Growing a sustainable bank

Supporting the banking journey

Building a better working world

Content

Introduction

In 2021, the Prudential Regulation Authority (PRA) issued its Supervisory Statement SS3/21, which sets out how it intends to approach the authorisation and supervision of new and growing banks in the UK.

The statement reflects the PRA's approach to supporting a vibrant banking sector in the UK that promotes innovation, competition and provision of service to different segments of the economy and population. In setting out its approach, it recognises that banks have a high regulatory and supervisory threshold, but it is prepared to 'soften' its approach somewhat in the early years so that these demanding requirements do not become a barrier to entry and effectively stifle the development of the sector.

The PRA has therefore defined an approach that it believes to be proportionate to the size and complexity of the requirements for banks in their first few years of being authorised by the PRA as a deposit taker (typically less than five years post-authorisation). It also takes into consideration that new banks are unlikely to meet all the expectations the PRA has of an established bank from inception and, in many cases, new banks will require time to build and demonstrate capabilities.

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We have prepared this report around the key elements of the PRA's expectations of new and fast growing banks, combined it with our own observations, our experience and some of our design approaches to offer a view on how potential or existing financial service operators may develop their banking strategies and establish themselves as a bank.

The PRA describes the typical stages in the journey of a new and growing bank from a regulatory and supervisory perspective as:

- Authorisation and start-up
- Progress from new and growing to becoming an established bank
- Ensuring the bank can achieve a solvent wind-down (SWD) of its business and has identified the appropriate resolution strategy
- Progress to becoming an established and mature bank with a settled business model, projected profitability and ability to meet certain thresholds

This report outlines the foundations of a banking journey and the requirements for a sustainable growth path:

- Define and design the now – designing, mobilising and kick-starting the journey
- From now to next – developing and growing in a sustainable way
- Planning the beyond – the future, post initial development and growth

Now, next and beyond of a banking journey

Now

Getting started

- Design the bank
- Apply for authorisation
- Build operations
- Establish the business

Context:

- Firm in mobilisation, authorised with restrictions for up to one year
- Firm authorised
- Untested business model, framework and policies
- PRA buffer set on new bank basis
- Most likely, loss-making

Next

Focus on growing in a sustainable way post authorisation

Development and growth

- Secure financial stability
- Adapt operations
- Grow fast but sustainably

Context:

- Rapid growth
- Business model refined based on experience
- Credible strategy to profitability
- Significant investment in refining governance, risk management and controls
- Reliant on capital injections
- PRA buffer set on new bank basis but on path to stress testing approach

Beyond

Focus on a settled business model and resolution tools

Reaching maturity

- Ensure competitiveness
- Expand business model
- Grow and reorganise

Context:

- Settled business model
- Either profitable or credible path to profitability with definite capital support
- Mature and embedded framework, in-line with regulatory expectations
- PRA buffer set on stress testing approach and credit risk measured on IRB basis
- Resolvability assessment framework (RAF) and ring-fencing

Planning now for the beyond

Not all banks start as a bank. There are many different starting positions from which financial services firms can embark on the banking journey, and it is important for firms to consider all of these options from the outset. A banking licence is not the only, nor necessarily the most appropriate, option for new entrants seeking to offer services similar to those performed by banks.

There are a number of alternative routes on the banking journey which may initially include authorisation as an e-money, consumer credit or payment services institution. For many FinTech businesses, an e-money licence is the right option for their business model, as they do not intend to accept customer deposits as a source of funding. Other FinTech firms, for example, may decide that they want to grow their business or offer innovative products and solutions to their customers as low-cost, fast, direct online competition to licenced banks. Many customers are less concerned with the regulatory status of a firm and are more interested in functionality and a seamless end-to-end experience.

There is no one-size-fits-all approach, and the journey that each firm decides to take must be appropriate to its long-term growth plans.

Not having a banking licence may work for some, but not for others. A banking licence essentially allows firms to take customer deposits - and if a firm is ultimately planning to provide credit to customers, this may be the most effective funding route. In addition, a banking licence allows firms to provide a broad range of everyday essential financial products that customers might expect, coupled with additional protection offered through the UK Financial Services Compensation Scheme (FSCS), which does not apply to e-money accounts. A banking licence may therefore be a part of the initial development plan or become part of the plan as the firm grows. However, we recommend that firms at least consider this at the outset of their financial services journey and build it into their planning and development cycle.

