



BANK OF ENGLAND  
PRUDENTIAL REGULATION  
AUTHORITY

Consultation Paper | CP19/14

# The implementation of ring-fencing: consultation on legal structure, governance and the continuity of services and facilities

October 2014

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Responses are requested by Tuesday 6 January 2015.

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# 1 Overview

1.1 The Prudential Regulation Authority (PRA) is required under the Financial Services and Markets Act 2000 (the Act), as amended by the Financial Services (Banking Reform) Act 2013, to make policy to implement the ring-fencing of core UK financial services and activities. This consultation paper (CP) sets out the PRA's proposed ring-fencing policy, including rules and supervisory statements, in three areas: (i) the legal structure of banking groups; (ii) governance; and (iii) the continuity of services and facilities. Consultation on other areas will follow in 2015.

1.2 The CP articulates the outcomes the PRA expects, but the way that firms achieve these outcomes is, in general, a matter for them. There are some areas, however, where a more prescriptive approach is necessary. This may be because the Act requires the PRA to make rules in specific areas, or because the PRA has judged that a more prescriptive approach is necessary to meet the PRA's requirements under the Act.

1.3 This CP is relevant to banks which will be required by the Act to ring-fence their core activities. Secondary legislation specifies that this will include banks with 'core' deposits — broadly those from individuals and small businesses — greater than £25 billion. It will also be of interest to financial and other institutions and customers who have dealings with these banks.

1.4 This CP is one of four papers published by the PRA on 6 October as part of its wider resolution and resilience agenda. The proposed rules and policies on which the PRA is seeking feedback contribute to this agenda in a number of ways. Enhanced protection for depositors and insurance policyholders and better access to protected deposits in the event of the failure of a firm will reduce disruption to the economy (see CP20/14 and CP21/14).<sup>(1)</sup> This is supported by proposals to ensure operational continuity in resolution for banks, building societies and investment firms regulated by the PRA (see DP1/14).<sup>(2)</sup> The Discussion Paper's proposals will help ensure that firms of all sizes make appropriate changes so that services necessary for the continuity of deposit-taking and other functions critical to the economy operate effectively following the failure of a firm. The implementation of ring-fencing through the proposals described in this CP will also contribute to ensuring the continuity of deposit-related services in the United Kingdom.

1.5 These measures advance the PRA's general objective of promoting the safety and soundness of firms by reducing the

adverse effect that the failure of firms could be expected to have on the stability of the UK financial system. Proposals to enhance insurance compensation advance the PRA's objective of contributing to the securing of an appropriate degree of protection for those who are or may become policyholders.

## Background to ring-fencing

1.6 In response to the financial crisis, a number of domestic and international reforms to bank regulation have been introduced or are currently being implemented. Many of these reforms seek to improve the resilience and resolvability of banks, including through making changes to their structure.

1.7 In the United Kingdom, the Independent Commission on Banking (ICB), chaired by Sir John Vickers, made recommendations on how the UK banking system could be reformed to improve financial stability and increase competition. The ICB issued its final report in September 2011.<sup>(3)</sup> It proposed, amongst other measures, the 'ring-fencing' of vital banking services from risks elsewhere in the financial system. This is intended to protect retail banking from risks unrelated to the provision of that service and ensure that banking groups which get into trouble can be resolved in an orderly manner, thereby avoiding taxpayer liability and ensuring the continuous provision of necessary retail banking services.

1.8 In June 2012, the Government published a White Paper which set out proposals for the banking sector based on the ICB's recommendations, including those relating to ring-fencing and increasing banks' capacity to absorb losses.<sup>(4)</sup> This formed the basis of draft legislation which was reviewed by the Parliamentary Commission on Banking Standards (PCBS). The Government's response to the PCBS, and its impact assessment, were published in February 2013.<sup>(5)</sup>

(1) *PRA Consultation Paper CP20/14*, 'Depositor protection', October 2014; [www.bankofengland.co.uk/pr/Pages/publications/cp/2014/cp2014.aspx](http://www.bankofengland.co.uk/pr/Pages/publications/cp/2014/cp2014.aspx).

*PRA Consultation Paper CP21/14*, 'Policyholder protection', October 2014; [www.bankofengland.co.uk/pr/Pages/publications/cp/2014/cp2114.aspx](http://www.bankofengland.co.uk/pr/Pages/publications/cp/2014/cp2114.aspx).

(2) *PRA Discussion Paper DP1/14*, 'Ensuring operational continuity in resolution', October 2014; [www.bankofengland.co.uk/pr/Pages/publications/cp/2014/dp114.aspx](http://www.bankofengland.co.uk/pr/Pages/publications/cp/2014/dp114.aspx).

(3) Independent Commission on Banking, Final Report, September 2011.

(4) HM Treasury/Department for Business, Innovation and Skills, *Banking reform: delivering stability and supporting a sustainable economy*, June 2012.

(5) HM Treasury/Department for Business, Innovation and Skills, *Banking reform: a new structure for stability and growth*, February 2013.

1.9 The eventual legislation — the Financial Services (Banking Reform) Act 2013 — received Royal Assent in December 2013. The Act defines 'core activities' as the regulated activity of accepting deposits and requires that banking groups which undertake core activities place these activities into ring-fenced bodies (RFBs).

1.10 To supplement the definition of core activities, the Act defines three 'core services'. These core services are: (i) facilities for the accepting of deposits or other payments into an account which is provided in the course of carrying on the core activity of accepting deposits; (ii) facilities for withdrawing money or making payments from such an account; and (iii) overdraft facilities in connection with such an account.<sup>(1)</sup> The PRA is required to discharge its general functions in a way that is consistent with its objectives relating to the provision of these core services, as described in the next section.

1.11 The Act also prohibits RFBs from undertaking 'excluded' activities, and specifies that this includes dealing in investments as principal. More detail on the definition of core activities and RFBs, and the activities which RFBs can and cannot undertake, is set out in two pieces of secondary legislation made by HM Treasury in 2014. *The Ring-fenced Bodies and Core Activities Order 2014* specifies that institutions which have more than £25 billion of core deposits from individuals and small businesses will be subject to ring-fencing requirements. It also provides for large organisations and high net worth individuals to place deposits outside RFBs if they so choose. *The Excluded Activities and Prohibitions Order 2014* defines commodities trading as an excluded activity, and makes a number of activity prohibitions with which RFBs must comply, such as incurring exposures to certain other financial institutions. A number of these exclusions and prohibitions are subject to exceptions.

1.12 In the European Union (EU), the European Commission published a proposal for a regulation on structural measures improving the resilience of EU credit institutions in January 2014.<sup>(2)</sup> The proposal included a ban on proprietary trading, and powers for supervisors to require the separation of other trading activities, including market-making, from deposit-taking within a banking group. This proposal has been submitted to the European Parliament and to the Council of the European Union. The outcome of this legislative process may affect elements of the PRA's implementation of ring-fencing, including the proposals set out in this CP.

## Advancing the PRA's objectives

1.13 The Act stipulates that in discharging its general functions the PRA must advance its general objective for promoting the safety and soundness of the firms it regulates primarily by seeking to ensure that the business of such firms

is carried on in a way which avoids any adverse effect on the stability of the UK financial system, and by seeking to minimise the adverse effect that the failure of such a firm could be expected to have on the stability of the UK financial system.<sup>(3)</sup>

1.14 The Act states that these adverse effects may in particular result from the disruption to the continuity of financial services. In meeting its objectives, the PRA works with other supervisory and resolution authorities to minimise any systemic instability that would result from disruption to a firm's essential and systemically important (or 'critical') functions. These critical functions can include deposit services provided to the retail sector.

1.15 The Financial Services (Banking Reform) Act 2013 amended the PRA's general safety and soundness objective in relation to ring-fencing and RFBs (see Box 1 on page 7).<sup>(4)</sup> This reflects the conclusion that some retail deposit services are so important that any disruption to their provision would adversely affect financial stability and the wider economy. Ring-fencing is intended to help ensure that these core services can be available continuously to individuals and small businesses.<sup>(5)</sup> Ring-fencing recognises, however, that there may be diversification benefits associated with banking groups. Consequently, complete separation is not required by the Act.

1.16 The PRA will take a proportionate approach in meeting its responsibilities for ring-fencing, in particular given the heterogeneous nature of the firms to which ring-fencing requirements will apply. In recognition of firms' specific characteristics, the differing impact of the policy proposals across firms and whether the particular element of the requirements delivers the policy outcomes in each case, the PRA will consider applications from firms for modifications of rules. The PRA has a discretionary power to waive or modify rules under section 138A of the Act where the application of rules would be unduly burdensome or would not achieve the purposes for which the rules were made, and so long as the waiver or modification would not adversely affect the advancement of the PRA's objectives.

1.17 The PRA's amended objective requires the PRA to seek to ensure the continuity of the provision of core services by focusing on two main aspects:

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- (1) Section 142C of the Act, as amended by the Financial Services (Banking Reform) Act 2013.
  - (2) European Commission, *Proposal for a Regulation of the European Parliament and of the Council on structural measures improving the resilience of EU credit institutions*, January 2014.
  - (3) Section 2B of the Act.
  - (4) Section 2H of the Act also requires that when discharging its general functions in a way that advances its objectives, the PRA must so far as reasonably possible act in a way which, as a secondary objective, facilitates effective competition in the markets provided by PRA-authorized persons in carrying on regulated activities. See also Chapter 6.
  - (5) See also *PRA Discussion Paper DP1/14*, 'Ensuring operational continuity in resolution', October 2014; [www.bankofengland.co.uk/pr/Pages/publications/cp/2014/dp114.aspx](http://www.bankofengland.co.uk/pr/Pages/publications/cp/2014/dp114.aspx).



## Box 1

### The PRA's objectives in respect of ring-fencing<sup>(1)</sup>

The Financial Services (Banking Reform) Act 2013 has amended the PRA's general safety and soundness objective to the effect that, when discharging its general functions in relation to ring-fencing, RFBs and groups containing RFBs, the PRA should seek to:

- 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 United Kingdom of core services;
- ensure that the business of RFBs is protected from risks (arising in the United Kingdom or elsewhere) that could adversely affect the continuity of the provision in the United Kingdom of core services; and
- 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 United Kingdom of core services.

(1) See section 2B of the Act, as amended by the Financial Services (Banking Reform) Act 2013.

- (a) implementing ring-fencing with regards to the **resilience** of an RFB to certain risks, by seeking to ensure that the business of an RFB is restricted and that the RFB has a degree of protection from shocks that originate in other parts of its group or the global financial system; and
- (b) implementing ring-fencing in a way that facilitates orderly **resolution** in the event that either an RFB or another member of its group fails, and supports the continuity of core services thereafter.

These aspects are considered separately in more detail below, although in many cases measures intended to improve the resilience of firms can also enhance their resolvability, as well as *vice versa*.

#### Resilience

1.18 Ring-fencing is intended to:

- restrict the business of an RFB and limit its exposure to certain risks in the rest of its group and the global financial system in order to improve the RFB's resilience to these risks and reduce the likelihood of disruption to the core services the RFB provides;
- simplify group structures by more closely aligning business lines with legal entities; and
- enable other measures that support resilience, including financial and non-financial resource requirements, to be applied to RFBs on a solo or sub-consolidated basis.

1.19 The PRA does not operate a zero-failure regime, including for RFBs.<sup>(1)</sup> While the PRA will seek to ensure that RFBs are resilient to certain risks, it would not be possible or desirable to ensure that they cannot fail. As such, the PRA will focus on ensuring that RFBs are protected from shocks that originate in the rest of the group or the global financial system in order to minimise disruption to the continuity of the provision of core services. Where this protection is insufficient to prevent failure, the second aspect — resolution — helps to ensure continuity can be achieved.

#### Resolution

1.20 Ring-fencing is intended to help ensure that RFBs and groups containing RFBs can be resolved in an orderly manner, with minimal disruption to the provision of core services. Ring-fencing should also support the restructuring of banking groups following resolution. As such, ring-fencing complements broader policies to improve arrangements for resolving failing banks.

1.21 Since the financial crisis, there have been a number of international initiatives aimed at reducing the impact of bank failure. These include:

- The Financial Stability Board's (FSB) *Key Attributes of Effective Resolution Regimes for Financial Institutions (Key Attributes)* which was endorsed by G20 leaders in 2011 and is the international standard for resolution regimes.<sup>(2)</sup> It sets out the elements of resolution regimes that the FSB considers necessary for authorities to be able to resolve financial institutions in an orderly manner without exposing taxpayers to loss from solvency support, while maintaining continuity of their critical economic functions.
- The EU Bank Recovery and Resolution Directive which was finalised in June 2014.<sup>(3)</sup> The Directive provides a common legislative framework for the recovery and resolution of banks and large investment firms within the EU, and has been designed to comply with the *Key Attributes*.
- In November 2014, G20 leaders will consider the key remaining measures necessary to end 'too big to fail'. These are likely to include an international standard for a minimum level of total loss-absorbing capacity for global systemically important banks, and proposals for cross border recognition of resolution actions.

