BANK OF ENGLAND

FSA®
Financial Services Authority

# A review of requirements for firms entering into or expanding in the banking sector

March 2013

# Contents

# Abbreviations used in this paper

| | |
|---|---|
| **BCOBS** | Banking: Conduct of Business sourcebook (FSA Handbook) |
| **BIP** | Bank Insolvency Procedure |
| **BIPRU** | Prudential sourcebook for Banks, Building Societies and Investment Firms (FSA Handbook) |
| **BTS** | Binding Technical Standards |
| **CCB** | Capital Conservation Buffer |
| **CDFI** | Community Development Finance Institutions |
| **CET1** | Common Equity Tier One |
| **COBS** | Conduct of Business sourcebook (FSA Handbook) |
| **COND** | Threshold Conditions (FSA Handbook) |
| **CPB** | Capital Planning Buffer |
| **CRD** | Capital Requirements Directive |
| **CRR** | Capital Requirements Regulation |
| **EBA** | European Banking Authority |
| **EEA** | European Economic Area |
| **EU** | European Union |
| **FCA** | Financial Conduct Authority |
| **FPC** | Financial Policy Committee |
| **FSA** | Financial Services Authority |

| | |
|---|---|
| **FSCS** | Financial Services Compensation Scheme |
| **FSMA** | Financial Services & Markets Act 2000 |
| **GENPRU** | General Prudential sourcebook |
| **ICAAP** | Internal Capital Adequacy Assessment Process |
| **ICB** | Independent Commission on Banking |
| **ICG** | Individual Capital Guidance |
| **ILAA** | Individual Liquidity Adequacy Assessment |
| **ILAS** | Individual Liquidity Adequacy Standards |
| **ILG** | Individual Liquidity Guidance |
| **IRB** | Internal Ratings Based |
| **IT** | Information Technology (Systems) |
| **MCOB** | Mortgages and Home Finance: Conduct of Business sourcebook (FSA Handbook) |
| **MiFID** | Markets in Financial Instruments Directive |
| **NED** | Non-executive Director |
| **OFT** | Office of Fair Trading |
| **PRA** | Prudential Regulation Authority |
| **PRIN** | Principles for Businesses (FSA Handbook) |
| **PS** | Policy Statement (FSA publication) |
| **PSR** | Payment Services Regulation |
| **RRP** | Recovery and Resolution Plan |
| **SCV** | Single Customer View |
| **SRR** | Special Resolution Regime |
| **SYSC** | Senior Management Arrangements, Systems and Controls (FSA Handbook) |
| **TC** | Threshold Condition |
| **TCF** | Treating Customers Fairly |
| **TSC** | Treasury Select Committee |

# Foreword

This review sets out significant changes to regulatory requirements and the authorisation process, which taken together, will reduce barriers to entry into the banking sector and, as a result, enable an increased competitive challenge to existing banks.

It is essential that new entrant banks meet basic standards that prevent undue risks to the financial system and to customers. But as long as basic standards are met, we should aim to make entry, and subsequent expansion, as easy as possible. A balance therefore has to be struck between the risk that new entrant banks will fail, and the benefits of easy entry.

We have therefore conducted a detailed review of our authorisation process and of all the prudential and conduct requirements that apply to new entrant banks. We have concluded that some changes should be made. Some of the changes (in particular in relation to capital and liquidity requirements) were already planned before we launched this review, but we have brought them together to present a comprehensive package.

The FSA's successor bodies, the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) will implement change along two dimensions:

- **Reforms to our authorisation process.** These are designed to provide firms with greater clarity about the information we need, to facilitate progress towards authorisation as rapidly as possible and, crucially, to provide firms with clear milestones along the path to authorisation, with the possibility of authorisation before they commit major resources to infrastructure investments.
- **A major shift in approach to the prudential regulation of banking start-ups.** This reflects the PRA's philosophy of regulation, within which the possibility of bank failure should be accepted as a normal market process as long as there are clear mechanisms in place to resolve banks smoothly without threatening financial stability, even if in some circumstances this could entail losses for uninsured depositors. Specifically the changes will involve:
    - No longer applying the additional requirements (known as 'add-ons and scalars') that we have previously applied to reflect the uncertainties inherent in start-ups.

These requirements often resulted in capital and liquidity requirements for start-ups being higher than for existing banks.

- Implementing the Basel III regime by applying at start-up only the 4.5% minimum Core Tier 1 capital requirement versus the 7% to 9.5% requirement that will apply to major existing banks (made up of the Core Tier 1 requirement plus the Capital Conservation Buffer and in some cases a Globally Systemically Important Bank surcharge).

These changes will not in themselves transform competitive intensity in UK banking. As both the Office of Fair Trading in its 2010 report on retail banking, and the Independent Commission on Banking in its comments on competition, noted other potential barriers to entry – such as ease of access to the payment system, or natural barriers of scale and brand – may be as important as regulation.

But together the changes set out in this review – and in particular the changed approach to capital – will make an important difference. They will be implemented by the FSA's two successor bodies – the FCA and the PRA, working together on a single application process for new firms.

**Adair Turner, FSA Chairman**

# 1

# Executive summary

## Background

After the Office of Fair Trading (OFT)[1] and the Independent Commission on Banking (ICB)[2] published their reports into competition and barriers to entry in the banking sector, the Treasury[3] asked the FSA and the Bank of England to review the prudential and conduct requirements for new entrants to the banking sector to ensure they are proportionate and do not pose excessive barriers to entry or expansion.

While these reports recognise that regulation is only one of the barriers facing new banks, the FSA's position as the gateway to the sector means it is important that our requirements are not unnecessarily burdensome. It is essential that new entrant firms meet basic standards that prevent undue risks to the financial system or to consumers; but the regulators need to achieve this while making entry as easy as possible, provided these basic standards are met.

## What is in this report?

This report sets out the findings from a review of current FSA processes and rules, and describes changes that will facilitate easier market entry in future. It covers both the specific prudential, conduct and organisational requirements that must be put in place for authorisation, and the process through which these rules are applied. The scope of the review and this report is restricted to banks, and does not include other deposit taking or credit institutions.

1 Review of barriers to entry, expansion and exit in retail banking, Office of Fair Trading, (November 2010): www.oft.gov.uk/shared_oft/personal-current-accounts/oft1282.
2 Final Report Recommendations, Independent Commission on Banking, (September 2011): www.hm-treasury.gov.uk/d/ICB-Final-Report.pdf.
3 Banking reform: delivering stability and supporting a sustainable economy, the Treasury, (June 2012): www.hm-treasury.gov.uk/d/whitepaper_banking_reform_140512.pdf.

This report is a joint publication by the FSA and the Bank of England, but has been written to reflect the imminent change to a dual-regulatory structure.

- Chapter 2 sets out the context for the review.
- Chapter 3 describes the FSA's current authorisation approach.
- Chapter 4 details the review itself and looks at the regulatory changes introduced by the Financial Services Act 2012.
- Chapter 5 sets out the changes to the authorisation process.
- Chapters 6 and 7 set out the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) approaches to new banks.
- Chapter 8 sets out the implementation timetable and describes how the regulators will work together.

The OFT and ICB reports also commented on barriers to expansion as well as to entry. We believe that the changes we propose in this report address both elements, particularly as we apply our requirements proportionately: for example, where we have reduced the capital requirements at entry, the firm will be required to make proportionate increases to its capital as it expands. The PRA will have regard to barriers to expansion in its supervisory approach, consistent with the principle to have regard to the need to minimise any adverse effect on competition. From a conduct perspective, the review has concluded that the conduct requirements are applied proportionately and therefore do not pose a barrier to entry or expansion.

In conducting the review we have drawn on both internal analysis and external sources of information and judgement. This is not, however, a market study that discusses the range of competition problems in relevant markets. It is an attempt to put right the shortcomings that the OFT and the ICB have identified. We have had: meetings with individual applicant firms; consultations with overseas regulators; discussions with industry consultants and advisers; and carried out a detailed review of the current authorisation process and previous application cases. The review revealed that applicant concerns about barriers to entry were focused on:

- the level of capital requirements for new banks and their ability to raise it;
- the level of liquidity requirements of new banks, given they have no track record in liquidity management; and
- the lack of certainty in the authorisation process and the way in which the process is executed.

In response to these findings, we are now making substantial changes, which will significantly reduce the risk that excessive regulatory barriers might restrict new entry. The new approach is a natural counterpart to the work underway on barriers to exit. Banks should be subject to the disciplines of the market. A key principle underlying the PRA's approach, underpinned by statute, is that it will not seek to operate a zero-failure regime. The PRA will aim for a position where the failure of any firm is orderly.[4] To build upon the progress of recent years, such as the introduction of the Special Resolution Regime, the PRA will require action from firms, and will contribute to the assessment and enhancement of the authorities' – such as the Bank's Special Resolution Unit's – capabilities and legal powers in dealing with failing firms.

Some of the changes (in particular in relation to capital and liquidity requirements) were already planned, but in this report the FSA and the Bank of England bring all of the changes together to present a comprehensive package.

## Key changes

The main features of the changes are:

- **Reduced capital requirements at authorisation**. This review offers capital concessions at authorisation and in the subsequent three to five year period to those new entrant banks that the FSA/PRA judge can be resolved in an orderly fashion with no systemic impact.[5] These concessions (Chapter 6) are:
  - capital set based on the projected balance sheet at a 12-month period;
  - no Pillar 2 scalars simply because the firm is new; and
  - Capital Planning Buffer (CPB) set as the wind-down costs of the bank – typically the operating costs for the next 12 months.
- **Reduced liquidity requirements for all new banks** (Chapter 6), which are:
  - all new banks will benefit from a recent reduction in liquidity requirements announced in the FSA Policy Statement PS13/1[6]; and
  - no automatic new bank liquidity premium.
- **Removing barriers to expansion** (Chapter 6):
  - As new banks, of whatever size, increase their lending to the real economy they will be able to benefit from offsets applied to their CPB requirements.[7]
  - The PRA will be ready actively to engage with new entrants and small banks prepared to put in the necessary work to move to the Internal Ratings Based (IRB)

4 Where the critical economic functions that the firm performs can be protected or wound down in an orderly way so that disruption is contained, even if in some cases losses may be incurred by unprotected depositors. In the UK eligible depositors per authorised entity are protected up to £85,000. In the EU eligible depositors are protected up to €100,000 under each Member State's deposit guarantee scheme.

5 The PRA will assess the significance of a firm to the stability of the UK financial system.

6 PS13/1, Removing the Simplified ILAS BIPRU Firm Automatic Scalar and other changes, (January 2013) www.fsa.gov.uk/static/pubs/policy/ps13-01.pdf.

7 www.fsa.gov.uk/library/communication/statements/2012/fpc.shtml

approach to the calculation of its credit risk. We recognise that the requirements to achieve IRB status are considerable for a small bank and that this may cause competitive distortions relative to banks undertaking similar business under the IRB approach. So the FSA/PRA:

- is taking considerable steps to reverse existing under-estimation of risk in the IRB approach; and
- will go further to recognise the less systemic nature of these smaller banks – so where a bank could be resolved under the Bank Insolvency Procedure, we will expand our proposed flexible application of the CPB, which will further level the playing field between small and large banks undertaking similar business.

- **Improvements to the existing authorisation process** (Chapter 5). When a firm delivers a complete application form with all supporting materials, the PRA and FCA will work together to complete all of our assessment and decision-making within six months. To support firms to provide a complete application, we are introducing a significant level of up-front support to the firm during the pre-application stage, including a challenge session. This means that from the start of the process to the end, providing that the firm itself is ready, it could start trading within six months. This approach is particularly suited to firms that have the development backing, capital and infrastructure to allow them to set the bank up at speed, e.g. subsidiarisation of branches or where firms are able to use existing IT and other infrastructure.
- **An additional option for the authorisation process** (Chapter 5). We know that some firms are not able to meet the six-month timetable because they cannot fund the up-front investment required, or because they have longer lead times in terms of raising capital or setting up the infrastructure. For these firms we are offering an alternative, three-stage route to authorisation that specifically addresses these barriers to entry. In particular this involves:
  - The same pre-application support, but applicant firms can then submit a shorter application that focuses on key essential elements (such as business case, capital, liquidity and key senior appointments), which, where the information is of the required quality, we will determine within six months.
  - Granting the firm an authorisation, but with a restriction that will enable the firm to then mobilise the remaining requirements such as capital, personnel, IT and other infrastructure. Firms have told us that it will be considerably easier to mobilise if they can tell potential backers that they are already authorised.
- **Streamlining the information requirements**, which means we expect to be able to significantly reduce the time taken for authorisation. We have reviewed the information that is requested from firms so that, irrespective of the option that is taken, the overall burden on firms is reduced. We will also take a proportionate and pragmatic approach

to the method of assessment employed, not necessarily requiring full written evidence for all areas of the assessment.

- **The PRA is also proposing additional measures when the Capital Requirements Directive IV (CRD IV) comes into force**: following full implementation of Basel III, new entrant banks will initially only need to meet a common equity tier one (CET1) capital of 4.5% of risk-weighted assets[8] versus the 9.5% rates applicable to major existing banks.[9] New entrants will be given longer to build up the additional 2.5% of capital required under Basel III (Chapter 6).

The FSA and the Bank of England believe these changes will lead to better outcomes – in terms of the capital required by firms and the time taken to authorise them – reducing the cost incurred by firms, giving them more certainty on the outcome of an application and levelling the capital requirements post-authorisation between small and large banks doing similar business.

During the course of the review the FSA has asked stakeholders (such as recent and prospective new entrant firms) for feedback on the proposed changes, including through two roundtable meetings. The response was strongly positive, with stakeholders believing that the proposals address key areas of concern. The FSA also asked for feedback on the effectiveness of our staff in operating the existing process. In general the feedback was that the interaction with FSA staff is positive, both in their professionalism and the level of technical expertise that is provided to firms to support them through the application process. This will be continued and, in many cases, enhanced through the proposed changes.

Some of these changes have already been implemented and the remainder come into effect at legal cutover on 1 April 2013, when the PRA and FCA come into being.

This has been a comprehensive review and we have made some bold changes, ones that respond to the difficulties faced by applicant firms. We believe the changes will make a significant difference to the ease with which new firms can enter the UK banking system.

8 Following the full implementation of Basel III, all banks (including new entrants) will have two common equity tier one capital requirements: 4.5% Pillar 1 plus 2.5% capital conservation buffer (CCB). Banks (including new entrants) can operate below the 2.5% CCB but, in doing so, must accept automatic restrictions on distributions of dividends, variable remuneration, etc. and agree a plan with the PRA to (re-)build the CCB. Within that plan, the PRA will use the discretion available to it to allow new entrants more time to build up the CCB.

9 The largest global systemically important banks will have to hold a further buffer of 2.5%.

# 2

# Introduction

## The regulatory framework

Under the current regulatory framework, individuals or firms that carry out regulated activities must be authorised by the FSA. In this capacity the FSA acts as the gateway to the banking sector, seeking to protect the safety and soundness of firms and the interests of consumers. In future, the Prudential Regulation Authority (PRA) will have a general objective to promote the safety and soundness of firms. One of the Financial Conduct Authority's (FCA) objectives will be to protect consumers.

To fulfil these objectives we have a duty to ensure that the applicant will satisfy (and continue to satisfy) what are called the threshold conditions.[10] The threshold conditions are the minimum conditions that a firm must satisfy to be granted and retain permission to carry on regulated activities. In setting these standards a balance has to be struck between ensuring that new entrants do not pose undue risks to consumers or to financial stability and the benefits that ease of entry and increased competition are expected to deliver. Following legal cutover the PRA and FCA will have separate threshold conditions; both regulators will determine whether, if authorised, an applicant firm, according to its nature, scale and complexity, would meet the threshold conditions at the point of authorisation and on an on going basis.

The Office of Fair Trading's (OFT) review[11] of barriers to entry, expansion and exit in retail banking (published November 2010) started a debate about whether regulation presents a disproportionate and overly burdensome barrier to new banks looking to set up in the UK. That debate was continued by the Independent Commission on Banking (ICB), whose final report[12] was published in September 2011.

The reports concluded that there was no clear evidence to indicate that the FSA's authorisation requirements were a barrier to entry. However, the reports commented that the authorisation process was lengthy and uncertain and that while improvements had been put in place, it was too early to assess their effectiveness. Both reports also commented that

10 The FSA's five threshold conditions are: legal status; location of offices; close links; adequate resources; and suitability.

11 Review of barriers to entry, expansion and exit in retail banking, Office of Fair Trading, (November 2010): www.oft.gov.uk/shared_oft/personal-current-accounts/oft1282.

12 Final Report Recommendations, Independent Commission on Banking, (September 2011): www.hm-treasury.gov.uk/d/ICB-Final-Report.pdf.

capital and liquidity requirements were seen by some as disproportionately high compared to incumbent firms and could exacerbate barriers to entry.

These observations led to the Treasury's request in their response[13] to the ICB report. This asked the FSA and the Bank of England to review the prudential and conduct requirements for new entrants to the banking sector to ensure these requirements are proportionate and do not pose excessive barriers to entry or expansion ('the review').

The proposed changes set out in this report reflect the findings of our review and the new philosophy of prudential regulation to which the PRA is committed, within which the possibility of bank failure should be accepted as a normal market process, **provided** that there are clear mechanisms in place to ensure orderly bank resolution without threat to financial stability.

The review also reflects the FCA commitment to balance the need for high standards with making sure that those standards do not stifle innovation or the appropriate levels of access for new participants.

## What is the purpose of this report?

This report sets out the approach we took to conducting the review, our findings, the changes being implemented as a result, and the timescale to implement them.

## What is the scope of this report?

This report focuses on the banking market and particularly on authorising new banks. It does not look at the change in control process for buying an existing bank.[14] There are a number of alternative business models that are not covered in our review. These include but are not limited to:

- credit unions;
- building societies; and
- community development finance institutions.

Annex 1 identifies where these alternative models sit in comparison to becoming a bank and defines what we are referring to as a bank.[15]

13 Banking reform: delivering stability and supporting a sustainable economy, the Treasury, (June 2012): www.hm-treasury.gov.uk/d/whitepaper_banking_reform_140512.pdf.

14 The FSA's change in control process, which applies when the ownership or control of a bank exceeds certain limits, is governed by the Acquisitions Directive.

15 A bank is currently defined as: (a) a firm with a Part IV permission which includes accepting deposits, and: (i) which is a credit institution; or (ii) whose Part IV permission includes a requirement that it comply with the rules in GENPRU and BIPRU relating to banks; but which is not a building society, a friendly society or a credit union; (b) an EEA bank which is a full credit institution.

There are also other models for lending/borrowing money, which include:

- crowd funding; and
- peer-to-peer lending.

Again, these are outside the scope of this report, although there is separate work underway on our approach to regulation of crowd funders and peer-to-peer lenders. More details are in Annex 1.

## Non-regulatory barriers to entry

Our review focused on whether the prudential or conduct regulations or the authorisation process could present a barrier to entry or expansion for banks.

Other non-regulatory barriers to entry or expansion exist and these are not included in our review. Indeed, some industry reports and the firms we consulted during this review typically identified these as greater barriers than regulation. These other barriers include:

- **Cost of agency banking and transactions –** this is particularly acute for new banks that require agency bank services (e.g. Bacs, CHAPS and Faster Payment Service). Industry participants reported the costs of agency banking are very high for some new entrants. These costs to a degree are set by industry standards governed by the Payments Council rather than the FSA. We note that the Treasury will be publishing a consultation document on the regulation in this area.
- **Barriers inherent in the banking market –** there are a number of other barriers that are inherent to the banking market or inherent to consumer attitudes rather than a result of rules and regulation. The primary issues include:
  - **Consumer reluctance to move current accounts –** difficulties in attracting new customers and encouraging them to switch from their existing bank has been highlighted in a number of reports (e.g. OFT).
  - **Consumer convenience –** customers may find it convenient to buy a number of services from the organisation where they have (historically) chosen to deposit their money.
  - **Branch network and brand name –** the OFT identified the lack of a wide branch network and an established brand name as a barrier to entry. A large branch network allows banks to capture a disproportionate share of deposits as consumers reward institutions with broad branch networks (i.e. there is a network effect in banking).
  - **Product range –** if banks have to offer a broad range of products in addition to a current account to be profitable, this could be a barrier for firms wishing to offer a much narrower product range.

