



Annual Report

1 March 2019–29 February 2020



Prudential Regulation Authority

Annual Report¹

1 March 2019 to 29 February 2020

Presented to Parliament pursuant to paragraph 19(4) of Schedule 1ZB of the Financial Services and Markets Act 2000 as amended by the Financial Services Act 2012, and the Bank of England and Financial Services Act 2016.

¹ Including the PRA Annual Competition Report, and the annual report of the Prudential Regulation Committee to the Chancellor of the Exchequer on the adequacy of PRA resources and the independence of PRA functions.

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This report is made by the Prudential Regulation Authority (PRA) under the Financial Services and Markets Act 2000 (FSMA) as amended by the Financial Services Act 2012, and the Bank of England and Financial Services Act 2016. It is made to the Chancellor of the Exchequer and covers the year ended 29 February 2020.

The report covers the requirements of paragraph 19 of Schedule 1ZB of FSMA.

The Bank of England Annual Report and Accounts for year ending 29 February 2020 is available on the Bank's website at www.bankofengland.co.uk/annual-report/2020. The PRA's audited accounts for the reporting year ending 29 February 2020 are set out on pages 159–167 of the Bank of England Annual Report and Accounts. HM Treasury has issued an accounts direction; disclosures relating to this can be found on pages 163–164 of the Bank of England Annual Report and Accounts.

Additional material can be found on the Bank's website at www.bankofengland.co.uk/prudential-regulation.

Any enquiries related to this publication should be sent to us at praannualreport@bankofengland.co.uk.

Consultation

Members of the public are invited to make representations to the PRA on the:

- PRA Annual Report;
- way in which the PRA has discharged, or failed to discharge, its functions during the period to which the report relates; and
- extent to which, in their opinion, the PRA's objectives have been advanced and the PRA has considered the regulatory principles to which it must have regard when carrying out certain of its functions (contained in section 3B of FSMA), and facilitated effective competition in the markets for services provided by PRA-authorized firms in carrying on regulated activities in accordance with section 2H of FSMA.

Please address any comments or enquiries to:

PRA Communications
Prudential Regulation Authority
20 Moorgate
London EC2R 6DA
praannualreport@bankofengland.co.uk

The consultation closes on Friday 18 September 2020.

Privacy and limitation of confidentiality notice

By providing representation to the PRA on this annual report, you provide personal data to the Bank of England. This may include your name, contact details (including, if provided, details of the organisation you work for), and opinions or details offered in the representations.

The representations will be assessed to inform our further work as a regulator. We may use your details to contact you to clarify any aspects of your response.

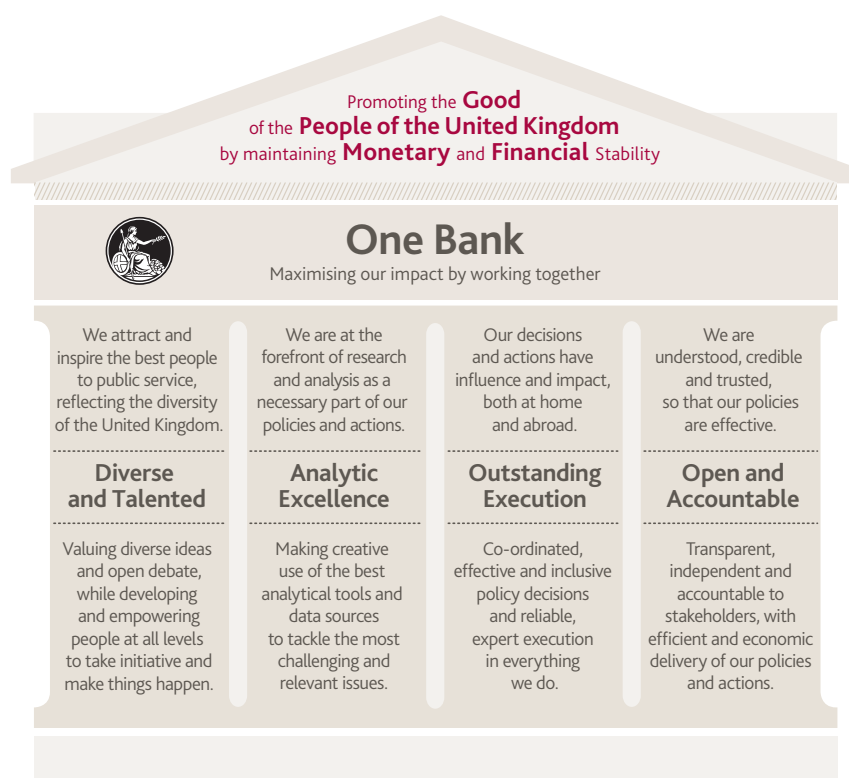
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Information provided in response to this report, including personal information, may be subject to publication or disclosure to other parties in accordance with access to information regimes including under the Freedom of Information Act 2000 or data protection legislation, or as otherwise required by law or in discharge of the Bank's functions.

Please indicate if you regard all, or some of, the information you provide as confidential. If the Bank of England receives a request for disclosure of this information, we will take your indication(s) into account, but cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system on emails will not, of itself, be regarded as binding on the Bank of England.

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Foreword by the Chair



Andrew Bailey
Governor,
Chair of the Prudential Regulation Committee

I am far from a disinterested observer in reviewing the PRA. As its first chief executive, I was responsible for setting up the institution and bringing it into the Bank. I have attended almost every PRA Board and more recently Prudential Regulation Committee meeting, first as PRA CEO, and then as CEO of the Financial Conduct Authority.

What is clear is that, as the Covid-19 crisis unfolded in the UK, the health of our financial system was not in question. This difference between this crisis and the one 12 years ago is in large part the work of dedicated colleagues at the PRA.

First, the PRA's approach means that all supervisory decisions about insurers, banks, building societies, and credit unions are made by the PRA using strong judgement. Those decisions are explicitly forward-looking and risk-based. The amount of time we devote to those decisions depends on both the size of the risk and the potential impact should it happen. By avoiding a one-size-fits-all or tick-box scheme, we hope to address risks in an effective and timely way, using our limited resources where they matter most.

Bank and insurance stress tests mean that both PRA supervisors, the PRC, and Financial Policy Committee have a better understanding of firms' resilience. They also act as a benchmark for firms to use in their own stress testing.

Capital and liquidity reforms, including Basel 3.1 and Solvency II are now in the final phases of implementation, with the major pieces in place. The PRA and wider-Bank have played a leading role in shaping the underlying international standards, and policy and supervision colleagues have now implemented these and are monitoring firms against these rules.

Ring-fencing means that the retail businesses of our major banks are separate from their investment banking divisions. This limits the impact that financial market volatility can have on the banks that people and small businesses use day-to-day.

At the time of writing, all of the PRA's work is being done remotely. The Bank's Moorgate Building, where most PRA staff are based, is currently closed. Colleagues, to their credit, have adapted with staggering speed to a new way of working, while at the same time coping with the increased demands events have placed on them. I am hugely impressed by the work done by Sam Woods and all colleagues in the PRA.

A handwritten signature in black ink that reads "Andrew Bailey". The signature is written in a cursive, flowing style.

26 May 2020

Report by the Chief Executive



Sam Woods
Deputy Governor, Prudential Regulation,
Chief Executive of the PRA

While we should always have at least one eye fixed on the future, this was even more important for the PRA last year. I have said for some time that we are moving on from the implementation of the post-crisis reforms, and into a phase where our priorities revolve more around defending our framework and looking out for new risks and opportunities. Our key pieces of work in 2019/20 speak to our efforts to make sense of the ways in which shifts in the wider environment impact on our regulation of financial firms — and where these shifts could present valuable opportunities to improve how we meet our objectives.

This can be seen perhaps most clearly in the work we have done on the financial risks from climate change. The question of how we tackle the causes and effects of climate change has been a profound question posed to all of us — well beyond the confines of the Bank and the PRA — over the past year. We have taken this question on in our own world of prudential regulation and the result is a Discussion Paper setting out a proposed framework for a 2021 biennial exploratory scenario, which when we implement it will probably be the world's first bottom-up system-wide climate stress test including both banks and insurers. Our work to establish the UK Climate Financial Risk Forum, co-chaired with the FCA, will also help to ensure that regulators are equipped with the tools and approaches necessary to address the climate-related financial risks we face.

We have also been firmly focused on the challenges and opportunities presented by the ever-evolving technological landscape. Rapid advances in technology that improve the efficiency of business services mean our firms are understandably increasingly reliant on technology to discharge their key functions. For us this means making sure they are operationally resilient and prepared for instances of severe disruption — be these from cyber-attacks or other causes. Our Consultation Paper on operational resilience makes clear that firms must take accountability for their own resilience, and addresses risks including those arising from the interconnectedness of the financial system and the complex and fast-moving environment in which firms operate.

Alongside our consultation on operational resilience, we consulted on proposals for modernising the regulatory framework on outsourcing and third-party risk management. These proposals aim to facilitate greater resilience and adoption of the cloud and other technologies, as the Bank set out in its response to Huw van Steenis' 'Future of Finance' report. This consultation should allow us to provide greater regulatory certainty in a number of key areas that are becoming ever-more important to our objectives.

Our secondary competition objective has continued to be an important piece of our work in this new phase of defending our framework and looking out for new risks and opportunities. We have been thinking carefully over the past year about how to ensure small and growing firms are not facing disproportionate barriers to growth. We have set out changes to capital requirements for credit unions, and are looking ahead to how we can ease regulatory burdens on other small firms.

Also as part of our looking ahead, we supported colleagues in the wider Bank to complete the Resolvability Assessment Framework (RAF). The RAF is designed to make the resolution process more transparent, comprehensible and therefore successful when it is needed. It is essential that we do not operate a no-failure regime, and planning for future resolution cases is therefore a crucial part of our regulatory activity.

The process of transitioning from the London interbank offered rate (Libor) to alternative interest rate benchmarks has been well underway over the past year. We have liaised closely with banks and insurers on their plans and actions to manage the transition, and these firms are now very much aware of our expectations for progress during 2020 and our requirements for evidencing their engagement with the wider transition efforts in the market. We have also been working to remove regulatory impediments to Libor transition, both domestically and internationally.

Other key pieces of work that have continued over the past year relate to the Senior Managers & Certification Regime (SM&CR) and implementation of the Solvency II regime. This was the first year in which all elements of the SM&CR were fully in place across all PRA-authorized firms — a significant step in enhancing individual accountability across regulated firms. We have continued our focus on trying to secure reforms to the Solvency II risk margin, and have been actively engaged with the European Insurance and Occupational Pension Authority's 2020 review and the International Association of Insurance Supervisors as it has developed its approach to this issue.

Finally, our work to prepare the financial sector for the UK leaving the EU has continued. We have made preparations to nationalise the Acquis so the UK will have a functioning regulatory framework once EU law no longer applies. We also put in place temporary regimes so that European Economic Area firms currently operating in the UK using the EU passport could continue to do so for a period after exit. We are continuing this work and more throughout the transition period.

As this report makes clear, 2019/20 has been another packed year. The PRA has been busy ensuring that we do our bit to prepare the financial system for upcoming risks, and that we are in a position to take full advantage of future opportunities. At the time of writing we are deep in the midst of dealing with a major new risk in the form of Covid-19. Thanks to our reforms over the past years, the financial system has been better prepared to deal with this risk. And given the huge efforts on that front I would like to give a particularly heartfelt thanks to everyone in the PRA for their work and dedication over the past year.



26 May 2020

Prudential Regulation Committee

Members and responsibilities



**Members as at
26 May 2020***

Top row, left to right

Andrew Bailey
Governor, Chair of the PRC

David Belsham
External member
Term: 1 May 2015
– 30 April 2021

Julia Black
External member
Term: 30 November 2018
– 29 November 2021

Ben Broadbent
Deputy Governor,
Monetary Policy

Middle row, left to right

Norval Bryson
External member
Term: 1 September 2015
– 31 August 2021

Sir Jon Cunliffe
Deputy Governor,
Financial Stability

Jill May
External member
Term: 23 July 2018
– 22 July 2021

Sir Dave Ramsden
Deputy Governor,
Markets and Banking

Bottom row, left to right

Sam Woods
Deputy Governor, Prudential
Regulation and Chief Executive
of the PRA

Christopher Woolard
Interim Chief Executive of the
Financial Conduct Authority
Term: 16 March 2020 –

Mark Yallop
External member
Term: 1 December 2014
– 30 November 2020

The PRC is the body within the Bank responsible for exercising the Bank's functions as the Prudential Regulation Authority (PRA) as set out in the Bank of England Act 1998 and the Financial Services and Markets Act 2000 (FSMA). The PRC is on the same legal footing as the Monetary Policy Committee and the Financial Policy Committee.

The PRC's terms of reference provide for 12 members, five members are Bank of England staff: The Governor; and four Deputy Governors. The Committee also includes, the Chief Executive of the Financial Conduct Authority (FCA), and at least six members appointed by the Chancellor of the Exchequer.

- The PRC is independent in all its decision-making functions, including making rules and the PRA's most important supervisory and policy decisions.
- The PRA functions are exercised by the Bank and are funded by PRA fees, with the PRC responsible for consulting on and setting the level of those fees.
- The PRC is required to report annually to the Chancellor of the Exchequer on the adequacy of resources allocated to the PRA functions and the extent to which the exercise of those functions is independent of the exercise of the Bank's other functions.¹

* The Bank of England Act 1998 provides for one member to be appointed by the Governor with the approval of the Chancellor. The Governor appointed Ben Broadbent.

* Sandy Boss was a member of the PRC until 17 January 2020.

¹ Available on pages 8–9 in this report.

- Since February 2016 members of the PRC have been indemnified by the Bank against personal civil liability on the same terms as members of Court.¹

The statutory objectives of the PRA, which underpin its forward-looking, judgement-based approach to supervision are:

- a general objective to promote the safety and soundness of the firms it regulates;
- specifically for insurers, to contribute to the securing of an appropriate degree of protection for those who are or may become insurance policyholders; and
- a secondary objective to, so far as is reasonably possible, act in a way which facilitates effective competition in the markets for services provided by PRA-authorized persons in carrying on regulated activities.

On 4 November 2019, HM Treasury issued its latest 'Recommendations for the Prudential Regulation Committee'.² This sets out aspects of the Government's economic policy to which the PRC should have regard when considering how to advance its objectives, and when considering the application of the regulatory principles in FSMA.

FSMA also requires the PRA to review, and if necessary revise, and publish annually its strategy in relation to how it will deliver its statutory objectives. The strategy is set by the PRC, in consultation with the Bank's Court of Directors. The PRA's strategy for 2020/21 was published with the PRA Business Plan on 9 April 2020.³

¹ See pages 5 and 10 of the Bank of England's Annual Report and Accounts 2019/20 available at www.bankofengland.co.uk/annual-report/2020.

² www.bankofengland.co.uk/letter/2019/remit-for-the-prc-2019.

³ www.bankofengland.co.uk/prudential-regulation/publication/2020/prc-business-plan-2020-21.

Annual report of the PRC to the Chancellor of the Exchequer

The adequacy of resources allocated to the performance of PRA functions and the extent to which the exercise of PRA functions is independent of other Bank functions.

This is the annual report by the Prudential Regulation Committee (PRC) to the Chancellor of the Exchequer under paragraph 19 of Schedule 6A to the Bank of England Act 1998 (as amended). It relates to the period of 1 March 2019 to 29 February 2020. The Prudential Regulation Authority (PRA) publishes this report as part of its commitment to transparency.

Background

Since 1 March 2017, the PRA has been part of the legal entity of the Bank of England (Bank). The PRC is a statutory committee of the Bank and is responsible for the exercise of the Bank's functions as the PRA. The PRC is on the same statutory footing as the Bank's Monetary Policy Committee (MPC) and the Financial Policy Committee (FPC). The PRA Annual Report summarises the PRC's responsibilities and the statutory framework under which the PRA operates. Under this statutory framework, the PRC is responsible for strategy, policy and rule making, and the adoption (with the approval of the Bank's Court of Directors) of the budget for the PRA. These functions cannot be delegated.

The performance of PRA functions

The PRA has published two approach documents setting out how it advances its statutory objectives: the PRA's approach to banking supervision and the PRA's approach to insurance supervision.¹ The PRA does not seek to operate a zero-failure regime. This is a key principle underlying the PRA's approach to supervision. Each year the PRC sets the PRA strategy and business plan, and adopts the PRA's budget. These are based on the PRA approach to supervision, the PRA operating model and risk tolerance, all agreed by the PRC.

The adequacy of resources

The PRA is fully funded by fees paid by regulated firms. The PRA consults each year on the allocation of fees among firms and has the ability, after consultation, to raise additional funds during the year for material changes. The PRA received one response to its fees consultation proposals in 2019/20;² which did not result in changes to the proposals and the PRA did not raise additional funds during this financial year.

The PRC seeks to ensure that its financial and non-financial resources are appropriately allocated to the work that best advances the PRA's objectives. In making judgements on the allocation of resources, the PRC takes into account a wide range of relevant considerations. These include the wider legislative and policy framework under which the PRA operates, including the duty to have regard to certain factors under the Financial Services and Markets Act 2000 (FSMA), and the Legislative and Regulatory Reform Act. The PRC also takes into account HM Treasury's recommendation letter,³ which contains recommendations about aspects of the Government's economic policy which the PRC should have regard to when considering how to advance the PRA's objectives, and when considering the application of the regulatory principles set out in FSMA. In addition, the PRA plans its resources to deliver multi-year programmes of work, (such as climate change or operational resilience), and responds to changes to the external environment and risk profile of its regulated firms.

The PRC receives and reviews regular updates on the PRA's performance and on how the PRA's financial and non-financial resources are allocated and monitored, as well as how any resource risks are being mitigated through: performance and assurance reporting; discussions of PRC papers; and PRC members' regular interaction with the

1 www.bankofengland.co.uk/prudential-regulation/publication/2018/pru-approach-documents-2018.

2 June 2019: www.bankofengland.co.uk/prudential-regulation/publication/2019/regulated-fees-and-levies-rates-proposals-2019-20 (for the 'Regulated fees and levies: Rates proposals 2020/21' see CP4/20: www.bankofengland.co.uk/prudential-regulation/publication/2020/regulated-fees-and-levies-rates-proposals-2020-21).