Applying for authorisation

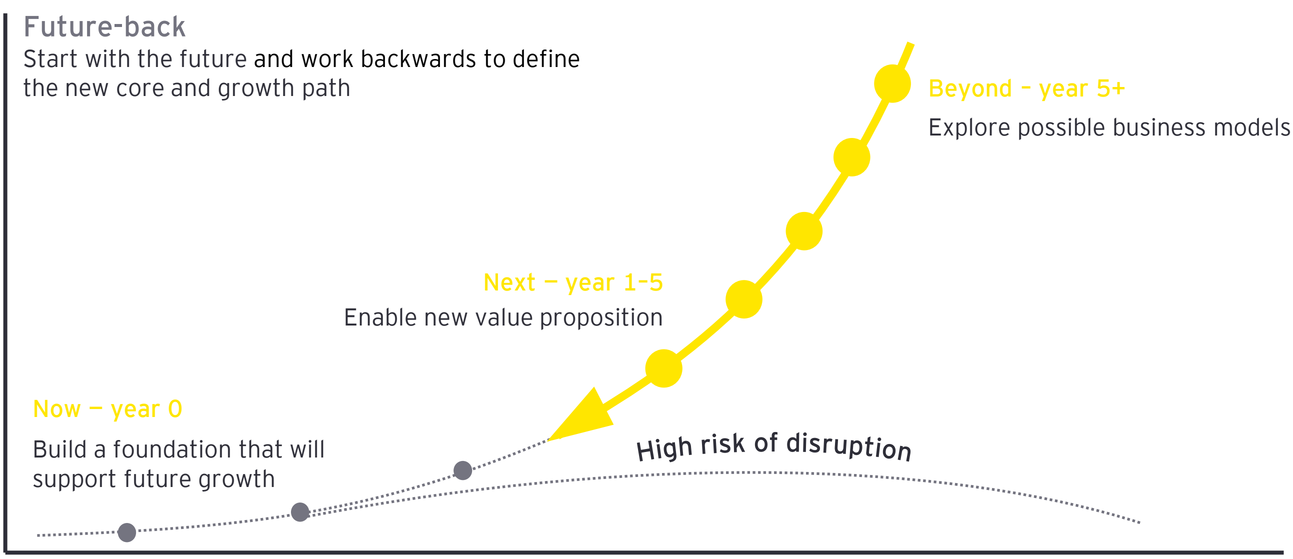
In our report *Applying for banking authorisation - Supporting your banking journey* we describe the many matters that need to be considered in a banking licence application. The key elements, however, are the business model and strategy, and the operating model. In other words, what are your markets, products and customers, how are you attracting the business and how are you delivering to, engaging with and servicing your customers?

Designing the business plan and operating model backwards and building it forward will result in a more efficient process in the long-run.

Irrespective of the starting point, be it as an e-money provider or bank licence, the pace of change in financial services means today's new financial firm needs to base its strategy on where it wants to be in five years and beyond. Essentially, we are advising firms to design the business plan and operating model backwards and build it forward. This future-back approach allows a new financial firm to operate in a focused and agile manner throughout its initial growth, resulting in a far-more efficient process in the long run. Outgrowing your resource skillset and your operating, governance and control environment, and having to retrospectively play catch-up will slow-down the business development, sometimes significantly, and cost considerably more.

When it comes to banks, the PRA is open to novel and untested business models, but will apply a higher degree of scrutiny to these banks to ensure governance and controls are appropriate and the bank understands the risks it is assuming. Firms will need to adopt a future-back approach to build now with a clear vision of the future. This will include developing business strategies and operating models, incorporating regulatory expectations. Being one step ahead will make the growth journey faster and more efficient, and ultimately will be reflected in more efficient capital requirements.

