

DESIGNATION OF INVESTMENT FIRMS BY THE PRA

1. In response to a request from the Government, this note sets out the Bank of England's and the FSA's initial views on how the Prudential Regulation Authority (PRA) will exercise the powers that would be conferred under the Financial Services and Markets Act 2000 (PRA-Regulated Activities) Order 201* (the draft Order)¹. The proposed draft Order will provide, amongst other things, for the PRA to designate certain investment firms for prudential regulation by the PRA rather than by the Financial Conduct Authority (FCA). The release of this paper is intended to assist Parliamentary scrutiny of the Financial Services Bill.

Twin peaks

2. On 2 April 2012, the FSA moved to a 'twin peaks' operating model internally. Under that model, the FSA has established separate 'prudential' and 'conduct' business units. The prudential business unit (PBU) prudentially supervises those deposit-takers and insurers that, once the Bill comes into force, will be regulated by the PRA within the Bank of England. The conduct business unit (CBU) carries out those functions that will be performed by the FCA.
3. The PBU will also supervise those investment firms that, once the Bill comes into force, will likely be designated for prudential regulation by the PRA. As part of the move to this 'twin peaks' operating model, it has been necessary for the FSA to determine for the time being which investment firms fall into this group.
4. The FSA has sought to ensure that those firms that it considers are most likely to be designated by the PRA are supervised by the PBU under the internal 'twin peaks' model. The PRA will review this in due course.

Policy background

5. In its February 2011 Consultation Document, HM Treasury (HMT) adopted a policy position that the PRA should regulate not only deposit-takers and insurers, but should also be able *“to designate certain investment firms for prudential regulation by the PRA where it determines that they could pose significant risks to the stability of the financial system or to one or more PRA-regulated entities within their group. These risks are likely to arise through the scale or complexity of such a firm's operations and its interconnectedness with other firms or the system as a whole.”*²
6. The Consultation Document went on to say that, in order for PRA designation to have value, the risks posed by the firm must be of a kind that can be mitigated by prudential regulation. HMT therefore envisaged that designation would apply only to firms which have permission to 'deal in investments as principal' and are therefore subject to the prudential requirements that relate to that permission³.

¹ A draft Order has been published by HM Treasury on its website at http://www.hm-treasury.gov.uk/d/fin_fs_bill_draft_si_pra_regulated_activities_order_jan2012.pdf

² HM Treasury - A new approach to financial regulation: building a stronger system (February 2011) (http://www.hm-treasury.gov.uk/d/consult_newfinancial_regulation170211.pdf) - para 3.23

³ *ibid.* - para 3.24

Legal context

7. To give effect to this policy intention, clause 8 of the Financial Services Bill adds a new section 22A to the Financial Services and Markets Act 2000 (FSMA), providing that HMT may, by order, specify which regulated activities are "PRA regulated activities". In January 2012, HMT published a draft of the Order.
8. The draft Order enables the PRA to designate certain investment firms for PRA prudential supervision and sets out broad criteria for such designations. An investment firm would meet the conditions for designation by the PRA where, broadly speaking, it:
 - (a) has, or has applied for, permission to deal in investments as principal; and
 - (b) has, or would have if it were authorised, a minimum capital of EUR 730,000, or is a broadly analogous EEA passporting firm or non-EEA firm (a 730K Investment Firm).Provided these conditions are met, the PRA may designate the eligible firm if it considers it "desirable" to do so having regard to its statutory objectives.
9. When deciding whether it is desirable to designate an eligible firm, the draft Order states that the PRA must have regard in particular to:
 - (a) the assets of the firm, and
 - (b) where the firm is a member of a group:
 - (i) the assets of other 730K Investment Firms within the group;
 - (ii) whether any other members of the firm's group have been designated; and
 - (iii) whether the firm's activities have, or might have, a material impact on the ability of the PRA to advance any of its objectives in relation to other PRA-authorised persons in its group.
10. In principle, HMT may add other PRA regulated activities to the Order or make other changes to the Order in due course.

Designation policy

11. The policy of designation has been drawn up because some investment firms could pose significant risks to the stability of the financial system or to one or more PRA-regulated entities in their group. It follows that they should be prudentially supervised by the PRA in pursuance of its objective of promoting the 'safety and soundness' of regulated firms by seeking to minimise any adverse effects of firm failure on the UK financial system. Whilst the draft Order states that the PRA must have regard to factors like those set out above, they are not exhaustive. The PRA may also have regard to other considerations in deciding whether it is desirable for an eligible firm to be designated.

Assets

12. Impact on the financial system is a function of a firm's size, the complexity of its operations, the substitutability of the services it provides and its connectedness with the rest of the system. In deciding whether an investment firm poses a risk to UK financial stability, the Bank and FSA expect the PRA to consider the value of the total assets of the firm.
13. The PRA will also consider firms' business models and booking practices to ensure that assets booked to the firm do not give a distorted view of the firm's business. Other assessments of asset values beyond those regularly submitted on a firm's regulatory returns (both end-of-day

and intra-day) may also be considered in order to identify whether a firm's assets, as disclosed in regulatory returns, provide an accurate representation of its risk-taking.

14. Whatever threshold is adopted by the PRA, it is envisaged that it will be reviewed periodically to ensure that it remains an appropriate indicator.

Group considerations

15. Some investment firms may be designated because they are part of a group containing other entities subject to PRA supervision (whether or not the overall group is subject to consolidated supervision in the UK or elsewhere). In judging whether a firm is material to such a group, the PRA will assess, for example, the share of the firm's revenues, balance sheet or risk-taking as a proportion of the group's revenues, balance sheet or risk-taking.
16. The PRA will also take into account the structure of a group. It will not be possible to structure a group to avoid the designation of an investment firm by simply establishing several investment firms within the same group that individually fall below the total assets threshold, but which are, in aggregate, above the threshold.

Periodic review of firms subject to designation

17. The draft Order requires the PRA to keep all designations under review. It will be important to guard against "designation volatility". It is envisaged that the assets threshold will, therefore, be applied based on an average value of assets over a specified period of time. Where an investment firm is designated, there should normally be a minimum period over which it will remain supervised by the PRA.
18. Where the PRA decides that a firm should no longer be designated, it will follow the procedures set out in the draft Order for the withdrawal of designation. The prudential supervision of the firm would then pass to the FCA.

Review of regulatory perimeter

19. As part of a developing area of policy on "shadow banking", the Financial Policy Committee (FPC) has a particular responsibility under the Bill to recommend, in light of its statutory objective to contribute to the achievement by the Bank of its financial stability objective, whether HMT should bring new activities within the scope of regulation via an amendment to the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001. The FPC may also recommend whether responsibility for supervision of firms engaged in that activity, or for any other activity already regulated, should be conferred on the PRA or the FCA, or be considered for designation across both regulators.