Financial Services Regulatory Insights

The PRA sets out an ambitious agenda

HOT TOPIC

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Highlights

The PRA's Business Plan for 2022/23 sets out a significant agenda, with major reforms planned to the core banking and insurance prudential regimes, as well as wider cross-sectoral initiatives.

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Summary

The PRA published its 2022/23 Business Plan on 20 April 2022, setting out its strategic priorities, workplan and budget. The Business Plan sets out the PRA's wide-ranging priorities for the banks, designated investment firms (henceforth banks) and insurance firms it supervises.

In place of the PRA's previous eight strategic goals, the 2022/23 workplan is structured around four strategic priorities:

- retain and build on the strength of the banking and insurance sectors delivered by the financial crisis reforms
- identify new and emerging risks, and lead on the development of international policy
- support competitive and dynamic markets in the sectors that the PRA regulates
- run an inclusive, efficient and modern regulator within the Bank of England.

The Business Plan provides a clear indication of the PRA's priorities at an important time for the regulator. Significant changes to prudential requirements are planned for banks and insurers in the coming years, through the implementation of Basel 3.1 and the Solvency II review. The PRA is also considering the implications of the powers and objectives it is likely to receive as a result of the Government's Future Regulatory Framework (FRF) review. While welcoming the renewed focus on international competitiveness and growth under the FRF, the PRA clearly sees the resilience firms have shown to recent crises as vindicating its focus on increasing the financial and operational resilience of banks and insurers. This is likely to influence the approach the PRA takes to Basel 3.1 implementation and to a lesser extent the Solvency II review, where the Government has already committed to a relaxation in a number of areas.

The PRA will also continue to develop its policy on topics such as the use of artificial intelligence by firms and diversity and inclusion, further embed the operational resilience and climate risk frameworks into ongoing supervision, and retain its ongoing focus on long-standing supervisory priorities such as regulatory reporting.

Banking sector initiatives

The PRA has committed to a number of important workstreams relevant to banks, including the finalisation of the Basel 3 reform framework, the resumption of the annual stress testing framework and further reviews of internal modelling:

- The PRA intends to consult in Q4 2022 on the implementation of the Basel 3.1 reform package, which has been designed to reduce excessive variation in banks' calculated risk weighted assets and to support more effective comparison of banks' capital ratios.This package represents the final installment of prudential reforms developed in response to the Global Financial Crisis and will be an important area for firms to consider, given the potential impact on their business models and market strategy. The PRA expects the implementation date of Basel 3.1 to be 1 January 2025.

- The PRA intends to update the UK leverage ratio framework to reflect changes due from 1 January 2023, when firms with non-UK assets above £10bn will come within the scope of the minimum requirement (we covered previous changes to the framework in this At a glance briefing). The PRA also plans to conduct a data-gathering exercise to assess the potential risks from contingent leverage, particularly in instances where firms might structure transactions to secure a lower exposure measure value than would otherwise be incurred.

- The Bank of England and the PRA will conduct the annual cyclical scenario (ACS) stress test later in 2022, with a revised timeline to be announced during Q2 2022. The Bank has delayed the timing of the test from March 2022, as a result of the Russian invasion of Ukraine. The 2022 ACS test will be structured around significant simultaneous UK and global recessions in the UK, significant falls in asset prices and increased level of global interest rates. The Bank will also conduct a separate test scenario focused on misconduct costs. This represents a return to the Bank's annual ACS stress testing framework, following COVID-19 crisis-related stress testing for the past two years.

- The PRA will be expecting qualifying firms to submit IRB model applications in line with their supervisory communicated timelines, following the implementation of new PRA requirements and supervisory expectations from 1 January 2022. The PRA has also announced it will publish a supervisory statement in 2022 that will consolidate all existing PRA supervisory expectations, rules and requirements on model governance, validation and general risk management. This is the latest tranche of PRA policy work in relation to IRB credit risk, which has sought to capture firms' use of modelling beyond the scope of previous PRA rules and guidance.

- The PRA will work with HM Treasury over 2022 to respond to any proposed changes to the ring-fencing and proprietary trading regimes arising from the recommendations of the independent Skeoch review.