1.22 The preferred resolution strategy for banking groups within the scope of ring-fencing is likely to involve a bail-in at

(1) *The PRA's approach to banking supervision*, June 2014; [www.bankofengland.co.uk/publications/Documents/prapproach/bankingappr1406.pdf](http://www.bankofengland.co.uk/publications/Documents/prapproach/bankingappr1406.pdf), and section 2G of the Act.

(2) Financial Stability Board, *Key attributes of effective resolution regimes for financial institutions*, October 2011.

(3) Bank Recovery and Resolution Directive: establishing a framework for the recovery and resolution of credit institutions and investment firms, Directive 2014/59/EU.

## Box 2

### The group ring-fencing purposes<sup>(1)</sup>

The Act requires the PRA to make rules to ensure the effective provision to an RFB of services and facilities it requires in relation to carrying on a core activity (which is the regulated activity of accepting deposits), and to make provision for group ring-fencing purposes, which are:

- ensuring as far as reasonably practicable that the carrying on of core activities by an RFB is not adversely affected by the acts or omissions of other members of its group;
- ensuring as far as reasonably practicable that in carrying on its business an RFB:
  - is able to take decisions independently of other members of its group; and

- does not depend on resources which are provided by a member of its group and which would cease to be available to the RFB in the event of the insolvency of the other member; and

- ensuring as far as reasonably practicable that the RFB would be able to continue to carry on core activities in the event of the insolvency of one or more other members of its group.

The Act requires the PRA also to make rules with respect to: board membership; risk management; remuneration policy; human resource (HR) policy; disclosure by an RFB; restricting an RFB from entering into a contract with group members other than on arm's length terms; restricting an RFB from paying dividends and making other payments to group members; and any other rules it considers necessary.

(1) See section 142H of the Act, as amended by the Financial Services (Banking Reform) Act 2013.

a holding company level.<sup>(1)</sup> Bail-in would recapitalise, where necessary, the relevant operating entity (whether an RFB or another member of the wider group) by passing losses generated in an operating entity up to the holding company. This should stabilise the group, allowing the RFB to continue to provide critical services while any necessary restructuring takes place.

1.23 Resolution at the holding company level should avoid the need to separate the RFB from the rest of the group at the point of resolution. But ring-fencing would facilitate any required reorganisation of a group that may need to occur as part of a subsequent restructuring plan. Structural separation provides resolution authorities with additional options to minimise any disruption to the continuity of core services in the United Kingdom. The PRA will, accordingly, focus on ensuring that the design of the ring-fencing regime facilitates orderly resolution and the continuity of core services in the event of the failure of an RFB or another member of its group.

### The PRA's proposed rules and supervisory statements

1.24 The implementation of ring-fencing will require rules and supervisory statements across a number of areas made in accordance with the group ring-fencing purposes as set out in Box 2. The specific areas addressed in this CP relate to:

- **Legal structures of groups containing an RFB.** Chapter 2 proposes that RFBs should not own entities which conduct excluded or prohibited activities as this would expose the RFB to risks unrelated to the provision of core services. It also proposes that RFBs are not owned by such firms to ensure the RFB is able to make decisions independently. These expectations will be set out in a supervisory statement.

- **The governance of groups containing an RFB.** Chapter 3 proposes rules in the areas of governance, risk management, internal audit, remuneration and human resources policy. Such functions underpin how RFBs make decisions and devise strategy which is critical, in particular, in enabling an RFB to take decisions independently of other group members.

- **Continuity of services and facilities.** Chapter 4 proposes rules governing how RFBs can receive services and facilities from other intragroup entities or third parties outside their group. These are intended to mitigate risks to the ability of the RFB to perform its core services arising from the acts, omissions, or the failure of other group entities. These proposals for RFBs complement a broader set of proposals set out in DP1/14 for all PRA-regulated deposit-takers (except credit unions) and investment firms on ensuring operational continuity in resolution.<sup>(2)</sup> This broader set of proposals also addresses the scenario where the RFB itself may act as a service provider to other group entities.

Draft rules and supervisory statements are set out in the appendices to this CP.

1.25 The PRA will undertake further consultation in due course on other aspects of ring-fencing. Chapter 5 of this publication sets out for feedback the PRA's initial thinking on financial separation and transparency and disclosure ahead of future consultation. Chapter 5 therefore does not include specific policy proposals as draft rules related to these areas are still being developed.

(1) This may be the ultimate or an intermediate holding company.

(2) *PRA Discussion Paper DP1/14*, 'Ensuring operational continuity in resolution', October 2014; [www.bankofengland.co.uk/pr/Pages/publications/cp/2014/dp114.aspx](http://www.bankofengland.co.uk/pr/Pages/publications/cp/2014/dp114.aspx).

1.26 Chapter 6 sets out the PRA's consideration of its statutory obligations in relation to the proposals in this CP, including a cost benefit analysis.

### FCA approach

1.27 The FCA is also an 'appropriate regulator' under the Act with responsibility for creating rules in relation to RFBs which are not PRA-authorized. It is not presently envisaged that there will be any RFBs which are not PRA-authorized at the time ring-fencing becomes operational.

1.28 The FCA is required under the relevant secondary legislation to make disclosure rules applying to entities which are not ring-fenced but sit within banking groups which include an RFB. These rules are to specify the information which such entities must provide to their account holders who are individuals, and the situations in which this information must be provided. These rules will include disclosure requirements for the situation in which a high net worth individual seeks to opt out of the ring-fence and place a deposit with a non ring fenced body. The FCA intends to consult on draft disclosure rules in 2015.

1.29 The PRA has consulted with the FCA on the draft rules and supervisory statements included within this CP. The PRA and the FCA will also work together closely as banks implement their ring-fencing plans, for example on any changes related to firms' authorisations.

### Responses and next steps

1.30 The Government has stated that its intention is for ring-fencing to be implemented from 1 January 2019. The PRA plans to complete its consultation process and publish rules and supervisory statements well in advance of this date in order to provide firms with sufficient time for implementation.

1.31 Views are sought on the proposals and issues for discussion in this CP by 6 January 2015. Respondents are requested to structure their responses by chapter.

1.32 The PRA expects to undertake further consultation during 2015, and to publish the PRA's rules and supervisory statements during the first half of 2016.

### Firms' preparations for ring-fencing

1.33 The PRA is aware that some firms within the scope of the ring-fencing requirements under the Act have already started to plan how to implement ring-fencing in time for the 2019 implementation date. The PRA requests that all firms that expect to be subject to ring-fencing requirements by 2019 submit a preliminary plan of their anticipated legal and operating structures to their PRA and FCA supervisors by 6 January 2015. Firms with growth plans that indicate that they may meet the core deposits threshold in 2019 should consult with their supervisors on whether or not such a submission would be appropriate.

1.34 The submitted plans should be consistent with resolution planning and prudential standards. They would ideally include provisional UK holding company and UK regulated entity balance sheets and profit and loss statements, enabling supervisors to assess the viability and sustainability of the entities and their level of going and gone-concern capitalisation. The PRA and FCA also request a project plan showing how firms intend to transition to the preferred legal and operating structures. This project plan should set out clear project governance arrangements, including key milestones and decision points. The plans should highlight any new authorisations, permissions or waivers likely to be required and any Part VII transfers requiring regulatory attestations. The PRA and FCA understand that firms' plans may change as further details of the regime are provided, however, preliminary plans are requested now in order to help the PRA and FCA decide the approach to implementation.

## 2 Legal structure

2.1 This chapter sets out the PRA's proposals to ensure that the structure of groups containing RFBs promotes the resilience and resolvability of those entities and is consistent with the group ring-fencing purposes described in Chapter 1. In particular, this chapter sets out the PRA's expectations for the legal ownership of RFBs and the entities which RFBs can own. The PRA will set out these expectations in a supervisory statement; a draft is included in Appendix 1. The PRA is not proposing rules in this area, but will consider using its existing powers, as necessary and to the extent consistent with UK and EU law, to impose requirements on firms and/or to give directions to parent undertakings to implement this policy.

2.2 The ring-fencing of entities providing core services within a banking group reduces the risk of disruption to those services whilst preserving some of the benefits of providing a range of services from within the same group. An RFB needs to be protected adequately from risks arising from other group entities, and the way that groups are structured can be important in this respect.

2.3 Particular risks may arise if RFBs are owned by entities carrying out excluded or prohibited activities as defined by the Act and the *Excluded Activities and Prohibitions Order 2014* (the Order), or if RFBs own such entities, as described below. As a result, the PRA expects that banking groups including RFBs will not be structured this way and will instead adopt a 'sibling structure'. This proposal will support meeting the group ring-fencing purposes, in particular that an RFB is '*able to take decisions independently of other members of its group*', that an RFB is '*not adversely affected by the acts or omissions of other members of the group*', and that an RFB would be able to '*carry on core activities in the event of the insolvency of other group members*'.

2.4 The Order prevents an RFB from having subsidiaries (or branches) located outside the European Economic Area (EEA), subject to an exemption for ancillary services undertakings which do not carry on activities which would be regulated in the United Kingdom. However, the Order does not require banking groups to adopt a sibling structure. Given the benefits of sibling structures, the PRA expects that banking groups containing RFBs will structure themselves in this way. This is consistent with the PRA's objectives under the Act.

### Proposals

2.5 The PRA's expectation is that an RFB should not have an ownership interest (including, but not limited to, shares, voting rights or other rights to participate in the capital or profits) in any entity which undertakes excluded or prohibited activities. Similarly, within a UK group or subgroup, the PRA does not expect an entity that undertakes excluded or prohibited activities to have an ownership interest in an RFB.

2.6 Instead, RFBs and entities that can conduct excluded or prohibited activities are expected to be structured as separate clusters of subsidiaries beneath a UK holding company. This is known as a 'sibling structure'. The PRA intends to set out its expectations on RFB exposures and intragroup transactions more generally in a future consultation (see also Chapter 5).

2.7 The PRA expects that risks to an RFB's provision of core services will be reduced by it not taking ownership stakes in entities which undertake excluded or prohibited activities. This will, for example, prevent losses related to international or investment banking being passed to an RFB from a subsidiary. It will also prevent an RFB becoming financially dependent on the income or profits of such activities. Such flows may be volatile, and dependence on them may threaten the resilience of the RFB. Finally, this approach will mean that an RFB is unable to circumvent ring-fencing requirements by transferring excluded or prohibited activities into a subsidiary.

2.8 There are also benefits where an RFB is not owned by entities undertaking excluded or prohibited activities. Operating as a subsidiary of such an entity could threaten an RFB's ability to make independent decisions. For example, it may face pressure from the parent to take actions not in its interests.

2.9 Relative to other types of ownership structures, a sibling structure may facilitate resolution by ensuring a cleaner split between an RFB and other entities in a banking group, thereby reducing the likelihood of an RFB's core services being disrupted following the failure of a group entity undertaking excluded or prohibited activities. It may also broaden the range of options available following failure by enabling resolution authorities to apply different resolution tools to the RFB and other group entities, and may facilitate a wider range of options for restructuring following resolution. For example, resolving a failed investment banking subsidiary without

disrupting the activities of the RFB is likely to be less straightforward if the RFB is a subsidiary of the investment bank.

2.10 The PRA's proposed approach is consistent with the Government's expectation, as expressed in the House of Lords debate on the Financial Services (Banking Reform) Bill, that the PRA would act to ensure that banking groups containing RFBs adopt a sibling structure.<sup>(1)</sup>

2.11 In principle, the PRA does not necessarily object to an RFB owning entities undertaking activities that are not excluded or prohibited under the Act. Nor does it necessarily object to the parents of RFBs undertaking such activities. This, however, would need to be considered on a case-by-case basis, taking into account the PRA's statutory objectives.

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(1) House of Lords Official Report (Hansard) (Session 2013.14), *Debate on Financial Services (Banking Reform) Bill*, Committee stage, 8 October 2013, cc35; [www.publications.parliament.uk/pa/ld201314/ldhansrd/text/131008-0001.htm#13100819000471](http://www.publications.parliament.uk/pa/ld201314/ldhansrd/text/131008-0001.htm#13100819000471).

## 3 Governance

3.1 This chapter sets out how the PRA proposes to meet its ring-fencing rule-making requirements in areas related to the governance of RFBs. This chapter also sets out the PRA's proposed additions relating to ring-fencing to the regulatory framework for individuals that the PRA and FCA are currently consulting on.<sup>(1)</sup> Draft rules are included in the Appendix to this CP, as is supplementary text for the supervisory statements which will accompany the new accountability regimes.