- **The high cost of set up** – not including the regulatory costs, we know it is expensive to set up a bank. Infrastructure costs, such as IT systems, are a substantial part of the overall cost.

## Regulatory reform

This is an FSA/Bank of England review, but we also look ahead to the regulatory changes. The Financial Services Act (the 2012 Act), which was given Royal Assent on 19 December 2012, provides a new framework for financial regulation in the UK. It comes into force on 1 April 2013, which we refer to as legal cutover.

The 2012 Act (and the necessary secondary legislation that supports it) creates the new UK regulatory architecture:

- The Financial Policy Committee (FPC) of the Bank of England has the primary objective of identifying, monitoring and taking action to remove or reduce systemic risks with a view to protecting and enhancing the resilience of the UK financial system. The FPC has a secondary objective which means that, subject to being content on the first objective, the FPC should support the economic policy of the government, including its objectives for growth and employment.
- The new PRA, a subsidiary of the Bank of England, will prudentially supervise deposit takers, insurers and the most significant investment firms.
- The FCA will regulate conduct in retail and wholesale markets, supervise the trading infrastructure that supports those markets and carry out the prudential regulation of firms not prudentially regulated by the PRA.

The FCA has a competition objective and duty. These will require the FCA to identify and address problems and adopt a more pro-competition approach to regulation, recognising the potential of competition to advance all of its operational objectives.

While we will continue to develop our views on how the competition objective will affect authorisation cases, the FCA's default position is that authorising a firm is pro-competition.

The changes outlined in this report will operate within the new regulatory framework. The PRA and the FCA will be involved and the changes will be integrated through a single administrative process, ensuring applicants only need to apply once and pay one application fee. Close working between the PRA and FCA will also ensure that firms do not need to duplicate information submissions to each regulator. Further detail on the cooperation between the PRA and FCA is in Chapter 8.

# 3

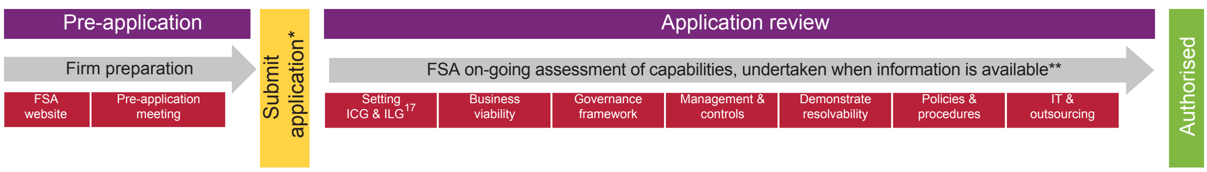
# The FSA's approach to authorising banks

When authorising any firm, we have a duty to ensure the applicant will satisfy (and continue to satisfy) the threshold conditions.[16] The minimum conditions cover the:

- legal status of the applicant;
- location of its offices and control of its business;
- impact of links with other firms or individuals on the effective supervision of the firm;
- adequacy of both financial and non-financial resources to operate the business; and
- suitability of the applicant, including the fitness of the governance arrangements and probity, competence and ability of management.

We assess a firm's application against these minimum conditions.

**Figure 1: Current authorisation process**




* Past experience is that applications are often not complete, leading to a longer application review period
** These assessments are not sequential and timing is dictated by the firm's preparation

As shown in Figure 1, under our current process, we hold a pre-application meeting with all potential applicants to discuss their proposals, identify any immediate issues, talk through the application process and help them understand what information they will need

16 Schedule 6 of FSMA expanded in COND 2.

17 ICG – Individual Capital Guidance, ILG – Individual Liquidity Guidance.

to send us when they apply. Depending on the completeness of the application, there is a statutory deadline of six months for making a decision on a complete application and 12 months for an incomplete one. A complete application needs to give us all the information required in the application form and be detailed enough for us to complete the assessment.

Once the application is received, we review:

- the business model and its viability;
- the capital and liquidity requirements necessary to support the level of business proposed;
- whether the firm could be resolved in an orderly way;
- the governance arrangements[18];
- the IT and any outsourcing arrangements; and
- key policies and procedures for operating the business once it is authorised, such as risk-management frameworks, compliance-monitoring programmes and anti-money laundering procedures.

The assessment is based on what the firm intends to do, the products it will sell, how large it intends to become and so on. The assessment is flexible so that more time is spent looking at larger, riskier firms and less time on firms with a simple model who do not intend to grow very large.[19] We also need to ensure an applicant is ready to start business before granting authorisation.[20] This means the applicant needs to show that it has all the regulatory capital in place, staff hired and trained, IT systems fully tested and implemented and business continuity arrangements in place, etc.

## Number of bank authorisations

Over recent years, the number of banking applications has remained fairly constant. As shown in Table 1, we have authorised 39[21] banks since 2006.[22] Of these, 30 were UK banks (standalone, part of a UK group or subsidiary of a foreign entity) and nine were UK branches of non-EEA banks.

18 Includes fitness and competency of the board and senior management, governance structures and committees.
19 COND 1.3.2 (G) (1).
20 COND 1.3.2 (G) (2).
21 Excludes EEA passported entities. An EEA bank is entitled to establish a branch, or provide services, in another EEA State. These passported-in banks are not required to undergo authorisation in the member state they are passporting in to.
22 Annex 2 contains a full list of banks authorised since 2006.

### Table 1: Analysis of bank authorisations since 2006

| Type of entrant | Totals |
|---|---|
| UK standalone/group | 8 |
| UK subsidiary of foreign entity | 22 |
| UK branch of non-EEA Bank | 9 |
| **Total** | **39** |

From 2006, the average time taken to authorise (from receiving an application to authorisation) is 11 months. We have not refused any banking applications in this time, although we accept that firms prefer to withdraw an application rather than risk refusal. Firms tend to withdraw applications either to work on issues raised while intending to re-submit in the future, or to manage timeframes when they are unable to demonstrate that they are ready to start business by the statutory deadline. In this second example, a firm will withdraw and re-apply so there is no loss of momentum in their preparations. What this does mean is that for some firms, generally the more complex cases, the time taken to authorise is longer than 11 months.

Table 2 shows a significant increase in the number of applications withdrawn and re-submitted since 2009. We have included variations of permission where a firm has added deposit-taking to its existing permissions, thereby becoming a bank.

Increased regulatory scrutiny and tougher UK and international prudential requirements have made it harder for new entrants to show the viability of their business model in a period of challenge for the business models of many established banks. This has resulted in an increase in the number of withdrawals and re-applications which has further increased how long it takes to authorise new entrants.

### Table 2: Decisions made

| | New applications | | | Variations of permission | | |
|---|---|---|---|---|---|---|
| | **Authorised** | **Withdrawn** | **Of withdrawn – re-applied** | **Authorised** | **Withdrawn** | **Of withdrawn – re-applied** |
| 2006 | 5 | 1 | - | - | - | - |
| 2007 | 10 | - | - | - | 1 | - |
| 2008 | 8 | 1 | - | 1 | 1 | 1 |
| 2009 | 2 | 6 | 3 | - | 2 | 1 |
| 2010 | 6 | 1 | 1 | - | 2 | 2 |
| 2011 | 3 | 5 | 5 | 2 | 2 | 1 |
| 2012 | 5 | 5 | 2 | - | 1 | - |
| **Total** | **39** | **19** | **11** | **3** | **9** | **5** |

Before the financial crisis in 2007, there were failings in our approach to authorising new banks. A detailed lessons-learnt report was conducted after the authorisation of Metro Bank and the following changes were introduced:

- increased transparency on the process so that firms better understand the requirements and can plan accordingly;
- better quality applications through providing greater information and support to firms in specialist areas (e.g. liquidity);
- identifying issues and concerns so they can be addressed by applicants at an early stage;
- better communication with applicants and steps to help them take the final actions to become authorised; and
- better capability and capacity of our people to support firms through the authorisation process (e.g. recruitment of specialists and enhanced training).

# 4 The review

This chapter outlines our approach to the review and key findings.

## Our approach to the review

We have conducted an extensive review of our approach to authorising firms. We considered whether the standards we apply to new entrants are appropriate, whether our approach to assessing these standards was proportionate and whether or not the process itself was unduly burdensome on the applicant. A range of stakeholders were consulted to ensure that the findings were representative and balanced across both regulatory requirements and process-related aspects.

- We spoke to a number of firms that have recently been authorised or are currently going through the process. We held two roundtable meetings with current applicants, recently authorised banks, consultants and other market participants to discuss their experiences and understand the areas where they encountered the most difficulties.
- We contacted colleagues in overseas regulators to understand how approaches vary in different jurisdictions and to see if there are any ideas that we can incorporate into our processes.
- We reviewed the approach to capital and liquidity requirements for new banks compared to incumbent banks.
- We reviewed the conduct rules that apply to banking applications and the evidence required from the firm to demonstrate compliance.
- We reviewed other requirements needed to satisfy the threshold condition tests, but that do not form part of our conduct and prudential rules.
- We reviewed each stage of the banking application process and past cases where the statutory deadline was exceeded to understand the causes of delays and whether those delays were regulatory or process in nature.

- We reviewed the findings from the Office of Fair Trading (OFT), the Independent Commission on Banking (ICB) and the Treasury Select Committee (TSC)[23] reports to see if there were recommendations on which we had not taken action or where we could further improve.
- We reviewed cases where we have held pre-application meetings, but where an application has not been forthcoming, to understand the reasons for that and whether the causes were regulatory in origin.
- We spoke with those who work closely with the applicant firms, including consultancy firms and industry experts, to understand from them where their clients experienced difficulties and whether these issues were within our scope to resolve.

## Key findings

The review identified the most significant concerns as:

- the level of capital requirements for new banks and their ability to raise it;
- the level of liquidity requirements of new banks, given they have no track record in liquidity management; and
- the lack of certainty in the authorisation process and the way in which the process is executed.

We had already initiated a review into the method behind setting capital and liquidity requirements for new banks and these proposals are covered in detail in Chapter 6.

Aside from capital and liquidity, the issues that were identified as the areas where firms had most difficulty all concerned the authorisation process:

- Authorisation is only granted at the end of the process once all the requirements have been completed satisfactorily. This requires a significant investment of seed capital to support the firm through the authorisation process without any certainty that the firm will be authorised. This uncertainty causes problems for firms, as investors are unwilling to commit, key staff are harder to attract, and firms themselves are unwilling to commit to major projects, such as IT development, until they are relatively far along the authorisation process, building unnecessary delay into the process.
- Becoming authorised often takes significant time and it is not clear to firms how the application will progress or what they can expect. The authorisation process is difficult to manage alongside the other activities they need to do to get the business going. The length of the process can be such that work completed early on, such as writing policies

23 Competition and choice in retail banking, House of Commons Treasury Committee, (April 2011): www.publications.parliament.uk/pa/cm201011/cmselect/cmtreasy/612/612i.pdf.

and procedures, becomes outdated and has to be redone, thus incurring additional time and cost.

- The information supplied by firms is often not up to the standard required – specifically in the level of detail provided, the extent of tailoring to that firm's situation, and the interpretation of the requirements in forms and supporting materials (e.g. ICAAP[24], ILAA[25], policies and governance structures and arrangements). This results in substantial interaction between the FSA and the applicant to get the application, or parts of the application, up to standard, which lengthens the overall process.

Overall, firms would like to see:

- Greater clarity of what is expected of them and how the authorisation process will work.
- A more structured approach with clear stages and milestones, so that progress can be shown and plans more easily made. There are some valuable lessons that can be taken from the approach to regulation in other jurisdictions, such as splitting the process into discrete stages.
- Greater certainty so that the more expensive parts of the set-up, such as building the IT systems, do not start until there is greater certainty regarding the authorisation.
- Authorisation granted earlier so that firms can engage with third parties who insist on regulatory approval beforehand.

In addition to the areas identified for improvement, the review also highlighted a number of positive aspects of the FSA's current authorisation process:

- Firms value the feedback and support we provide and would like more of this, particularly in the early stages (before submission).
- We have a wealth of expertise that we apply to firms to support the application process, particularly around capital, liquidity and governance arrangements. While we should not offer a consultancy service, we see the value in engaging with firms and firms tell us that they would like this to continue.
- Our staff deal with firms courteously and professionally. This manner of interaction is appreciated and supports a good working relationship throughout the authorisation process.
- We generally try to take a pragmatic approach, not sticking rigidly to process for the sake of it, but considering how to support firms to overcome problems.

24 The Internal Capital Adequacy Assessment Process.
25 Individual Liquidity Adequacy Assessment.

## Current conduct requirements and high-level standards

As part of the review, we were asked to consider whether the conduct of business rules posed a barrier to entry. We believed it would also be appropriate to review the high-level standards for businesses to ensure that all regulatory aspects had been covered. We took a three-strand approach to our assessment:

- We interviewed newly authorised and prospective new banks to understand what firms see as the key barriers to becoming a bank.
- We also reviewed the findings of other bodies regarding barriers to entry in banking.
- We reviewed our rules in two ways: firstly to assess whether they should be retained by the Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA); and secondly, to see if any could be repealed to reduce barriers to entry.

We spoke to recently authorised banks, firms who are considering applying to be a bank, and compliance consultants who typically support new banking applications. None of these identified the conduct regime or the high-level standards as a barrier to entry. We also reviewed the OFT's report and conclusions, as well as the ICB's report and conclusions, and neither of these identified our conduct rules or high-level standards as a barrier to entry for new banks or as a barrier to expansion for existing banks.

## Conduct requirements for the FCA

Where we have discretion, we take a risk-based and proportionate approach to setting rules, based on an assessment of risks to our statutory objectives.[26] Our conduct of business rules are largely principles-based. They do not dictate through detailed, prescriptive rules and supervisory actions how firms should operate their business, unless necessary. Instead, we set out desirable regulatory outcomes in principles and outcome-focused rules. This approach allows firms to decide themselves how best to align their business objectives and processes with the regulatory outcomes we have specified.

New and prospective entrants to the retail banking sector must comply with our Banking Conduct Regime[27], which began on 1 November 2009, and replaced the previous industry-owned codes that were monitored by the Banking Code Standards Board. The Banking Conduct Regime includes:

- The conduct of business requirements of the Payment Services Regulations 2009 (PSRs): UK legislation on payment services that implements the Payment Services Directive. These requirements cover services such as money remittance and bill payment services, which banks will typically offer.

26 FSA statutory objectives.

27 Prospective retail banks might also need to comply with other FSA rules, such as the Mortgage and Home Finance: Conduct of Business sourcebook (MCOB) and the Conduct of Business sourcebook (COBS), but we did not consider these in our review because the challenges they may pose are not unique to retail banks.

- The Banking Conduct of Business Sourcebook (BCOBS), which contains rules and guidance.
- The application of the FSA's Principles for Businesses (Principles) (see high-level standards below).

The PSRs set out more detailed conduct of business requirements that apply to payment services. We have no power to vary, repeal or waive any of the conduct of business requirements under the PSRs. Neither the Principles nor BCOBS apply if they conflict with the PSRs.

BCOBS comprises high-level rules that apply to retail banking services that fall outside the scope of the PSRs, together with more detailed rules that reflect conduct requirements set by EU legislation. As an example of the more detailed rules, BCOBS contains specific rules on distance communications, which give effect to requirements in the Distance Marketing Directive (BCOBS 3.1). There is very little scope for us to vary detailed rules that are set by EU legislation. We give guidance in BCOBS on how firms can comply with our rules. There is also industry guidance on aspects of our rules, which we will take into account when considering the exercise of our regulatory functions.

In carrying out our review of BCOBS, we have kept in mind the need to achieve a proportionate degree of consumer protection in the retail banking sector. There is recognition across the industry that consumer protection is important and that minimum standards of conduct must be universally met to maintain consumer confidence in the sector. We have also kept in mind that the FCA must – so far as is compatible with acting in a way that advances the consumer protection objective or the integrity objective – discharge its general functions in a way that promotes effective competition in the interests of consumers.

We believe that BCOBS requirements are necessary to secure an appropriate level of consumer protection. Fundamental principles such as the 'fair, clear and not misleading' rule for communications with banking customers (BCOBS 2.2) are vital to achieving a fair outcome for consumers.

Wherever possible though, we have drafted our BCOBS rules to give firms discretion in how they choose to meet the requirements. As an example, BCOBS 4.1.1 requires firms to provide or make available to customers, information about a retail banking service in good time and in an appropriate manner. This rule aims to ensure that consumers receive the right information at the right time, but it also provides some flexibility for a firm to comply in a way which is compatible with its individual business model.

We believe there is no case for reducing our conduct requirements, and where the conduct requirements arise from UK legislation (including the Financial Services & Markets Act 2000 and the PSRs) or EU law our power to implement change is restricted. Accordingly, we do not propose to reduce our conduct requirements when the FSA transitions into the FCA.

In the future any decision to strengthen our conduct requirements will only be taken if the measures proposed are a proportionate means of meeting our consumer protection objective. We will also seek to promote effective competition in the banking sector in the interests of consumers in so far as it is compatible with acting in a way which advances our consumer protection objective or integrity objective.

## High-level standards for the PRA and FCA

We also reviewed our high-level standards using the same three-strand approach. The high-level standards that are particularly relevant to the authorisation of firms are:

- the Principles for Businesses (PRIN);
- Senior Management Arrangements, Systems and Controls (SYSC); and
- guidance on the Threshold Conditions (COND).

These are fundamental high-level standards that reflect our principles-based approach to regulation. We believe that this approach offers firms a maximum degree of flexibility in the way they operate their businesses, without compromising consumer protection.

For this reason we do not believe these high-level standards pose a barrier to entry. However, in preparation for the new regulatory structure, we reviewed the FSA Handbook and identified which rules and provisions should be incorporated into the FCA's and PRA's Handbooks, in line with each regulator's new set of responsibilities and objectives. The outcome is that both regulators will have parts of PRIN and SYSC at legal cutover.

The approach taken to COND has been different: while the FCA will retain it, suitably amended for the new threshold conditions, the PRA will not. *The PRA's Approach to Banking Supervision* (the approach document)[28] sets out high-level policies that elaborate on the threshold conditions.

Identifying the relevant provisions in the FSA Handbook for the FCA and PRA Handbooks is aimed at delivering fit-for-purpose sets of provisions for each regulator at legal cutover. However, after legal cutover, the FCA and the PRA will amend their own policy materials as independent bodies in accordance with the processes laid down in the Financial Services Act 2012. This includes cooperation between them and external consultation. As set out in the PRA approach document, the PRA will, over time, replace the Handbook with a PRA rulebook. While there will be separate documentation, our objective when it comes to authorisation is that there will remain a single administrative process.

28 The PRA's approach to banking supervision, The Bank of England, Prudential Regulation Authority: www.bankofengland.co.uk/pra/Pages/publications/default.aspx.

## Conclusion

Our review has shown that there are significant improvements that can be made to the way we authorise new banks, and our proposals for changing this are set out in Chapter 5. There are also substantive changes to the prudential regime that we can make and these are covered in detail in Chapter 6.

However, there is no evidence that our conduct of business requirements or high-level standards are disproportionate or that they pose excessive barriers to entry or expansion in the banking market. We believe that to reduce these standards could increase the risk to consumers. However, case-by-case, we will undertake appropriate desk-based analysis to identify whether significant countervailing competition benefits are likely to be achieved.

When authorising any firm, we have a duty to ensure the applicant will satisfy (and continue to satisfy) the threshold conditions.[29] The minimum conditions cover the:

- legal status of the applicant;
- location of its offices and control of its business;
- impact of links with other firms or individuals on the effective supervision of the firm;
- adequacy of both financial and non-financial resources to operate the business; and
- suitability of the applicant, including the fitness of the governance arrangements and probity, competence and ability of management.

29 Schedule 6 of FSMA expanded in COND 2.

# 5

# Our revised approach to authorisation

We are proposing significant changes to the current authorisation process, with different options available to firms in recognition that a flexible approach is required to account for the variation in the applications that we receive.

We believe that the changes will help applicant firms through the challenges noted in the previous chapter and that ensuring better quality applications are received will result in more efficient use of resources for both the firms and the regulators.

Regardless of the option chosen, the changes should result in firms experiencing a quicker and more cost-effective authorisation process. We will retain the option for firms to submit a complete[30] application and have their authorisation determined within six months. However, for firms that require the certainty of an authorisation before a significant capital outlay, we intend to offer an alternative process that contains clear stages, so there is a distinction between meeting the key regulatory requirements and the wider operational needs of setting up a bank.