3 www.bankofengland.co.uk/letter/2019/remit-for-the-prc-2019.

PRA, including meetings with senior management and other staff. In particular, the regular reporting to PRC covers: progress against strategic aims; budget and headcount position; staff turnover; technology availability; and the PRA's risk profile. The reports and other evidence provided to the PRC during the year indicate whether the PRA has used its financial and non-financial resources to deliver its functions, in line with its business plan.

The Bank's internal control functions also apply to the PRA. This includes the Bank's risk management framework, Compliance function, Internal Audit function and the Audit and Risk Committee of Court. In addition, PRC members have the benefit of their own engagement with industry through meetings and events across the year.

Since 2018/19 the Bank has sought to operate a flat nominal budget for controllable costs.¹ In line with the rest of the Bank, the PRA has continued to prioritise its activities in 2019/20, resulting in an underspend of £2.6 million against budget predominantly due to the change in timelines and requirements in EU Withdrawal and increased capitalisation of project spend. Due to additional income received in the year, principally in the form of retained financial penalties, the PRA will return £6.2 million to firms (2% of the PRA's total budget) as part of the 2020/21 fee rates.²

The extent to which the exercise of PRA functions is independent of other Bank functions

The PRA has a number of safeguards in place to ensure it retains sufficient operational independence, including the independence of the PRC and the funding and reporting arrangements set out in FSMA and the Bank of England Act 1998.

The PRC is independent in all its decision-making functions, which include making rules and the PRA's most important supervisory and policy decisions. The PRC also maintains its independence by ensuring that actual and potential conflicts of interest across its members are identified and managed on a continual basis, and by having its own internal infrastructure and processes. PRC members' remuneration is determined by the Bank's Remuneration Committee.

The PRA is located within the Bank, which facilitates interaction with all areas of the Bank and ensures that there is effective policymaking on financial stability. This is done in a way which maintains the distinct roles and responsibilities of the Bank and the PRA and is in line with the Basel Core Principles. For example, in accordance with the relevant legislation, the Bank has arrangements in place to ensure that its functions as the UK's resolution authority and its supervisory functions (which are exercised in its capacity as the PRA) are operationally independent from one another and has issued a statement setting out these arrangements.³

The PRC is structurally separate from the FPC and MPC by having different external membership. The PRC and FPC hold all meetings separately, except those to discuss matters of mutual interest (for example, the annual concurrent stress test). The FPC sometimes takes decisions that constrain the decisions that can subsequently be taken by the PRC. The FPC also has specific powers of Direction over prescribed macroprudential measures and can make recommendations to the PRA, among others.

The fee income generated from regulated firms can only be used for the functions covered by the statutory framework under which the PRA operates. The PRA's budget covers PRA direct costs and indirect costs charged by the Bank, including centralised functions such as Technology, Finance and Human Resources. The Bank's external auditors review the allocation of indirect costs charged by the Bank and provide external assurance that costs have been allocated appropriately.

1 Readers are referred to the Bank's Annual Report and Accounts — 2019, where controllable costs are costs excluding pension costs, the costs of Notes Issuance and the costs of the real time gross settlement (RTGS) renewal programme: www.bankofengland.co.uk/annual-report/2019.

2 www.bankofengland.co.uk/prudential-regulation/publication/2020/regulated-fees-and-levies-rates-proposals-2020-21.

3 www.bankofengland.co.uk/-/media/boe/files/about/legislation/statement-structural-separation.

Senior leadership team as at 7 May 2020



Sam Woods
Deputy Governor
Prudential Regulation
and CEO of the PRA
(FPC, PRC)



Vicky Saporta*
Executive Director
Prudential Policy



Lyndon Nelson
Deputy CEO and
Executive Director
Supervisory Risk
Specialists and
Regulatory
Operations



Phil Evans
Director
Financial Prudential
Policy



Gareth Truran
Director
Cross-cutting and
Insurance Policy



Duncan Mackinnon
Director
Supervisory Risk
Specialists

* Also reports to Deputy Governor, Financial Stability.



Anna Sweeney
Executive Director
Insurance Supervision



Charlotte Gerken
Executive Director
Insurance Supervision



David Bailey
Executive Director
International Banks
Supervision



Sarah Breeden
Executive Director
UK Deposit-takers
Supervision



Rebecca Jackson
Director
International Banks
Supervision



Melanie Beaman
Director
UK Deposit-takers
Supervision

Find out more online
www.bankofengland.co.uk/about/people/prudential-regulation-committee

Review of 2019/20

The PRA's activities in 2019/20 were directed by the PRA's Business Plan (as set out in the PRA Business Plan 2019/20).¹

This section of the Annual Report outlines the work completed in pursuit of our 2019/20 strategic goals and in support of our statutory objectives. Readers may also find it helpful to refer to the 'PRA Business Plan 2020/21', which sets out the PRA's strategy and workplan for the coming year,² and the PRA approach documents.³

Box 1: Examples of how the PRA delivered its 2019/20 strategic goals



Have in place robust prudential standards comprising the post-crisis regulatory regime, and hold regulated firms, and those who run them, accountable for meeting these standards

- Fully implemented and operationalised the Senior Managers and Certification Regime (SM&CR) for all PRA-authorized firms, and evaluated its effectiveness in practice.
- Engaged with firms on actions and expectations to manage the transition from the London interbank offered rate to alternative interest rate benchmarks.
- Continued to refine our implementation of the Solvency II regime.



Continue to adapt to changes in the external market and to hold regulated firms, and those who run them, accountable for meeting our standards

- Continued to look ahead and perform horizon-scanning to pre-empt and mitigate risks to our objectives.
- Carried out ongoing work to embed climate change into financial and macroeconomic decisions.
- Used our statutory powers to conduct investigations and initiate enforcement action where needed to tackle threats to safety and soundness of PRA-authorized firms.



Ensure that firms are adequately capitalised, and have sufficient liquidity, for the risks they are running or planning to take

- Continued to assess the financial resilience of firms through our supervision at firm and sector level.
- Contributed to the work of the Basel Committee on Banking Supervision (BCBS) as it finalised revisions to the market risk framework.
- Ensured that insurers maintain capital for balance sheet risks arising from complex products and asset exposures.
- Worked jointly with the Bank's Financial Stability Directorate to deliver the annual concurrent stress test for the banking sector; supported the biennial exploratory scenario (BES) stress tests to explore the resilience of the banking system to a wide range of risks that may not be linked to prevailing economic or financial conditions; and launched our biennial insurance stress test for the largest regulated life and general insurers.

¹ April 2019: www.bankofengland.co.uk/prudential-regulation/publication/2019/pra-business-plan-2019-20.

² April 2020: www.bankofengland.co.uk/prudential-regulation/publication/2020/pra-business-plan-2020-21.

³ 'The PRA's approach to banking supervision' and 'The PRA's approach to insurance supervision': www.bankofengland.co.uk/prudential-regulation/publication/2018/pra-approach-documents-2018.



Develop our supervision of operational resilience in order to mitigate the risk of disruption to the provision of critical economic functions

- Published a joint Consultation Paper (CP) with the Bank and FCA on how the operational resilience of the financial services sector could be enhanced.
- Consulted on proposals for modernising the regulatory framework on outsourcing and third-party risk management.
- Initiated nine threat-intelligence led penetration tests (known as CBEST) and completed a further three initiated in 2018.



Ensure that banks and insurers have credible plans and capabilities in place to enable them to recover from financial stress events, and that we support the Bank as resolution authority to have a credible resolution strategy to manage a firm's failure in an orderly manner

- Supported the Bank in implementing the Resolvability Assessment Framework (RAF) for banks.
- Continued to work with major UK and international banks with significant trading and derivatives portfolios to ensure firms develop capabilities to wind down their trading and derivatives businesses in an orderly manner.



Facilitate effective competition by actively considering the proportionality of our approach as it contributes to the safety and soundness of the UK financial system

- Facilitated entry in the insurance and banking sectors, jointly with the FCA, through the New Insurer Start-up Unit and the New Bank Start-up Unit.
- Published further guidance material to help applicants wishing to use the UK Insurance Linked Securities market.
- Consulted on changes to the capital requirements that apply to credit unions to encourage the growth of successful credit unions.
- The Annual Competition Report, on pages 47–57, sets out our work over 2019/20 to support the delivery of our secondary competition objective.



Deliver a smooth transition to a sustainable and resilient UK financial regulatory framework following the UK's exit from the EU

- Carried out work to reduce risks and minimise disruption that could have occurred in the event that the UK left the EU without a withdrawal agreement.
- Prioritised activity to reduce risks and minimise disruption to firms' safety and soundness as the UK prepared to leave the EU covering work across policy development, authorisation and supervision.



Operate effectively by ensuring that resources are allocated to work that best advances our strategy and reduces the greatest risks to the delivery of our statutory objectives

- Continued to make improvements to data storage and analytics to support our assessment of firms' safety and soundness. For example, the PRA Data Innovation team has developed a number of new analytical tools to monitor new securitisation activities and encourage peer analysis across firms with related but idiosyncratic business models.
- Continued to co-ordinate with the FCA across a range of supervisory and policy matters.
- Feedback from firms gave us assurance on the effectiveness and quality of our supervisory framework and approach.



Have in place robust prudential standards comprising the post-crisis regulatory regime, and hold regulated firms, and those who run them, accountable for meeting these standards

Contribution to financial stability

We have contributed to the Bank's objective of maintaining financial stability through our policy development and implementation, for example:

- We conducted the annual stress test of the largest UK deposit-takers, which was completed on the basis of the changes to financial reporting under International Financial Reporting Standard (IFRS) 9. This informs policymaking by the PRC and the FPC. The results of the stress test were published on 16 December 2019.¹ For more information on stress testing see page 24, and on IFRS 9 see page 27.
- For both life and general insurers, we published updated scenarios and completed and analysed the biennial insurance stress tests.² Specifically for general insurers, we co-ordinated some of the scenarios and analysis with the Bermuda Monetary Authority as UK-based insurers cede a significant proportion of risks to Bermuda-based reinsurers. The stress test also included an exploratory exercise in relation to cyber underwriting and climate change. For more information on the Insurance Stress Test 2019 please see page 25.
- We published the Systemic Risk Buffer rates for ring-fenced banks and large building societies in May and December 2019,³ as set out in final policy published in December 2018.⁴ For more information on ring-fenced banks, please see page 44.
- The UK's withdrawal from the EU has significant implications for the way we discharge our responsibilities, and it continued to be a significant focus of our work over the past year. A core priority has been to reduce risks and minimise disruption that could have occurred in the event that the UK and EU had not reached a withdrawal agreement, and the UK had exited the EU with no deal during 2019 or on 31 January 2020. We made preparations to nationalise the Acquis — the full body of EU legislation — so that the UK will have a functioning regulatory framework once EU law no longer applies. We also put in place temporary regimes so that EEA firms currently operating in the UK using the EU passport could continue to do so for a period after exit. For more information on our work on EU withdrawal please see page 34.

Accountability — embedding and evaluating the governance regime for banks and insurers

Given that insurers were required to complete the first round of the annual certification process by December 2019, this was the first year in which all elements of the SM&CR were fully in place across all PRA-authorized firms, providing a common platform directed to enhancing individual accountability.

¹ www.bankofengland.co.uk/stress-testing.

² 'Insurance Stress Test 2019', June 2019: www.bankofengland.co.uk/prudential-regulation/letter/2019/insurance-stress-test-2019.

³ www.bankofengland.co.uk/prudential-regulation/publication/2019/systemic-risk-buffer-rates-for-ring-fenced-banks-and-large-building-societies.

⁴ Statement of Policy 'The PRA's approach to the implementation of the systemic risk buffer', December 2018: www.bankofengland.co.uk/prudential-regulation/publication/2016/the-pras-approach-to-the-implementation-of-the-systemic-risk-buffer-sop.

In doing so, the SM&CR strengthens governance within firms. It also provides us with a flexible tool that promotes better prudential outcomes across a range of areas (eg capital, liquidity, credit and operational risk) by ensuring that supervisors can, where appropriate, link risk mitigation actions to responsible individuals. In addition, we have asked firms to identify which Senior Manager(s) are responsible for financial risks from climate change and, where relevant, for resolution assessments. Given growing experience of the SM&CR on the part of firms and regulators, we began an evaluation to assess how effective the regime has been in practice, drawing on input from external stakeholders.

Alongside the SM&CR, our remuneration regime has worked to ensure that firms adopt remuneration policies that are consistent with, and promote, sound risk management and eliminate incentives towards excessive risk-taking. We also worked on the evaluation of the effectiveness of our remuneration rules, taking account of linkages to the SM&CR.

Libor

In September 2018, we and the FCA wrote to CEOs of major banks and insurers supervised in the UK asking for details of the preparations and actions they are taking to manage transition from the London interbank offered rate (Libor) to alternative interest rate benchmarks.¹ In June 2019 we shared with firms the key themes and good practice, and next steps following the letter. The responses to the Dear CEO letter highlighted much of the work that is already underway and how some firms have mobilised to meet this challenge. Responses also highlighted the very different states of readiness for dealing with the transition and associated risks demonstrated by the plans submitted. They also made clear that much more work remains to be done to deliver an orderly and timely outcome. The response to the Dear CEO letter provided a basis for this engagement to continue.

As part of the Bank's work on benchmark reform, we developed a new data template during 2019 to facilitate regular firm reporting on the transition away from Libor to alternative interest rate benchmarks. We engaged closely with firms using internal models to ensure that our review of the potentially large number of related model changes proceeded efficiently and in a way that did not impede progress on the wider programme.

In September 2019 we and the FCA jointly requested that major firms submit data on Libor and alternative risk-free rates exposures, and relevant management information (including transition plans and risk management documents) to help the regulators monitor firms' progress with transition. In 2019 Q4 we and the FCA met with firms to discuss their transition to Libor.

In December 2019 we wrote to the Chair of the Working group on Sterling Risk-Free Reference Rates (SRFRR) in response to their letter regarding regulatory capital impediments to Libor transition.² The PRA's letter set out what regulators were doing to remove obstacles to transition, where appropriate, both domestically and internationally. We were active in raising regulatory issues related to transition at the Basel Committee. In February 2020 the Basel Committee published a newsletter outlining regulatory and supervisory implications of benchmark rate reforms globally, which removed a potential obstacle related to capital instruments. The letter also set out some of the prudential risks firms need to address, including the risks that arise from failing to take adequate steps to transition.

¹ www.bankofengland.co.uk/prudential-regulation/letter/2018/firms-preparations-for-transition-from-libor-to-risk-free-rates.

² www.bankofengland.co.uk/prudential-regulation/letter/2019/prudential-regulatory-framework-and-libor-transition.

In January 2020 we and the FCA wrote again to firms on the next steps on Libor transition¹ where we set out our initial expectations for transition progress during 2020 and required firms to engage actively with the wider transition efforts in the market, both those of the authorities and of industry, and provide evidence of this engagement.

Solvency II — making improvements without eroding prudential standards

We have maintained our focus on reforms to the Solvency II risk margin and have been actively engaged in this topic, among others, in the European Insurance and Occupational Pensions Authority's (EIOPA) 2020 review. We continue to hold the view that the risk margin is too sensitive to the level of interest rates, and it is therefore too high for long duration liabilities in the current interest rate environment.

As a consequence of the risk margin, UK insurers have reinsured the majority of new longevity exposure offshore. We clarified our expectations of firms undertaking these transactions in January 2020.²

In our response to the Treasury Select Committee report on Solvency II,³ we committed to considering the feasibility of simplifying the transitional measure on technical provisions (TMTP) as we recognised the burden of maintaining multiple systems for recalculation of the TMTP. In the past year we consulted on and published final policy to provide further clarity on the consistency of Solvency I and Solvency II methodologies, and provided additional guidance for firms seeking to simplify the recalculation methodology of the TMTPs.⁴

For life insurers we continued our work on asset quality reviews and implementing our policy on equity release mortgages (ERMs). For more information on this work please see page 26.

1 www.bankofengland.co.uk/prudential-regulation/letter/2020/next-steps-on-libor-transition.

2 Policy Statement 1/20 'Solvency II: Longevity risk transfers - simplification of pre-notification expectations', January 2020: www.bankofengland.co.uk/prudential-regulation/publication/2019/solvency-ii-longevity-risk-transfers-simplification-of-pre-notification-expectations, including an update to Supervisory Statement 18/16 'Solvency II: longevity risk transfers': www.bankofengland.co.uk/prudential-regulation/publication/2016/solvency2-longevity-risk-transfers-ss.

3 February 2018: www.bankofengland.co.uk/prudential-regulation/publication/2018/pra-response-to-the-treasury-committees-inquiry-into-solvency-2.

4 Policy Statement 25/19 'Solvency II: Maintenance of the transitional measure on technical provisions', November 2019: www.bankofengland.co.uk/prudential-regulation/publication/2019/solvency-ii-maintenance-of-the-transitional-measure-on-technical-provisions.

Box 2: Enforcement: tackling threats to safety and soundness and strengthening accountability in PRA-authorised firms

At the start of 2019/20, we had 12 separate open cases, comprising investigations into firms at nine PRA-authorised groups and into 12 individuals.

In the 2019/20 financial year we opened six separate new cases, and opened investigations into firms at three PRA-authorised groups and into six individuals.