3.2 The Act requires the PRA to make rules on RFB board membership, risk management, remuneration policy and HR policy. The corporate governance arrangements of an RFB will underpin how it makes decisions in the context of the wider group. This is especially relevant to the group ring-fencing purpose that the RFB is '*able to take decisions independently of other group members*'. Moreover, if the RFB is able to take decisions independently it will be in a better position to meet the other group ring-fencing purposes. For example, the ability of the RFB to take decisions independently from other group members reduces the risk that the RFB will be '*exposed to acts or omissions of other members of its group*'.

3.3 Existing PRA rules for firms' governance and systems and controls go some way to delivering the group ring-fencing purposes. The PRA has therefore sought to make proposals for new rules only where it considers existing rules to be insufficient. These proposals are designed to meet the PRA's objectives in respect of RFBs. They should not affect the way in which existing PRA rules are interpreted in relation to other regulated entities in an RFB's group.

3.4 The proposed rules discussed in this chapter impose requirements upon each RFB at an individual level. As discussed in Chapter 5, it is currently envisaged that RFBs will be allowed to apply to form a subgroup with other group entities where such entities do not perform excluded or prohibited activities. Therefore, where such subgroups exist, the PRA intends that the requirements set out in this chapter will either be applied on a sub-consolidated basis or, in the case of some requirements, not be applied within the subgroup. This is to ensure that management decisions are aligned with group structure and the ring-fencing of core services.<sup>(2)</sup>

### Proposals

#### (i) General rules

3.5 The PRA proposes to introduce general rules that state the outcomes, based on the group ring-fencing purposes in the Act, that the PRA expects firms to achieve. The RFB must be able to demonstrate to the PRA its compliance with the ring-fencing rules.

3.6 The PRA proposes the following outcomes to be set out in the proposed general rules:

- RFBs are able to take decisions independently of other members of the group;
- RFBs take all reasonable steps to identify and manage conflicts of interest with other group members;
- RFBs take reasonable steps to identify and manage any conflicts between the duties senior management owe to the RFB and other interests they may have; and
- RFBs can demonstrate how they are meeting the ring-fencing rules.

3.7 The PRA recognises that RFBs will be part of broader banking groups. Consequently, there will be a number of — sometimes competing — interests in the group. The separation introduced by ring-fencing, combined with the outcomes required by the group ring-fencing purposes, will lead to instances where conflicts of interest arise more prominently in the RFB's relationship with other group entities. The PRA's expectation is that an RFB's governance framework enables the identification and management of these competing interests whilst supporting the objectives of ring-fencing.

3.8 The proposed rules in this chapter apply to all RFBs. At the same time, the PRA recognises that the individual position of each RFB in the context of its wider group, such as the size of an RFB's business relative to that of the wider group, may have a bearing on how often it finds its interests are not aligned with those of the wider group, as well as the degree to which the RFB's decision-making could be unduly influenced

(1) *PRA Consultation Paper CP14/14 / FCA Consultation Paper CP14/13*, 'Strengthening accountability in banking: a new regulatory framework for individuals', July 2014; [www.bankofengland.co.uk/pradocuments/publications/cp/2014/cp1414.pdf](http://www.bankofengland.co.uk/pradocuments/publications/cp/2014/cp1414.pdf).

(2) The application of these draft rules is subject to the finalisation and implementation of the policy on RFB subgroups which will be included in a subsequent consultation paper.

by other members of the group. As general policy, the PRA is also mindful of the need to ensure that the RFB has sufficient representation at the parent's board. Such considerations would be taken into account in considering any modification or waiver applications. A firm may apply for a waiver from, or modification to, the ring-fencing rules made under the Act. These would be assessed in accordance with the statutory test as set out in section 138A of the Act.

## (ii) Requirements for the board and board committees of an RFB

3.9 The Act requires the PRA to make rules on board membership for the group ring-fencing purposes. It states that PRA rules must include:

*'provision requiring a ring-fenced body to ensure that its board of directors (or if there is no such board, the equivalent management body) includes to a specified extent —*

- (i) *members who are treated by the rules as being independent of other members of the ring-fenced body's group;*
- (ii) *members who are treated by the rules as being independent of the ring-fenced body itself; and*
- (iii) *non-executive members'.<sup>(1)</sup>*

3.10 In meeting these requirements the PRA proposes the following rules on the membership of the RFB's board:

- at least half of an RFB's board, excluding the chair, must be independent non-executive directors (NEDs);
- the chair of an RFB must be independent during his or her tenure as chair;
- the chair of an RFB must not hold another chair position in another group entity board;
- no more than one third of an RFB's board members may be current employees or directors of another entity in the group;
- an RFB executive director on the board of an RFB must not hold other executive director positions on the board of another entity in the group that carries out excluded or prohibited activities; and
- an RFB must have its own risk, nomination, audit and remuneration non-executive board committees.

Each proposed rule is discussed in turn below.

### At least half of an RFB's board, excluding the chair, must be independent non-executive directors

3.11 The independence criteria in the proposed rules are intended to reflect the UK Corporate Governance Code.<sup>(2)</sup>

The purpose of this proposal is to ensure that the RFB's board includes members who are *'independent of the RFB itself...and non-executive members'*.

3.12 The criteria in the rules do not prohibit independent NEDs on the RFB's board from being independent NEDs on

other group boards provided they can be considered independent from both bodies and continue to fulfil the criteria for the RFB.<sup>(3)</sup> An executive from another part of the group would be permitted to sit on the RFB board as a non-executive. However, they would not be considered independent for the purpose of meeting the rule on independent non-executives.

### The chair of an RFB must be independent during his or her tenure as chair. The chair of an RFB must not hold another chair position in another group entity board.

3.13 The chair of the RFB board should be independent on appointment and thereafter according to the PRA's proposed independence criteria set out in the proposed rules. The independence criteria alone would not prohibit an independent chair from holding independent non-executive positions elsewhere in the group, potentially including a position as independent chair of another group board. The PRA does not wish to prohibit the chair of the RFB from sitting on other group entities' boards as a non-executive. However, given the chair's leadership role it would appear inconsistent with the group ring-fencing purpose relating to independent decision-making for the chair of the RFB board also to be responsible for chairing the board of another group entity (outside the RFB's subgroup). The PRA seeks views on the proposal that the chair of the RFB board may not hold another chair position in another group board.

### No more than one third of an RFB's board members may be current employees or directors of another entity in the group

3.14 This rule is intended to ensure that there are sufficient directors who are *'independent of other members of an RFB's group'* on the board of an RFB so that it is able to take decisions independently of other group members. Directors who hold positions in multiple entities in the same group will be required to manage inherent conflicts of interests where the interests of each entity are not aligned, including in circumstances where the group's financial resources are subject to stress. By limiting to a third the number of directors that can hold positions in other group entities, the PRA is seeking to achieve an appropriate balance between supporting the RFB's ability to take decisions independently from other group members and recognising the RFB's position as part of a wider group. Where a subsidiary of an RFB forms part of an RFB subgroup, as outlined in paragraph 3.4, RFB directors who are also employees or directors of this subsidiary would not count towards this threshold.

(1) Section 142H(5)(d) of the Act, as amended by the Banking Reform (Financial Services) Act 2013.

(2) The UK Corporate Governance Code 2014, published by the Financial Reporting Council, sets out standards of good practice in relation to corporate governance arrangements that listed firms follow on a 'comply or explain' basis. See [www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-2014.pdf](http://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-2014.pdf).

(3) The criteria are set out in rule 1.3 in the draft rules on board composition included in Appendix 4.

### An RFB executive director on the board of an RFB must not hold other executive positions on the board of another entity in the group that carries out excluded or prohibited activities

3.15 This rule would prohibit directors of an RFB from holding executive positions on the boards of both the RFB and other group entities that perform excluded or prohibited activities. Individuals undertaking executive functions in these circumstances would be subject to inherent conflicts of interest between their duty to promote the interests of the RFB and their duty to the entities which the RFB is intended to be ring-fenced from. This risk is more acute for executive than non-executive directors given their role in the day-to-day running of the entity. Executive directors of the RFB would still be able to hold executive positions in the parent entity and in any entities owned by the RFB.

### An RFB must have its own risk, nomination, audit and remuneration non-executive board committees

3.16 RFBs, as significant firms, will be required to have their own risk management, nomination and remuneration board committees under the rules implementing CRD IV.<sup>(1)</sup> The PRA proposes that RFBs should also have their own board audit committee.<sup>(2)</sup> This is already presupposed by the Capital Requirements Directive which states that '*Competent authorities may allow an institution which is not considered significant... to combine the risk committee with the audit committee*'.<sup>(3)</sup> Board committees should play a central role in supporting an RFB's ability to take decisions independently from other members of its group.

### Chairs of board committees

3.17 Consistent with the approach taken for the chair of the RFB board, the PRA also seeks views on the proposal that the chair of each board committee must not also hold the equivalent chair position on a board committee of another group entity (outside the RFB's subgroup).

### (iii) Risk management and internal audit

3.18 The Act requires the PRA to make '*provision requiring arrangements made by the ring-fenced body for the identification, monitoring and management of risk to meet specified requirements*'.<sup>(4)</sup>

3.19 The PRA has set out its general expectations for risk management and other control functions in its approach to banking supervision.<sup>(5)</sup> It expects risk management and other control functions to support and challenge a firm's decisions on the level of risk being run and the adequacy and integrity of the associated governance, risk management and financial and other control arrangements. Accordingly, the intended outcome of the PRA's proposals in these areas is for RFBs to have control functions that are able to provide this support and challenge in a way that supports the RFB's ability to take decisions independently and also ensures that the RFB is not

adversely affected by the acts or omissions of other members of its group.

3.20 Although the Act does not make specific provision for rules on internal audit, an effective internal audit function is a central part of a robust risk management framework to provide independent assurance on firms' internal controls. Therefore the PRA proposes also making provisions applicable to internal audit.

3.21 The existing PRA rules for risk management and internal audit place responsibility on the firm as the regulated entity, distinct from the rest of its group.<sup>(6)</sup> As discussed above in paragraph 3.16, an RFB will also have its own board committees for risk and audit that will support the decisions of the management body in these areas. The group would remain able to set group-wide policies. The PRA would, however, expect to see RFB board committees making recommendations as to whether the RFB and group policies, where relevant, are appropriate to support the interests of the RFB. As the RFB board will have responsibility for executive decision-making it will be able to go beyond group policies where necessary.

3.22 The PRA proposes the following additional rules for risk management and internal audit arrangements in RFBs.

### An RFB must have its own sufficient risk management and internal audit resource

3.23 The PRA proposes to require that an RFB has sufficient risk management and internal audit resource identifiable as dedicated to it to enable the RFB to take decisions independently of other members of its group. The PRA recognises that firms will have a range of different business models and may take different approaches to complying with the ring-fencing rules. The PRA has proposed this rule as an outcomes-focused requirement to allow firms some flexibility in how they choose to comply.

(1) PRA Policy Statement PS7/13, 'Strengthening capital standards: implementing CRD IV, feedback and final rules', December 2013, provides the interpretation that if a firm had been told by its supervisors that it was considered either a category 1 or 2 firm it would be treated as significant by the rules. See [www.bankofengland.co.uk/pras/Documents/publications/ps/2013/ps713.pdf](http://www.bankofengland.co.uk/pras/Documents/publications/ps/2013/ps713.pdf).

(2) EU Directive 2014/56/ED of the European Parliament and of the Council of 16 April 2014 amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts ('the 8th Directive') includes the requirement for 'public interest bodies', including listed banks, to establish an audit committee. The PRA has sought to ensure the requirements imposed through the proposed ring-fencing rules for an RFB's audit committee are consistent with the 8th Directive, and compatible with the FRC Guidance on Audit Committees, 2012.

(3) CRD IV, Article 76 (3).

(4) Section 142H(5)(g) of the Act, as amended by the Banking Reform (Financial Services) Act 2013.

(5) *The PRA's approach to banking supervision*, June 2014, page 23; [www.bankofengland.co.uk/publications/Documents/prasapproach/bankingappr1406.pdf](http://www.bankofengland.co.uk/publications/Documents/prasapproach/bankingappr1406.pdf).

(6) PRA rules in the Senior Management Arrangements, Systems and Controls sourcebook (SYSC 4.1.1 and 7) concern risk management including the requirement to establish, implement and maintain adequate risk management policies and procedures. There are also existing rules (SYSC 6.2) outlining firms' responsibilities regarding internal audit. The PRA's new draft rules on internal audit in RFBs include the responsibility for an RFB audit committee to monitor the effectiveness of the RFB's internal controls, internal audit function and risk management systems.