This chapter sets out the changes to the authorisation process that we are introducing. Chapters 6 and 7 will then set out how the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) will approach an authorisation. The process by which an authorisation is determined follows the consent process. This means that both the PRA and the FCA must consent to the authorisation of the applicant firm. If either regulator does not provide its consent, the firm cannot be authorised.

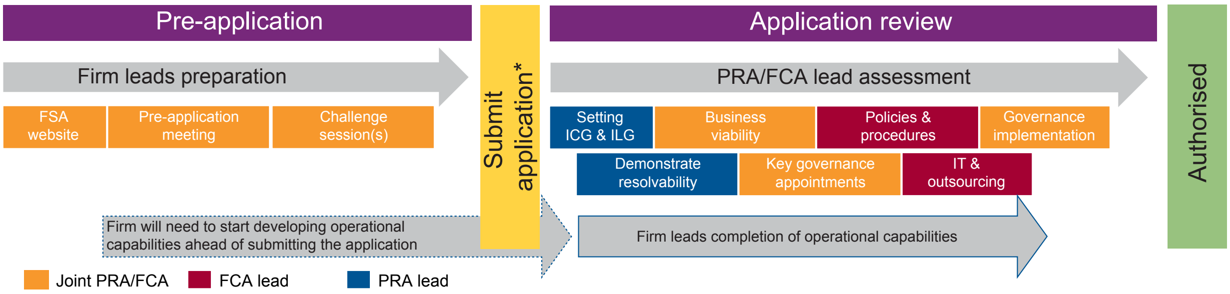
We will offer two broad options for the process of authorising new banks.

30 A complete application contains all the information necessary to enable us to complete our assessment work without needing to refer back to the applicant for further information or clarification.

## Option A

This approach is an enhancement of the current process (see Figure 2) and is particularly suited to firms that have the development backing, capital and infrastructure to allow them to set the bank up at speed. Examples would include the subsidiarisation of branches and where firms are able to utilise existing IT and other infrastructure.

### Figure 2: Revised authorisation process – Option A




* A firm targeting authorisation within six months (Option A) must submit in the application all the information required for the PRA & FCA to complete their assessments in the application review stage

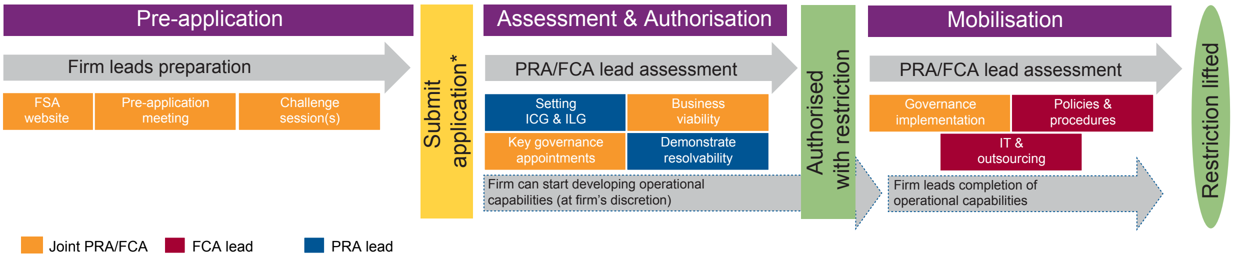
Where an applicant firm is able to deliver a complete application form with all the supporting materials, then the PRA and FCA will work together to complete the assessments and make a decision within six-months. Our experience is that few firms are able to provide us with a complete application. Therefore we are introducing a significant level of up-front support to firms during the pre-application stage, including a challenge session that has been universally welcomed by the firms we have spoken to, to help them do this.

This means that from the start of the process to the end, providing that the firm itself is ready, it could start trading within six months.

## Option B

We know that some firms are not able to meet the six-month timetable because they cannot fund the up-front investment required or because they have longer lead times in terms of raising capital or setting up the infrastructure. For these firms we are offering an alternative route to authorisation, which specifically addresses these barriers to entry. This is the staged 'mobilisation' route, shown in Figure 3.

## Figure 3: Revised authorisation process – Option B




* The application for the Mobilisation option only needs to include the information required for the assessment & authorisation stage, which is less than required in the application for Option A

This option offers the same pre-application support, but firms can then submit a shorter application that focuses on key essential elements (such as business case, capital, liquidity, key senior appointments) which, if the information is of the required quality, we will determine within six months. If the firm is successful we will grant them an authorisation, but with a restriction that will enable the firm to mobilise the remaining requirements such as capital, personnel, IT and other infrastructure. Firms have told us that it will be considerably easier to mobilise if they can tell potential backers that they are already authorised.

The length of the mobilisation phase is almost entirely down to the firm. It could be as little as three months, depending on the nature of the application, but it will be capped at 12 months to ensure the data on which the authorisation was granted do not become out of date. Once the firm has completed its mobilisation, the restriction will be lifted.

## Pre-application (both options)

We know that firms are not always clear on what they will need to do to achieve authorisation. We will, therefore, provide much more detailed information about the application process, the information to be supplied by the firm and the level of detail that the PRA and FCA will need to receive during the pre-application stage. The PRA and FCA websites will also contain clear information on the options and requirements for authorisation.

Firms have told us that they value the feedback and support they receive from the FSA and that they want more of this, particularly in the early stage of the process. We have taken this on board and will facilitate regular contact between firms and the PRA/FCA teams to ensure that this continues. In support of this we will also now hold a minimum of two (and more if appropriate) pre-application meetings with firms while they are developing their ideas and working on their application.

During our initial meetings, both the PRA and FCA will discuss the process with the applicant, take the opportunity to gain a greater understanding of the applicant's proposals, and raise any issues or concerns as soon as possible. Early on in the pre-application stage, we will also discuss and agree which option to pursue.

### How is this different to before?

There are two primary differences in the pre-application stage compared to the current approach.

Firstly, we have introduced a challenge session to ensure that firms receive the specific, detailed feedback on their proposals that they want. The purpose of the challenge session is to increase the likelihood of the applicant submitting a fully-completed application – that is, one that contains the necessary quality of information for the selected option.

The challenge session will take place when a firm's business model and strategies for meeting capital and liquidity standards are nearly complete. At the challenge session we will discuss the proposals in detail, feedback the findings of the reviews carried out and agree areas where further work needs to be carried out.

For Option A, the work undertaken in pre-application should substantially increase the likelihood that the application will be complete and, as a result, authorisation is more likely to be achieved well within the statutory deadline of six months. Currently, when received, most applications are incomplete and as a direct result take longer to determine.

For Option B, we believe that, if a firm follows the process outlined above and submits the information we ask for to the required standard, the FCA will be able to give its consent and the PRA will be able to authorise the firm well within six months.

The second key difference is the information required in the application. We have streamlined the information requirements so that, regardless of the option selected, the overall information required is less than in the current approach[31], and this will have both time and cost benefits for firms and regulators alike. While there are reduced information requirements overall, we expect the applicant firm to act on all the feedback they receive before applying for authorisation. As such, the timeframe for the pre-application stage will largely depend on the applicant firm's own timetable.

Under Option B, the amount of information to be submitted with the application will be greatly reduced, since we will only need the minimum amount of information that relates to activities that will take place in the subsequent mobilisation stage; for example, whether the IT systems will be built from scratch or outsourced.

## Assessment

During the assessment phase, in line with our efforts to streamline the information requested and meet the statutory deadlines, we will also determine the most appropriate and proportionate way to gain satisfaction that the firm will meet the threshold conditions. Rather than requesting written evidence for all elements of the application, we will employ different methods to complete the assessment, where appropriate, for example:

31 See Annex 10 for a comparison of the information required.

- asking the firm to attest that an action has been completed;
- reviewing samples of documentation;
- conducting on site visits and speaking to staff; and
- commissioning s166/s166A reports.[32]

For Option A, the assessments undertaken during the application review stage will largely take place as outlined in Chapter 3, with authorisation being given at the end of the application review stage. The key difference is that, assuming a complete application is received, we should be able to complete our assessment and decision-making within six months.

For Option B, the focus of the assessment will be on capital, liquidity, the viability of the business model and resolvability. We will also need the details of the key executives/directors that are in place and responsible for driving their vision forward, together with details of associated parties and commercial relationships relevant to the application.

The assessment stage has been designed to capture the key regulatory elements of a banking application and enable authorisation to be granted as soon as possible in the process. This will give firms the certainty that authorisation has been granted before costly activities such as the IT build-out have to be undertaken.

### How is this different to before?

Option B is fundamentally different to anything we have done previously. Under this option, a firm will (if it meets the threshold conditions) be authorised, and will appear on our register of authorised firms as a bank. We are not saying that we will be 'minded to' authorise a firm, or that an applicant will be authorised 'subject to' certain conditions being met.

During the assessment stage Individual Capital Guidance (ICG) and Individual Liquidity Guidance (ILG) will be set. Firms will, therefore, be clear about the capital and liquidity requirements that will apply as they build up their business. But the PRA will not ask an applicant firm to inject the full capital at authorisation. Instead, we will apply the minimum capital required under the European Capital Requirements Directive of €5m. As the next stage of the process (mobilisation) is capital intensive, and the Directive does not allow a bank's capital to fall below €5m at any time, the PRA will discuss the firm's plans and may, if appropriate, ask for additional capital to be held during mobilisation to ensure that the €5m level is not breached.

For the applicant to meet the threshold conditions, and in recognition of the fact that the necessary infrastructure is not yet in place, a restriction will be placed on the firm's activities at the point of authorisation. A restriction is a standard regulatory tool and currently many firms have a restriction attached to their activities. In this case, the restriction will allow the bank to accept deposits, but will limit the scale of the deposit-taking activities to reflect the

32 s166/s166A or skilled person reports are an option for authorised firms seeking variation of permission to become a bank, but we commit to using them proportionately.

lack of infrastructure and controls in place. The restriction may also limit the type of deposits that the applicant can accept during the mobilisation phase.

The purpose of this approach is to provide the leadership of the bank with the certainty that authorisation has been granted before it begins the potentially expensive build of infrastructure and capability in the mobilisation stage. It also reassures investors that the proposals meet minimum regulatory standards, and gives prospective employees the comfort that their jobs have a greater degree of security.

The timeframe for the assessment stage will largely be driven by the PRA and the FCA. If an application is submitted that contains sufficient information for both regulators to complete their assessment work, we anticipate the firm will be authorised well within six months.

## Mobilisation (Option B only)

The third stage, which applies to Option B only, is mobilisation, during which time the bank will raise capital, put in place and test an appropriate IT platform or outsourcing arrangements, hire the necessary staff, finalise policies and procedures that are appropriate to the activities it will carry out and conduct any relevant training. The bank's activities during the assessment and mobilisations stages do not have to be done strictly in sequence. Depending on how ready the bank is, it is possible to start the mobilisation activities during the assessment stage and this will clearly further support reduced timescales for a firm to begin trading.

The timescale for this stage will be largely driven by the firm. The PRA and FCA will discuss the firm's project plan for this stage towards the end of the assessment stage. While the timeframe is largely driven by the firm, the mobilisation phase cannot continue indefinitely, as the data on which the authorisation was granted will become out of date. We therefore anticipate that the mobilisation phase could take as little as three months to complete, depending on the firm's ability to mobilise, but will not take longer than 12 months. As with the work undertaken during the assessment stage, we will take a pragmatic approach to gaining satisfaction that the threshold conditions will be met, employing different methods where appropriate.

### How is this different to before?

Once the restriction is lifted, the bank can increase the scale of the activities it has been authorised to carry out. With the benefit of being authorised and able to focus fully on the operational elements, we anticipate that firms will want to progress rapidly through the mobilisation phase. The 12-month timescale is very much a backstop against unexpected or unforeseen delays.

While a small degree of flexibility can be applied to the 12-month timeframe, if we judge that a firm does not meet the conditions for the restriction applied at authorisation to be lifted, the PRA will apply a 'guillotine clause' to ensure that the authorisation does not continue past the point when the information on which the authorisation was based becomes out of date. The effect of the guillotine clause will be to remove the bank's authorisation.

# 6

# The PRA's approach to new banks

## Background

After legal cutover on 1 April 2013, the Prudential Regulation Authority (PRA) will be responsible for promoting the safety and soundness of deposit-takers (banks, building societies and credit unions), designated investment firms and insurance companies. Reflecting experience in the crisis and lessons learnt in the UK and internationally, the PRA's approach to supervisory assessment will be based on forward-looking judgements, with supervisory interventions clearly directed at reducing the major risks to the stability of the system.

As set out in the PRA's launch document[33] and approach document[34], in line with its approach to supervision, the PRA's forward-looking and judgement-based approach will carry over into its role in authorising firms.

Firms must apply to the PRA for authorisation if they want to undertake an activity, deposit-taking or insurance, that requires them to be regulated by the PRA.[35] So firms that want to become a bank must apply to the PRA for authorisation (permission) to do so.

The allocation of responsibilities for authorisation, for example of a new bank, will follow from the split between prudential and conduct of business responsibilities, reflecting the twin peaks approach to regulating deposit-takers. Making these decisions will require close cooperation between the PRA and the Financial Conduct Authority (FCA). Chapter 8 provides more detail on how the PRA and FCA will work together to perform the authorisation process.

The PRA will lead on and administer the application and be responsible for granting authorisation, but it must obtain the consent of the FCA before doing so. Authorisation to

33 Our approach to banking supervision, The Bank of England, Prudential Regulation Authority, (May 2011): www.bankofengland.co.uk/pra/Pages/publications/default.aspx.

34 The PRA's approach to banking supervision, The Bank of England, Prudential Regulation Authority: www.bankofengland.co.uk/pra/Pages/publications/default.aspx.

35 If a firm is already regulated by the Prudential Regulation Authority (PRA) but it wishes to vary its permission to undertake other types of additional regulated activity, it would need to apply to the PRA.

carry out deposit-taking activities will not be granted unless both the PRA, as prudential regulator, and the FCA, as conduct regulator, are satisfied that it should be.

There will be a single administrative process, with a single application form and a single timetable for decisions. The importance of ensuring the authorisation process is both clear to applicants and handled efficiently is fully recognised.

## What does this chapter discuss?

In Chapter 4, we explain that our review of the current authorisation process for new banks highlighted concerns with the process, as well as positive aspects of the existing approach. Therefore, the authorisation process has been revised to reflect these concerns and build on the elements of the process that work well. This chapter sets out the PRA's approach to the revised authorisation process for new banks.

We explain the changes we are making to how we set prudential requirements on authorisation for new entrants to the UK banking sector. We believe that these changes, in particular in relation to capital requirements, represent a significant improvement on current arrangements and reflect a more proportionate approach (see Boxes 3 to 5).

The PRA's approach focuses on new banks that can be resolved in an orderly way with no systemic impact. It is for these banks that the PRA can be more flexible in its requirements without putting at undue risk its general objective to promote the safety and soundness of all the firms it regulates (with a primary focus on the harm that these firms can cause to the stability of the UK financial system).

Regulators must balance appropriate standards against inappropriate barriers. If the regulator sees no clear path for a bank to exit, it will have a low-risk appetite with regard to new entrants. The changes set out in this chapter reflect the new philosophy of prudential regulation to which the PRA is committed. Within this philosophy, the possibility of bank failure should be accepted as a normal market process, provided that there are clear mechanisms in place to ensure orderly bank resolution without threat to financial stability, even if in some cases losses may be incurred by unprotected depositors. Those mechanisms include recovery and resolution plans (RRP), the Special Resolution Regime (SRR), the 'single customer view' (SCV) and the Financial Services Compensation Scheme (FSCS) limit of 100% of the first £85,000. While appropriate standards are still needed, the balance of risk is shifting in favour of a more open approach to new entrants to the UK banking sector.

The PRA's aim through its approach to assessing new bank applications will be for barriers to entry to be kept to a minimum, consistent with its objective and the principle to have regard to the need to minimise any adverse effect on competition.

This chapter also considers:

- The PRA's approach to the supervision of new banks in the first few years after authorisation.
- The impact of the European Union's (EU) Capital Requirements Directive (CRD IV) and Capital Requirements Regulation (CRR) on the assessment of capital requirements for new banks.
- The calculation of credit risk capital requirements for new banks and the PRA's commitment to the Internal Ratings Based (IRB) approach being achievable over three years.
- The PRA's approach to the capital of smaller, resolvable banks after authorisation.

For example, this chapter explains that we recognise that there are newer and/or smaller banks that may not be able to satisfy the requirements to follow the IRB approach to calculating credit risk capital requirements. It explains that we acknowledge that the standardised approach they follow instead can cause competitive distortions for them relative to established larger banks undertaking similar business under the IRB approach. The FSA/PRA are taking considerable steps to reverse the existing under-estimation of risk in the IRB approach, which will help to create a more level playing field between banks on the IRB approach and banks on the standardised approach. In addition, where the resolution-planning arrangements for a bank determine that it could be resolved under the Bank Insolvency Procedure (BIP), we will extend our proposed proportionate approach to setting capital planning buffers (CPB) (see Box 3).

## The PRA's approach to authorising new banks

The PRA will assess applicant banks from a prudential perspective against tests of safety and soundness using the same framework that will be employed to supervise existing firms. In other words, the PRA will determine whether, if authorised, an applicant would meet the PRA's threshold conditions[36], at the point of authorisation and on a continuous basis. In performing this assessment, the PRA will consider not just current risks, but those that could plausibly arise in the future. At the same time, the FCA will assess applicant banks against its conduct-focused threshold conditions.

To reflect the PRA's general objective, it will assess, in collaboration with the Bank of England's Special Resolution Unit, the extent to which an applicant bank is resolvable. An assessment of the resolvability of the proposed bank, both in initial and subsequent circumstances covered by the business plan, will be embedded into the authorisation process (see Box 2).

36 The threshold conditions are the minimum requirements that firms must meet at all times in order to be permitted to carry on the regulated activities in which they engage, see: www.legislation.gov.uk/uksi/2013/555/contents/made.

The PRA will take a proportionate approach to assessing new bank applications. This will result in a more effective use of resources for both applicants and us. All applications will be subject to a minimum level of assessment, beyond which work will be commensurate with the potential impact an applicant bank could have on financial stability, both by the way it will carry on its business and in the event of failure. This does not mean we are reducing standards, but that we will focus on the risks we judge to be most significant. This proportionate approach is reflected in the reduced documentation requirements that will need to be submitted to us where applicants' proposals are not complex[37] (see Box 1).

Under the revised authorisation process (both Options A and B), applicants will have direct contact with experts in PRA Supervision responsible for assessing new UK and international bank applications and for taking applicants through the authorisation process. Where applications are successful, as far as it is practicable to do so, the same supervisory resource responsible for taking the new bank through the authorisation process will also supervise it for, at least, the first few years after authorisation is granted.

The PRA's approach to international banks, including EEA and non-EEA branches, is set out in the approach document.[38] For prospective new banks that will be subsidiaries of overseas firms, the PRA's approach to the authorisation process will be the same as for prospective banks that will be UK-owned.

## The revised approach to authorisation

The authorisation process will be separated into the following distinct stages to provide a more structured approach to authorising new banks:

- pre-application;
- assessment; and for some applicants
- mobilisation.

For applicants that do not go through the mobilisation stage, this is referred to as Option A. For applicants that go through the mobilisation stage, this is Option B.

### Pre-application stage

The pre-application stage is designed to increase the likelihood that we will receive a fully-completed application, which means that all the information we need has been submitted and is of the standard that we require to perform our assessment, in particular

37 Under the current legislative drafts of the European Union's (EU) Capital Requirements Directive (CRD IV), the information we require an applicant bank to provide will be subject to binding technical standards (BTS) to be developed by the European Banking Authority by end-December 2015. It is our intention to continue our proportionate approach to information requirements for new bank applications described in this chapter as far as we are able to when the BTS come into force.

38 The PRA's approach to banking supervision, Bank of England, Prudential Regulation Authority: www.bankofengland.co.uk/pra/Pages/publications/default.aspx.

regarding the level of detail and the interpretation of our requirements to an applicant's own situation. The benefit of this is that it is likely considerably to reduce the time it takes to complete the assessment stage of the authorisation process.

During the pre-application stage, prospective bank applicants will receive extensive engagement from PRA Supervision better to understand the authorisation process, including our: overall approach; information requirements; expectations in relation to an application; approach to determining capital requirements (see Box 3); and approach to setting liquidity requirements for a new bank (see Box 5).