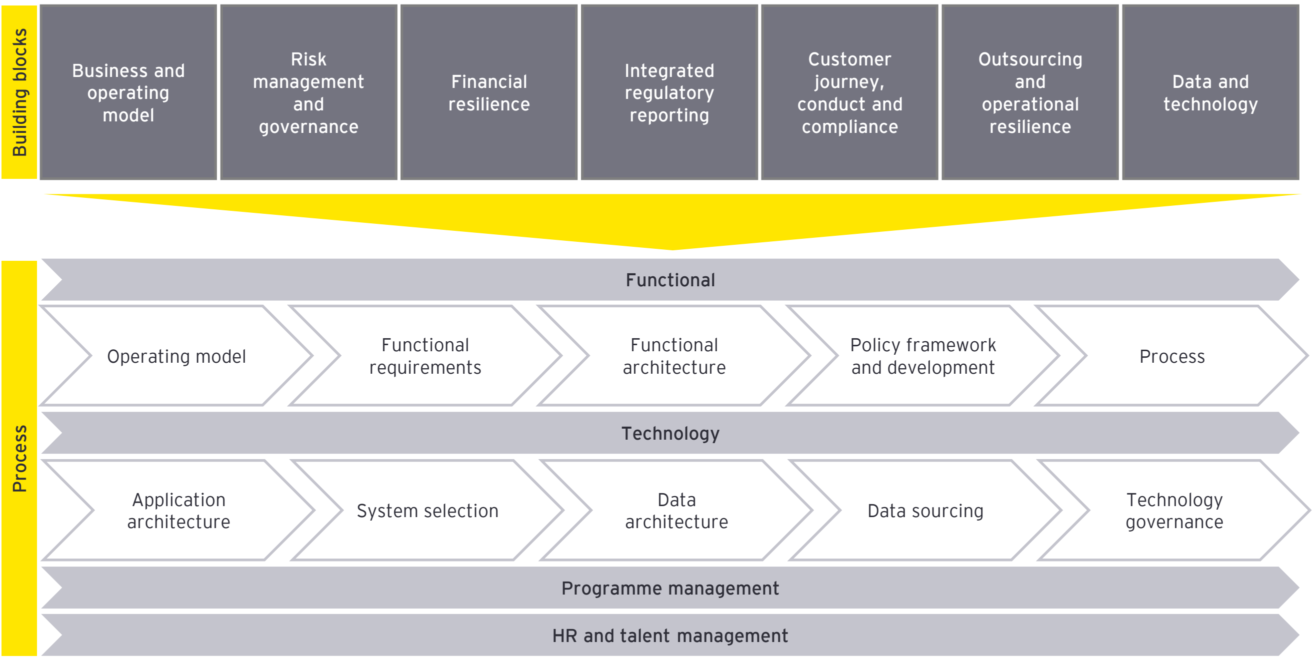
Future-back: planning today what will be tomorrow



Delivering the now

A banking licence applicant will need to build and develop its bank capability before, while and after the licence application is submitted. Establishing a bank entails managing a complex programme of disparate activities. It is essential to establish a clear vision and communicate to all stakeholders, both internal and external, throughout the journey. Stakeholder needs are varied, including regulators, executive management and programme delivery resources. The design and functional architecture of the bank should be agreed and clearly articulated at an early stage in the process. The overall design is crucial to functional, legal and regulatory requirements, as well as the IT and infrastructure specification. EY has a structured approach across all phases, for design and planning to mobilisation and implementation. Based on experience, we have developed fast-track business model design and testing processes, and clearly articulated operating models incorporating governance frameworks, risk management frameworks, outsourcing models, and compliance and reporting tools and services. Our multidisciplinary teams provide support on a range of topics as outlined below.

Bank building blocks



From now to next

Developing and growing in a sustainable way

Adopting a mindset and culture for success, new and fast-growing banks need to adopt a medium- to long-term view for measuring success, looking beyond the failures and successes of individual disparate activities.

As part of a bank's transformation from now to next and beyond, a newly-established institution is unlikely to be profitable right from the start. Establishing itself in the market and growing organically to the point of profitability will take time and considerable effort.

The PRA does not expect profitability from day-one after authorisation, but has outlined its expectation that a challenger provides a clear path to profitability. In our report 'Applying for banking authorisation' we explain that the regulatory business plan submitted as part of the authorisation process should not only include a five-year projection of a new entrant's business, but also demonstrate that this projection is stressed against under- and over-achievement of the expected business plan, recognising that there is uncertainty in a challenger's business environment.

While it is understandable that the PRA emphasises its expectation of a clear path to profitability, and it is equally understandable that a new entrant would want to become profitable as soon as possible, this needs to be achieved in a prudent manner, without entering into unduly high-risk activities or exposures, particularly if the risk management framework is still developing and, to some extent, is untested.