We also concluded five cases. Two cases were closed with no enforcement action. Three cases led to the following public outcomes:

- In May 2019 the PRA and the FCA imposed financial penalties on R. Raphael & Sons plc (Raphaels) for failing to manage its outsourcing arrangements properly between April 2014 and December 2016.¹ Raphaels received separate fines of £1,112,152 from the PRA and £775,100 from the FCA in respect of these breaches.
- The joint PRA and FCA investigation identified weaknesses throughout Raphaels' outsourcing systems and controls, which it ought to have known about since April 2014. These included a lack of adequate consideration of outsourcing within its board and departmental risk appetites, the absence of processes for identifying critical outsourced services, and flaws in its initial and on-going due diligence of outsourced service providers. Raphaels' outsourcing arrangements continued to be inadequate until the end of 2016, by which time Raphaels had designed new outsourcing policies and procedures to remedy the failings.
- In November 2019, we imposed a combined financial penalty on Citigroup Global Markets Limited (CGML), Citibank N.A, London branch and Citibank Europe Plc UK branch of £43.9 million for failings in relation to their internal controls and governance arrangements underpinning compliance with PRA regulatory requirements.² Between 19 June 2014 and 31 December 2018, or parts thereof, the firms' UK regulatory reporting framework was not designed, implemented or operating effectively. This led to them failing to submit complete and accurate regulatory returns to the PRA. The pervasiveness of the errors and mis-statements identified in the firm's returns raised fundamental concerns about the effectiveness of its regulatory reporting control framework, did not provide the PRA with an accurate picture of CGML's capital or liquidity position, and negatively impacted the PRA's ability to supervise Citigroup's UK operations.
- In February 2020, we published a number of notices to individuals connected with the failure of Enterprise the Business Credit Union Ltd (EBCU) in 2015.³ We published prohibition orders in respect of Mr Michael Graeme Grimsdale and Mr Richard Charles Nichols, banning both individuals from the financial services industry for their lack of integrity (and on the part of Mr Grimsdale, dishonesty). The PRA also publicly censured Mr Nichols, and publicly censured Ms Gillian Birkett and Mr Phil Neale for failing to act with due skill, care and diligence as directors at EBCU.

1 www.bankofengland.co.uk/news/2019/may/fca-and-pra-jointly-fine-raphaels-bank-1-89m-for-outsourcing-failings.

2 www.bankofengland.co.uk/news/2019/november/pr-fines-citigroups-uk-operations-44-million-for-failings.

3 www.bankofengland.co.uk/news/2020/february/pr-issues-two-bans-and-three-public-censures-following-failure.

In a sixth case, in October 2019 we issued a Decision Notice to Mr Stuart Malcolm Forsyth.¹ We prohibited Mr Forsyth from performing any function in relation to a regulated activity at any PRA-authorized firm, and imposed financial penalties of £76,180. We considered that Mr Forsyth's conduct demonstrated a serious lack of integrity, because between February 2010 and July 2016 Mr Forsyth transferred excessive amounts of his own remuneration to his wife to reduce his own tax liability and took steps to conceal that arrangement. The FCA imposed similar measures for similar reasons. Mr Forsyth has referred these decisions to the Upper Tribunal, which will make determinations and directions in due course.

As at 29 February 2020, in addition to the one Upper Tribunal referral, we have 12 open cases, comprising investigations into firms at nine PRA-authorized groups and 15 individuals. These cover the full spectrum of PRA-authorized firms and the individuals who run them from Category 1 to 5 firms across a range of industry sectors including insurers, banks, and credit unions.

Separately, following the Society of Lloyd's self-identification and disclosure to the PRA that aspects of its internal whistleblowing systems and controls had been ineffective for a period of time, we concluded that these arrangements required enhanced monitoring and scrutiny.² We were made aware of the issues when the Society of Lloyd's disclosed to the PRA on 15 February 2019 that the only anonymous whistleblowing channel provided for staff of the firm had not been operational since 1 October 2017. The Society of Lloyd's also acknowledged that it had not produced the expected annual whistleblowing report. With regards to mitigation, it is noted that other whistleblowing avenues were available for staff of the firm over this period. The Society of Lloyd's has voluntarily agreed to a number of additional requirements relating to whistleblowing.

1 www.bankofengland.co.uk/news/2019/november/prafca-publish-decision-notices-to-former-ceo.

2 www.bankofengland.co.uk/news/2019/december/prafca-announces-special-requirements-regarding-whistleblowing.



Continue to adapt to changes in the external market and to hold regulated firms, and those who run them, accountable for meeting our standards

The prudential regulatory framework must be responsive to changes in behaviours and the structure of the financial system, as well as risks arising from wider issues such as climate change and geopolitics.¹ Over the past year we continued to seek to identify aspects of regulation that can lead to unintended behaviours or outcomes and worked with other areas of the Bank to aid and inform our monitoring of firms and the financial environment so that the appropriate responses could be put into place. During 2019/20, we communicated where issues have been identified and good practice is available to share, using channels including letters, speeches and publications.²

In the banking and insurance sectors, we continued to facilitate market entry through the joint PRA/FCA New Bank Start-up Unit (NBSU) and the New Insurer Start-up Unit (NISU).³ For more information please read the Annual Competition Report (pages 47–57).

Operational resilience is becoming ever more important as firms increase their reliance on technology and the cyber-threat landscape widens. We continued to embed operational resilience in our supervisory approach, consulted on new policy to ensure that firms build resilience in their important business services and enhanced our monitoring of firms' operational resilience. For more information on our operational resilience work please see page 28.

International engagement

The UK is a global centre for the activities of banks and insurers. As the host regulator for internationally headquartered global systemically important banks (G-SIBs) and internationally headquartered global systemically important insurers (G-SIIs), we have an essential role in global consolidated supervision. Given the international nature of the largest wholesale firms operating here as both branches and subsidiaries, we need to understand the nature and extent of the risks facing these firms and their wider groups, and need an open, transparent and proactive exchange of information and views with the home state regulators. We have well-established co-operative relationships with home state regulators and group parent companies to support us in delivering supervisory priorities efficiently and effectively. Our supervisory engagements include regular calls, information sharing, thematic reviews, and joint on-site supervisory reviews. We have also hosted secondees from overseas regulators and sent our staff overseas as secondees. Over the past year we have focused our bilateral engagement with regulators from around the world, including with the US, the EU, China, Switzerland, Japan, and Canada, and more broadly have actively participated in global supervisory colleges.

We have continued to make progress in our assessments of a large number of third-country branch applications for EEA-based banks and insurers. We will continue to work closely with firms and their home state regulators on these applications and the supervision of cross-border firms. Furthermore, the Bank (including the PRA) has worked over 2019/20 to conclude a number of Memoranda of Understanding (MoUs) to facilitate continued supervisory co-operation and information sharing with European and other authorities.

¹ For all information on our work in response to Covid-19 see the dedicated PRA webpage: www.bankofengland.co.uk/coronavirus/information-for-firms.

² Examples are available from the Prudential Regulation homepage under 'PRA publications': www.bankofengland.co.uk/prudential-regulation.

³ See the dedicated webpages for the NBSU and NISU: www.bankofengland.co.uk/prudential-regulation/new-bank-start-up-unit and www.bankofengland.co.uk/prudential-regulation/new-insurer-start-up-unit.

Box 3: Climate change

Climate change, and society's response to it, creates financial risks that are directly relevant to our objectives. Our work on the financial risks from climate change forms part of the Bank's broader climate strategy to embed climate change into financial and macroeconomic decisions. Through our regulatory and supervisory functions we are working to ensure PRA-licensed firms effectively manage the risks climate change presents to the safety and soundness of their operations and financial stability.

Our domestic and international work programme in this area over the past year has grown significantly:

- In April 2019 we became the first central bank regulator to publish supervisory expectations that set out how banks and insurers need to develop their approach to the financial risks from climate change and embed it into their governance and risk management frameworks, scenario analysis and disclosures.¹ Our expectations are designed to ensure firms take a strategic approach, led by the Board, with clear accountability.²
- In December 2019 the Bank of England published a discussion paper, which sets out its proposed framework for the 2021 biennial exploratory scenario (BES) exercise — the world's first bottom-up system-wide climate stress test including both banks and insurers.³ The objective of the BES is to test the resilience of the largest banks and insurers to the physical and transition risks associated with three different possible climate scenarios, looking ahead over many decades. In addition, as part of the 2019 insurance stress test for life and general insurers we asked all participating insurers to undertake an exploratory exercise covering the transition as well as physical risks of climate change.⁴
- As announced in the UK Government's Green Finance Strategy, published in July 2019, HM Government formed a joint taskforce with UK regulators, including the PRA, to consider the most effective way to approach disclosure, including exploring the appropriateness of mandatory reporting. In line with expectations for industry, the Bank of England committed to disclosing how financial risks from climate change are managed across the Bank.⁵
- We established the UK Climate Financial Risk Forum (CFRF), co-chaired with the FCA, to develop practical tools and approaches to address climate-related financial risks. The forum brings together industry participants and regulators, and focuses on four work streams — risk management, scenario analysis, disclosure and innovation. In this reporting period we held three forum meetings and published their minutes and key points of discussion on our website.⁶

1 Speech by Sarah Breeden 'Avoiding the storm: Climate change and the financial system', April 2019: www.bankofengland.co.uk/speech/2019/sarah-breeden-omfif.

2 SS3/19 'Enhancing banks' and insurers' approaches to managing the financial risks from climate change', April 2019: www.bankofengland.co.uk/prudential-regulation/publication/2019/enhancing-banks-and-insurers-approaches-to-managing-the-financial-risks-from-climate-change-ss.

3 www.bankofengland.co.uk/paper/2019/biennial-exploratory-scenario-climate-change-discussion-paper.

4 www.bankofengland.co.uk/prudential-regulation/letter/2019/insurance-stress-test-2019.

5 April 2019: www.bankofengland.co.uk/news/2019/april/boe-to-disclose-assessment-of-how-it-manages-climate-related-financial-risk.

6 www.bankofengland.co.uk/climate-change/climate-financial-risk-forum.

- In May 2019, as part of a cross-industry working group we published a practitioner’s guide providing a framework for assessing the financial impacts of the physical risks from climate change for general insurers. The guide sets out a six-stage framework that insurers can follow, using existing tools and associated metrics to better assess, manage and report exposure to physical climate risks related to extreme weather events.¹
- Internationally, we are members of the Network for Greening the Financial System (NGFS). In April 2019, this coalition published its first comprehensive report.² The six recommendations in the report provided all central banks, supervisors and the financial community, as well as other policymakers, with deliverable goals that will help ensure a smooth transition to a low-carbon economy. The macrofinancial workstream of the NGFS, chaired by Sarah Breenen (Executive Director for UK Deposit-takers Supervision at the PRA and sponsor for the Bank’s work on climate change), published a technical annex³ that presents an overview of modelling approaches to and gaps in assessing the impact of climate change on the macroeconomy and financial stability.
- Over the course of 2019/20 we have been active in our engagement and led or participated in many climate-related meetings, speaking events and workshops with industry, investors, academics, regulators, government, and other authorities to share knowledge and build expertise.

1 www.bankofengland.co.uk/prudential-regulation/publication/2019/a-framework-for-assessing-financial-impacts-of-physical-climate-change.

2 www.ngfs.net/en/first-comprehensive-report-call-action.

3 www.ngfs.net/en/technical-supplement-first-ngfs-comprehensive-report.



Ensure that firms are adequately capitalised, and have sufficient liquidity, for the risks they are running or planning to take

Our objective to promote the safety and soundness of PRA-authorised firms is delivered in part through ensuring that firms have adequate financial resources for the risks they are running or planning to take. We assess the financial resilience of firms through our supervision at firm and sector level, and use stress testing to examine how firms cope with severe economic scenarios.

Banking

System-wide stress testing, thematic cross-firm reviews, continuous assessment meetings, scrutiny of regulatory returns and other data, and an assessment of where 'Pillar 1' capital requirements do not adequately capture risk remained core parts of our work to ensure firms are adequately capitalised and have sufficient liquidity.

For the liquidity framework, we focused on a number of areas to ensure firms have sufficient liquidity:

- In February 2018 we published the PRA110 liquidity reporting template (PRA110) and associated reporting instructions in Policy Statement (PS) 2/18 'Pillar 2 liquidity'.¹ In July 2019, PRA110 was implemented and the dual reporting period with FSA047 and FSA048 began.²
- Following a review of the feedback received, we considered that updates to the template and reporting instructions were needed. In June 2019, we published updates to the framework relevant to UK banks, building societies, PRA-designated investment firms, and non-EU EEA banks (effective from 1 January 2020).³
- In September 2019 we published CP24/19,⁴ which proposed new, enhanced expectations relating to firms' management of the prudential risks associated with asset encumbrance, in response to a recommendation in the Independent Review of the Prudential Supervision of The Co-operative Bank Plc (Zelmer review).⁵ CP24/19 set out what we consider those risks to be, namely that a lack of good quality unencumbered assets can impair the ability of firms to raise liquidity resources in a stress, and may cause creditors in normal times to consider the firm to be generally less resilient to stress. We proposed in that consultation that firms should demonstrate to the PRA that they understand and are managing those risks appropriately.
- In October 2019 we published CP27/19,⁶ which proposed to align the 'PRA's Approach to Supervising Liquidity Funding Risks' set out in Supervisory Statement (SS) 24/15 to the new Bank of England Market Operation's Guide (BEMOG). CP27/19 was published alongside the BEMOG.

¹ www.bankofengland.co.uk/prudential-regulation/publication/2016/pillar-2-liquidity.

² www.bankofengland.co.uk/prudential-regulation/regulatory-reporting/regulatory-reporting-banking-sector/banks-building-societies-and-investment-firms#reporting-of-pra110.

³ PS13/19 'Pillar 2 liquidity: Updates to the framework': www.bankofengland.co.uk/prudential-regulation/publication/2019/pillar-2-liquidity-updates-to-the-framework.

⁴ 'Asset encumbrance': www.bankofengland.co.uk/prudential-regulation/publication/2019/asset-encumbrance.

⁵ March 2019: www.bankofengland.co.uk/news/2019/march/independent-review-of-the-supervision-of-the-co-op-bank-published.

⁶ 'Liquidity: The PRA's approach to supervising liquidity and funding risks': www.bankofengland.co.uk/prudential-regulation/publication/2019/liquidity-the-pras-approach-to-supervising-liquidity-and-funding-risks.

For the capital framework, we focused on a number of areas to ensure firms are adequately capitalised:

- In January 2020 we published updates to the Pillar 2 Capital framework.¹ Since we published our approach to setting the PRA buffer,² the Bank's approach to stress testing has evolved. There have been changes to the stress testing hurdle rate and the way microprudential and macroprudential buffers interact. This in turn has implications for the way that the PRA buffer is calculated. The purpose of the policy is to bring greater clarity, consistency and transparency to our capital setting approach. In promoting a greater level of transparency, we seek to promote financial stability and the safety and soundness of PRA-authorised firms, and facilitate more informed and effective capital planning for banks.

We have helped the BCBS reach several milestones. The BCBS agreed on a targeted revision of the treatment of client cleared derivatives for the purposes of the leverage ratio. This revision balances the robustness of the leverage ratio as a non risk-based measure against unsustainable leverage with the G20 mandate to incentivise the central clearing of standardised derivatives. We played a leading role in the assessment, by the Financial Stability Board (FSB) and other standard setting bodies, of firms' incentives to clear.

We played a key role in shaping the BCBS discussion paper on the design of a prudential treatment for crypto-assets, which have the potential to raise financial stability concerns.

Insurance

We continued our focus on ensuring firms hold adequate capital for balance sheet risks arising from complex products and asset exposures. Supervisory teams continue to challenge management to ensure they are setting appropriate risk appetites for Solvency Capital Requirement (SCR) coverage and we reinforced our expectations around how senior management and boards should engage with a firm's Solvency II internal model.³ We closely monitored firms to ensure Solvency II internal models (IMs) were robust and adequately calibrated. We remain vigilant against potential model drift, observing divergence between the aggregated SCR of IM firms versus firms using the Solvency II standard formula and setting expectations for firms' modelling.⁴

For general insurers we focused on business plan optimism, reserving and underwriting oversight for specialist general insurer business models. In November 2019, following our first two letters to Chief Actuaries in 2018,⁵ we wrote to firms' Chief Actuaries and CEOs to share insights from our further reviews of firms' reserving during 2019.⁶ This included work on casualty lines for London Market firms, reserving in the UK motor market and a thematic review of case (outstanding claims) reserves in the retail and wholesale markets. Our conclusions were also informed by wider supervisory interactions with firms and other stakeholders, such as Chief Actuaries, Lloyd's and signing actuaries. Some of the key issues to emerge from this included: bias in reserve assessment; weakening

1 PS2/20 'Pillar 2 capital: Updates to the framework': www.bankofengland.co.uk/prudential-regulation/publication/2019/pillar-2-capital-updates-to-the-framework.

2 Statement of Policy 'The PRA's methodologies for setting Pillar 2 capital', January 2020: www.bankofengland.co.uk/prudential-regulation/publication/2015/the-pras-methodologies-for-setting-pillar-2-capital.

3 See David Rule's speech 'Model use and misuse', 14 May 2020: www.bankofengland.co.uk/speech/2019/david-rule-british-insurers-prudential-regulation-seminar.

4 See two letters from Sid Malik — one to Chief Actuaries: www.bankofengland.co.uk/prudential-regulation/letter/2019/observations-from-recent-regulatory-reviews; and one to Chief Risk Officers: www.bankofengland.co.uk/prudential-regulation/letter/2019/proxy-modelling-survey-best-observed-practice.

5 www.bankofengland.co.uk/prudential-regulation/letter/2018/review-of-actuarial-function-reports-in-general-insurance-firms and www.bankofengland.co.uk/prudential-regulation/letter/2018/joining-the-dots-the-actuarial-function-underwriting-capital-and-reserving.

6 www.bankofengland.co.uk/prudential-regulation/letter/2019/letter-from-gareth-truran-pra-current-areas-of-focus-for-general-insurance-firms and www.bankofengland.co.uk/prudential-regulation/letter/2019/letter-from-james-orr-feedback-from-recent-pra-reserving-reviews.

of case reserving basis; inadequate claims inflation allowance; attritional loss deterioration; and transparency over key judgements and assumptions in management information. We asked firms to make explicit reference to how they have considered the findings in their 2019 year-end reserving exercises and associated actuarial reports.

We also continued to support the development of international regulatory standards. In November 2019, the International Association of Insurance Supervision (IAIS) adopted a comprehensive supervisory framework that will enable cross-border supervision of Internationally Active Insurance Groups (IAIGs), as well as evolve the oversight of systemic risk in insurance and further the international common language for insurance groups' capital.¹ We engaged with a number of the IAIS committees and working groups involved in developing this framework, and provided leadership and active engagement across all the workstreams.