3.24 The intention of this proposal is not to restrict cross-utilisation of resources but to ensure that the RFB is not dependent on other group members. Systems and resources could therefore still be shared with other parts of the group where appropriate. Robust arm's length terms between the entities as to how costs and resources are attributed would be required.<sup>(1)</sup> The risk and internal audit functions could still operate within group policies and have reporting lines to group functions. However, the PRA expects to see clear evidence, through recovery and resolution planning and regular supervision, that these functions could operate on a separate and sufficiently resourced basis.

#### Senior managers for risk and internal audit

3.25 Consistent with the above proposal, the PRA considers that RFBs should have their own heads of risk management and internal audit. This is intended to ensure that RFBs have senior staff who will be senior managers under the proposed Senior Managers Regime with specific responsibility and accountability for risk management and internal audit in the RFB.<sup>(2)</sup> These individuals would not be prohibited from having reporting lines to group senior managers but would be expected to report to the chairs of the respective RFB board committees.

3.26 As discussed above, these control functions play an important role in supporting decision-making. It would be inconsistent, therefore, with the group ring-fencing purposes for the senior manager who has responsibility for these areas to have the same responsibilities for other firms in the group. The interests of the RFB will not always be aligned with those of the other members of the group. The PRA seeks views on this proposal relating to risk management and internal audit.<sup>(3)</sup>

#### (iv) Remuneration

3.27 The Act requires that the PRA make '*provision requiring a ring-fenced body to act in accordance with a remuneration policy meeting specific requirements*'.<sup>(4)</sup> Consistent with PRA CP15/14, the objective of the rules relating to remuneration in RFBs is to ensure that the rewards of banking are allocated in accordance with the full long-term costs and benefits of the risks taken.<sup>(5)</sup> The PRA proposes, therefore, to require that remuneration is allocated in a manner consistent with sound and effective risk management and the long-term interests of the RFB, as distinct from those of other members of the group or the group as a whole.

3.28 The RFB will have responsibilities for the remuneration of all RFB employees.<sup>(6)</sup> This does not mean that the RFB must necessarily have a separate remuneration policy from the wider group. The RFB will have responsibility for the implementation and content of the policies for RFB employees and be expected to adjust the content of group policies for

RFB employees should the group remuneration policy, or elements of it, be inconsistent with sound and effective risk management or the long-term interests of the RFB. This proposal is outcomes-focused to allow flexibility for arrangements to be made for instances where staff may perform services for entities outside the RFB and its subsidiaries.

#### (v) HR policies

3.29 The Act requires the PRA to make '*provision requiring a ring-fenced body to act in accordance with a human resources policy meeting specified requirements*', and defines HR policy as '*policy about the appointment and management of [personnel of a specified nature]*'.<sup>(7)</sup>

3.30 The PRA's existing requirements, outlined in the Senior Management Arrangements, Systems and Controls sourcebook (SYSC), provide that firms must employ personnel with the skills, knowledge and expertise necessary for discharging responsibilities allocated to them.<sup>(8)</sup> There are also provisions concerning the segregation of functions.

3.31 In addition, the duties of a board nomination committee are relevant to the appointment and performance of the board through its role in recruitment and reviewing policy and decision-making.<sup>(9)</sup> The PRA considers these responsibilities are sufficient to support the group ring-fencing purpose related to independent decision-making without making further rules.

3.32 The PRA proposes to apply to RFBs two rules related to HR policy, as follows.

#### In carrying on its business the RFB does not depend on personnel that would cease to be available in the event of the insolvency of another member of the group

3.33 This proposal is consistent with the group ring-fencing purpose in the Act relating to resource dependency. Personnel outside RFBs will still be able to provide services to the RFB providing that they meet the proposed rule. As with the other

(1) Arm's lengths arrangements will be covered in a later ring-fencing consultation. See Chapter 5 for an initial discussion.

(2) *PRA Consultation Paper CP14/14 / FCA Consultation Paper CP14/13*, 'Strengthening accountability in banking: a new regulatory framework for individuals', July 2014; [www.bankofengland.co.uk/pradocuments/publications/cp/2014/cp1414.pdf](http://www.bankofengland.co.uk/pradocuments/publications/cp/2014/cp1414.pdf), figure 1, page 14.

(3) Controlled functions falling solely within the remit of the FCA are not within the scope of this consultation.

(4) Section 142H(5)(e) of the Act, as amended by the Financial Services (Banking Reform) Act 2013.

(5) *PRA Consultation Paper CP15/14 / FCA Consultation Paper CP14/14*, 'Strengthening the alignment of risk and reward: new remuneration rules', July 2014; [www.bankofengland.co.uk/pradocuments/publications/cp/2014/cp1514.pdf](http://www.bankofengland.co.uk/pradocuments/publications/cp/2014/cp1514.pdf).

(6) The proposed rules define 'employee' in line with the definition in the PRA remuneration rules which includes individuals providing services to the firm from a third party.

(7) Section 142H of the Act, as amended by the Financial Services (Banking Reform) Act 2013.

(8) SYSC 5 — Employees, agents and other relevant persons.

(9) The duties of a nomination committee are set out in SYSC 4.3A.9 and in CRD Article 88, paragraph 2.

proposals in this section this rule is not intended to prohibit personnel from providing services to multiple group entities, including those that undertake excluded or prohibited services. Whether the RFB depends on personnel will be influenced by a range of factors, such as for example, how substitutable the skills are, and how essential the role is to the RFB in carrying on its business.

### Vacancies for independent NEDs on RFB boards must be advertised publicly

3.34 The PCBS' final report identified 'a danger that the non-executive directors of banks are self-selecting and self-perpetuating'.<sup>(1)</sup> The PCBS also recommended that 'in the interests of transparency, and to ensure that they [NEDs] remain as independent as possible' the PRA examine the merits of requiring each NED vacancy on the board of banking groups subject to ring-fencing to be advertised publicly. The PRA proposes to apply these recommendations to the board of the RFB, as it is the RFB that will be responsible for delivering core services.

3.35 The PRA is proposing an exemption for board chairs who resign their directorships before completing their term. This is aimed at addressing the possibility that a board chair may need to be replaced very quickly in an emergency, for market confidence and financial stability reasons. A requirement to advertise in these circumstances may be a barrier to necessary and timely appointments.

### (vi) Individual accountability in RFBs

3.36 On 30 July 2014, the PRA and FCA published a consultation paper which included proposals to replace the Approved Persons Regime with a Senior Managers Regime (SMR) for banks and PRA-designated investment firms based on the clarification of individual responsibility for key decision-makers and strengthened supervisory and enforcement powers over these individuals for regulators.<sup>(2)</sup>

3.37 One of the main objectives of the proposed SMR is to achieve a clear allocation of responsibilities to senior managers. Under the proposed regime, firms will be required to allocate Prescribed Responsibilities specified by the PRA among their Senior Managers.<sup>(3)</sup>

3.38 The allocation of responsibilities to individuals, including PRA Prescribed Responsibilities, would be set out in Statements of Responsibilities. Firms would be required to submit these statements when applying for approval on behalf of prospective Senior Managers, together with a Management Responsibilities Map showing how responsibilities are allocated among the firm's senior management. These documents would provide formal evidence of the areas which a Senior Manager is responsible for managing and may be used as evidence of responsibility in supervisory discussions and enforcement action.

3.39 The Government has previously stated that personal responsibility for ensuring that banks comply with the ring-fencing provisions would be delivered through the regulators' individual accountability regimes.<sup>(4)</sup> To support individual accountability in RFBs, the PRA proposes to introduce an additional Prescribed Responsibility for Senior Managers of RFBs for ensuring that the areas of the firm which they are responsible for managing comply with the ring-fencing requirements.

3.40 The PRA proposes to require this ring-fencing responsibility to be allocated to any Senior Managers in an RFB including, where relevant, Group Entity Senior Managers that are responsible for managing any area of the RFB's business that is subject to a ring-fencing requirement. Given that the ring-fencing requirements touch on many aspects of an RFB's business and governance, the PRA expects this responsibility to be allocated to all the Senior Managers on the board of an RFB and to a majority, if not all, of the RFB's other Senior Managers. This expectation will be set out in the supervisory statement that will accompany the SMR.<sup>(5)</sup>

3.41 The proposed ring-fencing responsibility will help underline the specific responsibilities of key decision-makers in an RFB to promote and safeguard the ring-fence. It will also facilitate enforcement action against individuals (including the application of the presumption of responsibility to Senior Managers under section 66B of the Act) where a firm breaches a ring-fencing requirement.

### Demonstration of compliance with the ring-fencing rules

3.42 Firms will be required to be able to demonstrate how they are meeting these proposed rules. This will allow supervisors to assess compliance with the ring-fencing rules. This supervisory assessment will form part of firms' continuous assessment cycles.<sup>(6)</sup>

(1) Report of the Parliamentary Commission on Banking Standards, *Changing banking for good*, June 2013, pages 343–44.

(2) PRA Consultation Paper CP14/14 / FCA Consultation Paper CP14/13, 'Strengthening accountability in banking: a new regulatory framework for individuals', July 2014; [www.bankofengland.co.uk/pradocuments/publications/cp/2014/cp1414.pdf](http://www.bankofengland.co.uk/pradocuments/publications/cp/2014/cp1414.pdf).

(3) The PRA Prescribed Responsibilities are listed on page 18 of PRA CP14/14 and the draft PRA Rules on Allocation of Responsibilities in Annex 7.3 (PRA Prescribed Responsibilities).

(4) HM Treasury/Department for Business, Innovation and Skills, *Banking reform: a new structure for stability and growth*, February 2013.

(5) The amendment to the supervisory statement that accompanies the SMR in PRA CP14/14 will be made when the ring-fencing rules are introduced. Proposed supervisory statement text is included in Appendix 3.

(6) The FCA will also have a role in ensuring that the way firms comply with the rules is consistent with the FCA's own objectives.

# 4 Continuity of services and facilities

4.1 This chapter sets out the PRA's rule-making proposals to help ensure that RFBs have appropriate arrangements in respect of the services and facilities they need to provide core services.<sup>(1)</sup> A draft supervisory statement and draft rules are included in the appendices.

4.2 As set out in the group ring-fencing purposes in the Act, ring-fencing should ensure that an RFB can continue to perform its core activities regardless of the acts, omissions or insolvency of other group members. Although the PRA's existing regulatory framework fulfils, to a certain extent, the objective of ensuring that RFBs have appropriate arrangements in place, the PRA considers it necessary to impose additional restrictions in respect of:

- any intragroup service arrangements an RFB may have; and
- service arrangements an RFB may have with non-group entities where those arrangements may be affected by the financial position of a group entity.<sup>(2)</sup>

4.3 The proposals in this chapter do not require RFBs to own and manage directly all of the services and facilities they need. Instead, firms will have flexibility in how they structure their service arrangements, subject to meeting the PRA's requirements. This approach is consistent with the Government's response to the ICB's recommendations and the PRA's approach to improving firms' resolvability more broadly.<sup>(3)</sup>

4.4 The proposals in this chapter should be read in conjunction with DP1/14 which sets out the PRA's current proposals for the principles that all deposit-takers (excluding credit unions) and PRA-designated investment firms should follow to demonstrate operational continuity in resolution and facilitate recovery and post-resolution restructuring. The principles set out in DP1/14 also cover the scenario where an RFB may own and manage its own shared services and facilities within a shared services division or act as a shared service provider to other group entities.

4.5 The proposals contained in this chapter apply only to those firms subject to ring-fencing and are additional to any proposals which may arise following feedback to DP1/14.

## Proposals

### (i) Intragroup service arrangements

4.6 The PRA proposes a rule requiring that an RFB may receive shared services and facilities from other group entities only

where such entities form part of the RFB's subgroup or are dedicated intragroup services entities.<sup>(4)</sup>

4.7 This rule is to help meet the group ring-fencing purposes in the Act which require the PRA to make rules ensuring that, as far as reasonably practicable, an RFB:

- *is not adversely affected by the acts or omissions of other group members in the carrying on of core activities;*
- *in carrying on its business is able to take decisions independently of other group members;*
- *in carrying on its business does not depend on resources that would cease to be available in the event of the insolvency of other group members; and*
- *would be able to carry on core activities in the event of the insolvency of other group members.*

4.8 As discussed in Chapter 5, it is currently envisaged that RFBs will be allowed to form a subgroup with other group entities where such entities do not perform excluded or prohibited activities. The PRA considers it proportionate to allow an RFB to receive shared services and facilities from such entities within its subgroup as the subgroup will be subject to supervision on a sub-consolidated basis and will not perform excluded or prohibited activities.

4.9 Allowing an RFB to receive shared services and facilities from dedicated intragroup services entities recognises that there are some services and facilities that may be shared across the ring-fence. The PRA considers that it would be disproportionate to require such shared services and facilities to be duplicated on both sides of the ring-fence or provided from within the RFB or its subgroup.