Managing your risks

As well as COVID-19 being a real test of a challenger bank's risk management and resilience, there have been long-standing concerns that challenger banks are not managing risk as effectively as they are growing their business. These concerns circled on challenger banks being overly optimistic in their assumptions on growth and viability, underestimating potential stresses to their business model, and their capability to raise capital when needed. It would be good practice for a challenger bank to regularly assess and prioritise the development of its risk and control framework as it grows, and adapts its regulatory documentation such as the Internal Capital Adequacy Assessment (ICAAP) and Internal Liquidity Adequacy Assessment (ILAAP), evidencing any input and challenge, and ensuring that stress testing and downside risk analysis plays a prominent role in any decision-making.

Managing capital and liquidity

The PRA's focus on reaching profitability should be seen in light of a new entrant's capability to achieve organic capital generation through the development of a

The PRA has outlined its expectations for new and fast-growing banks, balancing the required agility of new entrants and the stability of the UK financial sector.

sound business model and reduce its reliance on continual external capital injections.

Echoing the future-back approach outlined, defining and designing a firm's capital management framework and capital requirements alongside a detailed business and operating model will provide clear visibility and allow a fast-growing bank to move towards its goals over a five-year period. It is important that this plan is kept current by senior management, and that both shareholders and regulators are kept abreast of developments and changes.

Managing outsourcing relations

Often, new and fast-growing banks rely substantially on outsourcing and third-party providers as an integral part of their strategy. This may bring increased complexity with respect to governance, internal control, data security, record-keeping and reporting, compliance and contractual management. Irrespective of the size of the firm, the PRA has set out clear expectations of a financial institution's obligations to manage its outsourcing arrangements. New and fast-growing banks must meet these expectations in a manner that is proportionate to their size and complexity. To put it simply, while a new firm can outsource activities to a third party, the firm remains accountable for the management and control of these services in a structured way to ensure the firm's 'safety and soundness', including its operational resilience and ability to comply with any legal and regulatory obligations through appropriate controls.

Managing compliance

A key differentiator for the majority of challenger banks is a digitally-driven customer experience, from the ease of opening an account to the simplicity of payments and money transfers. This simplicity comes with a number of challenges, to prevent fraud and ensure compliance with regulatory conduct requirements: in particular, 'knowing your customer' at the point of onboarding and throughout the end-to-end customer journey.

When balancing a fast-growing customer base and continued enhancement of customer experience as a key differentiator, and managing a complex and wide-ranging FCA compliance landscape, the costs associated with embedding the right procedures and building the right compliance team make it a challenging endeavour. Not getting this right can have a substantial impact, from increased regulatory scrutiny to fines.

Key challenges for new and fast-growing banks

- Business model viability – a new and fast-growing bank will need to define and evaluate on an ongoing basis how it will attract, retain and develop its customer base. Consideration should be given to the underlying building blocks for successfully providing banking products and services.
- Growing whilst staying lean – launching and growing a compliant business whilst remaining innovative, agile and responsive to the needs of your clients and wider stakeholders: in particular, establishing the right procedures and compliance team to manage and navigate a complex FCA compliance landscape.
- Adapting the risk management framework – new entrants should have a proportionate approach in implementing and maintaining a risk management framework in line with the bank's operational practices, structures, controls, management information (MI) and governance.
- Balancing technology and human input – efficient integration and the compliant use of new technologies from the outset can aid implementation costs, operational agility and enhanced customer outcomes.
- Crisis management – Fast-growing banks need to be able to adapt to fast changing world with a clear understanding of the regulatory landscape and a plan for how to respond, and positioning themselves for growth and operational resilience.
- Continued digital transformation – new entrants continue to launch with disruptive propositions, whilst incumbents continue to invest in technology and re-focus their business lines with improved digital offerings to retain customers.
- Capital optimisation – investors are often private equity firms with new and fast-growing banks often relying on continual capital injections. As part of their growth, banks will need a clear capital plan and an understanding of the right mix of capital and debt, particularly if they have to meet minimum requirements for own funds and eligible liabilities (MREL) requirements. New and fast-growing banks will also need to consider initial public offering (IPO) at some stage in their growth

From next to beyond

The future, following initial development and growth

When a bank reaches certain triggers operationally or financially, the complexities of running its business will be further tested, as the PRA will start assessing the bank's operating and business model against its expectations for large and complex organisations. This means that the PRA will expect increasingly sophisticated risk management and governance, complex capital and liquidity planning processes, and the compliance challenges against an ever-growing customer base to be addressed. Immediate challenges will arise, particularly for firms that reach the threshold for the PRA to apply a bail-in or partial transfer resolution strategy.