Stress testing

For the banking sector, we supported the Bank's 2019 annual cyclical scenario (ACS) stress test, the results of which were published on 16 December 2019.² The test showed that the UK banking system is resilient to deep simultaneous recessions in the UK and global economies that are more severe overall than the global financial crisis, combined with large falls in asset prices and a separate stress of misconduct costs. The UK banking system would therefore be able to continue to meet credit demand from UK households and businesses even in the unlikely event of these highly adverse conditions. At the point in the test where banks' common equity Tier 1 capital ratios were lowest, they would still, in aggregate, be more than twice their pre-crisis level.

Over the past year, we also undertook a review of 20 non-systemic deposit-taking firms with different business models and activities, most of which exhibited faster asset growth than the market as a whole ('fast growing firms' or 'FGFs'). The review aimed to test the financial resilience of FGFs and enhance our knowledge of the funding and lending markets in which they operate. It comprised three elements: Internal Capital Adequacy Assessment Process (ICAAP) stress testing, based on the Bank of England's published 2018 stress scenario; asset quality reviews; and funding and lending analysis. In June 2019 we published our findings.³ The review provided some reassurance about the resilience of the sector while also identifying some weaknesses in individual FGFs' risk management practices which require attention.

We also supported the biennial exploratory scenario (BES) exercises. The 2019 BES was designed to explore the implications of a severe and broad-based liquidity stress affecting major UK banks simultaneously and consider how the reactions of banks and authorities to the stress would shape its impact on the broader financial system and the UK economy.

The Bank issued a discussion paper in December 2019 to consult relevant stakeholders on the design of the 2021 BES exercise on climate change. This included financial firms, climate scientists, economists, other industry experts, and informed stakeholder groups.

1 <https://iaisweb.org/page/news/press-releases-prior-to-2014//file/87183/media-release-iais-adopts-first-global-frameworks-for-supervision-of-internationally-active-insurance-groups-and-mitigation-of-systemic-risk-in-the-insurance-sector>.

2 www.bankofengland.co.uk/financial-stability-report/2019/december-2019.

3 Letter from Melanie Beaman, 'Review and findings: Fast growing firms': www.bankofengland.co.uk/prudential-regulation/letter/2019/review-and-findings-fast-growing-firms.

For the insurance sector, in June 2019 we launched our biennial insurance stress test asking the largest regulated life and general insurers to provide information about the impact of a range of stress tests on their business. At a sector level, this exercise allows us to assess market resilience and to be better prepared in the event similar scenarios were to occur. At a firm level, the Insurance Stress Test 2019 informs our view of a firm's risk management systems — it is not used to set capital requirements.

In addition, the stress test included an exploratory exercise in relation to cyber underwriting and climate change. The set of climate scenarios explored the impacts to both firms' liabilities and investments stemming from physical and transition risks.

Asset quality and liquidity

Insurance

The Prudent Person Principle (PPP) under Solvency II replaced the prescriptive asset admissibility requirements and quantitative investment limits that applied to insurance undertakings under the Solvency I regime.

Since the introduction of Solvency II, we observed through our supervision inconsistencies in the way the PPP is understood and applied by different firms. In September 2019, we consulted on proposed expectations for how insurers meet the standard set by the PPP.¹ Our draft SS clarified that, when applied to a particular firm's circumstances, the standards set by the PPP are likely to allow for a range of reasonable investment strategies. However, a firm should also consider more than just whether it has prudently invested its portfolio. We would exercise our independent judgement and expect insurers to take action where we judge that the PPP's standards are not being met. The draft SS also identifies some key issues for firms to consider when managing investment risk, and to which we pay close attention in the conduct of our supervision. It is, however, not intended to be an exhaustive guide to investment risk management as investment risks are unique to each individual insurer and group.

As part of our asset deep dives and investment governance reviews we asked insurance firms to provide evidence of their interpretation and implementation of the PPP. We also included the PPP considerations in the scope of a section 166 review for a firm.

In September 2019, we also consulted on proposed expectations in respect of firms' modelling of income producing real estate (IPRE) loans within their Solvency II internal models and in respect of the use of internal credit assessments for assigning fundamental spreads for illiquid, unrated assets.

We also reviewed insurance firms' internal rating frameworks and asked for the reviews of such frameworks by independent experts appointed under section 166 or by the firms.

We also published final policy on our expectations on insurers' approaches to managing liquidity risk. We drew on recent engagements with stakeholders in the insurance sector and our regulatory experience, including through reviews of Own Risk and Solvency Assessment (ORSA) reports and liquidity risk reviews of PRA-authorised firms, to identify some key issues for insurers to consider when managing liquidity risk, and to which we pay close attention in the conduct of our supervision. The final policy is not intended to be an exhaustive guide to liquidity risk management. An insurer is expected to understand the liquidity risk it faces and to apply the guidance proportionately, in light of the scale, nature and complexity of its activities.

¹ CP22/19 'Solvency II: Prudent Person Principle': www.bankofengland.co.uk/prudential-regulation/publication/2019/solvency-ii-prudent-person-principle.

We also continued our work on our expectations in respect of insurers investing in ERM portfolios. In particular, we have developed guidance on how the Effective Value Test (EVT) diagnostic tool can be used to monitor compliance with Solvency II requirements as economic conditions change, and how firms should allow for this when setting capital requirements for these investments.

Banking

For the banking sector, credit risk remains a dominant risk. Over 2019/20 we continued to assess credit risk and asset quality in PRA-authorized banks using:

- supervisory tools such as continuous assessment (meetings and regulatory returns data reviews), written auditor reports, and interactions with auditors;
- specialist-led reviews including assessments of firms' credit risk management, provision coverage, and asset quality;
- thematic reviews, combining financial stability and risk specialist resources to provide both micro and macro impact assessments for particular asset classes and sectors;
- annual stress testing under the new IFRS 9 accounting standard for the reporting of expected credit losses; and
- reviews of firms' ICAAPs.

Reviews were undertaken either by asset class (eg mid-market and small and medium-sized enterprises (SMEs), corporate, or owner-occupied mortgages) or by risk lifecycle stage. The reviews were conducted on a risk-based approach across domestic and international banks and building societies. Work has also been undertaken to assess firms' preparedness for EU withdrawal with respect to credit risk. For non-systemic firms a thematic review was conducted for FGFs to assess whether firms' governance and risk management capabilities were keeping in step with business growth.

For retail assets, having completed a consumer credit review at the start of this period, the focus moved to assessing UK mortgage asset quality across the largest UK banks. For corporate assets, thematic reviews were undertaken in respect of the UK SME and mid-corporate portfolios of the larger UK firms. Leveraged lending was also a focus of reviews. In respect of the international exposures of our regulated firms, we have undertaken reviews of US and Asian retail and corporate portfolios. For non-systemic firms a thematic review also commenced on the assessment of IFRS 9 provisions relative to asset quality. In addition to the reviews, our CEO/Chairs conference for non-systemic firms is used to share our thematic findings, and provide learnings and good industry practice.

Traded risk

Our approach to the supervision of banks' trading activities was broadly similar to that for credit risk. Over 2019/20 we continued to assess market risk, counterparty credit risk, and valuation risk in PRA-authorized banks, with our thematic reviews covering a range of topics including intraday risk management, emerging markets counterparty risk management, trading control reviews, credit risk mitigation techniques, autocallables, and model risk management. In addition, over 2019 we reviewed the risk management frameworks, processes and controls of significant London branches of European investment banks and have since been involved in monitoring any resulting remediation work.

We have continued to maintain a regular dialogue with firms on the implementation of new market risk capital requirements, the Fundamental Review of the Trading Book (FRTB). FRTB is significant for banks, particularly in relation to the internal models approach (where banks calculate requirements using their own models, subject to regulatory approval). Early engagement allowed us to develop an understanding of banks' intended modelling approaches.

International Financial Reporting Standard (IFRS) 9

Firms have now been applying IFRS 9 for two years. We continue to work closely with firms and their auditors to understand their approaches to expected credit loss (ECL) and the implications of those approaches for banks' capital ratios, and to encourage greater consistency of outcomes and high quality disclosures about ECL.

Under IFRS 9, banks provide for some or all ECL on all loans. The earlier recognition of losses under IFRS 9 compared to the previous accounting standard should enhance transparency and market confidence in measures of banks' capital positions, including in a downturn, thereby promoting the safety and soundness of individual firms, and so financial stability.

In October 2019, following a review of written auditor reports¹ received in 2019, we wrote to firms to give thematic feedback for the 2018/19 reporting period, which centred on ECL.² We had previously emphasised the importance of ECL being implemented well and in ways that achieve as much consistency of outcomes as is practicable.³ We were pleased to see that firms are continuing to evolve their ECL methodologies, enhance their models and develop the control and governance structures surrounding those models. We decided it would also be helpful to set out our views on practices that would contribute to a high quality and more consistent implementation of ECL.

We, the FCA, and the Financial Reporting Council are sponsoring the work of the Taskforce on Disclosures about Expected Credit Loss (Taskforce). The Taskforce involves preparers and market participants working together to try to reach a consensus on what good ECL disclosure looks like. The Taskforce's second report was published in December 2019.⁴ It focuses mainly on: disclosures that help users understand the types and the extent of credit risk exposure a bank has and how that risk has evolved; the forward-looking information about macroeconomic conditions used in estimating ECL; and the sensitivity of ECL provisions to different macroeconomic conditions.

We continued to work on the impact of the implementation of IFRS 9 on banks' capital positions. In the 2018 and 2019 ACS tests, the Bank adopted an approach to adjusting stress-test hurdle rates to take account of IFRS 9. The Bank is considering options for a more enduring treatment of IFRS 9.

1 Written auditor reporting involves the PRA developing a set of questions each year that external auditors of major UK banks answer in writing at the end of their audit. Our questions give auditors insights into regulatory concerns that may be relevant to their audit work. Auditors' responses help us to make more effective use of the work auditors do in areas that are of interest to supervisors.

2 www.bankofengland.co.uk/prudential-regulation/letter/2019/written-auditor-reporting-thematic-feedback-from-the-2018-2019-reporting-period.

3 Letter from Victoria Saporta 'Written auditor reporting — update and main thematic findings', October 2019: www.bankofengland.co.uk/prudential-regulation/letter/2019/written-auditor-reporting-update-and-main-thematic-findings; letter from Sam Woods 'Implementation of IFRS 9 Financial Instruments', November 2016: www.bankofengland.co.uk/prudential-regulation/letter/2016/letter-from-sam-woods-implementation-of-ifrs-9-financial-instruments; and letter from Sam Woods 'IFRS 9 Financial Instruments', August 2017: www.bankofengland.co.uk/prudential-regulation/letter/2017/letter-from-sam-woods-ifrs-9-financial-instruments.

4 [www.frc.org.uk/news/december-2019-\(1\)/taskforce-on-disclosures-about-expected-credit-los](http://www.frc.org.uk/news/december-2019-(1)/taskforce-on-disclosures-about-expected-credit-los).



Develop our supervision of operational resilience in order to mitigate the risk of disruption to the provision of important economic functions

A key priority for the Bank, PRA and FCA is to put in place a stronger regulatory framework to promote operational resilience of firms and financial market infrastructures (FMIs).¹ Given the increased reliance of firms on technology, operational resilience is vital. The growth of cyber-threats has shown us that firms may well be unable to provide the business services we all depend on for prolonged periods without they themselves being at risk of failing.²

Defining and shaping policy

In December 2019, we published co-ordinated CPs with the Bank and the FCA.³ These build on the concepts set out in the operational resilience Discussion Paper we published in 2018 and address many of the proposed policy changes based on the responses we received. The policy proposals make it clear that firms (banks, building societies, PRA-designated investment firms, UK Solvency II firms and the Society of Lloyd's and its managing agents) and FMIs are expected to take ownership of their operational resilience and to prioritise plans and investment choices based on their impacts on the public interest. If disruption occurs, firms are expected to communicate clearly by, for example, providing customers with advice about alternative means of accessing services.

Under the proposals we set out, firms and FMIs would be expected to:

- **identify their important business services** that if disrupted could cause harm to consumers or market integrity, threaten the viability of firms or cause instability in the financial system;
- **set impact tolerances** for each important business service, which quantify the maximum level of disruption they could tolerate;
- **identify and document** the people, processes, technology, facilities and information that support their important business services; and
- **take actions to be able to remain within their impact tolerances** through a range of severe but plausible disruption scenarios.

1 Press release 'Building operational resilience: impact tolerances for important business services', December 2019: www.bankofengland.co.uk/news/2019/december/building-operational-resilience-impact-tolerances-for-import-business-services.

2 Speech by Nick Strange 'Operational resilience — a progress report', May 2019: www.bankofengland.co.uk/speech/2019/nick-strange-operational-risk-europe-conference.

3 On 20 March 2020 the consultation period for these CPs was extended to 1 October 2020 as part of prudential policy measures to address the challenges of Covid-19: www.bankofengland.co.uk/news/2020/march/boe-announces-supervisory-and-prudential-policy-measures-to-address-the-challenges-of-covid-19.

For the PRA CP,¹ the proposals aim to address risks to operational resilience including those arising from the interconnectedness of the financial system, and the complex and dynamic environment in which firms operate. We consider that there is a need for a proportionate minimum standard of operational resilience that incentivises firms to prepare for disruptions and to invest where it is needed.

Outsourcing and third-party risk management

In December 2019, alongside the consultations on operational resilience, we also consulted on our proposals for modernising the regulatory framework on outsourcing and third-party risk management.² These proposals complement those on operational resilience and aim to facilitate greater resilience and adoption of the cloud and other new technologies, as set out in the Bank's response to the 'Future of Finance' report.³ The proposals also aim to align our supervisory approach with that of the European Banking Authority (EBA) and EIOPA.

The consultation aims to improve regulatory certainty in a number of areas of increasing importance to our objectives. For instance, it addresses how firms should:

- assess the materiality and risks of outsourcing arrangements and perform vendor due diligence;
- manage intragroup outsourcing arrangements;
- protect data outsourced to/shared with third parties such as Cloud service providers; and
- develop, document and test business continuity plans and exit strategies for their most important outsourcing arrangements to improve their ability to withstand and recover from a failure or major disruption at a service provider.

CBEST, SIMEX18 and operational resilience reviews

CBEST is a joint PRA and FCA framework for assessing the cyber resilience of firms' critical business functions through threat intelligence-led penetration testing. The PRA conducts assessments on a three-year cycle. In 2019, we initiated nine CBEST threat-intelligence led penetration tests and completed a further three initiated in 2018.

In November 2018, we tested our response to a sustained and widespread operational disruption resulting from a prolonged and broad cyber-attack. The outcomes and high-level findings of the 2018 sector-wide exercise (SIMEX18) were published in September 2019.⁴ Our key findings and recommendations included:

- **Opportunities to improve the way firms co-ordinate.** While participants agreed that impacts and responses were co-ordinated and discussed effectively at the strategic level, improvements could be made at an operational level. To address this, a review of the sector response framework will be undertaken to ensure that the sector can communicate and co-ordinate at an operational level during a crisis.

1 CP29/19 'Operational resilience: Impact tolerances for important business services', December 2019: www.bankofengland.co.uk/prudential-regulation/publication/2018/building-the-uk-financial-sectors-operational-resilience-discussion-paper.

2 CP30/19 'Outsourcing and third party risk management', December 2019: www.bankofengland.co.uk/prudential-regulation/publication/2019/outsourcing-and-third-party-risk-management.

3 June 2019; www.bankofengland.co.uk/report/2019/future-of-finance.

4 The Sector Simulation Exercise (SIMEX) is a live simulation day which takes place in real time and participants are also asked to complete an additional 'slow time' post exercise activity. Last year we chose a prolonged and broad cyber-attack as the basis for the exercise. For more information see: www.bankofengland.co.uk/report/2019/sector-simulation-exercise-simex-2018-report.

- **Disparity in risk tolerance for suspending services.** It is recognised that these differences may have significant knock-on effects to the market and real economy as a whole. Future work will focus on the production of industry guidelines and good practice for managing potential controlled suspension of services and system integrity risks.
- **Restoring data and recovering service.** Currently the ability of participants to support another operationally paralysed bank is constrained by the different ways in which data is stored. To improve response capability, work will be undertaken to scope the technical, and data requirements for providing services through alternative channels.
- **Communication practices.** The exercise demonstrated that use of UK Finance's incident management communications framework and co-ordination has significantly improved collective communications, with public lines developed in under an hour.

We are now in the process of developing several follow-up workstreams in partnership with industry.

Cyber stress testing

In June 2017, the FPC had set out the elements of the framework of regulation to strengthen the resilience of the UK financial system to cyber-risk: (i) clear baseline expectations for firms' resilience that reflected the importance of firms and the services they provide for the financial system; (ii) regular testing by firms and supervisors to ensure that resilience kept pace with the evolving nature of the risk; (iii) identification of firms that were outside the financial regulatory perimeter, but which might be important for regulated firms; and (iv) clear and tested arrangements to respond to cyber-incidents when they occurred.

The FPC agreed that as part of establishing clear baseline expectations for firms' resilience, it would set tolerances for how quickly critical financial companies must be able to restore vital financial services following a severe but plausible cyber-incident, and the Bank would use regular cyber stress tests to test firms' ability to meet these 'impact tolerances' in severe but plausible scenarios. The FPC launched a pilot cyber stress test in 2019 and we have been supporting this work.

Supervision of operational risk and resilience

Our approach to the supervision of banks' operational risk and resilience continued to assess the effectiveness of the operational risk management framework including service availability and business continuity management. Over 2019/20, we focused on firms' cyber resilience and on key areas of change including the increasing use of third-party services, adoption of Cloud services and the governance and delivery of significant IT and operational changes and firms.

More specifically, supervision work on operational risk and resilience included:

- Developing a cyber questionnaire (CQUEST) jointly with the FCA, and its pilot deployment across six banks and seven insurers.
- Engaging with firms through continuous assessment meetings to explore operational resilience through topics including governance, strategy, risk management, change, and third-party dependencies, and assessing firms' abilities to manage such changes. Reviews have included work looking at the governance and execution of IT change.

