that Basel 3.1 will have a significant impact on the Strong and Simple regime and will drive a degree of alignment in regulatory capital requirements amongst UK banks compared to previously.

2023 Priorities for banks operating in the UK

Two separate letters were published on 10 January 2023, one outlining the priorities for subsidiaries and branches of international banks that operate in the UK, and another for banks that are headquartered in the UK.

Priorities for International Banks

Firstly, the letter reinforced the PRA's intention to focus on firms' capital and liquidity levels – meaning the firms should maintain focus on these areas in the same vein as they have been in the past. This entails specific focus on ICAAPs and ILAAPs, and the production of COREP, PRA110, LCR and NSFR returns.

More specifically, the PRA has hinted at greater focus on *Risk Management and Governance*. For a very long time this has remained a subjective topic, but something of the utmost importance for the PRA as they have often applied a Risk management & Governance Scalar to increase capital and liquidity requirements on those firms that, in the PRA's view, falls short of standards. Following market volatility in 2022, because of the Russian invasion of Ukraine and, more seriously, extreme gilt market behaviours following the Liz Truss 'Mini-budget' , a number of risk management failings were observed to have crystalised. As a consequence, the PRA expects firms to step up their focus on counterparty risks, and adequately reflect this focus in their governance and control frameworks. The PRA appears to require firms to review their:

- onboarding and due-diligence arrangements, together with their counterparty pricing and margining frameworks; and
- stress test their counterparty exposures as part of their P2B analysis contained within ICAAP documentation.

We would advise that firms expand on these drives in their annual ICAAP and ILAAP, and quantify the impact of this assessment in their regulatory returns.

Second, the PRA has also hinted at greater focus on *Operational risk and resilience*. In response to SS1/21, firms should have identified and mapped their Important Business Services (IBS), set impact tolerances for these, and commenced a programme of scenario testing. The PRA has indicated that they will focus on how firms are maintaining this framework, and therefore, it is important for firms to test the operating effectiveness of this framework prior to the PRA's intervention. The PRA also intends to maintain focus on firms' outsourced operations, specially how such risks are aligned with SS 2/21 on third party risk management. It is therefore important for firms to review their compliance with the supervisory statement.

Thirdly, the PRA has clarified that it will focus on firms' *ability to manage their internal data*. The PRA have found significant deficiencies in data lineage and management across the industry, and the PRA's message is for firms to address this. Indeed, the PRA has been talking about this industry-wide weakness since 2021, and as such their messaging on this subject has become progressively assertive. We feel that on-site reviews of data management are imminent. A part of this has already been covered through s-166 reviews – which are also being imposed on small and medium sized banks. Yet again, the PRA has pointed to its Dear CEO letter from 2021 – where data governance and control were identified as a thematic finding. We would therefore urge firms to take steps to ensure that the correct checks and balances are in place to preserve the integrity of regulatory data.

Amongst other messages, the PRA has alluded to greater focus on climate change, and diversity and inclusion within regulated firms.

Priorities for UK-headquartered banks

The messages for UK-headquartered banks are identical to those that apply to international banks (discussed above). The only additional focus for UK-HQ'd banks is on Model Risk and Resolution.

Model Risk: The PRA has been talking about model risk for some time now, if not via Dear CFO letters then by reinforcing the principles of SS3/18 and the subsequent CP6/22. This was summarised in detail as part of our Q3 Regulatory Insights update. Firms are urged to review the provisions of the consultation paper and consider the baseline standards that they need to meet in the context of Model Risk. Some of the main topics for firms to cover entail:

- the definition of a model, and building a model inventory
- designing and rolling out a model governance framework, covering the RACI, model development, implementation and use
- design a programme for periodic validation of the models that the firm relies upon
- build in model risk mitigants in its approach to managing (and setting an appetite for) model risk

Resolution: The PRA has urged firms to which the Resolvability Assessment Framework applies, to ensure that they are able to achieve and/or continue to maintain the resolvability outcomes of the RAF. This entails such firms to attain greater transparency in their disclosures around their preparations for resolution. We would encourage firms to undertake internal reviews of their work on resolvability against the desired outcomes of the resolvability assessment framework.

What management should consider

Firms should ensure that their senior management team is able to talk about enhancement to risk management and governance, operational resilience and data management at their upcoming meetings with the PRA.

As a priority, firms must ensure that their data – especially those that contribute to regulatory reporting – are being managed in line with regulatory expectations. This entails a clear view of data lineage, comfort over source data, and accuracy of data processing (both regulatory as well as computational). A number of firms have fallen victim of weak data governance standards, and such issues are widespread and recurring. As such, this is an area that we expect the PRA to focus on more than others.

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