Restructuring the business

Whether a challenger bank grows organically or through mergers and acquisitions, what most likely started as a simple legal entity will need to be restructured. MREL requirements, for example, will dictate the possible need to establish a holding company for the group to issue its debt for external MREL purposes for firms applying a bail-in resolution strategy. Redefining a futureproof legal entity structure involves a fine balance between optimising tax, legal, prudential and accounting considerations, and managing the complexity – or better simplicity - of embedding the new structure. The sooner a bank considers its optimal entity structure by applying a future-back approach, the simpler the execution of the restructuring will be.

Embedding the Bank of England's Resolvability Assessment Framework

The Resolvability Assessment Framework (RAF) applies to UK firms notified by the Bank of England (BoE) that their preferred resolution strategy is bail-in or partial transfer. This includes UK banks and building societies regulated by the PRA rules on resolvability assessments, as well as firms that the BoE would expect to make use of its stabilisation powers in the event of a resolution. The BoE identified a series of generic barriers to achieving these outcomes for which it has defined specific requirements: a firm's process to ensure adequate financial resources through MREL, valuations in resolution (ViR) and funding in resolution (FiR), ensuring its operational continuity, including continued access to financial market infrastructures (FMIs) and communication and governance in resolution. These capabilities need to operate in an ongoing business-as-usual capacity, with the BoE expecting to see robust management and governance in the delivery of these capabilities.

Thresholds for the application of MREL

Following the BoE's July 2021 Consultation Paper (CP) 'The Bank of England's review of its approach to setting a minimum requirement for own funds and eligible liabilities (MREL)', we outlined in our Points of View on the BoE's approach of setting MREL our ideas on possible changes to the BoE's approach on defining the threshold for when a firm would need to apply MREL and at what level MREL should be set – in particular for mid-tier firms.

The BoE's final Policy Statement following the CP, while not changing the threshold itself, outlines two key concessions made to mid-tier bank's which EY proposed as part of our Points of View:

- The BoE has defined a 'glide path' over six years to meet end-state MREL requirements, effectively extending the transition period which had an expectation of 'at least 36 month'. This glide-path starts at a 'date T' set by the BoE for firms it has assessed must come into the scope of MREL. Typically the BoE will communicate this date with three years advance notice based on a firm's forecast of when it will reach the £15bn asset threshold and then give the firm six years to reach end-state MREL on a defined incremental basis over the six years.
- The BoE will review the definition of the 'transactional account threshold' and reiterate its approach to determining eligibility for MREL.

Effectively for new and fast-growing banks this provides an opportunity to plan their trajectory to MREL on a longer-term basis, allowing for a graduate increase of eligible MREL over a six year time-period, instead of as previously having to raise a substantial amount of MREL within a much shorter timeframe.

How EY can support you

EY's support starts at the beginning of your financial services journey. You may not want a banking licence today, but we can help you plan backwards and build forward. This applies to e-money providers, payment firms and digital and challenger banks. Some early design features can save a lot of cost in the future and accelerate your development and growth.

The Financial Stability team within the UK Financial Services Consulting practice supports clients in embedding key prudential regulatory expectations through the life cycle of the firm and helping it to grow in a sustainable way. Our services range from business consulting and advisory support, to hands-on assistance with the authorisation process and restructuring, through to recovery and resolution planning. As part of EY Consulting, we work closely with our wider Consulting network and our colleagues in EY Legal, Tax, and Strategy and Transaction services to provide a holistic approach to supporting clients on their banking journey. We have worked with a large number of firms at various stages of the growth cycle: (i) designing and building a new bank, (ii) scaling and growing an existing bank and (iii) acquiring and merging with another bank.

Key prudential capabilities for a sustainable growth path

- Recovery planning
- Resolvability assessment framework
- Resolution maintenance
- Wind down planning and modelling
- Crisis management and testing

- Licence applications
- Variation of permission
- New model applications
- Building the bank/Scaling up
- Regulatory engagement
- Restructuring

- Individual accountability (e.g. SMCR)
- Three lines of defence
- Risk appetite and tolerance
- Operational resilience
- Outsourcing
- Business continuity planning

- Capital
- Liquidity
- Financial resources optimisation
- Integrated regulatory reporting
- Trade reporting – implementation and remediation

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