To ensure prospective applicants understand the authorisation process, we will offer them an initial meeting to explain the process in detail and answer any preliminary questions they may have. This detail will also be available on the PRA website, which will reflect the revised process and requirements. This meeting also gives prospective applicants and key contacts from the PRA the opportunity to meet.

We will provide feedback on prospective applicants' proposals and discuss key issues with them early so that they have the opportunity to deal with these before submitting an application to us, which will improve success rates for applications. We do not expect applications to be submitted until all the key issues that we have highlighted during the pre-application stage have been fully dealt with by the prospective applicant.

So that we can provide constructive and timely feedback on prospective applicants' proposals, we will request that they submit information about their proposals, for example: a detailed business plan; ownership structure; details of any proposed board members and senior management already identified; and the capital strategy and liquidity strategy. We will review the information submitted in the context of the PRA's threshold conditions and general objective to identify any potential areas of concern.

We will provide feedback from our review of this information during challenge session(s) held with the prospective applicant during the pre-application stage, where their proposals will be discussed in more detail. Where appropriate, these sessions will be held together with our FCA colleagues. These challenge sessions are a key development from the current authorisation process.

The pre-application stage also allows us to clarify that the proposed business model is that of a bank and, therefore, helps prospective applicants to decide if they need to be a bank or an alternative type of deposit-taker (for example, a credit union or building society) (see Annex 1).

During the pre-application stage, the PRA and FCA will also determine in discussion with prospective applicants whether the mobilisation stage of the authorisation process (Option B) will be appropriate in their case.

## Assessment stage

The objective of the assessment stage is for the PRA and FCA to assess new bank applications against key regulatory requirements that need to be satisfied before authorisation can be granted.

Where applicants' proposals are not complex, the PRA will require less information than under the current authorisation process to perform its assessment (see Box 1).

For those applicants who go through the mobilisation stage (Option B), the FCA will require substantially less information to be submitted by the applicant at the assessment stage as it will complete a significant part of its assessment during mobilisation (see Chapter 7). However, the PRA will expect to complete the majority of its assessment during the assessment stage. Therefore, the PRA will require almost all of the information to be submitted by the applicant at the end of the pre-application stage. This recognises that the mobilisation stage is designed primarily to help applicants with the operational elements of becoming a bank.

For applicants who do not go through mobilisation (Option A), the PRA and FCA will require applicants to submit all the required information at the end of the pre-application stage, and will complete its assessment by the end of the assessment stage.

Given the work done by applicants and us in the pre-application stage to ensure the quality of applications, we will expect the majority of applications to be 'complete' and, therefore, for the assessment stage to be concluded within the six-month statutory deadline for complete applications under both Option A and Option B. Where applications are judged by the PRA and FCA to be 'incomplete', the assessment stage will be concluded by the 12-month statutory deadline for incomplete applications. We recommend that any prospective bank applicant wishing to achieve authorisation within six-months should arrange to meet with the PRA and FCA at the earliest opportunity to discuss its proposals.

During the assessment stage, the PRA will determine whether, if authorised, an applicant bank would meet the PRA's threshold conditions, at the point of authorisation and on a continuous basis. This will involve judging whether:

- its head office, and in particular its mind and management, will be in the UK if it is incorporated in the UK;
- its business is expected to be conducted in a prudent manner – and in particular that it maintains appropriate financial and non-financial resources;
- it is fit and proper and is appropriately staffed; and
- it (and its group) is expected to be capable of being effectively supervised (see below).

Consistent with its supervisory approach for existing firms, the PRA's assessment of new bank applications will include judging whether the applicant bank has a viable business model for the external environment it will operate in and the business risks it is likely to face. It will thereby aim to understand the proposed business model's sustainability and vulnerabilities. The PRA's analysis will include assessing where and how the proposed bank plans to make money, the risks it intends to take in doing so and how it will fund itself. It will be assessed at the level of the bank or the sector as appropriate and peer analysis will form an important part of this assessment.[39]

The PRA's assessment of the proposed business model will also include whether the PRA can effectively supervise the activities that the applicant bank will carry out – whether it is possible, with a reasonable amount of effort, for the PRA to form a clear view of the risks posed to the safety and soundness of the bank. Where the proposed business is particularly complex, the PRA will consider whether it is possible to evaluate effectively the prudential risks to the proposed bank arising from it.

As part of the assessment stage, the PRA will also determine capital and liquidity requirements for applicant banks (see Boxes 3 to 5).

Once we have completed our assessment, and assuming we are satisfied and have received consent from the FCA, we will grant authorisation to applicants. The PRA will approve new bank applications where it is satisfied that the bank will be prudently managed, has a viable business model in relation to all its material activities and that there are effective controls for risk identification and mitigation.

If the decision is taken at the pre-application stage that the mobilisation stage is appropriate for the applicant bank (Option B), the PRA will grant authorisation, but with a restriction that limits what the new bank can do. In all other cases (Option A), the PRA will authorise the applicant bank to conduct in full the regulated activities for which it applied.

39 For further information on the PRA's approach to business model analysis, see:
The PRA's approach to banking supervision, Bank of England, Prudential Regulation Authority:
www.bankofengland.co.uk/pra/Pages/publications/default.aspx.

**Box 1 – Documentation requirements for a new bank where proposals are not complex**

Where proposals are not complex, the PRA will require, as a minimum, the following finalised key documents. Where applicable, the documents should be updated following feedback received from us during the pre-application stage.

- Detailed business plan.[40]
- Ownership structure.
- Governance and management structure chart and assessment of the board and management team.
- Risk management framework, which shows the strategy for identifying and managing risks to the applicant bank's business, including details of risk management, finance and internal audit.
- ICAAP[41] and related policies (for example credit risk, concentration risk and provisioning policies).
- ILAA[42] and related liquidity returns based on the projected balance sheet.[43]
- Resolvability information proportionate to the potential impact of the applicant bank on financial stability (see Box 2).

**Box 2 – Assessing the resolvability of new banks**

To reflect the PRA's general objective, it will assess, with the Bank of England's Special Resolution Unit, the extent to which an applicant bank is resolvable. An assessment of the resolvability of the proposed bank, both in initial and subsequent circumstances covered by the business plan, will be embedded into the authorisation process, as this assessment is part of the test required to ensure that the PRA threshold condition that requires the 'business to be conducted in a prudent manner' is met at all times.

The PRA will aim for a position where the failure of any firm is orderly; that is, where the resolution of the firm is feasible and credible, without wider market disruption to the financial system or exposing public funds to risk, while maintaining continuity of their vital economic functions.[44] This will include taking supervisory action to reduce or remove firm impediments to resolution.

One option for resolving a failed bank (or building society) is to put the firm into the BIP. BIP is the default resolution option unless the public interest considerations weigh in favour of an exercise of a stabilisation option (for example, bank administration procedures, partial transfer, etc.) Resolution by way of the BIP may be the option that best meets the special resolution objectives where the most appropriate outcome would be the winding up of the failed institution's affairs in the interests of creditors as a whole, and prompt FSCS payouts to any eligible depositors or the bulk transfer of their accounts to another institution.[45]

---

40 As well as business model, business strategy and financial projections, the detailed business plan also should include any material outsourcing arrangements.

41 Internal Capital Adequacy Assessment Process (ICAAP). The process by which a firm assesses the amount of internal capital it considers adequate to cover all the risks to which it is exposed within the context of its overall risk management framework.

42 Individual Liquidity Adequacy Assessment (ILAA). The purpose of the ILAA is to help firms ensure they comply with the overall liquidity adequacy rule (BIPRU 12.2.1R). It is a firm's assessment and quantification of the liquidity risks it faces, how it intends to mitigate those risks and how much current and future liquidity is required. It is also an evaluation of its compliance with BIPRU 12.4 and 12.5.

43 The application will also need to indicate if the applicant will be seeking any liquidity modifications: Intra group; Whole firm; or Simplified ILAS.

44 Key Attributes of Effective Resolution Regimes for Financial Institutions, Financial Stability Board, (October 2011), see: www.financialstabilityboard.org/publications/r_111104cc.pdf.

45 In the event of a firm failure, an application to the court for a bank insolvency order may be made on one of three grounds: that a banking institution is insolvent, i.e. it is unable, or is likely to become unable, to pay its debts; that winding up the banking institution would be fair; that winding up the affairs of the banking institution would be fair and in the public interest.

**Box 2 – Assessing the resolvability of new banks**

We recognise that new banks are often small, unlikely to be of systemic importance, and in general straightforward to resolve, for example under the BIP (although resolution is not without its costs and these are passed on through increased FSCS levies). Therefore, in most cases, the PRA will require applicant banks to submit the following information to understand their resolvability as a proportionate alternative to providing a full RRP:

- **Group structure and key legal entity information** (comparable to Module 3 of the FSA's *RRP Guidance Pack for firms*[46]).
- An **explanation of how early warning signs and triggers** are integrated within its risk management framework.
- **Governance and overview of preparation of the applicant's proportionate resolution information** (and, if relevant, recovery plan). This helps us understand how the applicant has conducted the preparation of the information submitted to us to assess its resolvability. It assures us that the applicant's board and management understand the information submitted and support it as relevant and of appropriate quality (comparable to Module 1 of the FSA's *RRP Guidance Pack for firms*[47]).

The timeframe for submission of a full RRP will be agreed between PRA Supervision and the new bank.

Factors that may be taken into account to assess the resolvability of the applicant bank include the ability to repay depositors quickly, minimising the adverse effect of the bank's failure on the stability of the financial system. So if it is likely that the applicant bank could give rise to a FSCS-protected deposit by an eligible claimant, the PRA will also require it to be able to produce a single, consistent view of each eligible depositor's funds, to enable the FSCS to implement rapid pay-outs in the event of resolution. Therefore, we require all such deposit-takers at all times to be able to provide information to us to assess its SCV capabilities. For example:

- At application, we will require an applicant to submit its plan to implement electronic SCV.
- Within three months of receiving authorisation to accept deposits, the bank must provide an SCV implementation report and an SCV report.[48] It must also provide the FSCS with a representative sample of 10% or 10,000 (whichever is the smaller number) of its SCV.[49] The capability of the bank to do so will be a condition of continuing authorisation.
- We may perform a detailed review of the new bank's SCV files and systems capabilities within a reasonable timeframe of authorisation.

Where a bank meets the criteria to open as a branch in the UK, the PRA will engage with home resolution authorities to understand if the applicant has a credible recovery plan and may seek assurance on the development of a credible and feasible resolution plan for the parent bank that covers the UK activity.

46 RRP Guidance Pack for firms, (August 2011):
www.fsa.gov.uk/static/pubs/cp/cp11_16_rrp_guidance_pack.pdf.
The guidance pack is intended as a framework for firms to assist them in the completion of their recovery and resolution plans, supporting the policy proposals in CP11/16, Recovery and Resolution Plans, (August 2011):
www.fsa.gov.uk/static/pubs/cp/cp11_16.pdf and associated handbook rules.

47 RRP Guidance Pack for firms, (August 2011):
www.fsa.gov.uk/static/pubs/cp/cp11_16_rrp_guidance_pack.pdf.

48 COMP 17.3.1. A single customer view (SCV) implementation report explains how the firm has satisfied the FSA's SCV requirements (COMP 17.3.6). An SCV report is a report from the firm's board confirming that the firm's SCV system satisfies the FSA's SCV requirements (COMP 17.3.9):
http://fsahandbook.info/FSA/html/handbook/COMP/17/3

49 COMP 17.3.10:
http://fsahandbook.info/FSA/html/handbook/COMP/17/3

**Box 3 – Setting capital requirements for new banks we judge to be resolvable in an orderly way with no systemic impact**

**Background**

A bank should maintain appropriate capital resources, both in terms of quantity and quality, consistent with their safety and soundness and taking into account the risks to which they are exposed. The PRA will determine a minimum regulatory capital level and a buffer on top of this, expressed in terms of the Basel and EU risk-weighted assets framework, for all banks, including new entrants. This will comprise of three parts:

- Pillar 1 – an 8% minimum capital requirement against a bank's risk-weighted assets to provide protection against credit, market and operational risk, for which firms follow internationally agreed methods of calculation and calibration. The PRA will have no discretion to reduce Pillar 1.
- Pillar 2A – requirements advised by the PRA reflecting its estimates (usually expressed as a scalar to Pillar 1) of risks either not addressed or only partially addressed by Pillar 1 and of the capital needed to compensate for shortcomings in management, governance, risk management and controls.

Pillar 1 and Pillar 2A combined represent a bank's individual capital guidance (ICG).

- Pillar 2B/capital planning buffer (CPB) – guidance from the PRA reflecting a forward-looking assessment of the capital required to ensure that banks can meet ICG at all times, even after severe but plausible stresses. The CPB is a buffer that is not part of the regulatory minimum. Therefore, we have greater flexibility in this area.

**Revised approach**

We have considered the findings of our review of our current approach to setting capital requirements for new banks. We have determined that for new banks that are small, unlikely to be of systemic importance, and in general straightforward to resolve, for example under the BIP, the PRA will take a more proportionate approach. The existing capital-setting framework gives us the flexibility to do this. Looking forward, we will seek to use the flexibility available within CRD IV to maintain this proportionate approach.

We believe that the changes we are making represent a significant improvement on current arrangements as they will typically result in lower capital requirements for new entrants than under the current approach. This will allow new banks to build up capital over time to meet capital requirements as for incumbent firms.

The key principles of the PRA's approach to setting capital requirements for new banks that we assess to be resolvable in an orderly way with no systemic impact are as follows:

- A new bank will be expected to **hold as a minimum, sufficient capital to continue to meet Pillar 1 and Pillar 2A for at least the next 12 months based on the projected business plan plus the CPB**, from when the bank starts business[50] until it is required by us to meet capital requirements calculated on the same basis as for incumbent firms. The 12-month timeframe is consistent with the PRA's approach of an annual supervisory cycle. There may be instances where we judge it appropriate to set higher capital requirements for a new bank.
- **No automatic Pillar 2A scalars (capital add-ons) will be applied simply because the bank is new**[51]; Pillar 2A will be set in a consistent manner with incumbent firms.
- **A more flexible approach will be taken to calculate Pillar 2B/CPB**. The CPB will usually be set as the wind down costs for the bank (typically equivalent to the applicant's projected operating costs for the next 12 months). We expect this to result in significantly lower CPB than calculated under the standard methodology.[52]

50 This will be either at the end of the assessment stage or, for those applicants who go through the mobilisation stage (Option B), this will be at the end of the mobilisation stage once the restriction is lifted by the PRA.

51 For example, no automatic Pillar 2A scalar (capital add-on) will be applied for management and governance simply because the management team and board are new. As a matter of prudence, the PRA will exercise its supervisory judgement to apply a capital add-on if it considers it necessary on a case-by-case basis.

52 The standard methodology is set out in PS10/14, Capital Planning Buffers – feedback on CP09/30 and final rules, (September 2010): www.fsa.gov.uk/pubs/policy/ps10_14.pdf.

**Box 3 – Setting capital requirements for new banks we judge to be resolvable in an orderly way with no systemic impact**

The standard method to calculate the CPB is heavily influenced by changes in the balance sheet over the projected planning period. Therefore, as applicant banks would normally project a fast-growing balance sheet, the CPB for those firms can be significantly affected when calculated using the standard method.

The current policy on the CPB recognises that the approach to calculating the buffer will need to be determined on a case-by-case basis, taking into account the specific circumstances concerned.[53] The FSA has already decided to take fuller advantage of this flexible approach to ensure the CPB is proportionate to the risks a firm poses to its objectives. This approach will be continued by the PRA.

- **New banks may be allowed more time than existing firms to build up to the capital conservation buffer (CCB) of CRD IV**.

However, the very smallest banks may be affected by the minimum capital requirement of €5m specified by European Directive. There is an exception to this available to EU member states for 'particular categories of institution'. The UK has used this exception for building societies. The PRA plans to consult in Q2 2013 on a further exception for small banks.

Pending the outcome of this consultation, as a minimum a new bank will be required to hold the €5m minimum capital requirement. So, if an applicant bank's Pillar 1 plus Pillar 2A capital requirement calculated by the PRA is lower than €5m, the new bank would be required to hold €5m of capital plus the CPB.

For new entrants to the UK banking market that have established themselves successfully, **our expectation will be that after a reasonable period, typically between three to five years[54], they will be required by the PRA to meet capital requirements calculated on the same basis as for incumbent firms**. This includes the CPB calculated under the standard methodology.

However, if those banks cannot satisfy the conditions necessary to use the IRB approach to calculate credit risk capital requirements, and the standardised approach causes competitive distortions for them relative to established banks undertaking similar business on the IRB approach, provided we determine the bank can be resolved under the BIP, we will continue to apply our more flexible approach to calculating the CPB (see Graph 1b).

Both the PRA and a new entrant will need to ensure they are clear on the estimated future capital requirements the bank will be required to meet once it is established. We refer to this as the capital glide-path. The PRA will also need to understand the expected timeframe of the capital injections[55] required for the bank to progress along that capital glide-path. If further capital injections do not occur, the PRA will intervene and use its powers where required to ensure the bank continues to meet the PRA's threshold conditions.

53 PS10/14, Capital Planning Buffers – feedback on CP09/30 and final rules, (September 2010): www.fsa.gov.uk/pubs/policy/ps10_14.pdf.

54 The actual period will be influenced by several factors, including the rate of growth of the new bank in terms of size and complexity and when it expects to reach 'steady state'.

55 It is unlikely that new banks will raise capital organically as they are often loss making for the first few years.

**Box 4 – Example of the PRA's approach to setting capital requirements for new banks**

When the new bank starts business[56] (here T=0), its capital requirements will be the sum of:

- Pillar 1 set on the projected balance sheet at T+12 months.
- Pillar 2A set in a consistent manner with existing banks on the projected balance sheet at T+12 months.
- Pillar 2B/CPB set as the wind down costs (typically equivalent to the applicant's projected operating costs for the next 12 months).

The PRA will indicate the expected capital glide-path that the bank will be required to meet after a specified time period, usually between three to five years after it starts business. For the purposes of this example, the timeframe is assumed to be five years/60 months.

At each capital assessment until that point, the bank's capital requirements will be set on the same basis as described above.

**At 12 months:**

The PRA will carry out a capital assessment to review its capital judgements in relation to the bank and update the bank's capital glide-path, based on the actual balance sheet after the first 12 months and any revisions to the projected business plan.

**At 36 months:**

The PRA will carry out another capital assessment to review its capital judgements in relation to the bank and update the bank's capital glide-path, based on the actual balance sheet after 36 months and any revisions to the projected business plan.

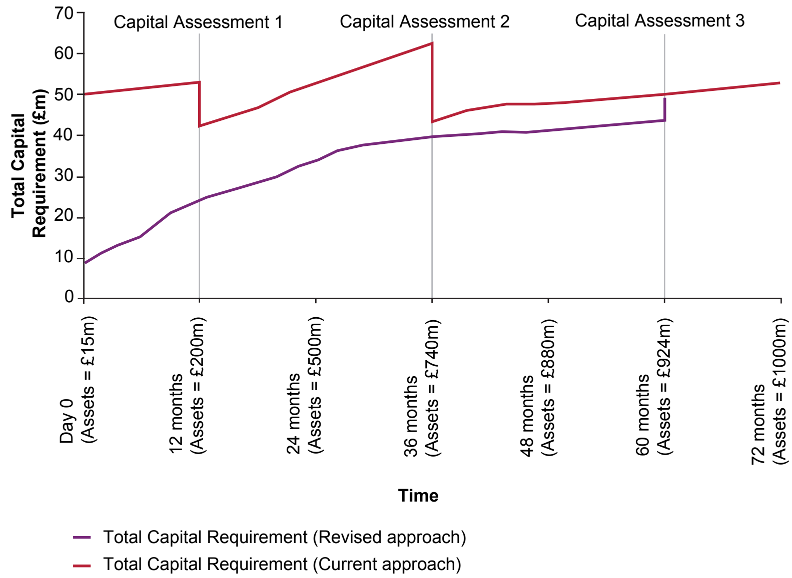
**At 60 months:**

The PRA will carry out a further capital assessment and will set the bank's capital requirements, including the CPB, on the same basis as for incumbent firms (unless the bank cannot satisfy the conditions to use the IRB approach and this causes competitive distortions for it relative to established banks undertaking similar business on the IRB approach. In which case, provided we determine the bank can be resolved under the BIP, we will continue to apply our more flexible approach to the CPB). We will expect the bank over the previous 60 months – informed by the capital glide-path – to have been building up its capital resources to meet this requirement.