4.10 However, in order to ensure that the group ring-fencing purposes are met, any dedicated intragroup services entity providing services to an RFB would need to meet any eventual

(1) See draft supervisory statement in Appendix 2 for an explanation of what is defined as 'services and facilities'. Note that the provision of services and facilities that an RFB needs to access relevant financial market infrastructure is outside the scope of the proposals in this chapter and may be addressed in a future consultation paper.

(2) *The PRA's approach to banking supervision* (June 2014) states that firms should have robust frameworks for risk management and financial and operational control, commensurate with the nature, scale and complexity of their business, and consistent with their safety and soundness. More specifically, the Senior Management Arrangements, Systems and Controls (SYSC) rules in the PRA's handbook set out the standards expected in relation to a firm's non-financial resources. See <http://fshandbook.info/FS/html/PRA/SYSC>.

(3) HM Treasury/Department for Business, Innovation and Skills, *Government response to the Independent Commission on Banking*, December 2011.

(4) A 'dedicated intragroup services entity' means an entity within the same group as the RFB whose only business is to provide services or facilities to other entities within its group.

expectations that the PRA has in respect of arrangements needed to ensure operational continuity in resolution (see DP1/14) and resolution planning more broadly.

4.11 The PRA also considered whether to allow an RFB to receive shared services and facilities from qualifying parent undertakings which may not meet the definition of being an intragroup services entity.<sup>(1)</sup> However, if a qualifying parent undertaking is a potential 'point of entry' for resolution then allowing the entity to be a service provider may make the balance sheet of that entity more complex, which could make it more difficult to conduct a bail-in.

4.12 Therefore, the PRA has not, at this stage, included a specific exemption in its draft rules allowing all qualifying parent undertakings to provide services and facilities to RFBs. However, the PRA welcomes comments on whether the identified potential barrier to resolution can be overcome through other measures.

#### **(ii) Intragroup and third-party service arrangements**

4.13 The PRA proposes a rule requiring that RFBs make arrangements to ensure that the provision of services and

facilities from both other group entities and third parties to an RFB cannot be disrupted through the acts, omissions or insolvency of other group members.

4.14 However, the PRA proposes, in line with the group ring-fencing purposes, that this rule would apply only in respect of those service arrangements that may adversely affect the ability of the RFB to conduct its core activities. This imposes a proportionality threshold on this requirement. In addition, the PRA will take account of any business continuity arrangements when assessing whether firms are meeting this requirement.

4.15 This proposal is necessary to help remove indirect channels of contagion from other group entities to the RFB which may adversely affect the ability of the RFB to perform its core activities. For example, an intragroup service entity or a third party should not terminate or withhold the provision of services to an RFB simply because another group entity has entered into resolution or insolvency.

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(1) A qualifying parent undertaking is a parent undertaking which is a UK company (or at least a company with a place of business in the United Kingdom) which is also an insurance holding company, a financial holding company, a mixed financial holding company or a financial institution. It is not an authorised person itself (or a recognised investment exchange or clearing house). See section 192B of the Act.

# 5 Discussion of future consultations

5.1 This chapter sets out the main areas to be covered in future PRA consultation. Some of the areas described below are derived directly from obligations imposed on the PRA by the Act or the accompanying secondary legislation. The PRA will need to develop its policy on these matters to implement the legislation in a way that best delivers what the Act requires. Other areas of ring-fencing policy are not directly prescribed in the legislation, but the PRA considers them relevant to meeting the group ring-fencing purposes as set out in the Act. In developing rules and requirements in these areas, the PRA will adopt an outcomes-based approach.

5.2 At this stage, the PRA is not presenting any specific policy proposals for consultation, but feedback is sought on the areas described below, which may also be useful context for the purpose of responding to the policy being consulted on elsewhere in this paper. The PRA also invites comment on other areas the PRA should consider in further developing its policy proposals.

## Intragroup arrangements

5.3 The Act requires the PRA to make rules in a number of areas covering the relationship of RFBs with other members of their groups. These include the making of rules to effect a *'provision restricting the payments that a ring-fenced body may make (by way of dividend or otherwise) to other members of its group'*.<sup>(1)</sup> In addition, the Act requires that the PRA make rules *'restricting the power of a ring-fenced body to enter into contracts with other members of its group otherwise than on arm's length terms'*.<sup>(2)</sup>

5.4 There are established legal, accounting and taxation frameworks that deal with dividends and intragroup payments. The PRA will consider these frameworks in developing its proposals, although given the group ring-fencing purposes set out in the Act, the PRA may set additional requirements.

## Prudential requirements

5.5 As described in Chapter 1, ring-fencing is intended to improve the resilience and resolvability of entities undertaking core services. This chapter notes four aspects of prudential requirements intended to ensure the financial resilience of the RFB that the PRA will take into account when developing policy.

### (i) Level of application of prudential requirements

5.6 Banks are subject to a range of prudential requirements, including in relation to their capital, liquidity and large exposures. These requirements can be imposed at different levels within a financial group. For example, under a group consolidated approach, all entities within the group will be captured, and the prudential requirements will be met by the group as a whole. At the other end of the spectrum, each entity within a group can be required to meet prudential requirements on an individual basis. Between these extremes, a subset of related group entities can be consolidated together ('sub-consolidation').

5.7 The Capital Requirements Regulation (CRR) and Directive specify the initial levels at which prudential requirements apply, but in some cases allow Member States either to modify the level of application or supplement it with additional levels.<sup>(3)</sup> Specifically, Article 11(5) of the CRR permits Member States to impose sub-consolidated requirements in addition to the existing individual and consolidated requirements, in respect of subgroups created pursuant to structural separation of banking activities in a group.

5.8 Chapter 2 set out the PRA's expectations that groups will form sibling structures. Within such a structure, it is currently envisaged that an RFB could apply to form a subgroup with entities that do not undertake excluded or prohibited activities (an 'RFB subgroup').

5.9 The PRA will consider how sub-consolidated requirements should be applied to these subgroups. An RFB and members of its subgroup would be required to meet prudential requirements on a sub-consolidated basis separately from those entities in the group which undertake excluded and prohibited activities. This is to ensure an RFB and its subgroup have sufficient own resources without relying on other group entities. This approach also reduces the risk that loss-making entities elsewhere in the group threaten the resilience or resolvability of the RFB.

(1) Section 142H(5)(b) of the Act, as amended by the Financial Services (Banking Reform) Act 2013.

(2) Section 142H(5)(a) of the Act, as amended by the Financial Services (Banking Reform) Act 2013.

(3) Capital Requirements Regulation 575/2013/EU and Capital Requirements Directive 2013/36/EU. In the United Kingdom, solo-consolidation is permitted as an alternative to individual requirements under certain conditions.

5.10 The PRA also expects that there is alignment between the RFB subgroup subject to prudential requirements and the subgroup to which the governance and operational arrangements proposed in Chapters 3 and 4 apply.

### (ii) Prudential standards

5.11 As set out in Chapter 1, ring-fencing aims to make an RFB more resilient by limiting its intragroup exposures. The CRR permits Member States to reduce the large exposures limit from 25% to 10% from July 2015 for intragroup exposures, where structural reform has been adopted and prudential requirements on a sub-consolidated basis are required.<sup>(1)</sup> The ICB proposed that intragroup exposures subject to the same limit as third parties, given the requirement that the underlying transaction be conducted on arm's length terms. The PRA will review the merits of both approaches.

5.12 There is also a number of ongoing consultations or reviews which may have implications for the prudential standards that RFBs might need to meet. For example, the Government has decided that RFBs should be subject to a 'ring-fence' capital buffer — above and beyond the Basel III minimum standards — of up to 3% of risk-weighted assets.<sup>(2)</sup> In addition, the Financial Policy Committee of the Bank of England has consulted on the role a leverage ratio requirement might play in the capital framework in the United Kingdom.<sup>(3)</sup> In developing its proposals the PRA will take into account the outcome of these reviews and consultations.

### (iii) Intragroup concessions

5.13 The CRR currently permits intragroup concessions in respect of risk weights and large exposure limits for exposures to other group members.<sup>(4)</sup>

5.14 The PRA will need to review whether these concessions can continue for exposures of the RFB to other members of its group that sit outside its RFB subgroup; in part because some of the concessions are granted under conditions that may cease to be valid. For example, the counterparty may cease to be subject to the same risk evaluation, measurement and control procedures, given the proposals in Chapter 3. More generally the concessions create a dependency on other group members, which would not be consistent with the aims of ensuring an RFB is resilient and that it would not be adversely affected by the acts or omissions of other group members.

5.15 Similarly, the PRA will review the intragroup liquidity, funding and cross-holdings arrangements for an RFB as part of developing its proposals for future consultation.

### (iv) Disclosures and reporting

5.16 The Act requires that the PRA make rules requiring the RFB to submit information on intragroup transactions.<sup>(5)</sup> More generally, the PRA will also need to monitor the performance

of the RFB to assess whether the overall ring-fencing objectives are being met. The PRA will therefore consider the nature and frequency of the reporting obligations for RFBs.

## Other matters

5.17 The secondary legislation requires that an RFB must be a direct participant of inter-bank payment systems.<sup>(6)</sup> This requirement is subject to certain exemptions, one of which is where the PRA has given its permission due to exceptional circumstances.<sup>(7)</sup> The legislation requires that the PRA publishes a statement containing guidance on what constitutes exceptional circumstances. As part of a future consultation, the PRA will therefore consider what this guidance might contain. It is likely that this will include consideration of whether transitional provisions in the context of mergers, acquisitions and divestments are appropriate.

5.18 Ring-fencing is intended to improve the resilience of an RFB by protecting it from risks arising in the global financial system and from other group entities. While the legislation specifically prohibits the RFB from having exposures to other financial institutions, it does include exemptions for certain financial institutions (for example, a building society) or for exposures arising from certain circumstances (for example, if an exposure arises from a transaction entered into for the purpose of managing the RFB's risks, or is to another group member enacted on arm's length terms).<sup>(8)</sup> Therefore, as part of future consultations and/or during the implementation process, the PRA will consider the risks facing the RFB and how they are managed, and will consider whether any further mitigation is required to deliver the group ring-fencing purposes.

## Process and practical implementation

5.19 The overall proposals for ring-fencing core activities and services have the potential to require a number of regulatory processes (for example, new authorisations, Part VII transfers and changes to waivers and permissions). Further consideration will be given to how these processes can be undertaken without unnecessary burden for firms or the PRA.

(1) Article 395(6) of the CRR.

(2) HM Treasury/Department for Business, Innovation and Skills, *Banking reform: draft secondary legislation*, July 2013.

(3) Bank of England, *The Financial Policy Committee's review of the leverage ratio*, July 2014; [www.bankofengland.co.uk/financialstability/documents/fpc/fs\\_cp.pdf](http://www.bankofengland.co.uk/financialstability/documents/fpc/fs_cp.pdf).

(4) For example Articles 113(6) and 400 of the CRR that have been implemented in the United Kingdom as the core UK group and the non-core Large Exposures Group.

(5) Section 142H(5)(c) of the Act, as amended by the Financial Services (Banking Reform) Act 2013.

(6) Article 13, the Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014.

(7) The other exemptions are where: (i) the RFB accesses the payment system through an intermediary which is an RFB in the same group; (ii) the RFB is not eligible to become a direct participant under the rules of the payment system; and (iii) the RFB accesses the payment system through an intermediary and where if access ceased, the RFB would be able to make payments via another intermediary or through another payment system or other means.

(8) See article 2 and articles 14–19, the Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014.

## 6 The PRA's statutory obligations

6.1 In making its rules and establishing its practices and procedures, the PRA must meet a number of legal obligations. The PRA must assess the costs and benefits of proposals and have regard to the regulatory principles as set out in the Act, including proportionality. In addition, when consulting on draft rules, the PRA is required to consider the impact on mutuals. The PRA has a duty to facilitate competition as a secondary objective subordinate to its general safety and soundness objective. Finally, the PRA must consider the equality and diversity impact of its proposals.<sup>(1)</sup>

### Cost benefit analysis

6.2 The proposals discussed in this CP are designed to contribute to the implementation of the ring-fencing of core services as set out in the Act and summarised in Chapter 1. The proposals apply to banking groups with at least £25 billion of core deposits as defined in the legislation. The analysis in this chapter covers the impact of the proposals discussed in this CP relating to legal structure, governance and ensuring continuity of services and facilities.

6.3 The analysis of the costs is limited to the incremental impact of these proposals, rather than the impact of the ring-fencing requirements placed on firms by legislation. An analysis of the overall costs and benefits of the implementation of ring-fencing was published by the Government in 2013.<sup>(2)</sup>

6.4 An important component of the cost associated with these proposals is the additional compliance cost borne by firms as a result of changing their booking and business models. The Government estimated that these would range between £150 million and £530 million per year. The full extent of these costs will depend on the proposals to be outlined by the PRA in further consultation. The PRA plans to undertake a survey of firms to examine the potential compliance costs of the full set of its proposals at that point.