Insurance sector initiatives

The PRA has announced several major workstreams relevant to insurers, including follow-up to the Government's review of Solvency II and details of the next stress test exercise:

- Following HM Treasury's review of Solvency II, the PRA intends to consult on a package of reforms to insurance regulation later in 2022 (HM Treasury's consultation was published on 28 April 2022). Ahead of its proposed consultation, the PRA has published a statement on the Treasury's consultation along with a Discussion Paper and accompanying Quantitative Impact Study.

- The main elements that the PRA expects to consult on are:
    - a reduction in the risk margin for long-term life insurance liabilities
    - adjusting the design and strengthening the calibration of the matching adjustment, to align with the actual risks held by insurers
    - expanding the eligibility criteria for matching adjustment portfolios to include assets with prepayment options or variable construction phases, to allow more investment in assets that contribute to UK GDP growth and net-zero targets
    - including morbidity risk-related liabilities within the eligibility criteria for matching adjustment portfolios
    - simplifying processes for the approval of internal models and of matching adjustment eligibility for less complex assets, in order to remove potential investment barriers
    - various changes to support a more competitive insurance market, including the raising of the threshold for the application of Solvency II rules, introducing a mobilisation process for new insurers, and reducing capital and reporting requirements for incoming branches.

- The PRA will start the next insurance stress test in May 2022 and will cover the largest general and life insurers. For life insurers, the PRA will assess sector resilience in relation to a severe market disruption to interest rates and liquidity, followed by a longevity shock. For general insurers, the PRA will focus the stress test on natural catastrophes and potential cyber attacks. The PRA also intends to develop its longer-term strategy for stress testing, and to use the results to guide its supervisory activity.

- The PRA will continue to review the use of models by insurers to qualify and manage their risks. It will also review subsequent model outputs to support the PRA's comparative assessment of firms across different prudential risk categories.

- The PRA has also set out specific areas for supervisory focus, which are mostly aligned to market and macro-economic factors. These include Covid-19 related credit exposures and market risk sensitivity in the life insurance sector and the impact of economic inflation and contract uncertainty risk across the general insurance sector.

Cross-sectoral initiatives

As well as sector-specific initiatives, firms should be aware of the PRA's cross-sectoral priorities and horizon-scanning work to identify longer-term risks to the PRA's statutory objectives.

Operational risk and resilience

- Throughout 2022, the PRA will assess how firms have implemented the operational resilience framework (which came into force on 31 March 2022). This will include an assessment of firms' plans to be able to remain within their impact tolerances for important business services within a reasonable time by 31 March 2025.

- The Bank of England, PRA and FCA will publish a joint discussion paper in due course, proposing regulatory and supervisory measures to help address potential systemic risks posed by critical third party providers (such as Cloud service providers). Firms will therefore need to consider their approach to outsourcing and third party risk management in line with this increased regulatory focus.

Governance and risk management

- The PRA intends to use the governance regime to help deliver better prudential outcomes across all regulated firms, by focusing on accountability for risk management (a key theme in a Dear CEO letter sent out in December 2021) and incentive-setting through remuneration. The PRA will also continue to focus on the quality of firms' regulatory reporting, underlining the ongoing importance placed by the PRA on the use of reporting data to support effective supervision.
- The PRA will consult later in 2022 (delayed from Q2 2022) on proposals to support greater diversity and inclusion (D&I) in the financial services sector. The PRA intends to publish the final policy during 2023 (delayed from Q4 2022). This work will build on the joint Bank of England, PRA and FCA Discussion Paper published in July 2021 (refer to PwC's At a glance briefing for further analysis) and will require firms to significantly step up their efforts to improve diversity and inclusion.

Climate change

- Over 2022, the PRA will switch from assessing firms' implementation of climate change related policy measures, to actively supervising firms' management of climate-related financial risks. The PRA will require the largest firms to report on how they have embedded their approach into their existing risk management frameworks, alongside their 2021/22 Internal Capital Adequacy Assessment Process (for deposit takers) or their Own Risk and Solvency Assessment (for insurers). A sample of the remaining firms will also be required to report based on their relative size and complexity, and the extent of climate-related financial risks that they face.
- The results of the 2022 Climate Biennial Exploratory Scenario will be published by mid-2022 and will inform the ongoing development of the PRA's supervisory approach to addressing climate-related financial risks.