-
- Reviewing new EU bank branch readiness for authorisation, including reviews of outsourcing frameworks and IT governance and frameworks.
 - A high-level thematic review across a number of firms to assess disaster recovery and business continuity planning.
 - Assessing compliance with the EBA's Guidelines on Information and Communication Technology Risk Assessment under the supervisory review and evaluation process (ICT SREP).
 - Engaging in the Basel Committee on Banking Standards' work to enhance banks' operational resilience, including a review of existing Committee documents, with a view to publishing an updated set of guidance/standards.
 - Fostering engagement with the financial sector on operational resilience through roundtable discussions with representatives of the financial services industry, advisory and legal firms, and industry bodies.
 - Monitoring firms' remediation and resolution of major IT incidents, including the post-incident restoration of a major organisation-wide IT systems and operations incident.
 - A detailed review of firms' use of Cloud technology, assessing the scale and nature of current and planned outsourcing activity. We also reviewed a number of specific Cloud outsourcing notifications from firms, and continued to monitor developments across the industry.



Ensure that banks and insurers have credible plans and capabilities in place to enable them to recover from financial stress events, and that we support the Bank as resolution authority to have a credible resolution strategy to manage a firm's failure in an orderly manner

The UK established a framework for resolution (known as the 'resolution regime') in the Banking Act 2009. The PRA works closely with the Bank to ensure firms are safe and sound.

In June 2019, the final elements of our policy on our expectations of firms to undertake recovery planning came into effect.¹

Resolvability Assessment Framework (RAF)

In July 2019, we implemented the RAF in conjunction with the Bank. The RAF is designed to make resolution more transparent, better understood, and more successful. It builds on the work done since the financial crisis, which aims to ensure that firms are, and are able to demonstrate that they are, resolvable. In addition to the Bank's PS on its approach to assessing resolvability, the RAF includes a:

- new Resolution Assessment Part of the PRA Rulebook. This requires the major UK firms to perform an assessment of their preparations for resolution, to identify any risks to successful resolution, and to put plans in place to address them. In addition, firms must submit a report of that assessment and publish a summary of their most recent report (public disclosure);² and
- PRA SS, which sets out the PRA's expectations on how firms should comply with the new Part of the PRA Rulebook and sets out the PRA's expectations regarding the importance of senior management accountability within firms.³

Solvent wind-down programme

We continued our work with the major UK and international banks with significant trading and derivatives portfolios to ensure firms develop capabilities to wind down their trading and derivatives businesses in an orderly manner in co-operation with international regulators and Resolution Authorities.

1 SS9/17 'Recovery planning', December 2017: www.bankofengland.co.uk/prudential-regulation/publication/2017/recovery-planning-ss.

2 PS15/19 'Resolution assessment and public disclosure by firms', July 2019: www.bankofengland.co.uk/prudential-regulation/publication/2018/resolution-assessment-and-public-disclosure-by-firms.

3 SS4/19 'Resolution assessment and public disclosure by firms', July 2019: www.bankofengland.co.uk/prudential-regulation/publication/2019/resolution-assessment-and-public-disclosure-by-firms-ss.



Facilitate effective competition by actively considering the proportionality of our approach as it contributes to the safety and soundness of the UK financial system

Our secondary competition objective (SCO) states that 'when discharging its general functions in a way that advances its objectives, the PRA must so far as is reasonably possible act in a way which facilitates effective competition in the markets for services provided by PRA-authorised persons in carrying on regulated activities'.¹

In October 2019, we proposed changes to the capital requirements that apply to credit unions.² As set out by Sam Woods in his October 2019 speech,³ the effect of the proposed changes should be to reduce overall capital requirements for the credit union sector by roughly one quarter, and encourage the growth of successful credit unions thus helping to facilitate effective competition.

We also focused on work to aid the development of the UK insurance linked securities market, and facilitate effective competition as participants can more readily understand the requirements/standards relevant to UK insurance special purpose vehicles (ISPVs).

For more information on how we are meeting our objective to facilitate effective competition, please read the Annual Competition Report (pages 47–57).

1 Section 2H of FSMA.

2 CP28/19 'Credit unions: Review of the capital regime', March 2020: www.bankofengland.co.uk/prudential-regulation/publication/2019/credit-unions-review-of-the-capital-regime.

3 'Credit union meets robot', October 2019: www.bankofengland.co.uk/speech/2019/sam-woods-speech-at-mansion-house-london.



Deliver a smooth transition to a sustainable and resilient UK financial regulatory framework following the UK's exit from the EU

The UK's withdrawal from the EU has significant implications for the way we discharge our responsibilities, and it continued to be a significant focus of our work over the past year. A core priority was to reduce risks and minimise disruption that could have occurred in the event that the UK and EU had not reached a withdrawal agreement, and the UK had exited the EU with no deal during 2019 or on 31 January 2020. We made preparations to nationalise the Acquis — the full body of EU legislation — so that the UK will have a functioning regulatory framework once EU law no longer applies. We also put in place temporary regimes so that EEA firms currently operating in the UK using the EU passport could continue to do so for a period after exit. This work and more will continue during the transition period, as outlined in more detail in the following sections.

Monitoring and mitigating risks

We supported the FPC in identifying, monitoring, and mitigating financial stability risks arising from the UK's withdrawal from the EU. A key priority was to ensure continuity of cross-border financial services, in the event that the UK left the EU without a withdrawal agreement. With the passage of the Withdrawal Agreement in January 2020, and the start of the transition period, our focus has shifted to ensuring continuity in the event that the transition period ends without arrangements that facilitate the provision of cross-border financial services.

Regulatory framework — nationalising the Acquis of EU law

We have worked closely with HM Treasury and other regulatory authorities (including the FCA) to ensure that the domestic regulatory framework for PRA-licensed firms is fully functional at the point at which EU law ceases to apply in the UK. This has included working with HM Treasury to develop necessary amendments to legislation, which have so far resulted in over 50 statutory instruments being made.

Authorisation

Preparations for the UK's withdrawal from the EU have continued in relation to authorisations of firms currently using the EEA financial sector passport to operate in the UK. Under the Temporary Permissions Regime, EEA firms that have been passporting into the UK are able to continue to operate in the UK if they submitted a notification or an application for authorisation to the relevant regulators.

Supervisory co-operation

Regardless of the UK's future relationship with the EU and given the openness of the UK financial system, it is important for the UK and EU regulators to maintain effective supervisory co-operation. This enables authorities to identify and manage risks to our objectives. We have continued to work with EU authorities to secure co-operation and information sharing agreements so that we can continue to carry out our supervisory responsibilities in an effective and efficient way after the end of the transition period.

The future financial services relationship

The future financial services relationship between the UK and the EU is for governments to decide following negotiations. The Bank continued to provide technical support to the Government as requested over the 2019/20 period, in accordance with its statutory objectives and those of the PRA.



Operate effectively by ensuring that resources are allocated to work that best advances our strategy and reduces the greatest risks to the delivery of our strategic objectives

Embedding the plan for PRA technology

In line with the implementation of our regulatory change agenda, we have continued to make incremental improvements to data storage and analytics to support our assessment of firms' safety and soundness. This has included the implementation of new tools that allow us to build reports with more in-depth and visual representations of data — for example, the PRA Data Innovation team has developed a number of new analytical tools to monitor new securitisation activities and encourage *ad hoc* peer analysis across firms with related but idiosyncratic business models.

Building on our work over the recent years to implement a more consistent approach to new regulatory reporting requirements, we have also collaborated with other areas of the Bank on our RegTech strategy, which aims to identify improvements to our ways of working and make good use of new and available technology. Some of this work was recognised at the Central Banking Fintech and Regtech Global Awards in 2019, where the PRA's Data Innovation team received the TechForward Award for its innovative application of artificial intelligence (AI) technology to improve its processing and analysis of the large volumes of unstructured data it receives from regulated firms.

In 2019/20 we mobilised a project to explore the value and feasibility of making the PRA's Rulebook machine-readable over the next three to five years.

Risks to the delivery of the PRA Business Plan, unforeseen events and execution risk

We have continued to develop our risk management framework through 2019/20. One aspect of this is our approach to operational risk management, which is a part of the Bank's wider risk framework, where we have strengthened our processes to identify risks that are relevant to the PRA as a whole and to develop better risk mitigation strategies. We have also improved our business planning to take full account of, and inform, those risks. We have also worked to improve the quality of identification, reporting and mitigation of external risks to our objectives. This information, taken alongside the data we collect on our assessment of the risks within individual firms, give us a better overall view of our risk universe enabling management and PRC to take a more holistic view of our mitigation strategy and controls.

Internal factors

In support of the Bank's target to maintain a flat nominal budget for 2019/20, the PRA's senior management team conducted an extensive exercise to consider how best to allocate our resources to deliver our eight strategic goals. In order to deliver our objectives within flat controllable costs we have focused recruitment activity on specialist skill sets and restricted all non-essential travel and training, focusing instead on developing our internal training framework. We incorporated sufficient flexibility in our resource planning to adapt to changes in both the internal and external environment, and as a result, have been able to deprioritise, streamline or delay work as appropriate to deliver our regulatory and supervisory obligations.

Measuring progress

In 2019/20, we continued to draw on a variety of information to monitor the progress of delivery against our statutory objectives, strategy and business plan on an ongoing basis.

The PRC and the Supervisory Risk and Policy Committee (SRPC) regularly received information on both quantitative and qualitative measures and indicators, to make an assessment of delivery against the PRA's strategy, business plan, statutory objectives, and risk tolerance. This enables the PRC to report to the Chancellor of the Exchequer on the adequacy of resources and provide sufficient information on supervisory processes and outcomes (see pages 8–9).

FCA: effective regular co-ordination

We have continued to co-ordinate well with the FCA across a wide range of policy, authorisations and supervisory matters. We assess our performance every quarter against the statutory Memorandum of Understanding (MoU). In particular, the PRA and the FCA worked collaboratively on the UK's withdrawal from the EU with open dialogue, ongoing engagement and co-ordination of activity.

There has been positive engagement and co-ordination with the FCA on a number of other supervisory and policy matters of joint interest, notably: climate risk; operational resilience; cyber-risk; SM&CR; remuneration; and financial crime.

We have proactively shared information, where appropriate, with ongoing discussions on replacing shared systems, sharing regulatory data and developing shared principles.

Enforcement also continues to be an area of close collaboration. Joint investigations were conducted in accordance with the MoU and its annexes through regular meetings and scheduled updates (see Box 2 on pages 17–18 for an overview of enforcement activity for 2019/20). Both regulators worked closely on the authorisation of new firms and applications under SM&CR.

We continued to engage with the relevant teams at the FCA to share the outcomes of respective firm feedback surveys, and to embed suggested changes to strengthen the current regulatory landscape.

Firm feedback

We seek input from firms on the effectiveness and quality of our supervisory framework and approach. One of the ways we do this is through the annual firm feedback survey. This process is overseen by a team which is independent of frontline supervision.

The survey gives PRA-authorized firms the chance to comment on a number of topics, including:

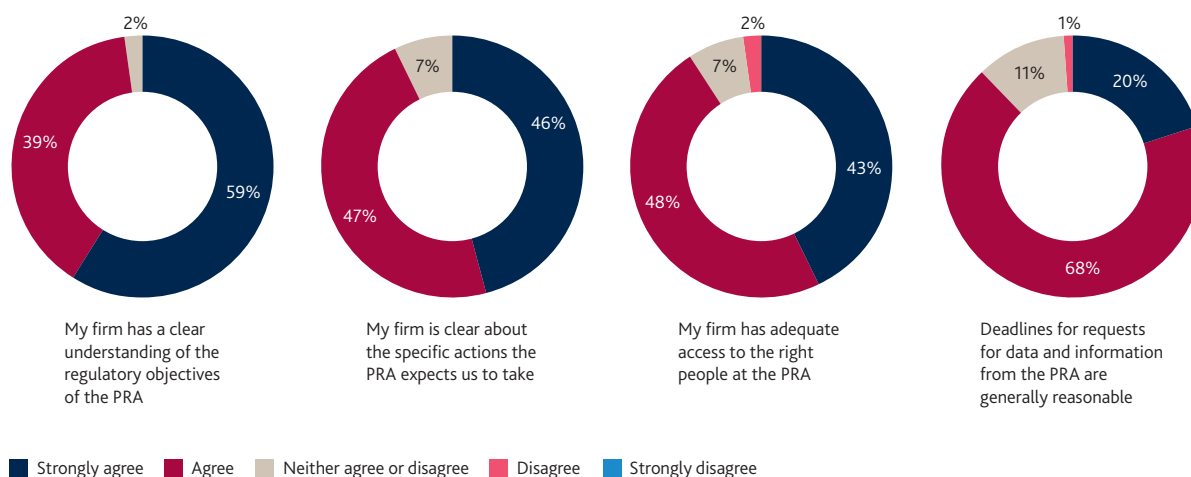
- our understanding of firms;
- the firm's understanding of the PRA's regulatory objectives and expectations;
- the PRA's level of challenge to firms;
- the effectiveness of firms' relationships with us;
- our co-ordination with other regulators on data requests; and
- our approach to new technology (from 2020).

We provide firms with the opportunity to make additional comments and ask for improvements we could make. It is important that we continue to understand, as the PRA evolves, both what firms think works well, and what we might do differently.

The survey was completed by 207 firms in 2019. We held 29 follow-up meetings with the largest firms, and one roundtable with a sample of small UK banks.

Chart 1 shows a selection of the survey results reflecting the type of issues for which the PRA sought an opinion. The full quantitative results are available on the Bank’s website.¹

Chart 1 Excerpt from firm feedback survey results 2019



Overall, scores this year were positive and consistent with last year. Firms gave the most positive scores for their understanding of the PRA’s objectives and relationships with the PRA.

Responses to questions about co-ordination with other regulators were more mixed, with a higher proportion of neutral scores. We have explored this in our discussions with firms. Some have been positive about the PRA’s work with the FCA and overseas regulators. A number have given a more neutral response, on the basis that the question is not very relevant to their firms.

We have sought to act on the feedback from previous surveys:

- We set up a framework to review data requests and co-ordinated requests where possible to avoid duplication. This has reduced the overall number of requests. We also improved the timeliness of feedback (and been clearer about when we will not give feedback).
- We improved the supervisory handover process to ensure new supervisors are better briefed about firm and live issues. Feedback has been positive about the changes.

¹ The full results are available on the Bank’s website; www.bankofengland.co.uk/prudential-regulation/publication/2019/results-of-the-firm-feedback-survey-2018-19.

- We worked to make the secure email portal more stable for users during an upgrade in 2019.
- Firms expressed concerns about the timeliness of Senior Managers and Certification Regime (SMCR) approvals. (A few firms reported similar issues for model application approvals.) They said it would help to have better information throughout the approval process. Firms also wanted improved co-ordination between the PRA and FCA. We have investigated a number of cases which showed that the quality of applications was the main cause of delays. We worked with the FCA to improve the guidance to firms on the information required for applications to address this.
- Firms fed back that they have difficulties using the Bank of England Electronic Data Submission (BEEDs) portal. The challenges included a short window of time to submit data, password problems, absence of automatic calculation functions, and unclear guidance. We made some improvements to address these problems and will continue to assess the portal's performance going forward.

Box 4: Parliamentary accountability

Our objectives are set by Parliament. We take our duties to Parliament very seriously and representatives of the PRA aim to account for our decisions as transparently and clearly as possible. Owing to the 2019 General Election, we appeared at fewer parliamentary hearings than in previous years.

Sam Woods and Lyndon Nelson appeared on behalf of the PRA at collectively three public hearings with parliamentary committees, including the Treasury Select Committee (TSC) and the Lords' EU Financial Affairs sub-Committee (EUFASC), as follows:

- Financial services post-Brexit, 12 February 2020 (EUFASC).¹
- Bank of England Financial Stability Report, 15 October 2019 (TSC).²
- IT failures in the financial services sector, 24 July 2019 (TSC).³

As well as appearing before Committees, representatives of the PRA correspond with parliamentary committees and members of Parliament regularly to explain more about our work.

1 www.parliament.uk/documents/lords-committees/eu-financial-affairs-subcommittee/financial-services-after-brexit/ucEUFA120220ev3.pdf.

2 <http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/treasury-committee/it-failures-in-the-financial-services-sector/oral/104030.html>.

3 <http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/treasury-committee/bank-of-england-financial-stability-reports/oral/106363.html>.

Box 5: Communications — supporting the PRA's objectives

A vital part of the delivery of our statutory objectives and supervisory approach is the PRA's industry-wide communications. This includes publications, briefings, speeches, and letters to firms and industry participants on both policy and supervisory activity.

In 2019/20 we:

- provided communications to industry to support key initiatives, including preparations for EU withdrawal to ensure a fully functioning legal and regulatory framework for financial services, delivering improvements to our implementation of Solvency II, and developing the microprudential supervisory approach to operational resilience;
- continued to provide updates on dedicated webpages for initiatives such as strengthening accountability, structural reform, Solvency II, CRD IV and stress testing, created a new webpage dedicated to our secondary competition objective, continued to support the Bank in the production of Knowledge Bank articles — dedicated to creating accessible information on the Bank's work to the public, and supported the Bank in the updating of pages on initiatives such as EU withdrawal and climate change;
- published a number of documents across the range of our regulatory and supervisory activities — including policy aligned with other areas of the Bank and the FCA. We also published 13 speeches, 17 letters, and 10 other publications (including Notes, Statements and Reports). Areas covered included the risks posed by cyber and other operational incidents, our work on climate change, Libor, Solvency II-related updates, and updates on our policy to deliver a smooth transition ahead of the UK's withdrawal from the EU;
- continued to issue the monthly PRA Regulatory Digest, which remains one of our most downloaded publications; and
- in addition to the written word, we continued our engagement with firms and other industry participants in a variety of forms. We have hosted briefings on a range of topics, and provided speakers and panellists for a number of events hosted by others, including the FCA, overseas counterparts, and trade and professional bodies.

2019/20 policy publications¹

28

Consultation Papers

25

Policy Statements

15

Supervisory Statements

3

Statements of Policy

¹ www.bankofengland.co.uk/prudential-regulation/policy.

Complying with FSMA

This section covers a number of issues that we take into account when carrying out our duties or other areas that we report on.