### Legal structure

6.5 The way in which groups containing RFBs are structured will be important in meeting the Act's requirements in terms of the resilience and resolvability of RFBs. Given the objectives of ring-fencing, sibling group structures will help reduce the risk that the core services provided by an RFB could be disrupted by the failure or activities of entities undertaking excluded or prohibited activities. The value of this risk

reduction is likely to be significant. By increasing the simplicity and transparency of group structures, these proposals should also reinforce levels of market discipline.

6.6 A sibling structure will impose costs on the groups subject to ring-fencing requirements in two ways. First, there will be restructuring costs, and second, there will be the ongoing costs of operating within the revised group structures. The latter are likely to be associated with higher reporting, operational and legal costs. There may also be effects on customers, as restructuring may require changes to contracts with clients, such as the novation of trades.

6.7 It is recognised that firms have different business models and differing relative scales of activities. In developing its policy, the PRA is mindful of ensuring that there is a balance between ensuring that ring-fencing objectives are met, whilst considering the impacts on firms and more broadly. Although there are costs associated with restructuring, these are to be set against the broader benefits of ring-fencing set out in Chapter 1. The costs and benefits will vary by firm depending on the complexity of current group structures, resolution strategies and business activities.

### Governance

6.8 The proposed governance rules meet the PRA's rule-making requirements set out in the Act by supporting the RFB's ability to take decisions independently of other group members, reducing the likelihood that the RFB will be exposed to the acts or omissions of other members of its group, and therefore helping to maintain the continuity of provision of core services. In addition, such arrangements improve the resilience and resolvability of RFBs, thereby supporting the continuity of the provision of core services. Such benefits are considered significant.

6.9 The PRA has sought to take an outcomes-based approach to achieve its rule-making obligations in this area wherever possible. As such the PRA's proposed approach provides some flexibility for firms in how they choose to meet these requirements.

(1) See sections 2H, 3B, 138J(1), 138J(2) and 138K(2) of the Act.

(2) HM Treasury/Department for Business, Innovation and Skills, *Banking reform: draft secondary legislation*, July 2013. This impact assessment estimated significant benefits to the UK economy from ring-fencing and related reforms corresponding to an annualised net present value of approximately £7.1 billion (in 2011/12 terms). The net benefit figure estimated by the Government included the private costs to banks, which were estimated to be between £1.7 billion and £4.4 billion per annum.

6.10 The proposed governance rules are likely to result in some initial and ongoing costs to the firms in scope, especially in areas where the PRA's proposals are more prescriptive rather than outcomes-based. These areas include:

- the establishment of new boards and board committees for the RFBs to meet the proposed membership requirements;
- the proposals on risk management and internal audit; and
- the requirement for NED vacancies to be advertised publicly.

6.11 Firms have a high degree of flexibility in how to meet the new requirements for remuneration and HR policies. As a result, individual firms will be able to exercise discretion in deciding the most cost-effective way to implement the proposals.

### (i) Board and board committee membership

6.12 A separate board will support the RFB in its ability to take decisions independently of other group members. The requirement to establish separate risk, audit, nomination and remuneration committees will contribute towards this.

6.13 The proposals on board composition will result in ongoing costs associated with the maintenance of the RFB board and the additional directors that will be required to meet the membership criteria.

6.14 The recommendations will require the recruitment of additional NEDs (firms will need an RFB board, a separate board for entities that undertake excluded or prohibited services and in some instances a new holding company). Assuming remuneration levels for RFB board members are similar to those of the group board and based on current remuneration levels, this may range from £50,000 to £100,000 per year per NED for the type of firms expected to be within the scope of the proposals.

6.15 The RFB will be required to establish its own risk, audit, nomination and remuneration committees, and directors will receive a fee for board committee responsibilities. According to current group remuneration levels in this area, and assuming remuneration levels will be similar for RFBs, each committee member might be paid between an additional £15,000 and £30,000, relative to the remuneration estimates described above, and committee chairs an additional £30,000 to £70,000.

6.16 The estimated cost of the board composition proposals is between £1 million and £2 million a year per firm, based on the additional salaries of new directors. This figure is based on a number of assumptions, and in practice will vary depending on how firms choose to structure their operations within the flexibility the rules allow them.

### (ii) Risk management and audit

6.17 It is expected that the majority of staffing changes necessary to create the required separate resources for risk

management and audit are likely to be achievable through a reallocation or reorganisation of existing personnel. Additional cost may be necessary for some newly required roles such as senior managers for risk management and audit responsible only to the RFB, and the new non-executive chairs of the RFB risk and audit committees.

6.18 The requirement for an RFB to have its own sufficient risk management and internal audit resource will bring benefits to the RFB, as staff will have specific knowledge of the business, as well as reducing the risks associated with competing demands on internal audit and risk management resources from the RFB and entities that undertake excluded or prohibited services.

6.19 The intention of this proposal is not to restrict cross-utilisation of resources unduly but to ensure the RFB is not dependent on other group members. Systems and resources could therefore still be shared with other parts of the group, where appropriate.

6.20 The proposed rule is constructed so as to ensure that the RFB is not dependent on the rest of the group while not preventing functions operating within group policies and reporting to group functions. This recognises that RFBs will remain part of wider banking groups.

### (iii) Vacancies for NEDs on RFB boards must be advertised publicly

6.21 The PCBS raised a '*danger that non-executive directors of banks are self-selecting and self-perpetuating*'.<sup>(1)</sup> By requiring the board vacancies of an RFB to be advertised publicly, RFBs should benefit from widening the pool of NEDs and being able to take advantage of a diversity of backgrounds, skills and insights.

6.22 The cost of publicly advertising board vacancies at the RFB is relatively small. The cost of advertising vacancies can range from a few thousand pounds for a small advert in a national newspaper, up to £100,000 for a full-page colour advert in a major global publication.

### (iv) Individual accountability in RFBs

6.23 The PRA does not anticipate any additional costs to firms from the proposal to introduce an additional Prescribed Responsibility for Senior Managers of RFBs to ensure that the areas of the firm which they are responsible for managing comply with the ring-fencing requirements. Firms will already be required to have processes for drafting statements of responsibility and responsibility maps. The additional prescribed responsibility will help underline the ring-fencing specific responsibilities of senior managers.

(1) Report of the Parliamentary Commission on Banking Standards, *Changing banking for good*, June 2013, page 343.



## Continuity of services and facilities

6.24 The proposed rules ensure that RFBs have continuity of the services and facilities they need. This contributes to ensuring that RFBs can continue to undertake core activities regardless of the acts, omissions or insolvency of other group members. The PRA considers that the proposals give banking groups sufficient flexibility in how they set up their intragroup operational arrangements, subject to them meeting the conditions set out in Chapter 4. This helps to minimise any implementation costs whilst meeting the requirements of ring-fencing.

6.25 The proposals to improve operational continuity for RFBs address both intragroup service arrangements and third party service arrangements.

### (i) Intragroup service arrangements

6.26 The proposal to impose certain restrictions on the group entities that an RFB can receive services and facilities from is not expected to result in significant additional costs to the firms subject to ring-fencing.

6.27 Additional costs are more likely to arise where a banking group:

- is currently operating its shared services and facilities from an entity from which an RFB will not be permitted to receive services and facilities from under this proposal; and
- the banking group was not otherwise intending to adopt a structure consistent with these proposals in order to accommodate ring-fencing, improve their resolvability or for some other business need.

6.28 Preliminary discussions with firms suggest that this proposal will not generate material additional costs for banks beyond those included in the Government's estimates of the transitional costs of implementing ring-fencing.

6.29 The benefit of this proposal is that it helps ensure that an RFB can continue to provide its core services even if other group entities fail.

### Intragroup and third-party service arrangements

6.30 The proposal to ensure that RFBs' service arrangements are not capable of being disrupted through the acts, omissions, or insolvency of other group members will require firms to review some of the prospective contractual arrangements between their RFBs and other group entities and third parties.

6.31 However, given that firms have until 2019 to implement ring-fencing it is not considered that this proposal will result in any material additional costs beyond the time needed to discuss with relevant parties and agree the new contractual

terms. The PRA considers this work can be done through firms' existing resources.

6.32 The benefit of this proposal is that it helps remove an indirect avenue of contagion from other group entities to the RFB. For example, in the absence of this proposal, an intragroup service entity or a third party could potentially terminate or withhold the provision of services to an RFB simply because another group entity has entered into insolvency.

## The PRA's regulatory principles

6.33 In developing the proposals in this CP, the PRA has had regard to the eight regulatory principles which are set out in section 3B of the Act. Of these, four principles are of particular relevance:

- *The principle that the burden or restriction imposed by a measure should be proportionate to the benefits which are expected as a result.* The PRA has followed this principle when developing the proposals outlined in this CP, and has indicated in the CP the key areas of its judgements. The focus on developing outcomes-based policies, where possible, is consistent with taking a proportionate approach. Also relevant is the PRA's power to waive or modify rules where their application might be unduly burdensome, as discussed in general in Chapter 1, and considered further in Chapter 3 in relation to governance.
- *The principle that the PRA should exercise its functions transparently.* In this CP, the PRA sets out all the key information relevant to its proposals, and gives respondents the opportunity to comment.
- *The principle relating to the responsibilities of senior managers of firms subject to requirements imposed under the Act.* The proposed new regulatory framework for individuals consulted on in PRA CP14/14, including the proposed Senior Managers Regime, provides clear responsibility for senior managers in regulated firms.<sup>(1)</sup> Alongside the proposed specific ring-fencing Prescribed Responsibility discussed in Chapter 3, the proposed ring-fencing rules generally complement the proposed measures in PRA CP14/14 by establishing the RFB as a separate regulated entity and requiring both the RFB and entities that perform excluded or prohibited activities to allocate their own Prescribed Responsibilities to senior managers. Where the proposed governance ring-fencing rules prescribe separation of certain roles it will be possible for these individuals to be allocated the Prescribed Responsibilities associated with only one entity. For example, the rule for executive board members

(1) PRA Consultation Paper CP14/14 / FCA Consultation Paper CP14/13, 'Strengthening accountability in banking: a new regulatory framework for individuals', July 2014; [www.bankofengland.co.uk/pradocuments/publications/cp/2014/cp1414.pdf](http://www.bankofengland.co.uk/pradocuments/publications/cp/2014/cp1414.pdf).

not also holding executive board positions in other group entities that perform excluded or prohibited services means it will be clear which individuals are responsible for the business of the RFB. This will create clearer accountability for the decisions taken by the RFB as distinct from the wider group.

- *The principle that a regulator exercises its functions in a way that recognises the differences in the nature of, and objectives of, businesses carried on by different firms subject to requirements under FSMA.* Although the population of firms in scope of these proposals will be small, the PRA recognises that even within this population there will be a range of business models. In the area of governance rule-making, in particular, the PRA has sought to use an outcomes-based approach wherever possible to meet its rule-making requirements under the Act to allow firms flexibility as to how they meet them. Where the PRA considers specific rules are necessary, thresholds have been proposed at levels the PRA considers suitable.

## Impact on mutuals

6.34 The PRA has a statutory requirement to state whether the impact on mutuals will be significantly different from the impact on other firms.<sup>(1)</sup> Building societies, credit unions and industrial and provident societies are exempt from ring-fencing requirements,<sup>(2)</sup> and from the definition of financial institutions to which RFBs may not have exposures. The PRA, therefore, does not expect mutuals to be materially affected by the proposals within this CP.

## Impact on competition

6.35 The Act introduces significant changes to the way banks are structured, and their interactions with other financial firms, their customers and their service providers. These changes are likely to have important impacts on competition. The Act also introduces some specific recommendations to support competition in banking, including the new PRA competition objective.<sup>(3)</sup>

6.36 The proposals in this CP which would result in a 'sibling' structure are intended to ensure RFBs are not exposed to risks associated with activities unrelated to the provision of core services and are able to make decisions independently. In so doing, these proposals may help reduce cross-subsidies from the RFB to other group entities. This may reduce any funding advantages enjoyed by such firms and thereby help reduce barriers to entry in banking markets.

6.37 The proposals on operational continuity intend to ensure that essential economic services can continue following firm failure. Making banks more resolvable facilitates market exit and should facilitate competition by reducing the implicit

subsidy received by banking groups and the associated funding advantages.

6.38 Finally, the proposals on governance ensure that decision-making in RFBs supports the interests of the RFB, rather than those of other group entities. This should ensure that an RFB is able to take decisions independently of other group members, helping to reduce cross-subsidies in banking groups undertaking both retail and investment banking.

## Equality and diversity

6.39 The PRA may not act in an unlawfully discriminatory manner. It is also required under the Equality Act 2010 to have due regard to the need to eliminate discrimination and to promote equality of opportunity in carrying out its policies, services and functions. To meet this requirement, the PRA has performed an assessment of the equality and diversity implications of the proposals in this CP. In general, the PRA's assessment suggests that the proposals do not give rise to equality and diversity implications.