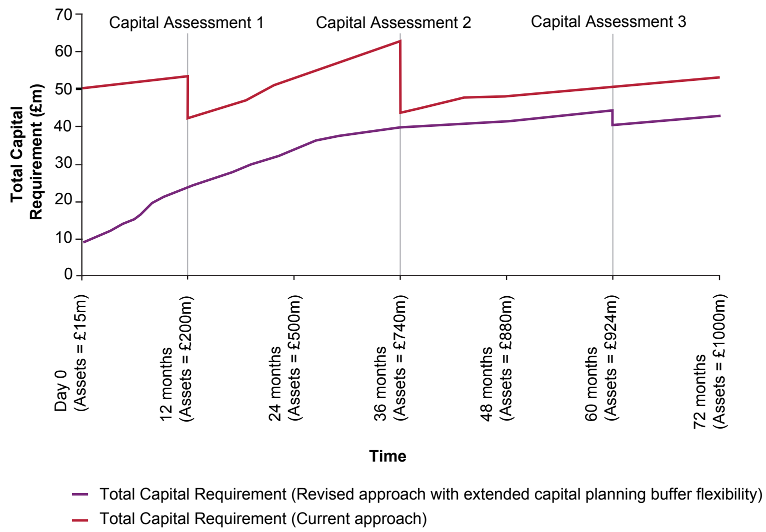
See Graph 1a.

56 This will be either at the end of the assessment stage or, for those applicants who go through the mobilisation stage (Option B), this will be at the end of the mobilisation stage.

## Graph 1a – Example of the PRA's approach to setting capital requirements for a new bank




## Graph 1b – Example of the PRA's approach to setting capital requirements for a new bank which cannot satisfy conditions to follow the IRB approach



Graphs 1a and 1b present an example of a theoretical new bank that we assess is not systemically important and is straightforward to resolve under the BIP. The example compares the new bank's capital requirements calculated on the current approach and compares this to the revised and more proportionate approach the PRA will take as explained in Box 3. In this example, we assume the new bank:

- carries out residential mortgage lending only;
- follows the standardised approach to calculate credit risk capital requirements as it cannot satisfy the conditions necessary to follow the IRB approach; and
- grows significantly in the first five years (60 months) after starting business, in particular in the initial three years.

Graph 1a assumes that the new bank:

- is required to meet capital requirements calculated as for incumbent firms five years after it starts business.

Graph 1b assumes that the new bank:

- at that point is able to demonstrate that calculating credit risk capital requirements on the standardised approach causes competitive distortions for it, relative to established banks undertaking similar business on the IRB approach. Therefore, we will continue to apply our more flexible approach to the CPB.

**Box 5 – Determining liquidity requirements for new banks**

The PRA expects all firms to be able to meet their obligations as they fall due on a continuous basis with sufficient confidence, including in stressed circumstances. A liquidity stress, whether firm-specific or market-wide, can occur suddenly and unexpectedly. Without adequate resilience, a bank, whether new or established, can become unviable in a period of days. This contrasts with solvency-driven threats to viability, which in general materialise over significantly longer periods. This difference explains why the PRA does not intend to exercise the same proportionality for liquidity requirements on authorisation as it will for capital requirements.

Consistent with the PRA's risk appetite, we have now reduced the starting point for individual liquidity guidance (ILG) for new banks on the standard liquidity regime in line with that for incumbent banks. **No automatic premium to ILG will be applied simply because the bank is new.** As a matter of prudence, the PRA will be able to exercise its supervisory judgement to apply a premium if it considers it necessary on a case-by-case basis. We will consider applications by new banks that are eligible for the simplified liquidity regime on a similar basis.[57]

57 We recognise that it may not always be appropriate to apply BIPRU 12.5 (Individual Liquidity Adequacy Standards) to every ILAS BIPRU firm. For a firm which operates a relatively simple business model, it may instead be appropriate to allow the firm to calculate the size and content of its liquid assets buffer according to a simplified approach prescribed in the Handbook in advance of any review by us of that firm's liquidity risk. BIPRU 12.6 sets out the conditions which must be met.

## Mobilisation stage

We understand from our review that some applicants find it problematic, or are reluctant to invest substantial sums of money, without the assurance of being authorised to hire remaining staff, develop detailed governance arrangements, finalise policies and procedures, deliver a suitable and stable IT platform and raise all the required initial capital.

To help those applicants who are faced with these challenges, the revised authorisation process contains Option B: for applicants to be granted authorisation by us to accept deposits, but with a restriction that limits what the new bank can do and then go through the mobilisation stage.

The purpose of the mobilisation stage is so that the bank is able to demonstrate to investors, prospective personnel and third-party service providers that it has received an authorisation (albeit with a restriction) from the PRA. It gives applicants greater confidence to be able to complete the creation of a fully functioning bank. The mobilisation stage is also the period during which the bank completes all the conditions necessary for the restriction to be lifted by the PRA.

It is necessary to place a restriction on the newly-authorised bank to ensure that it will not breach the PRA's threshold conditions by, for example, not having all the capital resources and governance arrangements in place that are necessary to run a fully operating bank in a safe and sound manner.

The FCA will complete a significant part of its assessment during the mobilisation stage (see Chapter 7). The PRA will expect to complete the majority of its assessment during the assessment stage. This recognises that the mobilisation stage is designed primarily to help applicants with the operational elements of becoming a bank. Therefore, the majority of engagement during the period of mobilisation will be between the FCA and the new bank.

The PRA and FCA will work with the bank's project plan for completing the mobilisation stage and the bank will be expected to set out the timeframe of its plan early in the authorisation process. This early discussion will help the PRA and FCA to ensure that appropriate resource is available to conclude the mobilisation stage with the new bank.

On being granted authorisation with a restriction and throughout the mobilisation stage, currently a new bank will be required to hold the €5m minimum capital requirement set out in the European Directive. Therefore, at authorisation, the PRA will require the bank to hold additional capital above the €5m minimum requirement, for example by the amount of the bank's expected running costs for the mobilisation stage, to ensure that throughout this stage the new bank maintains the required minimum €5m at all times. Once the restriction is lifted and the new bank starts business, it will be required to meet individual capital guidance (ICG) and individual liquidity guidance (ILG) determined during the assessment stage (see Boxes 3 to 5).

Therefore, at the end of the mobilisation stage, the PRA will determine if the bank meets its ICG and ILG and also that it satisfies the PRA's threshold conditions against the full scope of its activities. If it does, and the FCA is also satisfied, we will lift the restriction and the bank will be able to begin in full the regulated activities for which it applied.

The mobilisation stage cannot continue indefinitely as the information submitted to us by the applicant to perform our assessment would need to be updated. We anticipate that it will not take longer than 12 months for a new bank to be able to complete the mobilisation stage. The timeframe could be much shorter depending on the bank's ability to mobilise. If after 12 months we judge that the new bank does not meet the conditions necessary for us to lift the restriction on it, we will apply a 'guillotine clause' to remove the new bank's authorisation. This clause will ensure that the mobilisation stage does not continue past the point where the information on which the authorisation was granted becomes out of date.

Therefore, under Option B, the maximum timeframe between receiving an application and lifting the restriction could be 18 months. This assumes that: it takes a maximum of six months (but we expect it to be within six months) to complete our assessment during the assessment stage; and the bank takes the maximum 12 months (but we expect it to be shorter) to mobilise and demonstrate to the PRA and FCA that it has met the conditions for the restriction to be lifted.

Under Option A, the timeframe between receiving an application and granting applicants authorisation to carry out in full the activities for which they applied, would be a maximum of six months for complete applications and a maximum of 12 months for incomplete applications.

Therefore, the mobilisation stage will not be appropriate for all applicant banks. The PRA and FCA will determine in discussion with applicants whether it is appropriate on a case-by-case basis, normally during the pre-application stage.

## Implementing the PRA's approach

The PRA's approach to the revised authorisation process will be implemented in full from legal cutover on 1 April 2013. Before that, we have introduced the following improvements:

- pre-application stage challenge sessions;
- the revised approach to liquidity requirements; and
- the revised approach to setting capital requirements for new banks (which we judge to be resolvable in an orderly way, with no systemic impact).

## The PRA's approach to supervising new banks

As explained earlier in this chapter, applicants will have direct contact with experts in PRA Supervision responsible for assessing new UK and international bank applications and for taking applicants through the authorisation process. Where applications are successful, as far as it is practicable to do so, the same supervisory resource responsible for taking the new bank through the authorisation process will also supervise it for, at least, the first few years after authorisation is granted. This will leverage the existing knowledge of, and relationship with, the firm developed during the authorisation process to deliver the supervision required for new banks effectively and efficiently.

We recognise the greater intensity of supervision needed for newly-authorised banks. For example, where new banks receive capital concessions on entry, the PRA will need to ensure it is clear on the estimated future capital requirements the new bank will need to meet once it is established (the capital glide-path) and the expected timeframe of the capital injections[58] required for the bank to progress along that glide-path. PRA Supervision will need to monitor closely the bank's progress and should further capital injections not occur as planned, the PRA will intervene and use regulatory powers where required to ensure the bank continues to meet the PRA's threshold conditions. Also, the PRA will almost certainly need to perform capital assessments on a more regular basis than for existing banks of the same size to:

- ensure our approach to setting capital requirements continues to be appropriate (for example, if the business grows significantly quicker or differently compared to the bank's projections, we may accelerate the point at which it is required to meet capital requirements calculated as for incumbent firms); and
- keep the capital glide-path up-to-date.

See Boxes 3 and 4.

This continuous assessment approach to supervision is a core part of the PRA's supervisory approach but not the FSA's approach.

The greater intensity of supervision needed for newly-authorised banks also reflects that new banks' management may have limited experience of regulatory requirements the bank is required to comply with.

58 It is unlikely that new banks will raise capital organically as they are often loss making for the first few years.

## CRD IV – impact on new banks

CRD IV is expected to come into force in 2014.[59] Under CRD IV there will be no change to the existing EU requirements on initial capital, but there will be changes to the Pillar 1 requirement with which all banks (including new entrants) will have to comply. Flexibility will remain in the detailed methodologies for the application of Pillar 2A, but will be subject to more constraints, including: a capital assessment subject to European Banking Authority (EBA) guidelines; and at least an annual supervisory stress test on banks, to be performed under methodologies set out in EBA guidelines.

The CRD IV buffer requirements are the same for all banks and we expect that they will not fully replace the CPB, which is set on a firm-specific basis. Therefore, the PRA is likely to continue to set firm-specific capital buffers for some banks where it is appropriate to do so after CRD IV has been implemented. As far as possible, the PRA will apply similar principles to the treatment of new banks' CRD IV and firm-specific buffers under the new regime as set out earlier in this chapter with respect to the current CPB. However, CRD IV will limit the PRA's discretion with respect to the CRD IV buffers, for example because a firm that does not meet minimum buffer requirements will be subject to certain automatic distribution constraints.

In particular, CRD IV will implement the Basel III capital conservation buffer (CCB), which requires all banks to hold common equity tier 1 (CET1) capital of at least 2.5% in relation to its risk-weighted assets. This is in addition to the absolute minimum of 4.5% CET1 capital. The CCB will be phased in between 1 January 2016 and year-end 2018, becoming fully effective at 2.5% on 1 January 2019 (although Member States can introduce it sooner). So, from that date, all banks will need to hold CET1 capital of at least 7%.[60] From 1 January 2016, all banks (including new entrants) that do not maintain a CCB at the appropriate level will be subject to automatic restrictions on distributions such as dividend payments and variable remuneration, and required to agree a plan with the PRA to meet their CCB within an appropriate timeframe. In assessing what would be an appropriate timeframe to enable a new bank to meet the CCB, the PRA intends to adopt a proportionate approach so that new banks that it judges to be resolvable in an orderly way with no systemic impact may be afforded more time to meet the CCB than would generally be the case for existing banks.

CRD IV will not set out specific liquidity standards, but there will be a basic requirement to meet general liquidity standards, the detail of which will be set out in further EU legislation expected in 2014, to take effect from 2015. Higher or stricter standards can be imposed by the PRA on individual banks through supervisory measures under Pillar 2. New banks will be subject to the same liquidity standards as all other banks.

59 The legislation has yet to be finalised so this report has been prepared on the basis of the current legislative drafts.

60 The largest global systemically important banks will also have to hold a further buffer of 2.5% common equity tier 1 (CET1) capital, taking their CET1 level to 9.5%, to be introduced within the same transitional timeframes as the capital conservation buffer. In addition, all banks will be required to hold a countercyclical capital buffer, to be set by the Financial Policy Committee (FPC) for UK exposures. For more information about the FPC's powers in this area see: www.bankofengland.co.uk/financialstability/Pages/fpc/coreindicators.aspx.

## Calculating credit risk

Providing accurate measures of credit risk is fundamentally complex. There are requirements (currently in CRD III, but soon to be in the CRD IV) to mitigate the risk of allowing banks to use their own estimates of risk. The European legislation gives the option of the standardised approach – the simpler approach – or the IRB approach.

Neither approach is perfect. The standardised approach is attractive for its simplicity but it is crude in its calculation of risk. On the other hand, the IRB approach can lead to under-estimates of risk. However, there are constraints in place on the extent to which firms can reduce capital requirements through the use of IRB models, and the general policy direction is for these constraints to be a more prominent feature of the new regulatory framework. For example, Basel III introduces a leverage ratio, which at the level of the whole balance sheet requires a minimum amount of Tier 1 capital relative to assets/exposures. Furthermore, a key work-stream of the Basel Committee is focused on delivering greater comparability of capital requirements generated using banks' internal models and this may lead to policies that reduce the possibility of risk and capital requirements being under-estimated.

Separately to this work on barriers to entry, the FSA, and in future the PRA, is taking steps to reverse the under-estimation of risk in the IRB approach with a more rigorous approach to IRB standards. A notable example of the new approach is the requirement for IRB firms to apply 'supervisory slotting' for commercial real estate exposures (slotting gives a higher capital charge than the standardised approach).

For a bank wanting to move to the IRB approach, European law requires it to demonstrate that it: is a models-driven bank, using models to measure risk internally and make strategic decisions; has been using relevant IRB-type rating systems for at least three years; has adequate governance arrangements in place around the models; and has adequate data to build the models.[61]

An overseas existing established bank setting up a subsidiary in the UK might be able to meet in a shorter time period the criteria that would otherwise require it to have been using the relevant IRB-type rating systems for at least three years, if it is already an IRB user in its home market. However, it might take more time to meet the data requirements, depending on whether: it is choosing to use the advanced or foundation approach[62] for corporate exposures; and it intends to base its probability of default estimates for such exposures on internal data or use an existing commercial model.

61 With exceptions for retail exposures, it should have at least five years' data and be able to make appropriate adjustments to reflect the economic cycle.

62 The key difference with the advanced approach is that in addition to being able to estimate the likelihood of a borrower defaulting, a firm may also use its own estimates of the amount it would lose if the borrower defaulted and its exposure at default, rather than basing these elements of the capital calculation on fixed parameters and rules set out in the Banking Consolidation Directive (2006/48/EC).

For banks that are prepared to invest the considerable time, effort and cost involved to move to the IRB approach, the PRA will commit to:

- actively engage with those banks to ensure they understand the requirements they need to meet to be granted approval to follow the IRB approach;
- ensure that this information is set out clearly in one place on our website;
- discuss and agree with those banks a credible plan for achieving approval to follow the IRB approach for part or all of their credit risk;
- provide general guidance on the areas of those banks' lending where they would be likely to see capital benefits through following the IRB approach (see Graphs 2a to 2c);
- approval to follow the IRB approach being achievable over three years, which is the minimum amount of time required for a bank to build statistically valid capital models (if one assumes that the bank can meet the adequate data test by that time); and
- adopt a streamlined approach to considering applications to use the IRB approach[63] from banks that the PRA judges are not systemically important.

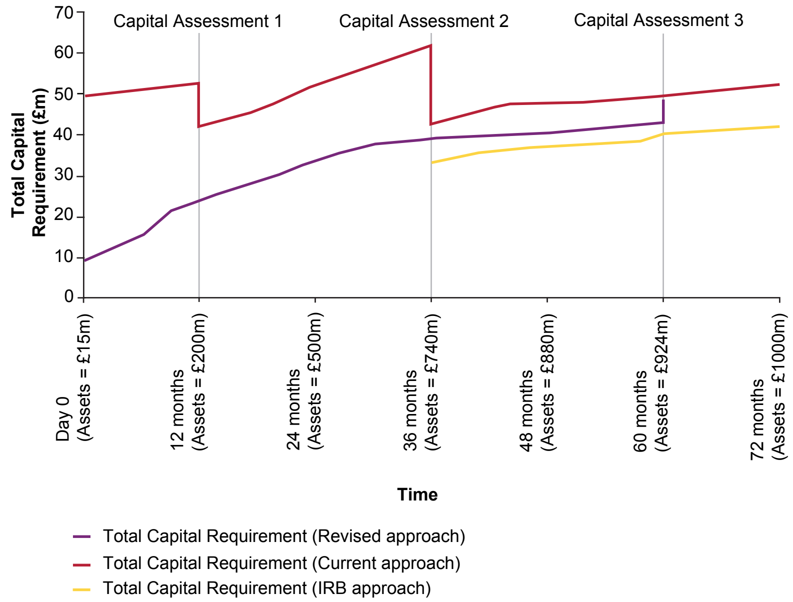
With regard to the data used to build IRB models, the PRA will be willing for a bank to supplement internal data with external data provided the requirements for the use of such external data are met. For example, that the data are representative of the portfolios for which they will be used. We would expect a bank's board to satisfy itself that these requirements are met.

In situations where a bank receives approval to follow the IRB approach within three to five years after authorisation, the capital concessions for new entrants to the UK banking sector set out in Box 3 will no longer apply to that bank.

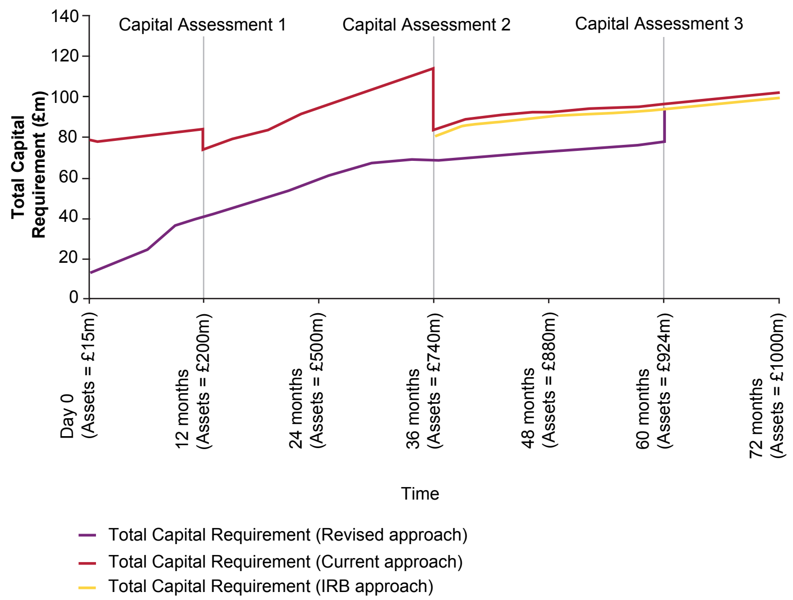
We acknowledge that the requirements set out in European law to achieve IRB approval are considerable for banks. We recognise there are banks that cannot, or do not want, to satisfy the requirements to follow the IRB approach and that the standardised approach to calculating credit risk capital requirements may cause competitive distortions for them relative to established banks undertaking similar business under the IRB approach. The FSA/PRA is taking considerable steps to reverse existing under-estimation of risk in the IRB approach, which will help to create a more level playing field between established banks on the IRB approach and newer banks on the standardised approach. In addition, we will go further to recognise the less systemic nature of these smaller banks. Where the resolution planning arrangements for a bank determine that it could be resolved under the BIP, we will extend our more flexible application of the CPB, which will further level the playing field between small and large banks undertaking similar business (see Graph 1b).