These include:

- complying with FSMA;
- complying with the regulators' code and principles;
- our complaints scheme;
- details of how we have used the provisions of section 166 of FSMA; and
- sections 339A and 339B of FSMA relating to firms' auditors.

Complying with FSMA

In carrying out our functions during the reporting period, we were required to, so far as was reasonably possible: (i) act in a way which advances our general objective to promote the safety and soundness of PRA-authorized persons; and (ii) specifically for insurers, act in a way which contributes to the securing of an appropriate degree of protection for those who are or may become policyholders (sections 2B and 2C of FSMA). This report sets out how we have discharged our functions and the extent to which, in our opinion, the objectives have been advanced.

Section 3B of FSMA sets out a number of regulatory principles to which the PRA must have regard (under section 2H(2) of FSMA) in discharging its general functions. These are the:

- (a) need to use resources in discharging our general functions in the most efficient and economic way;
- (b) principle that a burden or restriction which is imposed on a person, or on the carrying on of an activity, should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction;
- (c) desirability of sustainable growth in the economy of the UK in the medium or long term;
- (d) general principle that consumers should take responsibility for their decisions;
- (e) responsibilities of the senior management of persons subject to requirements imposed by or under FSMA, including those affecting consumers, in relation to compliance with those requirements;
- (f) desirability where appropriate of exercising our functions in a way that recognises differences in the nature of, and objectives of, businesses carried on by different persons (including different kinds of persons such as mutual societies and other kinds of business organisations) subject to requirements imposed by or under FSMA;
- (g) desirability in appropriate cases of publishing information relating to persons on whom requirements are imposed by or under FSMA, or requiring such persons to publish information, as a means of contributing to the advancement by the PRA of its objectives; and
- (h) principle that the PRA should exercise its functions as transparently as possible.

We take these principles into consideration when carrying out our functions, including when making policy.

Further, in carrying out our functions during the reporting period, we were required to, so far as was reasonably possible, act in a way which facilitated effective competition in the markets for services provided by PRA-authorized persons in carrying on regulated activities (section 2H(1) of FSMA). There are several examples of how meeting this requirement was achieved in the PRA Annual Competition Report on pages 47–57.

Details of how we have met our general duty to consult (under section 2L of FSMA) and considered any representations made (under section 2N of FSMA) can be found on page 39, which also explains how the PRA engages with firms more generally. These arrangements include the establishment and maintenance of the PRA Practitioner Panel (the Panel) under section 2M of FSMA. The Panel is an independent body representing the interests of practitioners in the financial services industry. It plays an important role in PRA policymaking by providing appropriate challenge and scrutiny. As well as PRA policies, the Panel also considers items from other directorates within the Bank of England whose policies have a potential prudential impact.

In 2019/20, the Panel met six times and provided the PRC and senior management from across the PRA and the Bank with feedback on topics including the evaluation of the SM&CR, the transition from the Libor to alternative risk-free rates, financial risks from climate change, and preparations for our work on the UK withdrawing from the EU. The Panel continued to provide input into policy at different stages of development — from practical insights to implementation, to proposals under consultation, to early stage policy development. After its development in 2018, the Insurance sub-committee met twice during the 2019/20 reporting period. It provided input on insurance-focused topics such as the analysis and monitoring of Life and General Insurers' model drift, and the PRA's expectations relating to the PPP.

The PRA and FCA have a duty to ensure a co-ordinated exercise of functions and to maintain a memorandum of understanding describing how they intend to comply with that duty (under sections 3D and 3E of FSMA respectively). Details of how this has been managed effectively are covered on page 36.

We have the power to require the FCA to refrain from taking certain actions, specified under section 3I of FSMA, or to give a direction to the FCA in relation to with-profits policies (section 3J of FSMA). We did not exercise this power during 2019/20.

Section 354B of FSMA outlines our duty to co-operate with other persons (whether in the UK or elsewhere) who have functions similar to ours, or have functions relevant to financial stability. Details of how we have complied with this duty are throughout this report and in particular on pages 19 and 36.

Regulators' code and principles

In accordance with sections 21 and 22 of the Legislative and Regulatory Reform Act 2006 and the Legislative and Regulatory Reform (Regulatory Functions) Order 2007, the PRA, when exercising its functions, is required to have regard to the following Regulators' Principles and Code.

Regulators' principles

- Regulatory activities should be carried out in a way that is transparent, accountable, proportionate and consistent.
- Regulatory activities should be targeted only at cases in which action is needed.

Regulators' code

- Regulators should carry out their activities in a way that supports those they regulate to comply and grow.
- Regulators should provide simple and straightforward ways to engage with those they regulate and hear their views.
- Regulators should base their regulatory activities on risk.
- Regulators should share information about compliance and risk.
- Regulators should ensure clear information, guidance and advice is available to help those they regulate meet their responsibilities to comply.
- Regulators should ensure that their approach to their regulatory activities is transparent — including publishing on a regular basis, details of their performance against their service standards, including feedback received from those they regulate and data relating to complaints about them. Details of firm feedback are set out on page 36; details of complaints are set out below; and the PRA's statutory performance report is published on our website.¹

PRA's complaint scheme

As part of the statutory Complaints Scheme (under Part 6 of the Financial Services Act 2012), we are responsible for ensuring formal complaints against us are dealt with in an efficient and effective manner. During the reporting period we received eight formal complaints. Four of those complaints were still under investigation at the end of the reporting period. Of the four that were concluded: two were excluded under the scheme as the subject matter was not within the scope of the scheme; one was considered and not upheld; and the remaining complaint was partially upheld. Two of these complaints were referred to the Financial Regulators Complaints Commissioner who was still considering these at the end of the period.² The Commissioner was also considering a joint complaint against the PRA and FCA. Details of the final decisions will be available on the Commissioner's website.³

Section 166 reports by skilled persons

Section 166 (s166) of FSMA provides a regulatory tool which gives us powers to obtain an independent expert review of aspects of a regulated firm's activities. Such reviews can be undertaken where we seek additional information, further analysis, expert advice and recommendations, or assurance around a particular subject. In 2019/20, we used the s166 tool 29 times (2018/19: 17 times). We commissioned six reviews (2018/19: nine) where we contracted directly with the skilled person.

The reviews fell within the areas shown in **Table A**. In 2019/20 there were nine reviews of firms' regulatory reporting under Lot F, of which the majority were commissioned following the Dear CEO letter, dated 31 October 2019, on the reliability of regulatory returns.

¹ www.bankofengland.co.uk/prudential-regulation/authorisations.

² One has subsequently been classified as against the Bank of England. The second has been considered separately by both the PRA and FCA.

³ <https://frccommissioner.org.uk/final-reports/pr-the-prudential-regulation-authority/>.

Table A Section 166 reviews by areas of focus

| Lot ^(a) | Total for 2018/19 | Total for 2019/20 |
|--|-------------------|-------------------|
| Lot B: Governance and individual accountability | 1 | 1 |
| Lot C: Controls and risk management frameworks | 5 | 9 |
| Lot F: Prudential — deposit-takers, recognised clearing houses and PRA-designated investment firms | 4 | 12 |
| Lot G: Prudential — Insurance | 7 | 4 |
| Lot J: Technology and information management | – | 3 |
| Total | 17 | 29 |

(a) A detailed description of the services provided under each lot can be found on the PRA's website; PRA's approach to supervision: www.bankofengland.co.uk/prudential-regulation/publication/2018/pr-a-approach-documents-2018.

The total estimated cost of commissioned s166 reviews in 2019/20 was £16.9 million (2018/19: £4.5 million), of which the cost per review ranged from £86,000 to £2.8 million (2018/19: £84,000 to £499,000).¹ Of this total, the cost of the six reviews where we contracted directly with the skilled persons is estimated to be £1.3 million² (2018/19: nine at a cost of £2.4 million). The estimated cost of the reviews commissioned on regulatory reporting during the year was £7.7 million. The costs disclosed include actual costs incurred by the firms or an estimate where actual costs are not yet available.

Meeting with auditors

Under section 339A(2) of FSMA the PRA is required to issue and maintain a code of practice which includes arrangements on the: (i) sharing with auditors of PRA-authorized persons of information that we are not prevented from disclosing; and (ii) exchange of opinions with auditors of PRA-authorized persons. We published Legacy SS7/13 'The relationship between the auditor and the supervisor: a code of practice' (the Code) in April 2013.³ Section 339B of FSMA states that we must make arrangements for meetings to take place at least once a year with the external auditor of any PRA-authorized person to which section 339C of FSMA applies. 33 firms (2018/19: 34) fell within the scope of section 339B FSMA during the reporting period and we conducted 44 meetings (2018/19: 46) with the auditors of these firms. At least one meeting with the auditor of each such firm was held during the reporting period with the exception that the PRA met with one firm shortly after the end of the PRA reporting period (2 March 2020). We look to auditors to contribute to effective supervision by directly engaging with us in a proactive and constructive way. We also report to the PRC annually on the quality of the relationship between auditors and supervisors. For the period to 28 February 2019, we reported the results of a survey of supervisors to the PRC. A significant majority of those surveyed were satisfied with their auditor-supervisor relationship. The PRA continues to focus on maintaining open and constructive relationships that add value.

¹ The comparative figures have been revised from the figures reported in the PRA Annual Report 2018 to reflect actual costs incurred for reviews that were finalised in 2019/20. Two reviews commissioned in 2018/19 remain ongoing. The reported costs for these reviews remain as estimates.

² Costs of directly contracted s166 reviews include VAT.

³ www.bankofengland.co.uk/prudential-regulation/publication/2013/the-relationship-between-the-external-auditor-and-the-supervisor-a-code-of-practice-ss.

Structural reform

Structural reform (also referred to as ring-fencing) has been in effect since 1 January 2019. Ring-fencing requires UK banking groups with more than £25 billion of core retail deposits to ensure the provision of core services (broadly facilities for accepting core retail deposits, and payments and overdrafts relating to core retail deposit accounts) is separate from certain other activities within their groups, such as investment and international banking.¹ As at 1 January 2020, the following UK banking groups are in scope of ring-fencing and contain at least one ring-fenced body (RFB): Barclays, HSBC, Lloyds Banking Group, Royal Bank of Scotland, Santander UK, TSB and Virgin Money.²

Our activity relating to ring-fencing advances our general safety and soundness objective which requires us to discharge our functions in a way that seeks (among other things) to:

- (i) ensure that the business of RFBs is carried on in a way that avoids any adverse effect on the continuity of the provision in the UK of core services;
- (ii) ensure that the business of RFBs is protected from risks (arising in the UK or elsewhere) that could adversely affect the continuity of the provision in the UK of core services; and
- (iii) minimise the risk that the failure of an RFB, or of a member of an RFB's group, could affect the continuity of the provision in the UK of core services.

Schedule 1ZB of FSMA requires us to report in our Annual Report in general terms on certain aspects of ring-fencing including: the extent to which RFBs have complied with ring-fencing provisions in legislation and PRA rules; the steps taken by RFBs to comply with ring-fencing provisions; the steps we have taken to enforce ring-fencing provisions; the extent to which RFBs are undertaking activities that would be excluded or prohibited but for an exception in the legislation; and the extent to which RFBs appear to have acted in accordance with our guidance relating to ring-fencing provisions. Our Annual Report for the period 1 March 2018 to 28 February 2019 was the first to include this information.

The legislation specifies the activities that must be conducted by RFBs, as well as the activities RFBs are prohibited from undertaking. Any activities falling outside those two categories — for example taking deposits from large corporates, or mortgage and credit card lending — can be carried out from either side of the ring-fence ('permitted business'). Banking groups chose to structure their groups in different ways, reflecting their current operations and preferred business strategies. As a result, some groups have placed almost all permitted business within the ring-fence, while some others have chosen to locate significant proportions of their permitted business outside of the ring-fence. Over the previous year, the structure of most firms' RFB subgroups have remained substantially the same, with only minor changes for some firms.³ Firms have generally complied with our group structure policy set out in SS8/16 and we have not identified any concerns.⁴

1 The requirement for large UK banking groups to ring-fence their core services by 2019 is set out in FSMA 2000 (as amended by the Financial Services (Banking Reform) Act 2013).

2 Key information and materials relating to ring-fencing, including the list of RFBs, is available on our dedicated webpage: www.bankofengland.co.uk/prudential-regulation/key-initiatives/structural-reform.

3 In September 2019, CYBG plc was renamed Virgin Money UK plc. This did not result in any changes to the composition of the ring-fenced subgroup.

4 'Ring-fenced bodies (RFBs)', December 2017: www.bankofengland.co.uk/prudential-regulation/publication/2016/ring-fenced-bodies-ss.

Our focus in the 2019/20 reporting period has been on ensuring the ring-fencing arrangements established by firms are effective in practice, and remain so. In particular, our attention has been on assessing the effectiveness of new governance structures and risk management arrangements, including operationalisation of ring-fencing related policies. In the 2020/21 reporting period, we plan to continue to review firms' arrangements in these areas.

Ring-fencing provisions are numerous, detailed and wide-ranging, touching on many aspects of the operations of the banks subject to them. As reported last year, we considered that all firms in scope had successfully delivered ring-fencing in a manner that supported our objectives and was consistent with the intended outcomes of the ring-fencing regime. Over the past year, firms have continued to take measures to ensure ongoing compliance with ring-fencing provisions and guidance issued by us. These measures varied among the firms depending on their business models and included strengthening compliance monitoring processes, conducting internal reviews of their implementation of the ring-fencing regime, conducting ICAAPs and Internal Liquidity Adequacy Assessment Processes (ILAAP) for their ring-fenced subgroups, and testing the efficiency of governance arrangements.

During this reporting period RFBs, for the most part, complied with the individual ring-fencing provisions and associated guidance, but we have been notified of a limited number of further instances of non-compliance. These were mostly of very low materiality and the majority related to legacy positions. In all such cases, the firms took steps to resolve breaches immediately or put remediation plans in place.

We have not taken any enforcement action in respect of the ring-fencing provisions in the past year.¹ Where it was judged additional action would improve firms' compliance with ring-fencing provisions, we have taken non-statutory supervisory action, such as requesting some firms to review and attest to their compliance with ring-fencing provisions.

Use of exceptions

The activities of RFBs are restricted by our rules and ring-fencing legislation. For example, the legislation prohibits RFBs from carrying on 'excluded activities' and contains certain 'prohibitions', including:

- dealing in investments or commodities as principal;
- incurring exposures to relevant financial institutions (RFIs);
- accessing payment systems indirectly; and
- having branches or subsidiaries in a country which is not an EEA Member State.

The legislation also sets out certain permitted exceptions to these 'excluded activities' and 'prohibitions' to allow RFBs to carry out activities which they would otherwise be prohibited from undertaking. These exceptions aim to allow RFBs to undertake activities typical for a retail and commercial bank, such as 'dealing in investments as principal' for risk management purposes, collateral management, selling simple derivatives to its account holders subject to limits,² transactions with central banks, and managing pension liabilities.

¹ For information on the use of the PRA's statutory powers see www.bankofengland.co.uk/prudential-regulation/pru-statutory-powers.

² Limits are defined in Article 12 of EAPO.

Our rules require an RFB to have policies in place that specify in detail the circumstances in which it will make use of exceptions ('exceptions policies'). We assess RFBs' use of exceptions through ongoing supervisory engagement, regulatory reports, and by undertaking reviews of RFBs' exceptions policies. This informs us of the extent to which RFBs undertook activities that would be excluded or prohibited but for an exception in the legislation.

Overall, the information reviewed by us suggests that firms' use of exceptions is consistent with the objectives of the ring-fencing regime, and that firms have not taken risk positions which exceed the risk limits set out in the legislation.

The legislation includes exceptions to permit RFBs to deal in investments as principal or to incur exposures to RFIs where the sole or main purpose of the associated transaction is to hedge risks. All firms used this exception. The vast majority (more than 85%) of the hedging exceptions used by RFBs were those relating to hedging changes in interest rates. The remainder of the hedging exceptions (less than 15%) were used to hedge other risks, such as changes in exchange rates, in share price indices, or consumer price indices. The relatively higher use of the exception for interest rate hedging is in line with the PRA's expectations as this type of hedging is a prominent risk management activity for many retail banks. Exposures to RFIs related to hedging were relatively small compared to firms' capital bases.

The exceptions not related to hedging, such as for customer derivatives, own securitisations and covered bonds, trade finance, conduit lending, infrastructure finance, and ancillary exposures, were used by most RFBs to varying degrees. The use of these exceptions was within any applicable limits and consistent with the RFBs' business models. For example, the exception permitting RFBs to sell simple derivatives to its account holders, was used by five of the seven RFB groups, with a relatively low value of related exposures which were within the limits defined in ring-fencing legislation.

The exceptions related to other prohibitions, such as non-EEA undertakings, were used only to a small extent. RFBs were also generally direct participants in the main UK payment systems that they used, and where those payment systems were accessed indirectly, this was often through another RFB in the same group.

There is a transitional provision in the legislation¹ that permits an RFB to retain or sell investments after 1 January 2019, provided that: (a) the investment in question was acquired before 1 January 2019; and (b) the investment is due to mature by 31 December 2020. Overall, the majority of the investments that were allowed under the transitional provision have now matured or been sold.

¹ The transitional provision is set out in Article 21 of EAPO.

Annual Competition Report — June 2020¹

This is our fifth Annual Competition Report (the Report), marking the sixth year since our secondary competition objective (SCO) came into force on 1 March 2014. We produce this Report to meet the Government's request for an Annual Report setting out how we are delivering against our SCO.² The SCO, as set out in Financial Services and Markets Act 2000 (FSMA), states that:

'When discharging its general functions in a way that advances its objectives, the PRA must so far as is reasonably possible act in a way which, as a secondary objective, facilitates effective competition in the markets for services provided by PRA-authorised persons in carrying on regulated activities'.