Digitalisation and technology

- The PRA will continue to monitor risks and opportunities arising from digitalisation, including product developments, the emergence of new banking business models centring on payments, and the management of systemic risks arising from third party service providers. The PRA and the FCA will consider specific digitalisation risks to the insurance sector, including potential risks around the market entry and impact of large technology companies. The PRA will also continue to oversee potential risks emerging from firms' level of business in cryptoassets, by requiring firms to report their exposure levels and future investment plans.
- The PRA plans to publish a Discussion Paper on Artificial Intelligence (AI) in 2022, to explore its potential role in relation to the challenges and risks related to the use of AI in financial services.

Competitive markets

The Government has proposed a new secondary objective for the PRA to support international competitiveness and economic growth. Ahead of the potential confirmation of this objective, the PRA is developing initiatives in a number of areas:

- The Government will publish a new Financial Services Bill later in 2022, which will propose reforms to the UK's financial services regulatory framework recommended through HM Treasury's FRF review. The PRA will publish a Discussion Paper in 2022, proposing its longer-term approach to prudential policy-making under the FRF.
- The PRA is developing a strong and simple prudential regime for smaller non-systemic banks and building societies, and plans to publish a Consultation Paper in 2022/23. This will set out the proposed scope and criteria for firms to be considered eligible. In the insurance sector, the PRA will seek to simplify and expedite the authorisations process to support competition. The PRA will also consult on a mobilisation regime to reduce barriers to entry for new insurance retail firms and raise thresholds for the application of Solvency II requirements.
- The PRA will do more in the coming years to increase confidence that firms can exit the market without disturbing it. It will review the approach to wind-down and run-off planning, building this into core supervisory activity and tools.

What do firms need to do?

The PRA's current agenda is perhaps the most significant since its inception in 2013, hence the proposed budget of £320.9m in 2022/23, which represents an increase of £24.3m (8.2%) over 2021/22. The PRA's aim is to hire more staff in its supervisory risk specialist, policy and data science areas to help deliver its workplan.

The PRA acknowledges that its plan could be constrained by capacity or significant external events, but the breadth and significance of the PRA's regulatory and supervisory agenda will result in significant demands for all PRA regulated firms. Banks and insurers will need to prepare for significant reforms to core prudential requirements, albeit many of the planned reforms to Solvency II will be welcomed by the sector. The PRA's supervisory agenda will remain exceptionally busy. Supervisory interactions are likely to focus on further embedding new requirements such as operational resilience and climate risk, and driving improvements in areas such as risk management and regulatory reporting. In addition, the PRA's agenda continues to grow, with an increased focus on topics such as D&I, digitalisation and crypto.

Among the wide-ranging agenda for banks, firms should focus on:

- The implications of the Basel 3.1 package for their business models and wider market strategy, ahead of the PRA's proposed consultation in Q4 2022. Basel 3.1 will have a significant impact on banks across the spectrum of business models and those firms operating in multiple jurisdictions are likely to face a significant degree of divergence in approaches to implementation.
- The PRA is clearly concerned by the failings shown by the losses incurred due to the failure of Archegos Capital Management and supervisors are likely to probe risk management capabilities, particularly in investment banks.
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- Firms reliant on internal models should review their approach to governance, validation and general risk management ahead of the publication of the PRA's overall approach later in 2022.

Insurance firms should particularly consider the following PRA workstreams:

- Firms should consider the specific Solvency II reform components that HM Treasury and the PRA intend to consult on in 2022, in terms of potential impact on their business model and market strategy. HMT is committed to significant changes to a number of Solvency II requirements, with a potentially material reduction in capital requirements.

- Firms should regularly review their approach to use of internal models, given the PRA's intention to increase supervisory oversight in this area.

The following cross-sectoral priorities will also be important for firms:

- Senior Management Functions should prepare for the PRA's supervisory oversight to strengthen in relation to firms their management of climate-related financial risks and ability to meet the new operational resilience requirements.
- Firms should also be looking to make meaningful and sustainable progress on D&I, given the likelihood of formal PRA policy being developed in this area.
- The PRA's focus on issues such as AI, Cloud and crypto will increase in 2022, with separate discussion papers on the regulatory approach to AI and critical third parties expected. Firms are at different levels of maturity in adoption of these technologies, but it is vital that adoption strategies fully consider the emerging regulatory priorities in these areas.
- As further details emerge over 2022, firms that may qualify for the PRA's anticipated simplified regimes for smaller institutions should consider how the proposals might reduce their costs and support more effective competition in their target markets.

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