63 Application to use the IRB approach takes the form of a waiver request from the firm to the FSA/PRA.

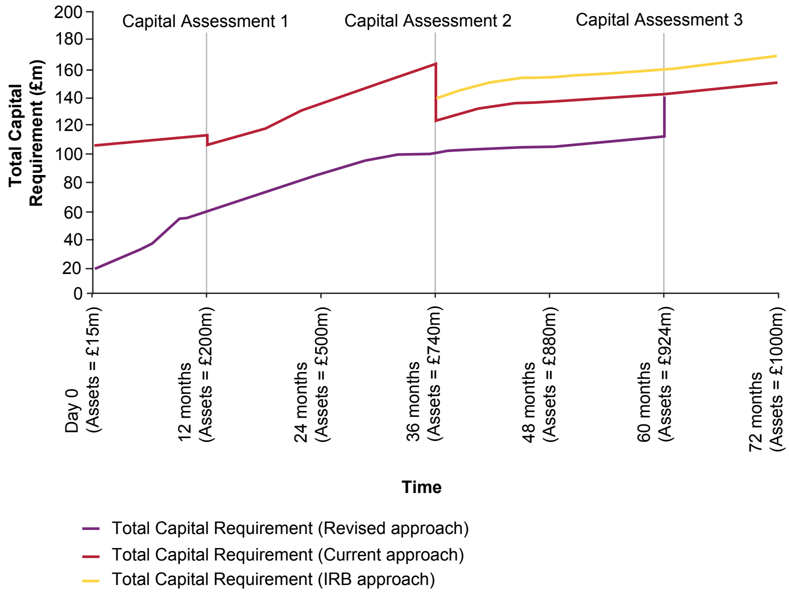
## Graph 2a – Example of the PRA's approach to setting capital requirements for a new bank with approval to follow the IRB approach (residential mortgage lending only)




## Graph 2b – Example of the PRA's approach to setting capital requirements for a new bank with approval to follow the IRB approach (residential mortgage and commercial real estate lending in equal proportions)



**Graph 2c – Example of the PRA's approach to setting capital requirements for a new bank with approval to follow the IRB approach (commercial real estate lending only)**




Graphs 2a to 2c present three examples of a theoretical new bank in which the bank is granted approval to follow the IRB approach three years after it starts business. At that point, the PRA's revised and more proportionate approach to setting capital requirements for new banks no longer applies (but would otherwise have applied up to the end of year five after authorisation) and the new bank is required to meet capital requirements calculated as for incumbent firms, including the CPB calculated under the standard methodology (see Box 3). The three examples are identical except that in each case, the composition of the new bank's lending is different.

The three examples demonstrate that the standardised approach to calculating credit risk capital requirements, in general, does lead to higher capital requirements for residential mortgage lending compared with the IRB approach. However, for other lending, for example commercial lending (particularly commercial real estate), the standardised approach can lead to lower capital requirements compared to the IRB approach. Therefore, it cannot be categorically stated that the IRB approach leads to lower capital requirements. Banks wanting to follow the IRB approach will need to understand where they would be likely to see capital benefits before they invest the considerable time, effort and cost involved to move to the IRB approach.

## The PRA's approach to the capital of smaller, resolvable banks after authorisation

It is important that recently-authorised banks, where they are small, unlikely to be of systemic importance, and in general straightforward to resolve, for example under the BIP, are not disadvantaged compared to new entrants benefitting from the revised and more proportionate approach to setting capital requirements explained in this chapter. So we are proposing to review the capital of any such bank authorised since April 2011 where a capital assessment has not yet been performed in the ordinary course of supervision and we will then extend this assessment to such institutions.

As explained above, we are also proposing additional help to any bank that cannot, or does not want, to satisfy the requirements to follow the IRB approach in the following specific circumstances: the resolution planning arrangements for that bank determine that it could be resolved under the BIP; and the standardised approach to calculating capital requirements is causing competitive distortions for it relative to established banks undertaking similar business under the IRB approach. That help will take the form of the more flexible application of the CPB such as described for new entrants (see Box 3).

The general liquidity review for all banks will cover any liquidity anomalies for already authorised banks (see Box 5).

# 7

# The FCA's approach to new banks

With effect from legal cutover on 1 April 2013, the Financial Conduct Authority (FCA) will be responsible for ensuring that relevant markets function well, for the conduct supervision of financial services firms, as well as the prudential supervision of firms not supervised by the Prudential Regulation Authority (PRA). This means it will be the conduct regulator for firms wanting to undertake activities (deposit-taking or insurance) that will require them to also be regulated by the PRA for prudential matters.

For firms whose activities include deposit-taking or insurance, the PRA will be the lead regulator and firms wishing to carry out these activities will need to apply to the PRA for authorisation. The PRA will lead on and administer the application, but will not be able to authorise the firm unless the FCA gives its consent. Although there are two regulators, there will be a single administrative process for making an application, with just one application form to complete. Chapter 8 contains more detail about how the PRA and FCA will work together during the authorisation process.

This chapter sets out the FCA's approach to the revised authorisation process for new banks that was described in Chapter 5.

The FCA's approach to authorising new banks or banks that are expanding their activities aims to balance our objective to promote competition in the interests of consumers with the need to apply appropriate barriers to entry to deliver consumer protection. We will ensure that the approach does not cause disproportionate barriers to entry or expansion, and by doing so, adversely affect on competition.

## The FCA's approach to authorising new banks

The FCA's approach documents[64] set out the approach the FCA will take to supervising firms and the FCA will carry this proportionate and judgement-based approach over into the way that it authorises new banks.

The FCA will assess applicant banks from a conduct perspective against its strategic objective to make markets function well. In doing so, the FCA will reach a conclusion about whether, if authorised, the applicant will meet the FCA's threshold conditions, both at the point of authorisation and on an ongoing basis. At the same time, the PRA will assess applicant banks against its threshold conditions from a prudential perspective.

The FCA will have different threshold conditions to the FSA and those relevant for dual-regulated firms are:

- effective supervision (including close links);
- appropriate non-financial resources;
- suitability; and
- business model.

The big difference is the business model threshold condition, as there is a clear parallel between the other three and the FSA's threshold conditions.

The new business model threshold condition demonstrates the importance that the FCA places on a firm's ability to put forward an appropriate, viable and sustainable business model, reflecting the nature, scale and complexity of the business a firm intends to carry out.

The FCA's assessment of a firm's business model will focus on how the firm demonstrates that its business model meets the needs of its proposed customers and does not place them or the wider financial services system at undue risk. The FCA will look to recommend refusing an application at an early stage if concerned by the risk posed by a firm's business model.

The FCA will, as far as is practicable, align its approach with that taken to analysing business models and identifying conduct risks in FCA supervision although still bearing in mind the unique challenges involved with assessing the business model of new start-up firms.

We envisage a three-strand approach to assessing a firm's business model:

- Firm specific – An analysis of the viability of the firm will be done, including an assessment of the firm's product range, sources of income, likely interactions with customers, the culture of the firm (where possible), future strategy (including growth strategies, etc). This will also include assessment under stress scenarios, as this is one example of when there could likely be a significant impact on customers, and any

64 The Financial Conduct Authority – Approach to Regulation, (June 2011):
www.fsa.gov.uk/static/pubs/events/fca_approach.pdf and
Journey to the FCA, (October 2012):
www.fsa.gov.uk/static/pubs/other/journey-to-the-fca-standard.pdf.

concerns over models that might limit customer choice. This is not an exhaustive list of the considerations and it is likely that elements of this assessment will overlap with the assessments outlined below.

- Product/distribution – A specific assessment will be made of the potential conduct risks arising from the product offering of the applicant firm and a forward-looking assessment of future potential conduct risks arising from new product offerings. The conduct risks arising from specific products or methods of distribution will be assessed in the context of the target customer for said products and their suitability for those customers.
- Sector analysis – The FCA Authorisations team will look to draw on the extensive sector-specific knowledge that exists within the supervisory areas to identify emerging risks, and to inform our forward-looking assessment of firms' business models.

In addition to its overarching strategic objective, the FCA has an objective to promote competition in the interests of consumers. Reducing the barriers to entry should facilitate the entry of more banks and therefore more consumer choice.

The FCA will take a more proportionate approach to assessing applications for new banks, resulting in a more effective use of resources for both applicants and us. We have streamlined the information requirements and we will work with the firm in the pre-application stage to ensure that the supporting documentation required is relevant and proportionate. In Option B we have substantially reduced the amount of information that we ask for in the application, pushing back some requirements to mobilisation. Instead of a one-size fits all approach in terms of our information requirements, we will tailor these specifically to the firm and its business plans.

All applications will be subject to a minimum level of assessment based on the information asked for, after which our work will depend on the scale and nature of the activities the applicant plans to undertake and the risks in turn that this poses to the FCA's objectives. So we will always be interested in assessing the business model, but a simple business model with a limited product range will require less scrutiny than a firm proposing multiple product ranges, a range of distribution channels and an ambitious growth plan. This does not mean that we are reducing standards, rather that we will clearly focus on the risks that we judge to be the most significant.

All applicants will have access to the FCA Authorisations team, who are experts in assessing the applications we receive from all dual-regulated firms. We will be on hand to take applicants through the authorisation process and to ensure a seamless and integrated handover to our Supervision Division once the authorisation has been granted and the mobilisation stage completed (if applicable).

## Option A – a complete application

As outlined in Chapter 5, the enhanced version of our existing process is separated into two distinct parts:

- pre-application, and
- application review.

### Pre-application stage

During the pre-application stage, prospective applicants will have regular contact with the FCA Authorisations team to ensure that they understand the authorisation process and what to expect, what information we will require, and when and how we will approach (in conjunction with the PRA) our assessment of the viability of the business model.

More information will be made available on the FCA website about the authorisation process, what our expectations are and what firms can expect from the FCA. We will update this information regularly to ensure that it reflects our latest thinking.

We will hold at least two, and possibly more, meetings with the applicant firm during this phase and, where possible, these meetings will be held in conjunction with our PRA colleagues. We will provide feedback on the prospective applicant's proposals and will highlight key issues as soon as possible to ensure they are addressed before an application is submitted.

To provide constructive and timely feedback to enable firms to take action at an early stage, we will need to see information about the applicant's proposals while they are still in the pre-application stage. This information is likely to include a detailed business plan, the ownership structure, details of all board members, senior management and other staff, governance arrangements, proposals for the policies and procedures to support the business and substantial detail about the IT infrastructure and any outsourcing arrangements. This information will be reviewed in the context of the FCA's threshold conditions and the feedback from this review will be provided to the firm in the form of a challenge session.

These challenge sessions are new to the authorisation process and represent a key development. These sessions will provide an opportunity for firms to clarify their proposals and for issues to be discussed face-to-face so that firms are clear on our concerns and can ask us questions directly.

The intention is that firms should not submit an application until all the issues highlighted during the pre-application stage have been addressed. This should greatly increase the likelihood that the application will be complete[65] and that we will have all the information to the required standard, to complete our assessment.

65 A complete application contains all the information necessary to enable us to complete our assessment work without needing to refer back to the applicant for further information or clarification.

The FCA's approach to firms that will be subsidiaries of overseas banks will be the same as that for UK-owned banks, although the pre-application stage may include a meeting with senior management from the parent or head office, as well as contact with the home regulator.

### Application review stage

In Option A, the application review stage is for the FCA and PRA to assess new bank applications against the key regulatory requirements that need to be satisfied before authorisation can be granted. For the FCA, this consists of determining whether, if the applicant were to be authorised, it would meet the FCA threshold conditions both at authorisation and on an ongoing basis. This includes ensuring that:

- The firm is capable of being effectively supervised by the FCA, having regard to the nature and complexity of the proposed activities, its structure and the impact of links with other entities and individuals.
- The firm's non-financial resources are appropriate for the conduct of the regulated activities to be carried out. This includes proper operation and management given the scale and nature of the business, including appropriate systems and resources to mitigate the risks of financial crime.
- The applicant is suitable, including the fitness, probity, competence and ability of the key individuals of the firm who are already in place.
- The applicant's strategy for doing business, including the viability of its business model, must be suitable for a person carrying on the regulated activities intended to be carried out.

Of particular interest to the FCA will be the business model assessment, where outputs from the PRA's assessment of capital and liquidity requirements will also help, as well as the key governance appointments in relation to how the applicant intends to put the consumer at the heart of its business and how Treating Customers Fairly (TCF) will be implemented.[66]

Often a big element of any banking application is the IT arrangements, and these span building a new system from scratch through to outsourcing virtually all operations. We do not specify particular IT systems – we are concerned that the systems implemented will hold customers' money safely and securely, free from phishing and hacking attempts and that all customer data is equally secure. We also want to know that business continuity arrangements are appropriate.[67]

We are aware of companies in other jurisdictions that offer a 'one-stop shop' for a bank's IT requirements, which include sort code and agency banking, among other services. We know that these activities can be difficult, costly and time consuming for banks to set up from scratch, so we have engaged (and are willing to continue to do so) with enterprises

66 The FSA published Journey to the FCA in October 2012, which covers the need for firms to put consumers at the heart of their business in more detail.
See www.fsa.gov.uk/static/pubs/other/journey-to-the-fca-standard.pdf

67 Further details regarding the IT systems and why we are interested in them are detailed in Annex 9.

that are looking to establish a similar service in the UK, as we recognise that the availability of this type of service would make a big difference to some of our applicants. The existence of these services would also very likely streamline our assessment further still, as we would become more familiar and comfortable with the offerings and their suitability to banks.

In addition to IT and outsourcing, other key areas will include assessing the individuals in the remaining controlled functions and ensuring the relevant policies and procedures are in place (although it is highly unlikely that we would want to review all the policies and procedures).

Given the work done during the pre-application stage to ensure the quality and completeness of applications, where an applicant firm is able to deliver a complete application form with all supporting materials, we anticipate that the applications will be concluded within the six-month statutory deadline. This means that from the start of the process to the end, providing that the new bank itself is ready, it could start trading within six months.

## Option B – The revised authorisation process

The new process has been divided into three distinct stages, responding to the request from firms to offer a clearer, stage-gate approach to the overall process. The three stages are:

- pre-application;
- assessment; and
- mobilisation.

### Pre-application stage

This is very similar to the pre-application discussions described in Option A above. In this case, the focus is not on ensuring that a firm can submit a complete application, but that the firm is well-placed to submit those elements of the application that apply during the assessment phase and that these will have sufficient detail to allow us to complete the assessment phase. During the pre-application stage, prospective applicants will still have regular contact with the FCA Authorisations team as described in the pre-application section above.

The intention is that firms should not submit an application until all the issues highlighted during the pre-application stage have been addressed. This should greatly increase the likelihood that we will have all the information completed to the required standard to complete our assessment.

The FCA's approach to firms that will be subsidiaries of overseas banks wishing to follow Option B will be the same as that for UK-owned banks, although the pre-application stage may include a meeting with senior management from the parent or head office, as well as contact with the home regulator.

## Assessment stage

For Option B, the regulatory requirements that need to be satisfied before the FCA can consent to authorisation are broadly the same as for Option A. The key difference is that the focus for non-financial resources will be on the key individuals that will be in place.

We believe, particularly where the applicant's proposals are not complex, that we will require considerably less information during the assessment stage, before authorisation is granted, than is required under the current authorisation process. Given this, and the work done during the pre-application stage to ensure the quality and completeness of applications, we anticipate that the majority of applications following the new process will be concluded within six months.

Assuming that we are satisfied with our assessment, and once we have provided the PRA with our consent, the PRA (assuming it is content to do so) will authorise the applicant, but will put a restriction[68] in place that limits what the new bank can do.

It is necessary to place a restriction on the newly-authorised bank to ensure that it will be able to meet the FCA's threshold conditions without having the management, governance, controls and so on that are necessary to run a bank in a safe and sound manner and provide adequate protection for consumers.

## Mobilisation stage

Once a firm is authorised with a restriction, it will enter the mobilisation stage. This stage is designed to help firms with the operational elements of becoming a bank, which they either currently struggle to complete without being authorised or are reluctant to invest substantial sums of capital without the certainty of authorisation.

The purpose of the mobilisation stage is to give the firms the certainty that they want (through being authorised) to be able to complete the build-out of a fully functioning bank. Or, to put it another way, mobilisation is the period during which the newly-authorised bank completes all the conditions necessary for the restriction to be lifted and full banking activities to begin.

However, the mobilisation stage cannot continue indefinitely as the information used to complete the assessment would then need to be updated. So we anticipate that a new bank would be able to complete the mobilisation phase within a 12-month period.

While a small degree of flexibility can be applied to that timeframe, if the PRA or FCA judge that a new bank does not meet the conditions for the restriction applied at authorisation to be lifted, the PRA will apply a 'guillotine clause' to ensure that the authorisation does not continue past the point when the information on which the

68 As the bank does not have the infrastructure in place to conduct full scope deposit taking activities, the restriction will limit the extent to which the firm can engage in those activities until such time as the regulator is satisfied that the infrastructure is in place.

authorisation was based becomes out-of-date. The guillotine clause will remove the bank's authorisation.

During the assessment stage, the FCA will work with the applicant bank to understand its own project plan for completing the mobilisation stage, and will determine the most appropriate and proportionate way to satisfy itself that the new bank will meet the FCA's threshold conditions if the restriction is lifted. By doing this, we will ensure that once the firm enters the mobilisation stage, we only ask for information that is necessary and will apply a range of methods to complete our assessment. These could include:

- asking the new bank to attest that an action has been completed;
- reviewing documentation (or just a sample of documents);
- conducting on site visits and speaking to staff; and
- commissioning s166/s166A reports.[69]

It should also be noted that the firm's activities during the assessment and mobilisation stages do not have to be done strictly in sequence. Depending on the firm's level of preparedness, it is possible to start the mobilisation activities during the assessment stage and this will clearly further support reduced timescales for a firm to begin trading.

## Implementing the FCA's approach

The FCA will implement this revised process in full on 1 April 2013. However, the FSA has already implemented the increased engagement with firms and the challenge session at the pre-application stage.

Finally, we wish to be clear that firms do not have to follow the revised process (Option B). We have introduced this option as it addresses many of the issues that firms tell us that they encounter during our current process. However, there may be firms for whom those issues are not a major challenge. In these instances, where firms can submit a complete application with all the supporting documentation, we will continue to offer Option A, which includes completing our assessment and making a decision within six months.

We recommend that any firm wishing to achieve authorisation within six months should arrange to meet with the PRA and FCA at the earliest opportunity to discuss its proposals.

69 s166/s166A or skilled person reports are an option for authorised firms, but we commit to using them proportionately.

## Summary

We have addressed the areas of concern that firms told us they had, specifically:

- **The overall time for authorisation will be reduced.** By investing time and resource with firms up front, and providing clear and detailed feedback in the pre-application stage, we will help to improve firms' understanding of the information we are looking to receive from them, making it much more likely that applications will be complete when they are received. So where an applicant firm is able to deliver a complete application form with all supporting materials, we anticipate that we will be able to complete our assessment and make our decision more quickly than currently.
- **We have streamlined the information requirements from firms** so that, regardless of the option that is taken, the overall burden on firms is reduced. We will also take a proportionate and pragmatic approach to the method of assessment employed, not necessarily requiring full written evidence for all areas of the assessment.
- **We have also made the process much clearer**, with stages along the way so that firms can manage the progression of the application alongside the other activities that they need to do to get their business up and running. Work on elements such as writing policies and procedures can be done at a time that is more appropriate and in line with the firm's project plan.
- **Where appropriate we have introduced the mobilisation stage**, which moves authorisation much further forward in the process, giving the certainty that firms told us was lacking in the current process. Firms will be able to engage with investors and potential new recruits on the basis that they have been authorised, and they will be able to commit to the expense of major projects or commitments such as IT build-outs or major outsourcing contracts on the basis of that authorisation.

# 8

# Implementing the changes

We could not introduce this new process and all the associated changes earlier, as the threshold conditions test will change at legal cutover. However, we have introduced as much as we can before legal cutover and have structured our approach and this report to reflect the new regulatory structure that will shortly come into operation.

Throughout the implementation period, the Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) will also need to talk to stakeholders to ensure that they are kept informed on progress and have the opportunity to submit feedback and suggest other improvements that can be considered.

Here we give some more detail on the changes, along with the rationale for timing of the key changes, pre or post-legal cutover.