6.40 The creation of separate boards for RFBs, particularly taken with limits on the number of members from elsewhere in the group, will result in an increase in the number of directorships in the UK banking industry. The proposal that vacancies for NEDs on RFB boards must be advertised publicly is designed to address the '*danger that non-executive directors of banks are self-selecting and self-perpetuating*', as highlighted by the PCBS.<sup>(4)</sup> By opening up the recruitment process RFBs will be able to recruit for the increased number of board positions from a wider pool of potential NEDs, potentially attracting new applicants with a diversity of backgrounds, skills and insights.

6.41 The new senior managers for risk and internal audit at the RFBs will be subject to the proposed Senior Managers Regime.<sup>(5)</sup> The proposals will allow more than one individual to perform a Senior Management Function or a function in scope of the Certification Regime at the same firm, thereby accommodating individuals working under a job-share arrangement. If this was not the case, the proposed rules could be considered to discriminate indirectly against individuals working under a job-share arrangement, for instance, due to family obligations such as maternity or paternity.

(1) Mutuals are defined as building societies, friendly societies, industrial provident societies and EEA mutual societies.

(2) Section 142A(2) of the Act, as amended by the Financial Services (Banking Reform) Act 2013.

(3) Section 2H of the Act.

(4) Report of the Parliamentary Commission on Banking Standards, *Changing banking for good*, June 2013, page 343.

(5) *PRA Consultation Paper CP14/14 / FCA Consultation Paper CP14/13*, 'Strengthening accountability in banking: a new regulatory framework for individuals', July 2014; [www.bankofengland.co.uk/pradocuments/publications/cp/2014/cp1414.pdf](http://www.bankofengland.co.uk/pradocuments/publications/cp/2014/cp1414.pdf).

# Appendices

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- 1 Draft supervisory statement on ring-fenced bodies: legal structure

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  - 2 Draft supervisory statement on ring-fenced bodies: continuity of services and facilities

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  - 3 Amendment to draft supervisory statement on the PRA Senior Managers Regime as set out in Annex 9.1 of PRA CP14/14/FCA CP14/13

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  - 4 Ring-fenced bodies instrument

## Draft supervisory statement on ring-fenced bodies: legal structure

### 1 Introduction

1.1 This supervisory statement is aimed at ring-fenced bodies (RFBs) as defined in the Financial Services and Markets Act 2000, section 142A.

1.2 The purpose of this supervisory statement is to set out the expectations that the PRA has in relation to the ownership structure of banking groups containing one or more RFBs. The content of this supervisory statement sets out some of the factors that the PRA will take into consideration when deciding whether or not to impose requirements in relation to the group ownership structure of such banking groups.

### 2 Expectations of banking group structures containing an RFB

2.1 The PRA will seek to ensure the continuity of the provision of core services by an RFB.

2.2 Where an RFB's group structure could adversely affect the safety and soundness of the RFB and therefore pose risks to the continuity of provision of core services, the PRA may use its powers under section 55M of the Act to impose requirements on such an RFB.

### 3 Expectations of the types of entity that an RFB may own

3.1 The PRA's expectation is that an RFB must not have ownership rights in an entity that carries out prohibited or excluded activities. Ownership rights may include, but are not limited to, voting rights and other rights to participate in the capital or profits of the relevant entity. This reduces the risk of losses associated with international or investment banking activity weakening the RFB. As a result, this approach helps to ensure the continuity of the provision of core services by

implementing ring-fencing with regard to improving the resilience of RFBs. It may also reduce the complications associated with the possible resolution and/or failure of a subsidiary if it undertook excluded or prohibited activities.

3.2 The PRA will adopt this approach proportionately to achieve the outcomes set out by the group ring-fencing purposes of the Act.

3.3 In principle, the PRA does not necessarily object to an RFB owning entities undertaking activities that are not excluded or prohibited under the Act. This would be considered on a case-by-case basis.

### 4 Expectations of the types of entity that may own an RFB

4.1 Within a UK group (that is, the group headed by the ultimate UK parent), the PRA does not expect an entity that undertakes excluded or prohibited activities to have ownership rights in an RFB. This supports the RFB's ability to make independent decisions. The PRA would adopt this approach proportionately to achieve the outcomes set out in the group ring-fencing purposes.

4.2 In assessing whether an entity in the same UK group as an RFB that does not carry out excluded or prohibited activities should be restricted from owning an RFB, the PRA will consider the resilience and resolvability of the RFB and risks posed to the continuity of provision of core activities. This assessment will include the extent to which:

- the RFB is able to make decisions independently of group entities;
- the RFB is not reliant on resources in group entities (for example capital resources) which may cease to be available in the event of insolvency of that group entity; and,
- the RFB is sufficiently insulated from risks in the rest of the group, so as to ensure it is not adversely affected by the acts or omissions of group entities.

## Draft supervisory statement on ring-fenced bodies: continuity of services and facilities

### 1 Introduction

1.1 This supervisory statement is aimed at ring-fenced bodies (RFBs) as defined in the Financial Services and Markets Act 2000, section 142A.

1.2 The purpose of this supervisory statement is to set out the PRA's expectations on the arrangements that RFBs may make where they receive services and facilities from other intragroup entities or third parties outside of their group.

### 2 Intragroup service arrangements

2.1 An RFB may receive shared services and facilities only from other group entities where such entities are part of the RFB's subgroup or are dedicated intragroup services entities.<sup>(1)</sup>

2.2 'Shared services and facilities' refers to those services and facilities which are needed to support the business of the RFB and other group entities. For example: data-processing services; property management services; information technology; data centres; and back office functions. Note that this is not an exhaustive list.

2.3 Where an RFB relies on services and facilities that are not shared with other group entities then it is expected that these

should be owned and managed by the RFB itself or the RFB should contract directly with third parties for the provision of them.

### 3 Intragroup and third party service arrangements

3.1 The provision of services and facilities from other group entities and third parties to an RFB should not be capable of being disrupted through the acts, omissions, or insolvency of other group members.

3.2 It is expected that this could be achieved through RFBs ensuring:

- that their contractual arrangements do not contain clauses such as set off rights, liens, netting arrangements, material adverse event provisions which could be triggered as a result of the acts or omissions of other group members. Note that this is not an exhaustive list of relevant contractual provisions; and
- that a material deterioration in the financial circumstances of another group entity, or an insolvency or resolution event, does not disrupt any arrangements the RFB has with relevant parties which are necessary for it to conduct its core activities.

(1) A 'dedicated intragroup services entity' means an entity within the same group as the ring-fenced body whose only business is to provide services or facilities to other entities within its group.

## Amendment to draft supervisory statement on the PRA Senior Managers Regime as set out in Annex 9.1 of PRA CP14/14 / FCA CP14/13

[New ring-fencing material is underlined]

### 1 Introduction

1.1 This supervisory statement applies to all 'relevant authorised persons' as defined in section 71A of FSMA namely:

- banks;
- PRA-designated investment firms;
- building societies; and
- credit unions.<sup>(1)</sup>

1.2 The statement sets out the PRA's expectations of how these firms should comply with the rules in the PRA Rulebook dealing with Senior Management Functions (SMFs) and Allocation of Responsibilities<sup>(2)</sup> including:

- the responsibilities of the Chairman and Senior Independent Director (SID); and
- the content of Statements of Responsibilities and Management Responsibilities Maps.

1.3 This statement seeks to advance the PRA's statutory objectives by ensuring the safety and soundness of the firms it regulates by promoting good corporate governance and strengthening the accountability of key decision-makers through a clearer allocation of responsibilities.

### 2 PRA SMFs

2.1 This section sets out the PRA's expectations of how firms should comply with, and interpret, the rules on SMFs in the PRA Rulebook, which govern the scope of the PRA's Senior Managers Regime.

#### Link to the firm's regulated activities

2.2 For a function to be an SMF as defined in section 59ZA(2) of FSMA it must relate to carrying out a regulated activity. An individual based outside the United Kingdom can perform an SMF if he is responsible for managing an area relating to the firm's Part IV Permissions.

2.3 The PRA therefore expects firms to put forward individuals performing an SMF for approval even if they are physically located outside the United Kingdom.

#### Meaning of 'managing' in FSMA

2.4 Section 59ZA(2) of FSMA also requires a senior manager to be responsible for managing one or more aspects of the firm's regulated affairs which, as section 59ZA(3) clarifies, can

include taking part in decisions about how those affairs should be carried on.

2.5 Consistent with the definition of 'managing' in section 59ZA, the PRA expects relevant authorised persons to, where appropriate, put individuals employed by parent or group entities forward for approval as senior managers if they are involved in decisions affecting its business and meet the statutory test.

2.6 The PRA does not expect senior managers to have ultimate authority over the areas they manage; ultimate authority and responsibility will continue to rest with the board. In the PRA's view 'responsibility for managing' includes, but is not limited to:

- managing or overseeing an area or function under the delegated authority of the board;
- direct responsibility for briefing, reporting and putting matters for decision to the board in respect of an area; and/or
- chairing the board or a board committee and taking part in their collective decision-making.

#### Executive and oversight SMFs

2.7 The PRA distinguishes between two types of PRA SMF (except for small credit unions) as set out in the rules on SMFs in the PRA Rulebook:<sup>(3)</sup>

- executive functions (listed in Chapter 3) comprising individuals responsible for actively managing specific areas or functions and reporting on them to the board and its committees;<sup>(4)</sup> and
- oversight functions, (Chapter 4) comprising individuals who do not perform an executive function at the firm but chair its board and/or one or more of its committees (or in the SID's case, appraise the Chairman).

2.8 Table A lists all SMFs specified by the PRA

#### Mandatory number of SMFs

2.9 Every relevant authorised person, except small credit unions, must have an individual approved to perform the Chief Executive, Chief Finance and Chairman functions. Small credit unions must put at least one individual forward for approval as a credit union Senior Executive Manager. In most cases, the PRA expects this individual to be the CEO or equivalent.

(1) At the time of writing, the rules underpinning this draft statement do not apply to non-UK institutions under section 71A(6)(b) of FSMA, including UK branches of overseas firms. HM Treasury plans to consult on extending the scope of the Senior Managers Regime to incoming branches (later in 2014). Subject to the outcome of HM Treasury's consultation, the PRA will consult on how to apply the Senior Managers Regime to incoming non-European Economic Area branches.

(2) <http://fshandbook.info/FS/prerulebook.jsp>.

(3) Defined as credit unions with average gross total assets of less than or equal to £25 million.

(4) All references to specific rules in the PRA Rulebook may be subject to changes in drafting or numbering.

**Table A** PRA SMFs

Executive	Oversight
Chief Executive	Chairman
Chief Finance	Chair of the Audit Committee
Chief Risk	Chair of the Risk Committee
Head of Internal Audit	Chair of the Remuneration Committee
Head of Key Business Area	Senior Independent Director (SID)
Group Entity Senior Manager <sup>(a)</sup>	

(a) Group Entity Senior Managers may perform either an executive or an oversight function depending on the exact nature of their involvement with the firm, which should be made clear in their Statements of Responsibilities and the firm's Management Responsibilities Map.

2.10 However, where existing rules or standards do not require a firm to appoint or establish:

- independent Internal Audit or Risk functions; or
- Audit, Remuneration or Risk Committees; or
- a SID; and
- the firm has elected not to do so, the PRA does not require it to have individuals performing the corresponding SMFs. These firms must allocate Responsibilities 18–20 in Chapter 4 of the rules on Allocation of Responsibilities among their remaining senior managers, as appropriate.

2.11 **Table B** lists the types of relevant authorised person which are required to have certain SMFs.

**Table B**

SMF	Firms covered
Chief Risk	<i>Common platform firms</i> where proportionate SYSC 7.1.6R.
Head of Internal Audit	<i>Common platform firms</i> where proportionate SYSC 6.2.1R.
Chair of the Audit Committee	<i>Issuers with securities</i> admitted to trading on a regulated market who have to appoint a statutory auditor DTR 7.1.
Chair of the Risk Committee	Significant firms in scope of the Capital Requirements Regulation <sup>(a)</sup> ( <i>CRR firms</i> ) SYSC 7.1.18R.
Chair of the Remuneration Committee	<i>CRR firms</i> with assets above £15 billion SYSC 19A.3.12R.
SID	<i>Premium-listed companies</i> (comply or explain) <i>Corporate Governance Code Provision A.4.1</i> (comply-or-explain).

(a) <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:176:0001:0337:EN:PDF>.

## Independence requirements and banned combinations of SMFs

2.12 Certain rules prevent individuals from performing specific combinations of SMFs at the same firm or require certain SMFs to be performed independently of any other functions or activities of the firm. **Table C** lists the SMFs subject to such restrictions or independence requirements.