Part 1: Application of the secondary competition objective in our work

This section of the Report provides an update on key policy and supervisory decisions taken to deliver against the SCO. The focus of these outcomes reflects the strategy set out in the 2019/20 Business Plan³ to:

- support the joint PRA and FCA New Bank Start-up Unit (NBSU) and New Insurer Start-up Unit (NISU);
- further refine the framework to facilitate the issuance of insurance linked securities (ILS) through insurance special purpose vehicles (ISPVs);
- implement policies to facilitate internal ratings based (IRB) model applications from smaller banks and refine the Pillar 2A capital framework;
- develop in a proportionate manner our approach to operational resilience in our prudential framework;
- assess the competition implications of our policies and check for any unintended distortions to competition; and
- conduct further analysis on barriers to growth for smaller firms, including by assessing the extent to which the overall regulatory burden is affected as firms grow organically in size and complexity (see Box 7 — Reducing barriers to growth).

Supporting the authorisation of new banks and insurers

During the year we authorised nine new banks, one credit union, three new insurers and one new insurance special purpose vehicle (ISPV) (see summary statistics below).

1 The Annual Competition Report (ACR) has been produced in response to a request from the Government, included in HM Treasury's 2015 Productivity Plan 'Fixing the foundations: creating a more prosperous nation', that the PRA should publish an annual report setting out how it is delivering against its secondary competition objective (SCO) and, in particular, 'the steps it is taking to drive more competition and innovation in financial services markets and to help ensure that the right incentives exist for new banks to enter the market'. All versions of the ACR are available on the Bank's website: www.bankofengland.co.uk/prudential-regulation/secondary-competition-objective.

2 The rationale for the SCO, how the PRA interprets it, and what the SCO means for the PRA's regulation of banks and insurers is set out in the Bank of England's Quarterly Bulletin article, 'The Prudential Regulation Authority's secondary competition objective', December 2015: www.bankofengland.co.uk/quarterly-bulletin/2015/q4/the-pra-secondary-competition-objective. Of particular relevance to this Report is the speech by Sam Woods, Deputy Governor for Prudential Regulation and PRA Chief Executive at the Mansion House, London, that underlines the importance of these activities for competition: www.bankofengland.co.uk/speech/2019/sam-woods-speech-at-mansion-house-london.

3 www.bankofengland.co.uk/prudential-regulation/publication/2019/pr-a-business-plan-2019-20.

The NBSU provides information and support to those thinking of becoming a new bank in the UK and enables potential applicants to understand the required standards of being an authorised bank. Authorisation is the start of a firm’s journey to being a fully established bank and the NBSU encourages firms to consider the evolution of their business and control framework following the point of authorisation. The NBSU held a well-received seminar in October 2019 that provided potential new bank applicants and consultants with regulatory expectations across a range of topics.

Following the launch of the New Insurer Start-up Unit (NISU) by the PRA and FCA in 2018, there has been an increase in firms reaching out to regulators about setting up new insurers in the UK. Overall, however, interest in new insurers remains significantly lower than for new banks.

In light of this, we are continuing to consider how a pipeline of new insurers can be further facilitated including assessing the appropriateness of a ‘mobilisation’ (authorisation with restriction) phase for insurers, as is available for new banks. As part of this, we have been engaging with the Government and industry bodies to discuss developments in digital insurance technology and innovation — more commonly known as Insurtech — and looking at why, to date, most Insurtech firms operating in the UK have chosen to do so as insurance intermediaries (eg managing general agents), rather than as direct insurers.

Summary statistics on new authorisations in 2019/20

From 1 March 2019 to 29 February 2020 we have authorised:



In September 2019, we published CP19/19 that included proposed updates to clarify and elaborate on the PRA’s requirements regarding the authorisation of ISPVs and their ongoing supervision.¹ We also published FAQs specific to the ISPV regime, and updated our other ISPV guidance and supporting documents. This package of work aids the healthy development of the UK ILS market, and facilitates effective competition, as participants can more readily understand the requirements and standards relevant to UK ISPVs.

Implementing policies to facilitate IRB and refining Pillar 2A

We finalised a review of our approach to IRB credit risk model applications for smaller banks and building societies in March 2019² to facilitate access to IRB models for these firms. Since launching the review, we have approved IRB permissions for three additional firms, increasing the total number of IRB permissions to 19. Feedback received from one of those firms indicated that the new modular approach is succeeding in providing greater clarity and transparency to firms regarding the review process. There are now 21 firms at different stages in the IRB application pipeline: ten firms have indicated they are considering pre-engagement; and four firms are actively planning an application, of which two firms are engaging to identify any major issues and to receive preliminary feedback before application (as at 29 February 2020).

¹ CP19/19 'Insurance special purpose vehicles: Updates to authorisation and supervision', September 2019: www.bankofengland.co.uk/prudential-regulation/publication/2019/ispvs-updates-to-authorisation-and-supervision.

² PS7/19 'Credit Risk: The definition of default', March 2019: www.bankofengland.co.uk/prudential-regulation/publication/2018/credit-risk-the-definition-of-default.

In December 2017, we finalised our refinements to the Pillar 2A capital framework. These provide a framework, applied as part of a capital review, for supervisors to consider systematically the appropriateness of a reduction in variable Pillar 2A add-ons for firms using the standardised approach for credit risk. This is to ensure the total amount of a firm's capital does not exceed the amount necessary to ensure the sound coverage of risks. To date, 25 firms have benefited from a reduction to their Pillar 2A add-ons, with an average adjustment of 1.44% of risk-weighted assets.

Developing our approach to operational resilience

As part of our policy proposals on operational resilience,¹ we facilitated effective competition by ensuring that the costs of managing operational resilience and meeting our draft rules and expectations would be proportionate to the size and complexity of the firm. For example, larger and more complicated firms would be expected to identify a greater number of important business services and have more complex business services that require mapping.

Assessing the competition implications of our policies

Barriers to entry and expansion

Lowering firms' operating costs and ensuring these costs are proportionate given differences in firm size and complexity helps reduce barriers to entry and expansion. In December 2019, we set out changes for modernising the regulatory framework on outsourcing and third-party risk management, which helps firms manage their operating costs.² Recently, firms' interactions with third parties have evolved significantly, particularly with respect to new technology. The 'Future of Finance'³ report identified that a lack of clear regulatory expectations has the potential to limit firms' ability to realise the full potential of outsourcing. These evolving practices also create risks. The proposed changes we set out seek to modernise our expectations relating to outsourcing and third party risk management, and clarify how smaller firms could comply proportionately.

Barriers to exit

Ensuring that firms can exit the market in a safe and sound manner should they fail facilitates effective competition by providing greater certainty and confidence for investors to provide capital that supports entry and expansion of firms in relevant markets. In July 2019, we finalised new rules for large banks and building societies to assess their preparations for resolution, submit a report of their assessment to us, and publish a summary of this report ('public disclosure'), as part of the Resolvability Assessment Framework (RAF).⁴ These requirements are aimed at increasing firms' accountability and at encouraging progress as they ensure that market participants and firms' stakeholders are informed of these preparations.

1 For more information on the development of our operational resilience policy, please read pages 28–31.

2 CP30/19 'Outsourcing and third party risk management', December 2019: www.bankofengland.co.uk/prudential-regulation/publication/2019/outsourcing-and-third-party-risk-management.

3 Bank of England Future of Finance report, June 2019: www.bankofengland.co.uk/report/2019/future-of-finance.

4 SS4/19 'Resolution assessment and public disclosure by firms', July 2019: www.bankofengland.co.uk/prudential-regulation/publication/2019/resolution-assessment-and-public-disclosure-by-firms-ss.

Box 6: Review of the credit unions regime¹

In October 2019, we set out proposed changes to capital requirements that apply to credit unions.

Following a review of the existing requirements, we identified barriers to expansion, particularly for those credit unions approaching £10 million in total assets or 15,000 members. In addition, we found that the current link between capital and credit union membership size and activities creates unnecessary complexity in the regime. Typically, credit unions see their capital requirement double at the point these thresholds are reached.

We proposed a 'graduated rate' approach for credit unions with more than £10 million in total assets. This approach requires higher levels of capital to be held only against total assets that exceed the threshold. We consider that the proposals would provide a greater degree of flexibility to larger credit unions and remove barriers to growth for those approaching £10 million in total assets. Removing the barriers to growth was part of our broader work on evaluating how regulatory thresholds, and the overall complexity of the regulatory framework, can affect UK Deposit-takers (see Box 7).

The capital regime for credit unions is significantly different from that for banks and building societies. We looked at whether the credit unions' regime overall would affect competition more generally in the UK deposit-taking sector (ie banks, building societies and credit unions). Many credit unions, especially those with community-based common bonds, target customers that are generally unprofitable for banks and building societies to pursue and that are not eligible for credit elsewhere. We consider that the position occupied by credit unions means that they generally do not compete directly with banks or building societies such that there is no negative impact on effective competition in the UK deposit-taking sector.

¹ CP28/19 'Credit unions: Review of the capital regime', October 2019: www.bankofengland.co.uk/prudential-regulation/publication/2019/credit-unions-review-of-the-capital-regime.

Maintaining a 'level playing field'

In the banking sector, we undertook a number of measures to ensure that firms face the same requirements for a given level of risk to facilitate effective competition. These measures include:

- **Counterparty credit risk model limitations.**¹ In July 2019 we proposed to introduce an exposure floor for counterparty credit risk to facilitate a more consistent interpretation of requirements for recognition of excess collateral posted by counterparties and to ensure a more unified approach to holding capital against model limitations and assumptions among firms.
- **Credit risk default, the probability of default and loss given default for IRB firms.**² In 2019 we finalised our approach to the definition of default for credit purposes, and set out our proposed expectations relating to probability of default (PD) estimation, loss given default (LGD) estimation and the treatment of defaulted exposures in the IRB approach. Requiring all firms that use the IRB approach to use the same materiality thresholds and number of days past due definition facilitates effective competition by ensuring greater consistency of approach across IRB firms. The requirements also increase consistency between the existing standardised approach (SA) and IRB firms.
- **Asset encumbrance.**³ Firms encumber assets when pledging them to credit-enhance funding (eg as security for a loan). In September 2019, we proposed clearer expectations for firms to demonstrate that they have considered prudential risks appropriately when encumbering assets. The proposals asked firms to determine for themselves the prevalence and severity of risks associated with asset encumbrance rather than applying a 'one size fits all' approach. The proposed expectations accommodate a broad diversity of business models, sizes and complexities while ensuring requirements are the same for any given risk.

For the insurance sector, we also undertook a number of measures to ensure that firms face the same requirements for a given level of risk and consequently facilitate effective competition. These measures include:

- **The prudent person principle (PPP) in Solvency II.**⁴ In September 2019 we set out proposed expectations to help firms manage their investment risk properly and to ensure consistency of application. For more information on this please read page 25.
- **Insurers' liquidity risk management.**⁵ In September 2019 we outlined our expectations on how insurers comply with applicable liquidity risk management requirements. Setting out consistent expectations of insurers' liquidity risk management frameworks helps firms manage their liquidity risk properly, while allowing sufficient flexibility to tailor their approach to their business and ensuring consistency of application.

1 CP17/19 'Counterparty credit risk: Treatment of model limitations in banks' internal models', July 2019: www.bankofengland.co.uk/prudential-regulation/publication/2019/counterparty-credit-risk-treatment-of-model-limitations-in-banks-internal-models.

2 PS7/19 'Credit risk: The definition of default', March 2019: www.bankofengland.co.uk/prudential-regulation/publication/2018/credit-risk-the-definition-of-default and CP21/19 'Credit risk: Probability of Default and Loss Given Default estimation', September 2019: www.bankofengland.co.uk/prudential-regulation/publication/2019/credit-risk-probability-of-default-and-loss-given-default-estimation.

3 CP24/19 'Asset encumbrance', September 2019: www.bankofengland.co.uk/prudential-regulation/publication/2019/asset-encumbrance.

4 CP22/19 'Solvency II: Prudent Person Principle', September 2019: www.bankofengland.co.uk/prudential-regulation/publication/2019/solvency-ii-prudent-person-principle.

5 CP4/19 'Liquidity risk management for insurers', March 2019 and PS18/19 'Liquidity risk management for insurers', September 2019: www.bankofengland.co.uk/prudential-regulation/publication/2019/liquidity-risk-management-for-insurers and SS5/19 'Liquidity risk management for insurers', September 2019: www.bankofengland.co.uk/prudential-regulation/publication/2019/liquidity-risk-management-for-insurers-ss.

- **Income producing real estate (IPRE) loans.**¹ In September 2019, we set out our proposed expectations on how firms assess the risks and develop internal models in respect of IPRE loans and on the use of internal ratings for unrated illiquid assets. These expectations help ensure that the risks in insurers' portfolios are assessed in a consistent manner across all firms, and that firms cannot obtain a competitive advantage by avoiding the costs of effectively managing these risks.
- **Equity release mortgages.**² In April 2019 we consulted on proposals that extended and clarified our expectations in respect of firms' investment in equity release mortgage (ERM) portfolios. The proposals ensure that all insurers providing ERMs properly assess and price the risks. In addition, by being transparent about the framework and clarifying the technical aspects, the proposals provide a common and clear minimum basis for assessing ERM risks that operates appropriately in a range of market conditions and for different ERM product variants.

Part 2: Implementing and embedding the SCO

This section of the ACR sets out how we have continued the process of embedding the SCO into our policy and supervisory decision-making, and provides a summary of our engagement with external stakeholders.

Embedding the SCO in our processes

In the 2018/19 ACR we outlined steps that we have taken to put effective processes in place to ensure that staff responsible for developing and reviewing prudential policy always consider the SCO. The number of policy outcomes set out in Part 1 highlighting where competition has been a key element in the development of policy demonstrates the extent to which these efforts have been successful.

Engagement with external stakeholders

At the annual Mansion House City banquet in October 2019, Sam Woods took a fresh look at barriers to growth for deposit-taking firms, focusing on regulatory thresholds and the complexity of rules (see Box 7 of this report for more detail).

Following this examination of thresholds present in our regulations, we identified the credit union sector as one area of focus, where the structure of the PRA's requirements can lead to cliff-edge effects for growing firms and we consulted on how we could improve this (see Box 6 of this report for more detail).

We also reviewed the complexity of the regulatory rules for UK deposit-takers. We found that the relevant rules were indeed complex and that this complexity had increased. This a challenge for small firms and a simpler regime could benefit our safety and soundness and competition objectives.

Sam concluded his speech by saying that we have no intention of weakening the resilience of the financial system, but there is a need to be dynamic and focus on tackling emerging threats and seizing opportunities — such as thinking afresh about barriers to growth.

Engagement with other regulators

We maintain working relationships with relevant UK regulators both as part of our legal requirements and where we have an interest in outcomes that may affect our objectives. We had regular meetings with both the Financial Conduct Authority (FCA) and Competition and Markets Authority (CMA) for this purpose.

1 CP23/19 'Solvency II: Income producing real estate loans and internal credit assessments for illiquid, unrated assets', September 2019: www.bankofengland.co.uk/prudential-regulation/publication/2019/solvency-ii-ipre-loans-and-internal-credit-assessments-for-illiquid-unrated-assets.

2 CP7/19 'Solvency II: Equity release mortgages — Part 2', April 2019 and PS19/19 'Solvency II: Equity release mortgages — Part 2', September 2019: www.bankofengland.co.uk/prudential-regulation/publication/2019/solvency-ii-equity-release-mortgages-part-2.

Box 7: Reducing barriers to growth

In 2019, we started evaluating how the complexity of regulation affects firms of different sizes and competition. In 2019/20 we focused on understanding the extent of the burden faced by firms. We did this in two ways. First, we looked at the regulatory ‘gradient’— the number of new rules that kick in as firms grow and cross regulatory thresholds. Second, we measured the textual complexity of different rules.¹

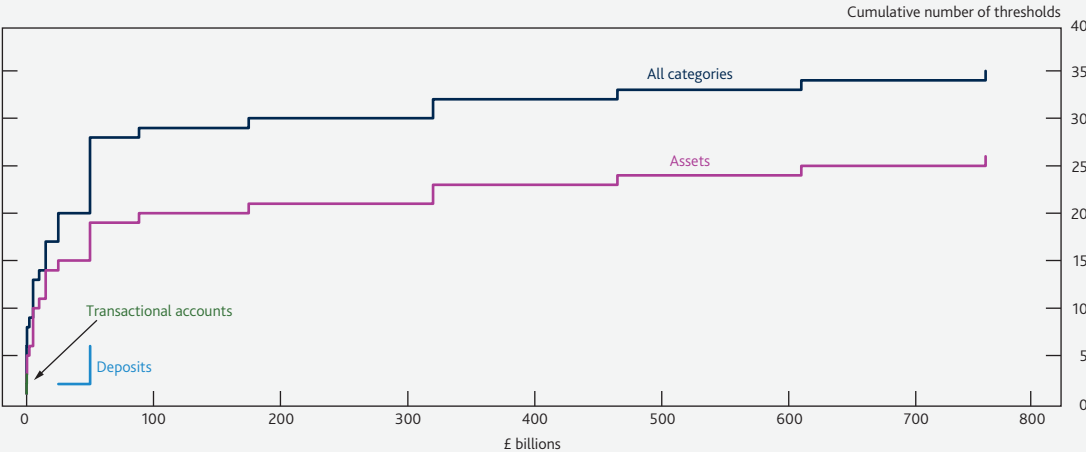
Regulatory thresholds

Regulatory thresholds ensure that the regulation of different-sized firms is commensurate to the risks that they pose to the financial system, and are therefore sensible from a risk as well as a competition perspective. However, thresholds could act as a barrier to expansion if firms slow down their growth before reaching that threshold to avoid triggering the new requirement. There are also non-regulatory barriers to growth: for example, sticky deposits mean that a firm might struggle to attract new deposits.

In 2019 we carried out a stock-taking exercise of all regulatory thresholds for UK deposit-takers to understand the extent to which thresholds may pose a barrier to expansion of firms. We identified thresholds across all areas of policy and found that the thresholds were concentrated in capital, reporting and remuneration requirements. Asset size was the most common threshold although we identified a number of other unique measures used to set thresholds.

Chart A shows the ‘gradient’ of thresholds that firms face as they grow. We translated all thresholds to an equivalent asset value to map them on one scale. Most thresholds are concentrated in the area below a size corresponding to £50 billion in assets or deposits.