- Pre-application meetings will continue to be held. Challenge sessions have already been successfully trialled and are now a formal part of the process for all potential new applicants.
- The revised approach to liquidity requirements has been implemented from January 2013.
- The revised capital approach for new banks that we judge to be resolvable in an orderly way with no systemic impact has already been trialled.
- We have reviewed the application packs to enable the PRA and FCA to provide clearer information and support about what sections need to be completed and when they need to be submitted (before a more fundamental review of the structure and content of the application packs post-legal cutover).
- At legal cutover we will be in a position to begin the new process (as we are assessing against different threshold conditions, it was not possible to introduce this earlier). We will also launch the new PRA and FCA websites, providing reference materials and key information for applicants.
- Following legal cutover we will comprehensively re-visit the content of the application packs and re-structure them to align to the new process.

We also know that firms are concerned that the separation of the FSA into the PRA and the FCA will make the application process more onerous, with two separate regulators working independently and increasing the burden of meetings and information requests on firms.

Figure 4 shows the interactions between the PRA, the FCA and applicant firms during the course of an application under both Options A and B. Wherever possible, the PRA and FCA will hold joint meetings with firms, to ensure that firms do not have to cover the same ground twice.

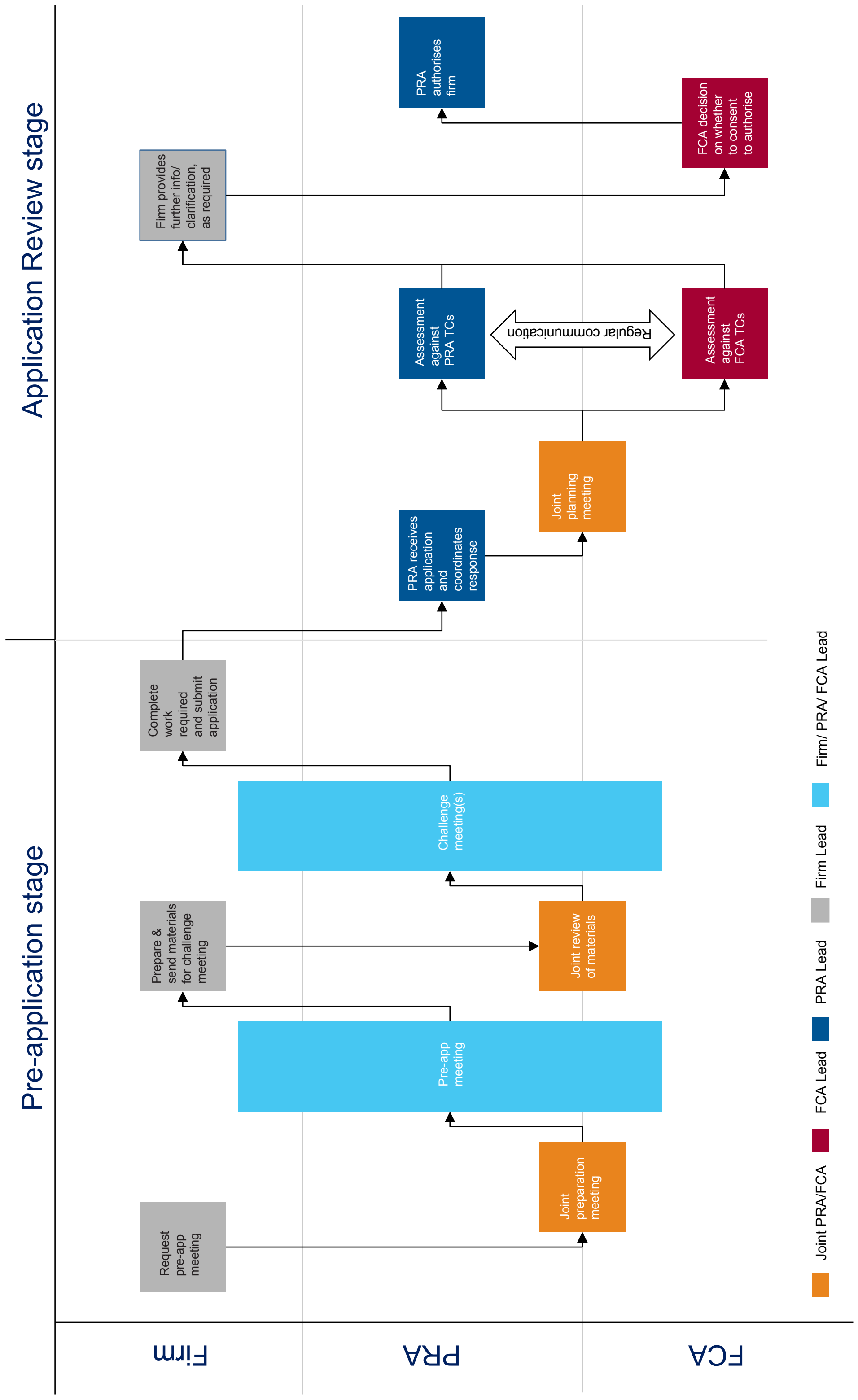
There is still only one application form for firms to complete, and while the PRA leads and coordinates the application process, there will be regular meetings with the FCA, as both regulators recognise the need for regular and ongoing communication throughout the authorisation process.

We believe that the successful implementation of these changes will address the key concerns raised by both applicants and the industry reviews, across regulatory requirements and the authorisation process. Doing so will build on the changes that have already been made, leading to a better experience for applicants, more effective use of time and critical resources (at firms and the regulators), and increasing the efficiency of the authorisation process – all while promoting the safety and soundness of the firms within the context of the stability of the UK financial system and maintaining the necessary rigour to protect consumers.

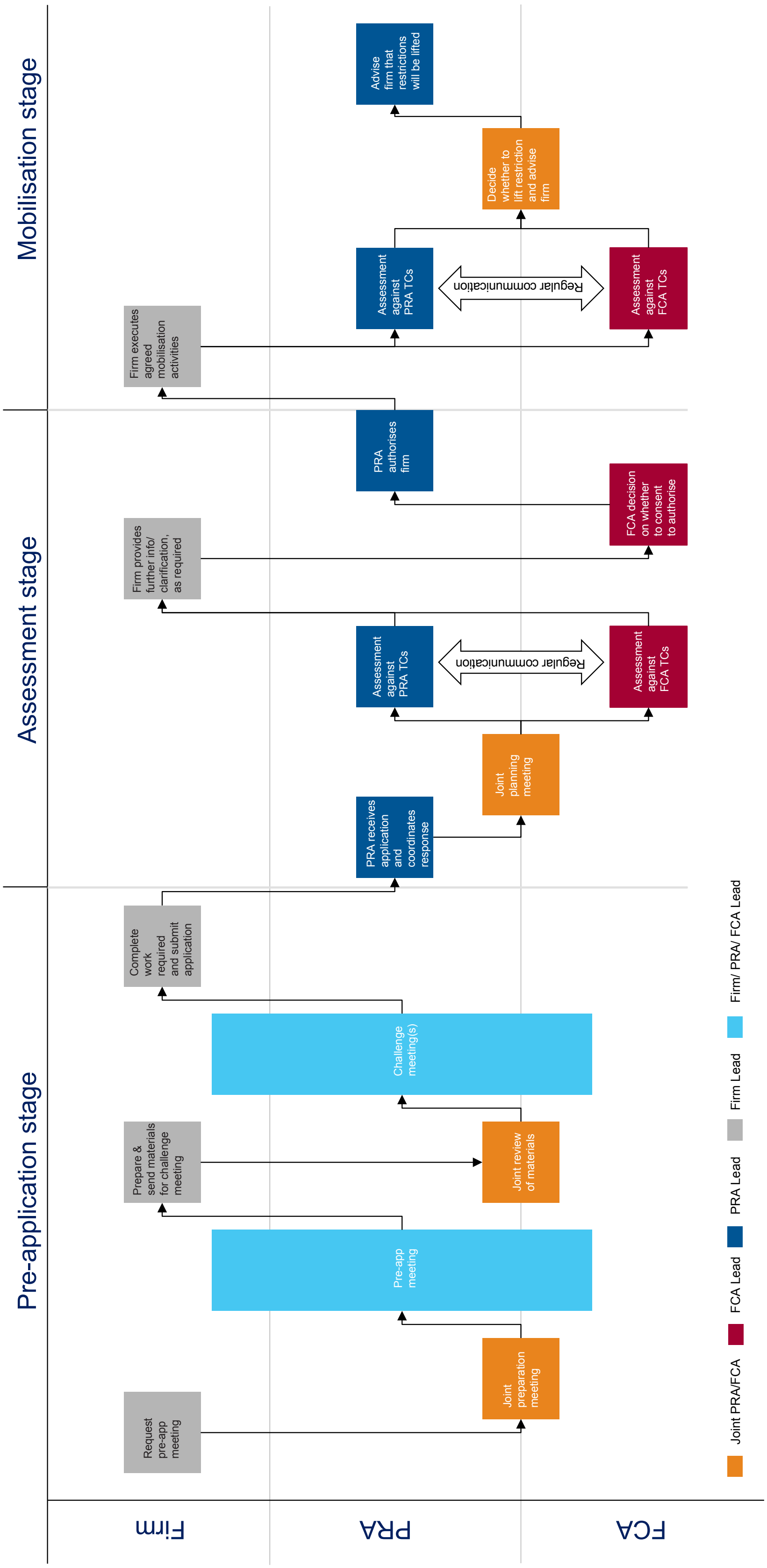
These changes will transfer to the PRA and FCA, ensuring that the progress that is made before legal cutover will be built into how these organisations approach authorisations. Finally, and critically, we will continue to listen and act appropriately on feedback that is provided to us by our stakeholders.

## Figure 4: How the PRA and FCA will work together

### Option A



## Option B


Pre-application stage
Assessment stage
Mobilisation stage
Firm
PRA
FCA
Request pre-app meeting
Joint preparation meeting
Pre-app meeting
Prepare & send materials for challenge meeting
Joint review of materials
Challenge meeting(s)
Complete work required and submit application
PRA receives application and coordinates response
Joint planning meeting
Assessment against PRA TCs
Regular communication
Assessment against FCA TCs
Firm provides further info/ clarification, as required
FCA decision on whether to consent to authorise
PRA authorises firm
Firm executes agreed mobilisation activities
Assessment against PRA TCs
Regular communication
Assessment against FCA TCs
Decide whether to lift restriction and advise firm
Advise firm that restrictions will be lifted
Joint PRA/FCA
FCA Lead
PRA Lead
Firm Lead
Firm/ PRA/ FCA Lead

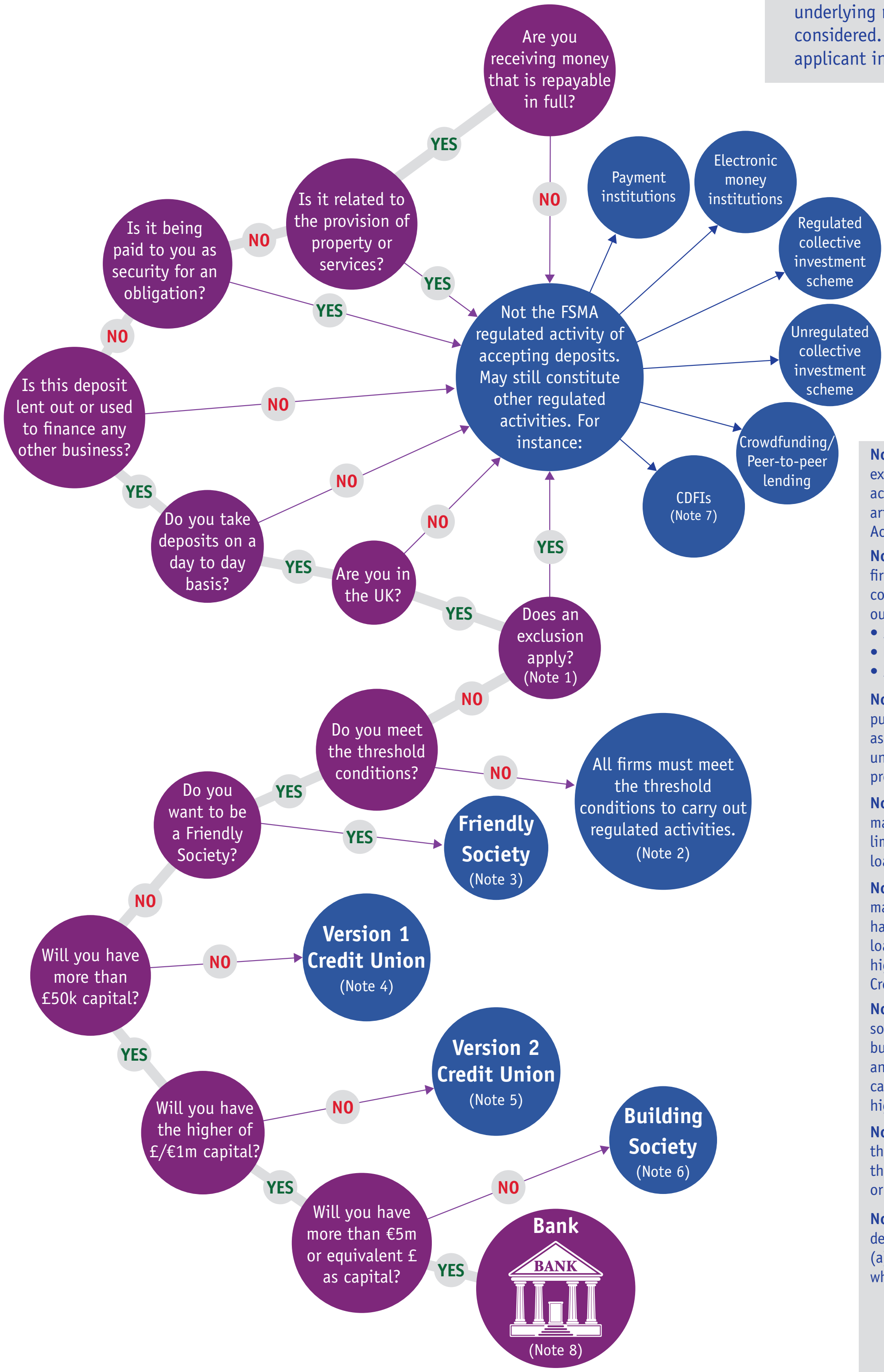
## Annex 1

# Alternatives to being a bank – the options

The following flow chart is intended only as a simplified guide and the underlying rules should always be considered. It also assumes the applicant intends to be a UK entity.

# Am I a bank?

The following flow chart is intended only as a simplified guide and the underlying rules should always be considered. It also assumes the applicant intends to be a UK entity.




**Note 1:** Exclusions – Several specific exclusions to the regulated activity of accepting deposits are listed in articles 6 to 9AB of the Regulated Activities Order.

**Note 2:** Threshold Conditions – All firms must meet the threshold conditions to be authorised to carry out regulated activities. These include:
- being a corporate or a partnership;
- having adequate resources; and
- being a fit and proper person.

**Note 3:** Friendly Society – Main purpose of a friendly society is to assist members during sickness, unemployment or retirement and to provide life insurance.

**Note 4:** Version 1 Credit Union – These may only lend to members and have limits on the amount and term of loans they can make.

**Note 5:** Version 2 Credit Union – These may also only lend to members and have limits on the amount and term of loans they can make but these are higher and longer than for Version 1 Credit Unions.

**Note 6:** Building Society – A building society is more restricted in the business it can conduct than a bank, and has more limited options to raise capital. It must hold a minimum of the higher of €1m or £1m in capital.

**Note 7:** Depending on the nature of the activities carried on by the CDFI, they may either be authorised by FSMA or may only need to be registered.

**Note 8:** Bank – A bank is currently defined as:
(a) a firm with a Part IV permission which includes accepting deposits, and:
  (i) which is a credit institution; or
  (ii) whose Part IV permission includes a requirement that it comply with the rules in GENPRU and BIPRU relating to banks;
  but which is not a building society, a friendly society or a credit union;
(b) an EEA bank which is a full credit institution.

## Alternatives to being a bank

Setting up a bank may not be the only, or in some cases the most appropriate, model and alternatives exist that provide some of the services of a bank without the cost and formality involved in setting up a bank. There are also varying degrees of legislative restrictions on the scope or size of these businesses, which are matched by differing levels of regulatory requirements that may include authorisation or simple registration. These alternatives include, but are not limited to:

- Credit unions are financial cooperatives that are owned and controlled by their members. They can offer savings, lending and other services to their members who meet a 'common bond' criteria – such as they live and work in the same area or work for a certain employer. There are limitations in the extent of business that they can do, but they also have proportionately lower regulatory requirements compared to banks. A credit union requires authorisation, but the requirements are much lower than for a bank.
- Building societies are mutual deposit-taking institutions whose 'principal purpose' is to make loans secured on residential property. Building societies can carry out a wide range of other activities, including other types of lending and investment, money transmission services, and insurance mediation services. Building societies are subject to a range of legislative restrictions, such as 75% of lending to be secured on residential property or (with certain exemptions) limits to their treasury activities, which prevents them acting as market makers in securities. Building societies also require authorisation.
- Community development finance institutions (CDFI) may specialise in lending to small/medium enterprises and social enterprises that have been unable to secure credit from mainstream sources. Funding for CDFIs can be generated from a variety of sources, including from corporate social responsibility programmes of other banks, European Development Funds and local authorities, charitable foundations and business angels. Some CDFIs can take the form of companies, but many are Registered Societies, which are an alternative form of corporate vehicle. Depending on the activities that the CDFI wants to carry out, they may not need to be authorised and regulated under the Financial Services & Markets Act 2000.

The FCA note that these players could be important sources of innovation and competition in the banking sector. In some cases, these players may well be competing directly with banks in relevant markets. To the extent that their regime affects the firms concerned, the FCA will be very mindful of its competition obligations.

## Crowdfunding and peer-to-peer lending

Crowdfunders and peer-to-peer lenders are outside the scope of this review, as they are not banks, but they still provide alternative sources of lending and can provide investment in start-up businesses.

### Crowdfunding

Crowdfunding is a way of funding a project or venture by raising relatively small amounts of money from a large number of individuals, typically via the internet. Given the nature of the different crowdfunding models, not all firms operating as crowdfunders require authorisation. In cases where authorisation is required, for example where firms are selling equity or issuing debt securities, it is most likely that this would be by an investment firm.

We are currently considering our approach to crowdfunding and reviewing our perimeter guidance so that it is clearer for firms the different types of regulated activities that crowdfunders could be undertaking and which firms would fall within our regulatory scope. We intend to consult on our overall approach and timescales will be confirmed shortly.

Meanwhile, we will continue to deal with applications on a case-by-case basis to ensure that the appropriate controls are in place given the risks posed to consumers of investing in these types of products.

### Peer-to-peer lending

Peer-to-peer or social lending is the practice of matching lenders, who are individuals, to borrowers, who are individuals ('peers') without the intermediation of traditional financial institutions like banks. It is usually facilitated through online marketplaces or platforms, which charge an arrangement fee or take commission.

While not currently in the scope of the FCA, peer-to-peer platforms are likely to require a consumer credit licence from the OFT. The Treasury announced at the end of 2012 that the FCA will regulate peer-to-peer operations when it assumes responsibility for consumer credit from April 2014. Consultation[70] has begun on the proposed consumer credit regime and the FCA will consult specifically on the regulation of borrowing and lending through peer-to-peer platforms in autumn 2013.

70 A new approach to financial regulation: transferring consumer credit regulation to the Financial Conduct Authority, HM Treasury, (March 2013): www.hm-treasury.gov.uk/d/consult_transferring_consumer_credit_regulation_to_fca.pdf and CP13/7, High-level proposals for an FCA regime for consumer credit, (March 2012): www.fsa.gov.uk/static/pubs/cp/cp13-07.pdf.

## Annex 2

# Banks authorised since 2006

ABOC (London) Ltd

Abu Dhabi Islamic Bank (UK) Ltd

Arab Banking Corporation (BSC)

Bank of Ceylon (UK) Ltd

Bank of China (UK) Ltd

Bank of Communications

Bank of Cyprus Advances Ltd

Bank of Ireland (UK) plc

Bank of Philippines Islands (Europe) plc

Cambridge and Counties

CCBC (London) Ltd

DBS Bridge Bank Ltd

Emirates NBD PJSC

Europe Arab Bank plc

European Finance House

European Islamic Investment Bank plc

Export-Import Bank of India

FirstRand Bank Ltd

Gatehouse Capital plc

GE Commercial Distribution Finance

Guaranty Trust Bank plc

House of London and the Middle East plc

Industrial Bank of Korea

Intelligent Management Services Ltd

Intercontinental Bank (UK) plc

Macquarie Bank Europe

MediCapital Bank plc

Mega International Commercial Bank Co Ltd

Metro Bank plc

Morgan Stanley Goldfish Ltd

Northern Rock plc

OneSavings Ltd

Punjab National Bank (International) Ltd

RBC Dexia Investor Services Trust

Silicon Valley Bank

The Access Bank UK Ltd

Wells Fargo Bank, NA

Westpac Europe Ltd

Zenith Bank (UK) Ltd

## Annex 3

# Review of findings from the OFT, TSC and ICB reports

The following annex summarises the findings from the following three reports:

- the Office of Fair Trading's (OFT) review of barriers to entry, expansion and exit in retail banking[71];
- the House of Commons Treasury Committee's (TSC) report on competition and choice in retail banking[72]; and
- the Independent Commission on Banking's (ICB) final report recommendations.[73]

The table below summarises the findings that fall within the remit of the FSA and subsequently the Prudential Regulation Authority and the Financial Conduct Authority (FCA).

### Summary of findings

| Report finding | OFT | TSC | ICB | Response |
|---|---|---|---|---|
| There was no clear evidence received to indicate that FSA authorisation requirements are a barrier to entry. | Y | | Y | The authorisation process has been reviewed and we have significantly reduced the amount of information to be submitted at application. |

71 Review of barriers to entry, expansion and exit in retail banking, Office of Fair Trading, (November 2010): www.oft.gov.uk/shared_oft/personal-current-accounts/oft1282.

72 Competition and choice in retail banking, House of Commons Treasury Committee, (April 2011): www.publications.parliament.uk/pa/cm201011/cmselect/cmtreasy/612/612i.pdf.

73 Final Report Recommendations, Independent Commission on Banking, (September 2011): www.hm-treasury.gov.uk/d/ICB-Final-Report.pdf.

| Report finding | OFT | TSC | ICB | Response |
|---|---|---|---|---|
| Authorisation process identified as a potential barrier due to length and lack of transparency over requirements. | Y | Y | Y | The authorisation process has been clarified and enhanced with an additional option to ensure authorisation takes place as soon as possible. Overall the process will be more transparent with clear stage-gates throughout. |
| Capital and liquidity requirements may be disproportionately high for new entrants compared to existing firms (due to scalars applied); new requirements to be introduced (CRD IV) could exacerbate these. | Y | Y | Y | We are making changes to the capital and liquidity requirements for new entrants and recently authorised banks. |
| There was no clear evidence received to indicate that the FSA's conduct of business rules represent a barrier to entry or expansion, or that they impact disproportionately on smaller or larger financial institutions. | Y | | | We are not proposing to amend the conduct of business rules, which set the standards that firms must meet. However, the FCA has committed to applying a proportionate approach in the application of these requirements. |
| High cost of meeting the IT requirements is a barrier if firms do not believe that they will reach sufficient scale. | Y | | | The high-level standards require firms to have systems and controls that are appropriate to their business. We do not intend to amend these standards, but we have committed to keeping our review work proportionate. |

## Annex 4

# Findings from overseas regulators

In this annex we summarise the findings from overseas regulators.

We contacted six overseas regulators, covering a number of different jurisdictions, to understand their approaches to the authorisation of new bank entrants and to identify practices that could be incorporated into our processes. The findings from those conversations are summarised in the following table.

### Summary of findings from overseas regulators

| Aspect | Results summary |
|---|---|
| Volume of new bank entrant applications | The majority receive less than two new entrant applications per year.<br>One receives between ten and 15 new entrant applications per year.<br>Since the financial crisis, greater numbers have been received linked to restructuring of existing banking groups or change in control for failed banks. |
| Type of banking authorisation process | Two employ a two-stage process where authorisation is granted followed by a specified period in which the bank must become fully operational. After this period (if not operational) the authorisation expires.<br>The majority operate within multi-regulator regimes, where a new bank entrant will require approval or consent from more than one regulator. A subset of these operate in regimes where the regulators are designated specifically as a prudential or conduct regulator and where both prudential and conduct approval is required for a new bank entrant to achieve authorisation.<br>One regulator operates in a regime where only the prudential regulator makes the authorisation decision and the bank becomes dual regulated with a conduct regulator post-authorisation. |

| Aspect | Results summary |
|---|---|
| Pre-application meetings | Most consider pre-application meetings to be essential to the authorisation process, allowing big issues to be identified at a very early stage and improving the standard of the application submitted.<br>The time from pre-application meeting to actual submission of an application (if received) can extend to two years. |
| Assessment and standards | The common critical assessment areas are business plan viability, capital and governance, with other areas varying across regulators.<br>While all prudential regulators see capital as a key criteria, none make allowance for lower requirements for start-up banks and responses indicated that their approach to new banks is likely to be more conservative. The capital time horizon is typically three to five years. A single regulator has extended capital required to cover seven years (was previously three years) due to bank failures and one allows capital to be injected between preliminary authorisation and full operational authorisation.<br>Two regulators define standards for minimum board size. |
| Statutory and voluntary deadlines | Only one regulator has a statutory deadline for authorisation decisions and this is not measured in elapsed time as the 'clock' can be stopped while awaiting requested information.<br>Both regulators with a two-stage process and a single regulator with a one-stage process employ an expiry mechanism whereby the authorisation lapses if the firm has not achieved operational status within specified periods.<br>Two specifically mentioned voluntary deadlines but one of these is also subject to a 'stop the clock' process.<br>All viewed ensuring the application was of sufficient standard outweighed speed of authorisation. |
| Average times to authorisation | For a two-stage process the average time ranged from 12-18 months.<br>For a one-stage process the average time ranged from one year to between two and three years.<br>One simply confirmed that the process took as long as needed and others gave no average time. |
| Quality of applications | Issues with applications (where expressed) were generally around the quality, clarity and viability of the business model and plan. The lack of relevant experience of applicants for 'approved persons' roles was also mentioned. |
| Decision making | Three make the regulatory decision at manager level with one having ratification by a decision committee. |
| Refusal vs. withdrawal | Commonly firms who do not meet the regulatory standards applied to withdraw their applications rather than go through refusal processes. |

## Annex 5

# Past cases review

We reviewed a sample of past cases where the statutory timescales had been exceeded, looking particularly for cases where the business model has included a reasonable proportion of retail activity. In this review, the focus was on the elements of an authorisation assessment that the FCA would be interested in. The review was conducted before the proposal to change the authorisation process was formulated and helped to shape the thinking behind that proposal.

The key findings from the review are as follows:

- Authorisation is only granted once all the requirements have been met satisfactorily. The uncertainty this causes is a problem for firms, particularly start-ups:
  - Investors are more comfortable committing capital once authorisation is certain.
  - It can be difficult to justify the expenditure on building and testing IT systems ahead of any certainty of authorisation.
  - It can be difficult to attract the right calibre of staff required to operate the bank ahead of authorisation, and in doing so can incur unwanted costs.
- Achieving authorisation often takes significant time, particularly the IT operations. Plans and documentation required later on the process often get out of date and require unnecessary updating:
  - Plans are developed up front even where they are not necessarily used until later in the process.
  - Firms would like to see a more structured approach to the authorisation process, with clear stages and milestones, so that progress can be shown and plans more easily made.
  - Firms tend to develop and build the IT systems throughout the course of the application process.
  - Issues (almost always) crop up during the application and these have to be addressed.

- The information supplied by firms is often not of the standard required – specifically in the level of detail provided, extent of tailoring to that firm's situation, and interpretation of the requirements in forms and supporting materials (e.g. Internal Capital Adequacy Assessment Process, Internal Liquidity Adequacy Assessment, policies, and governance structures and arrangements):
  - Applications lack the level of detailed information required.
  - Firms misunderstand what information is required or which aspects apply to them (e.g. consideration of specific risks, firm stress tests).
  - Firms do not always appreciate the level of scrutiny that should and will, be applied to authorisation of a banking license.
- The FSA has a wealth of expertise that it applies to firms to support the application process and firms would like this to continue:
  - The process is complex and difficult to navigate, so support is important to better understand the requirements, timescales, process and the expectations from both parties.
  - Time spent discussing the business model and business plan assumptions is considered valuable.
  - The FSA has valuable subject matter expertise in capital, liquidity and governance arrangements.
- The FSA generally takes a pragmatic approach, not sticking rigidly to process for the sake of it, and considers how to support firms overcoming problems rather than creating unnecessary obstacles.

## Annex 6

# Feedback from potential applicants

We hold a number of pre-application meetings each year with firms who would like to discuss their proposals for submitting a banking application. Out of the 48 meetings we had over last three years, 22 firms have submitted an application and 12 of those have been authorised.

| Status | Years | | | Total |
|---|---|---|---|---|
| | 2010 | 2011 | 2012 | |
| Pre-application meetings | 16 | 13 | 19 | 48 |

For firms where a pre-application meeting has been held but no application has yet been submitted, we have reviewed the reasons for this.

Most firms have confirmed that they are still considering applying, the reasons why they have not done so as yet have been summarised below:

- The current economic condition is not conducive to starting a new bank.
- Their proposed business strategy does not need an authorisation as a bank.
- More time and/or resources are needed to complete their application.
- Internal business decisions/strategy have yet to be finalised before an application can be submitted.
- They are still looking to bring on board the right people to drive the process of forming a bank.

None of the respondents indicated that regulations or the authorisation process was considered as the main reason for their delay in applying, although some did comment that the process of banking authorisation is lengthy and therefore could be considered onerous.

## Annex 7

# Feedback from compliance consultants

We spoke to contacts at the consultancies that most frequently support applicants in making banking applications. These firms were asked to comment on the issues that applicants find onerous or struggle with.

We also engaged with a number of other consultancies and niche market firms, as we are aware that there is a minority of potential applicants who do not, for whatever reason, contact the FSA but who are, nevertheless, very vocal in their (perceived) inability to obtain authorisation as a bank.

Feedback received was broadly similar from both groups consulted and the common feedback has been summarised below. There were, however, a couple of other points raised by the smaller consultancies and niche market firms: concerns that past regulatory history will be an issue and a perception that the FSA will not hold a pre-application meeting until the applicant is ready to submit the application.

A summary of issues raised is included in the table below.

| Issue | Comment |
|---|---|
| Capital and liquidity | Requirements are more onerous for new firms.<br>Liquidity is higher for new firms than existing firms.<br>Capital requirements unclear for existing complex non-banks wishing to add banking to group.<br>Lack of transparency around scalars and add-ons, and actual requirements at point of authorisation not always clear. |
| Capital raising | An issue for an unauthorised firm as the uncertainty puts investors off.<br>Tend to leave as late as possible for one-off projects. |
| NEDs | Struggle to identify and recruit good non-executive directors. |

| Issue | Comment |
|---|---|
| Board/executive | Seen as an additional cost before business going live.<br>Improved openness and clarity required around the impact of candidates' regulatory pre-history. |
| IT | Having to invest in IT systems up front. |
| Pre-application | Clearer and more direct feedback on 'showstoppers' and issues would be helpful. |
| Business models | Impression that the FSA is negative to innovative or rapid growth models and to business plans including non-prime lending.<br>Perception that it is easier to use the Change in Control route to become a bank. |
| Application process | Difficult to navigate.<br>Unclear on the FSA's expectations.<br>How complete does an application have to be?<br>Progress communication not always frequent enough.<br>Conditional approval, allowing firms to concentrate on the operational issues and then grant the licence in full would be a big help. |
| Regulatory reform | Uncertainty – will regulatory reform mean two application forms, two sets of meetings, etc? |

## Annex 8

# Feedback from roundtable meetings

As part of our review we have held two roundtable meetings. The first, in October 2012, was with recently-authorised firms to gather feedback on their experiences of the authorisation process and to share early thinking on our proposals.

The second, in January 2013, included banks that had recently expanded their activities and firms currently applying for authorisation, along with representatives from trade bodies, consumer representatives, parliamentarians, compliance consultants and representatives from the Treasury, the Bank of England and the Department for Business, Innovation & Skills. At this meeting we sought early feedback on the proposals presented in this report.

Both events were conducted under Chatham House rules and this annex presents a summary of the output.

The feedback on the current process can be summarised as follows:

- Firms would like to see a more structured approach to the authorisation process:
  - The process is currently viewed as very binary – this causes uncertainty for investors and difficulty in recruitment.
  - The extended duration can (but doesn't always) lead to periods without any communication, which doesn't support the necessary momentum.
  - Separating into stages would allow progress to be evidenced and plans more easily made.
- There is a view from some firms that there is not a level playing field with existing banks, specifically around the capital and liquidity requirements (e.g. differences in the buffers added to capital and liquidity requirements).

- Firms would like to see a shorter period to authorisation so that plans and documentation do not get out of date, therefore require unnecessary updating.
- Firms value the feedback and support provided by the FSA and would like more of this, particularly in the early stages (before submission), e.g. liquidity feedback and input can be provided later in the process (than for capital). However, firms would like this earlier.
- The FSA generally deals with firms courteously and professionally. This manner of interaction is appreciated and felt to support a good working relationship throughout the authorisation process.

Both meetings also provided an opportunity to gain feedback on our proposals. This feedback may be summarised as follows:

- The proposals represented a positive step forward and were viewed as making the approach more commercial.
- The proposals on capital were well received.
- The revised process was positively received. Key to this was the reduction in ambiguity as a result of the earlier authorisation, which should facilitate capital raising, recruitment and investment in the operational aspects of the firm (e.g. IT systems build, outsourcing arrangements, etc.).
- The FSA should ensure that senior management are involved in cases earlier to ensure wider input and mitigate the impact of changes in approach or personnel changes. Together with this, the proposal to allocate a case officer at pre-application stage to augment the level of interaction was considered very helpful.
- Challenge sessions are already proving valuable but should involve broad representation from across the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) to avoid duplication of effort.
- Strong regulation is important and offers a sensible benchmark for firms and competition should not be fostered through compromise on these standards.
- Concerns were raised that unless the PRA and FCA work closely together there is the potential for duplication of effort and delays.

## Annex 9

# Importance of Information Technology systems

Given the nature of the banking business (e.g. impact on customers and economic activity) and its necessary links into payments and other market-wide systems, no bank can operate without IT and related systems appropriate to its size and the type of business it wants to carry out. Such technology enables key processes that a bank uses to develop, deliver and manage its products, customer services and critical support operations. More importantly, no bank should operate without systems that are well-controlled, safe and secure.

Therefore the bank's management must ensure it understands the role that technology plays in supporting its business functions, and to determine the IT platform, systems and controls that best meets these needs. Neither regulation nor regulators impose 'state of the art' IT and related systems on banking applicants – they do require applicant firms to provide assurance that whatever systems they choose will be, and will continue to be, adequate (and no more) to run their proposed business and protect their customers in a well-controlled, safe and secure manner.

So what aspects would we typically ask applicant firms about?

| What a bank's IT system needs to have | Why? | Supporting documentation requested (where applicable) |
|---|---|---|
| IT governance and strategy in keeping with the importance of IT systems to the bank's business | A bank needs to have IT that enables it to achieve its strategic business goals and objectives, and a clear governance structure with authority and accountability over IT activities. | 1. IT strategy<br>2. Firm organisation chart<br>3. IT organisation chart<br>4. Overview systems diagram<br>5. Overview network diagram<br>6. Overview description of IT |

| What a bank's IT system needs to have | Why? | Supporting documentation requested (where applicable) |
|---|---|---|
| IT risk management | IT systems support the critical operations and services to customers. So identifying vulnerabilities and threats to the security and availability of data and services enables senior management to put in place a framework to ensure these risks are controlled and managed satisfactorily. | |
| Project and change management | When changes are made to IT systems, controls should ensure proper implementation of the changes so that the security of business/ customer data or the availability of services to customers is not compromised. | 1. Project development plan |
| Information security controls | The IT system(s) have effective basic security measures in place to prevent a) customer and firm data being compromised (e.g. stolen) and misused (with potential loss to both the customers and the bank, and reputation issues for banking services) and b) external parties being able to prevent genuine customers from using the bank's services through electronic attacks. | 1. Security accreditations e.g. PCI DSS, ISO27001<br>2. Information Security policy and procedures<br>3. Penetration test results<br>4. Independent IT security reports<br>5. Passwords policy & standards |
| Service delivery and incident handling and business continuity plans and disaster recovery arrangements | Every organisation is at risk from potential 'disasters' that include: natural/environmental disasters; accidents/sabotage; power/energy disruptions; communications failure; cyber attacks/hacker activity.<br><br>Sufficient built-in resilience and a tested business continuity plan (matched to the size and complexity of the business) helps ensure that an institution has the resources and information needed to deal with these emergencies to either enable critical services or products to continue to be delivered to customers, or ensuring that there are tested disaster recovery plans in place to restore the critical services in an acceptable timeframe. | 1. Significant IT incidents in last 12 months<br>2. Disaster recovery plan<br>3. Business continuity test results |

| What a bank's IT system needs to have | Why? | Supporting documentation requested (where applicable) |
|---|---|---|
| Outsourcing/ offshoring controls | Where a bank chooses to outsource to third parties the operation of IT or other key functions which materially affect its customers or critical business operations, it remains responsible for ensuring that those functions are properly carried out, safe, secure and controlled. Proper oversight and monitoring of such critical outsourcing arrangements is necessary to prevent loss to customers, and maintain both customer service standards and critical business operations.<br><br>Such arrangements would only be reviewed where they related to activities defined as critical and the review would only cover the processes and arrangements the applicant bank will use to select and oversee the arrangements. The review would not normally examine the outsource supplier's systems in detail. | 1. Principle outsourcing contracts |

Adequate IT systems appropriate (and no more) to the size and complexity of its proposed business are required for an applicant bank to satisfy the adequate non-financial resources minimum threshold condition for authorisation, expanded by the general requirements in the Senior Management Arrangements, Systems and Controls (SYSC) Handbook for technology risk and business continuity as explained in the above table. In addition, where an applicant chooses to outsource material parts of its operations, specific rules in SYSC derived directly from the MiFID EU directive must be met in relation to any such arrangements that have material impact on customers or are critical business operations.

## Annex 10

# Material and information to be submitted by firms at application

An adequate application for any banking authorisation is a not just a factor of the quantity of application documents submitted, but also the quality of the information provided. The significant strengthening of the pre-application engagement focuses firms on submitting material of an adequate standard to enable the application assessment to be carried out without the need for extended iterations of material. In addition, the review has reduced the quantity of the material required (see table below), particularly for the mobilisation route, by allowing greater tailoring of the process to individual applicants' circumstances and proposals.

**Illustrative example of material submitted at application.**

| Assessment area | Current approach | Option: Complete application with authorisation within six months | Option: Authorisation followed by mobilisation |
|---|---|---|---|
| Business plan | Fully developed | Fully developed | Fully developed |
| Recovery and resolution plan | Key elements (structure, Single Customer View plan, early warning signs, governance & approach over how resolution information will be developed) | See Chapter 6 Box 2 | See Chapter 6 Box 2 |
| Financial resources:<br>ICAAP & ILAA | Fully developed | Fully developed | Fully developed |

| Assessment area | Current approach | Option: Complete application with authorisation within six months | Option: Authorisation followed by mobilisation |
|---|---|---|---|
| Governance<br>Structure<br>Board<br>Senior management | Fully developed<br>Substantially in place<br>All key senior management identified | Fully developed<br>Substantially in place<br>All key senior management identified | High-level structure<br>Key 'guiding minds' in place*<br>Senior management roles critical to mobilisation identified ready for recruitment* |
| Infrastructure including IT systems | Substantially developed with systems to cover life of business plan – full detail | Substantially developed with systems to cover business in initial years – some tailoring based on strengthened pre-application stage | High-level outline of IT systems* |
| Material outsourcing | Full detail of relationships, contracts and related documents | Full detail – some tailoring based on strengthened pre-application stage | High level outsourcing plans* |
| Conduct of business policies and procedures | All submitted | Scope for some tailoring based on strengthened pre-application stage | Not required* |

*Completed in mobilisation with certainty of being authorised.

Greater case-by-case tailoring through strengthened pre-application stage. Potential material at application reduction of 0 – 10%

Potential material at application reduction 40 – 50%

The Financial Services Authority
25 The North Colonnade Canary Wharf London E14 5HS
Telephone: +44 (0)20 7066 1000 Fax: +44 (0)20 7066 1099
Website: www.fsa.gov.uk
Registered as a Limited Company in England and Wales No. 1920623. Registered Office as above.