Chart A Thresholds in UK prudential regulation, translated onto an assets/deposits basis (for UK deposit-takers)

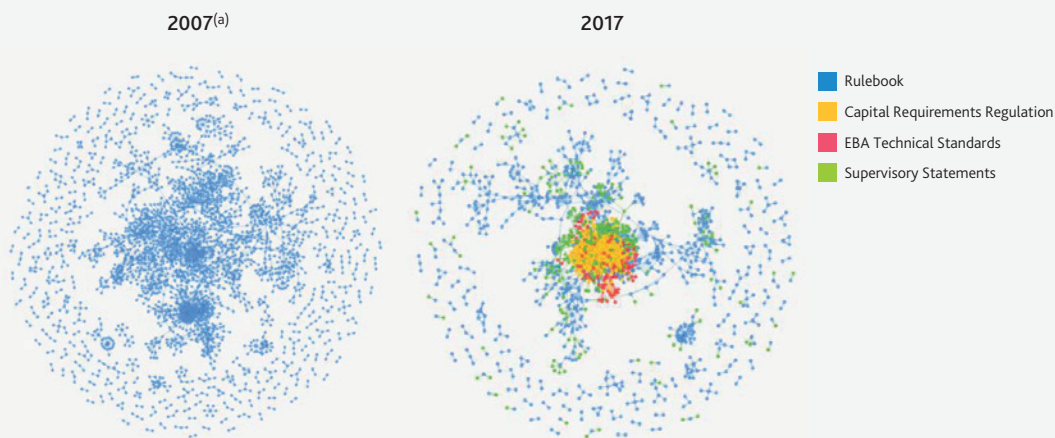


¹ Both are discussed in detail in Sam Woods, ‘Credit union meets robot’, speech at Mansion House, London, 24 October 2019: www.bankofengland.co.uk/speech/2019/sam-woods-speech-at-mansion-house-london.

Complexity

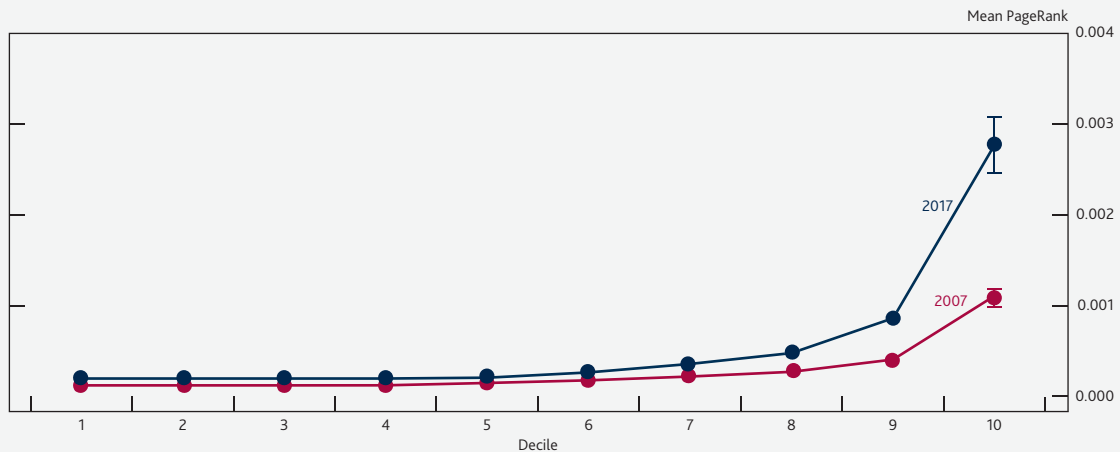
Regulatory complexity may be harder to master for small firms with limited compliance resources and may be a barrier to expansion for these firms. To measure regulatory complexity, we focused on the information burden of understanding individual rules, as well as the nature of the interactions between them, comparing the pre-crisis regulation with the post-crisis regulatory framework.¹

Chart B Network of cross-references in the regulatory framework (for UK deposit-takers)



(a) Nodes represent prudential rules in the FSA handbook.

Chart C PageRank network centrality measure (for UK deposit-takers)^(a)



(a) PageRank summarises the centrality of a node within a network. In this case, it counts the number and quality of cross-references to a provision to estimate how important the provision is. More important, ie more central, provisions are likely to get more direct and indirect links from other provisions. To construct the decile plot, we calculate PageRank for each provision, rank the provisions (separately for 2007 and 2017), and then split them into 10 bins (deciles). We display the mean for each bin, and the 95% confidence intervals (vertical lines).

¹ For details see: Amadjarif Z, Brookes J, Garbarino N, Patel, R and Walczak, E (2019), 'The language of rules: textual complexity In banking reforms', *Bank of England Staff Working Paper No. 834*; www.bankofengland.co.uk/working-paper/2019/the-language-of-rules-textual-complexity-in-banking-reforms.

Rules are interconnected through a web of cross-references. **Chart B** shows a simplified but real representation of how four layers of regulation for UK banks interlock with each other: EU regulation in the CRR, EBA Technical Standards, our Rulebook and Supervisory Statements. The simple observation from this analysis is that the core of the network, mainly comprising the CRR, is a lot more interconnected in 2017 than it was in 2007.

To provide a more direct measure of the complexity, **Chart C** compares PageRank scores for the provisions in the 2007 and 2017 banking frameworks. PageRank summarises how central a node is within a network. In this case, it counts the number and quality of cross-references to a provision to estimate the provision's importance. Important provisions are likely to get more direct and indirect links from other provisions. Connectedness increases to the greatest extent for the most central individual provisions.

Part 3: Competition-focused research activities

We are committed to maintaining a flow of policy-oriented research projects aimed at deepening our understanding of the complex relationship between prudential regulation, financial stability and effective competition.

Since the publication of last year's ACR, we have published further research on:

- the relationship between bank competition and risk;
- platform competition and incumbency advantage;
- competition effects of the refinement of Pillar 2; and
- the connection between competition and financial leverage.

In addition to this research, we have updated our previous research on measuring competition in the UK deposit-taking sector which is discussed in Box 8.

The relationship between bank competition and risk¹

We extended previous research and examined the link between competition and solvency risk for all banks and building societies (firms) in the UK using a detailed picture of the relationship between competition and firm solvency risk.

We found that stronger competition was associated with greater firm stability for high-risk firms while the opposite relationship was true for relatively less risky firms. When looking at the influence of firms' size and ownership we found a number of differences. First, stronger competition was associated with greater stability for UK banks in general, with only small, low-risk banks being the exception. Second, the relationship was mixed for building societies: stronger competition was associated with greater stability for high-risk building societies but associated with reduced stability for lower-risk building societies. Third, we found that more competition was associated with higher insolvency for foreign banks. Finally, we found that firms that were close to their minimum capital requirements were less likely to increase risk in the face of stronger competition.

¹ See de-Ramon, S, Francis, W and Straughan, M (2018), 'Bank competition and stability in the United Kingdom', *Bank of England Staff Working Paper No. 748*; www.bankofengland.co.uk/working-paper/2018/bank-competition-and-stability-in-the-united-kingdom.

These findings are consistent with our current application of the SCO and indicate that our prudential tools are effective in addressing both prudential and competition issues.

Platform competition and incumbency advantage¹

We developed a model to explore how the cost of switching for customers can be an advantage for an incumbent platform provider.

We found that the coexistence of platforms engaged in effective competition, relies on the relative strength of costs to customers of switching platforms over the network effects (the extent to which a platform covers more or less market participants). Only when switching costs are stronger than network benefits is market tipping avoided (where the winner takes all). However, the same condition also underpins the presence of a material competitive advantage to the incumbent platform regarding any entrant platform. Therefore, regulatory intervention aimed at facilitating switching, for example by imposing data portability, might worsen entry condition as the incumbent platform is less accommodative.

Our results have clear policy implications. Intervention aimed at lowering customer switching costs to support greater competition might unintendedly make entry more difficult, as the incumbent's strategic stance becomes less accommodative. This suggests that this type of intervention should take place only after a new entrant has managed to gain a foothold in the market.

Competition effects of the refinements to the Pillar 2A approach²

We studied how banks and building societies reacted to PRA announcements on the refinement of the Pillar 2A Holistic Approach in 2017.

We observed that eligible firms likely to receive capital relief invest more in low loan to value (LTV) ratio mortgages following the publication of our policy on Pillar 2A capital requirements.³ They increased their propensity to invest in low LTV mortgages (up to 60%) by about 9 to 13 percentage points relative to firms that were not eligible or are uncertain to be eligible, conditional on granting a mortgage. We take this as evidence that they repositioned by investing in low LTV mortgages to increase their capital relief.

Our results on the announcement effect suggest that the policy might have had its intended effect of increasing the low LTV mortgage market share of SA banks, helping to level the playing field between SA and IRB firms and facilitating effective competition. However, additional analysis is needed to explore the effects of the implementation of the policy.

Connection between competition and financial leverage⁴

We investigated the relationship between profitability and financial leverage for US listed non-financial corporations by taking into account the degree of product similarity among competing firms, which can drive intense pricing rivalry thus undermining the sustainability of high price-cost mark-ups.

1 Siciliani, P and Giovannetti, E (2019), 'Platform competition and incumbency advantage under heterogeneous switching cost — exploring the impact of data portability', *Bank of England Staff Working Paper No. 839*; www.bankofengland.co.uk/working-paper/2019/platform-competition-and-incumbency-advantage-under-heterogeneous-switching-cost.

2 Arnould, G, Guin, B, Ongena, S and Siciliani, P (2020), '(When) do banks react to anticipated capital reliefs?', *Bank of England Staff Working Paper* (forthcoming).

3 PS30/17 'Pillar 2A capital requirements and disclosure', December 2017; www.bankofengland.co.uk/prudential-regulation/publication/2017/pillar-2a-capital-requirements-and-disclosure.

4 Siciliani, P, Yoon, K and Banal-Estanol, A (2020), 'Revisiting the nexus between profitability and financial leverage through the competition lens', *Bank of England Staff Working Paper* (forthcoming).

We found that in markets where there can be such a concern the relationship between profitability and financial leverage is negative; whereas in the rest of the markets the relationship is positive, as posited by the dynamic trade-off theory of corporate finance, whereby firms increase their degree of financial leverage in response to profitability improvements. Not only do firms exposed to comparatively higher degree of product substitutability make less use of financial leverage, but they also rely less on long-term debt.

Box 8: Measuring competition in the UK deposit-taking sector

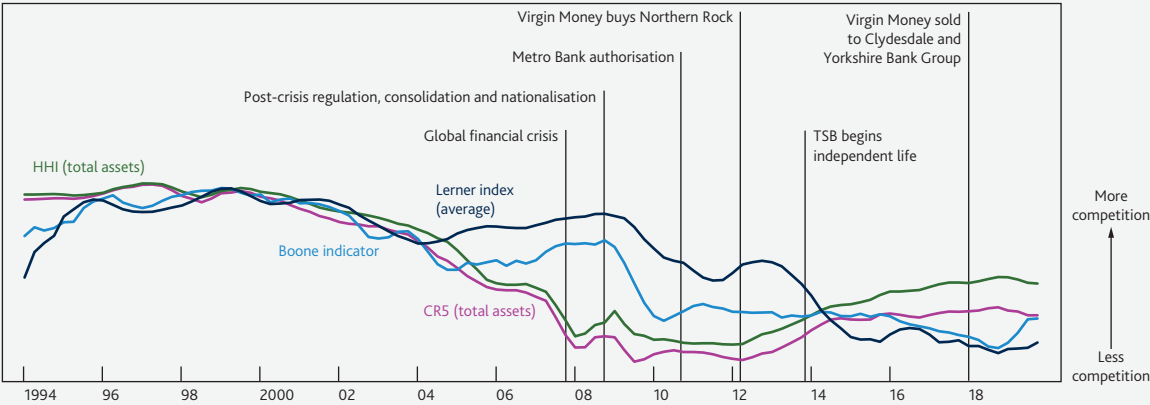
We used updated regulatory data for UK banks and building societies (collectively 'deposit-takers') to update the measures of competition that we first reported in 2016.

We constructed a number of measures that provide different perspectives on competition and concentration in the deposit-taking sector. In particular, we compared and contrasted four measures: the Lerner index, a measure of market power; the Boone indicator, a measure of competition intensity; and the Herfindahl-Hirschman index (HHI) and five-firm concentration index (CR5), which are measures of market concentration¹ (Chart A).

Our measures suggested that competition intensity was strong in the mid-1990s, following a notable period of deregulation in the 1980s. Competition became less intense in the early 2000s and decreased in the period immediately ahead of the financial crisis (2003/07), and also fell during the 2007/09 financial crisis.

Since that time, competition intensity has remained subdued at levels below those evident just before the financial crisis, and notably lower than those recorded in the mid-1990s.

Chart A UK bank competition indices^(a)



(a) Data from Bank of England individual bank solo-consolidated regulatory data returns (for more information see *Bank of England Staff Working Paper No. 652* (2017); www.bankofengland.co.uk/working-paper/2017/an-overview-of-the-uk-banking-sector-since-the-basel-accord-insights-from-a-new-regulatory-database). All indices are normalised between 0 and 1 over the period for comparison, with higher values indicating more competition. Indices estimated from quarterly data presented as annual averages. CR5 is an index of the market share from the five largest UK banks. HHI is the Herfindahl-Hirschman index for total assets. Boone indicator is a measure of competition based on market share gains of the most efficient firms. Lerner index is a measure of the average margin on banking services. A detailed methodology to calculate the indices is described in *Bank of England Staff Working Paper No. 748* (2018); www.bankofengland.co.uk/working-paper/2018/bank-competition-and-stability-in-the-united-kingdom.

1 See de-Ramon, S and Straughan, M (2016), 'Measuring competition in the UK deposit-taking sector', *Bank of England Staff Working Paper No. 631* for more detail on the construction of these measures; www.bankofengland.co.uk/working-paper/2016/measuring-competition-in-the-uk-deposit-taking-sector.

Financial review of 2019/20

The PRA incurred operating costs in 2019/20 of £271 million (2018/19: £278 million). Costs continued to include exceptional and non-recurring items such as the Structural Reform Programme, and the UK's withdrawal from the EU. Where these exceptional costs are attributable to a particular segment of our authorised population we will typically raise a Special Project Fee, otherwise they will fall to our fees in relation to ongoing regulatory activity.

Against our budget (£273 million), the PRA came in below by £2 million. This was predominantly due to the change in timelines and requirements in EU Withdrawal and additional capitalisation of project spend. Due to additional income received in the year of £4 million principally in the form of retained financial penalties the return to firms for the next financial year is £6 million.

Under the Bank of England and Financial Services Act 2016, the Bank is required to present financial and other disclosures in respect of its activities as the PRA. These are available on pages 159–167 of the Bank's Annual Report and Accounts 2019/20.¹

¹ www.bankofengland.co.uk/annual-report/2020.

Abbreviations

| | | | |
|---------------|--|-----------------|--|
| ACR | Annual Competition Report | FRTB | Fundamental Review of the Trading Book |
| ACS | Annual cyclical scenario | FSB | Financial Stability Board |
| AI | Artificial intelligence | FSMA | Financial Services and Markets Act 2000 |
| Bank | Bank of England | G-SIB | Global systemically important bank |
| BCBS | Basel Committee on Banking Supervision | G-SII | Global systemically important insurer |
| BEEDS | Bank of England Electronic Data Submission | IAIG | Internationally Active Insurance Group |
| BEMOG | Bank of England Market Operations Guide | IAIS | International Association of Insurance Supervision |
| BES | Biennial Exploratory Scenario | ICAAP | Internal Capital Adequacy Assessment Process |
| CEO | Chief Executive Officer | ICT SREP | Information and Communication Technology Risk Assessment under the supervisory review and evaluation process |
| CFRF | Climate Financial Risk Forum | IFRS 9 | International Financial Reporting Standard 9 |
| CGML | Citigroup Global Markets Limited | ILAAP | Internal Liquidity Adequacy Assessment Process |
| CMA | Competition and Markets Authority | ILS | Insurance linked securities |
| CP | Consultation Paper | IM | Internal model |
| CQUEST | Cyber Questionnaire | IPRE | Income producing real estate |
| CRD IV | Capital Requirements Directive IV | IRB | Internal-rating based |
| CRR | Capital Requirements Regulation | ISPV | Insurance special purpose vehicle |
| EBA | European Banking Authority | LGD | Loss given default |
| EBCU | Enterprise the Business Credit Union Ltd | Libor | London interbank offered rate |
| ECL | Expected credit loss | LTV | Loan to value |
| EEA | European Economic Area | MoU | Memoranda of Understanding |
| EIOPA | European Insurance and Occupational Pensions Authority | MPC | Monetary Policy Committee |
| ERM | Equity release mortgage | NBSU | New Bank Start-up Unit |
| EU | European Union | NGFS | Network for Greening the Financial System |
| EUFASC | EU Financial Affairs sub-Committee | NISU | New Insurer Start-up Unit |
| EVT | Effective Value Test | ORSA | Own Risk and Solvency Assessment |
| FCA | Financial Conduct Authority | PD | Probability of default |
| FGF | Fast growing firm | PPP | Prudent Person Principle |
| FMI | Financial market infrastructures | | |
| FPC | Financial Policy Committee | | |

| | |
|----------------------|---|
| PRA | Prudential Regulation Authority |
| PRA110 | PRA110 liquidity reporting template |
| PRC | Prudential Regulation Committee |
| PS | Policy Statement |
| RAF | Resolvability Assessment Framework |
| Raphaels | R. Raphael & Sons plc |
| RFB | Ring-fenced body |
| RFI | Relevant financial institution |
| s166 | Section 166 |
| SA | Standardised approach |
| SCO | Secondary competition objective |
| SCR | Solvency Capital Requirements |
| SIMEX18 | 2018 Sector Simulation Exercise |
| SM&CR | Senior Managers and Certification Regime |
| SME | Small and medium-sized enterprise |
| SRFRR | Sterling Risk-Free Reference Rates |
| SRPC | Supervisory Risk and Policy Committee |
| SS | Supervisory Statement |
| Taskforce | Taskforce on Disclosures about Expected Credit Loss |
| TMTP | Technical measure on technical provisions |
| TSC | Treasury Select Committee |
| UK | United Kingdom |
| Zelmer review | Independent Review of the Prudential Supervision of The Co-operative Bank Plc |

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