2.13 Where rules do not prevent an individual from performing a combination of SMFs, the PRA may still decide not to approve him to perform the desired combined functions in some circumstances, including but not limited to, where the PRA considers that:

**Table C**

SMF	Restrictions
Chief Executive	A firm must ensure that an individual who performs the Chairman Function on its behalf does not simultaneously perform the Chief Executive Function within the same firm.
Chairman	<b>Rule 7.2 of the rules on SMFs.</b>
Chief Risk	Must be an <b>independent senior manager with distinct responsibility for the risk management function</b> . Where the nature, scale and complexity of the activities of the CRR firm do not justify a specifically appointed person, another senior person within the firm may fulfil that function, provided there is no conflict of interest SYSC 7.1.22R. See also guidance in SYSC 21.
Head of Internal Audit	Must be <b>separate and independent from the other functions and activities of the firm</b> SYSC 6.2.1R.
Chair of the Risk Committee Chair of the Remuneration Committee	Must not perform any executive function in the firm SYSC 7.1.18R and SYSC 19A.3.12R.

- the functions are incapable of being effectively performed together inherently or in practice, such as Chairman and SID; or
- the individual's qualifications, training, competencies and/or personal characteristics render him fit and proper to perform one function but not the other(s).

## Sharing a PRA SMF

2.14 In certain circumstances, including but not limited to job-share arrangements, a firm may be allowed to have more than one individual performing a single SMF.

2.15 However, the PRA expects SMFs to be shared only where appropriate or justified. The norm should be for every firm to have a single individual performing each of the PRA SMFs which the firm is required to have. This individual should be the most senior employee or officer responsible for managing that area (see above for the definition of managing).

2.16 Where two or more individuals share an SMF, each will be individually responsible for all the responsibilities conferred by that function. It follows that, in the event of a firm breaching a relevant requirement (as defined in section 66B(4) of FSMA) relating to that SMF's area(s) of responsibility, every individual approved to perform it will be potentially liable unless they can individually satisfy the PRA that they took reasonable steps to prevent, stop or remedy the breach (hereafter the 'reasonable steps test' as set out in section 66B of FSMA). The particular circumstances regarding the division of tasks between individuals sharing an SMF may, however, have a bearing on whether one or both can satisfy the 'reasonable steps test'.

### 3 Allocation of responsibilities to senior managers

#### Responsibilities inherent in the definition of each PRA SMF

3.1 Every SMF, specified by the PRA in its rules, is defined by reference to the responsibility inherent in that function.

3.2 This inherent responsibility entails managing an aspect of the firm's affairs which the PRA considers involves, or might involve, a risk of serious consequences to the firm, business or other interests in the United Kingdom.

3.3 The definition of each SMF will be used to identify responsibility for an area in the event of a firm breaching a relevant requirement. For example, where a failure with a firm's risk controls causes it to breach a relevant requirement, the individual(s) performing the Chief Risk function is likely to be initially identified as being responsible and asked to satisfy the 'reasonable steps test'.

3.4 In addition to or instead of the senior manager to whom the responsibility was formally allocated, the PRA may require other senior managers to satisfy the 'reasonable steps test' if, on the facts, they were responsible for the area where the contravention occurred.

3.5 The PRA also retains the ability to take enforcement action against employees, other than senior managers, who were 'knowingly concerned' in a contravention of a relevant requirement.

#### Prescribed Responsibilities

3.6 In addition to the responsibilities inherent in the definition of each SMF, Chapter 4 of the rules on Allocation of Responsibilities sets out a number of 'Prescribed Responsibilities', which cover:

- the firm's implementation and operation of the new accountability regimes;
- the culture and standards within the firm;
- a number of areas which the PRA has specific interest in as a prudential regulator; and
- responsibilities which a firm must assign if it does not have a specific senior manager.

3.7 The PRA requires firms (other than small credit unions) to allocate PRA Prescribed Responsibilities to any individual performing an SMF specified by the PRA or by the Financial Conduct Authority (FCA) in SUP 10C of the FCA Handbook (except the FCA's 'Significant Responsibility' SMF).

3.8 Certain Prescribed Responsibilities can only be assigned to individuals performing an 'oversight' PRA SMF or to the following FCA SMFs:

- non-executive director (NED); or
- Chair of the Nominations Committee.

3.9 The rules on Allocation of Responsibilities require all Prescribed Responsibilities to be allocated within all firms other than small credit unions. However, in limited cases, the PRA may waive a requirement to allocate one or more Prescribed Responsibilities to a firm that satisfies the test in section 138A(4) of FSMA, ie a firm that can demonstrate that:

- compliance with the unmodified rules would be unduly burdensome or would not achieve the purpose for which the rules were made; and
- the direction would not adversely affect the advancement of any of the PRA's objectives.

3.10 In practice, the PRA is likely to grant waivers where a firm can demonstrate that it does not carry out an activity relating to a given Prescribed Responsibility.

3.11 The PRA expects firms to allocate many Prescribed Responsibilities to the senior manager they are most closely linked to. A specific example is set out in **Table D**.

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#### Table D

The rules on Allocation of Responsibilities require firms to allocate responsibility for ensuring and overseeing the integrity and independence of the:

- the internal audit function in accordance with SYSC 6.2 (Internal audit);
- the compliance function in accordance with SYSC 6.1 (Compliance); and
- the risk function in accordance with SYSC 7.1.22R (Risk control).

These responsibilities must be allocated to Oversight SMFs. The PRA expects these to be the chairs of the relevant board committees (Audit and Risk).

Moreover, the PRA interprets these Prescribed Responsibilities as encompassing an obligation to ensure that the Chief Risk, Compliance and Head of Internal Audit cannot be dismissed or have any other disciplinary sanction without the agreement of the board, including at least a majority of NEDs.

#### Allocation of prescribed responsibility for complying with the ring-fencing requirements

3.12 The PRA expects ring-fenced bodies (RFBs) to allocate to the majority, if not all, of their Senior Managers, including the Senior Managers on its board, responsibility for ensuring that the areas of the firm which they are responsible for managing comply with the ring-fencing requirements. This is an exception to the expectation set out in 3.11 above, that Prescribed Responsibilities should be allocated to the individual senior manager they are most closely linked to.

3.13 As outlined in paragraph 3.4 above, in the event of a breach by the firm of its ring-fencing obligations, the PRA may apply the presumption of responsibility in section 66B of FSMA to any Senior Managers who are either:

- allocated responsibility for ensuring that the areas of the firm which they are responsible for managing comply with the ring-fencing requirements; or
- on the facts, can be deemed responsible for the area where the contravention occurred.



3.14 Each Senior Manager will need to satisfy the PRA that they took reasonable steps to prevent or stop the breach of the ring-fencing requirements or face the prospect of individual sanctions.

### Prescribed Responsibilities for small credit unions

3.15 Small credit unions are subject to the tailored Prescribed Responsibilities listed in Chapter 6 of the Allocation of Responsibilities, which they must allocate to any senior manager approved by either the PRA or FCA (excluding the FCA 'Significant Responsibility' SMF).

### Additional responsibilities

3.16 Firms are free to assign to a senior manager, and include in his Statements of Responsibilities, additional responsibilities not covered in the PRA's rules.

3.17 Additional responsibilities must not modify or qualify any responsibilities prescribed by the PRA.

3.18 The PRA may also request firms to include specific responsibility for a regulatory outcome in the Statement of Responsibilities of the relevant individuals.

### Responsibilities of the Chairman and SID

3.19 The PRA considers that the responsibility inherent in the definition of the Chairman function in Rule 4.2 of the rules on SMFs encompasses responsibility for the following:

- promoting an open exchange of views, challenge and debate at the board;
- ensuring that NEDs have the tools, resources and information to carry out their roles effectively, particularly their challenge function; and
- providing a genuine check and balance to the executives.

3.20 Moreover, the PRA expects firms to allocate the following Prescribed Responsibilities to the Chairman:

- the induction, training and professional development of all persons performing SMFs on behalf of the firm and all members of the firm's management body;
- leading the development of the firm's culture and standards in relation to the carrying on of its business and the behaviours of its staff; and
- ensuring and overseeing the integrity and independence of the firm's policies and procedures on whistleblowing and for ensuring that staff who raise concerns are protected from detrimental treatment.

3.21 The PRA also expects Chairmen to remain appraised of matters relating to the board and its individual committees and to take steps to facilitate this, for instance by having regular discussions with the Chairs of the Audit, Remuneration and Risk committees outside of board meetings.

3.22 Given the importance and responsibility of the role, Chairmen are expected to commit a significantly larger proportion of their time to their functions than other NEDs. The PRA expects Chairmen, in particular those of major firms, not to have or take on additional commitments which may interfere with the fulfilment of their responsibilities to the firm under the Senior Managers Regime.

3.23 The PRA may consider using its powers to impose conditions on approval to limit a Chairman's ability to take on external commitments where it considers that doing so may advance the PRA's objectives.

### Appraising the Chairman

3.24 The rules on SMFs in the PRA Rulebook specify a SID SMF, which entails 'particular responsibility for leading the assessment of the performance of the person performing the Chairman function'. Where a firm has chosen not to have a SID, it must allocate responsibility for appraising the Chairman to another NED.

3.25 The PRA expects the assessment of the Chairman to include, but not be limited to the:

- extent to which he has fulfilled the responsibilities referred to in this statement; and
- quality and sufficiency of resources allocated to his office (consistent with Rule 7.1 in Allocation of Responsibilities).

## 4 Statements of Responsibilities and Management Responsibilities Maps

### Statements of Responsibilities

4.1 Certain SMFs, notably Heads of Key Business Areas and Group Entity Senior Managers may apply to individuals performing a diverse range of roles and influencing the firm in different ways.

4.2 Consequently, the PRA expects the Statements of Responsibilities of individuals performing these functions to include detailed information of any particular aspects of the firm which they are responsible for managing or overseeing.

4.3 Section 62A of FSMA requires firms to submit a revised Statement of Responsibilities whenever there is a 'significant change in the aspects of the authorised person's affairs which the person is responsible for managing in performing the function'.

4.4 The PRA will determine whether a 'significant change' has taken place on a case-by-case basis. However, the list below sets out non-exhaustive examples of potential significant changes which, in the PRA's view, may require the submission of a revised Statement of Responsibilities:

- A variation of the individual's approval, either at the firm's, the PRA's or FCA's initiative, resulting in the imposition of a condition or time limit.
- Fulfilling or failing to fulfil a condition on approval imposed by the PRA or FCA.
- The addition, reallocation or removal of a PRA Prescribed Responsibility, an FCA key business function or an additional responsibility.
- The sharing of an SMF originally performed by one individual among two or more individuals.

### Management Responsibilities Maps

4.5 The PRA's and FCA's rules and FCA guidance require firms to develop and maintain a Management Responsibilities Map, which must be a single, up-to-date document setting out their management and governance arrangements. **Table E** lists

some of the information which the PRA expects a Management Responsibilities Map to contain. A full list is available in Rule 7.3 of the rules on Allocation of Responsibilities in the PRA Rulebook.

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#### Table E

- An up-to-date list of all senior managers approved by the PRA and the FCA.
- A list of each senior manager's responsibilities as set out in their current Statement of Responsibilities.
- A checklist confirming that all PRA Prescribed Responsibilities/Credit Union Prescribed Responsibilities (as applicable) have been allocated.
- Where one or more Prescribed Responsibilities have not been allocated, the reason why.
- A list of all reporting lines from all senior managers to other individuals in the relevant authorised person, the board and any board committees.
- Where the relevant authorised person is a subsidiary or part of a group, details of any reporting lines from senior managers in the relevant authorised person to individuals and decision-making bodies outside it.

**PRA RULEBOOK: RING-FENCED BODIES INSTRUMENT [YEAR]**

**Powers exercised**

- A. The Prudential Regulation Authority (“PRA”) makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 (“the Act”):
- (1) section 137G (The PRA’s general rules);
  - (2) section 137T (General supplementary powers); and
  - (3) section 142H (Ring-fencing rules).
- B. The rule-making powers referred to above are specified for the purpose of section 138G(2) (Rule-making instrument) of the Act.

**Pre-conditions to making**

- C. In accordance with section 138J of the Act (Consultation by the PRA), the PRA consulted the Financial Conduct Authority. After consulting, the PRA published a draft of proposed rules and had regard to representations made.

**PRA Rulebook: Ring-fenced Bodies Instrument [YEAR]**

- D. The PRA makes the rules in Annex A and Annex B to this instrument.

**Commencement**

- E. This instrument comes into force on [DATE].

**Citation**

- F. This instrument may be cited as the PRA Rulebook: Ring-fenced Bodies Instrument [YEAR].

**By order of the Board of the Prudential Regulation Authority**

[DATE]

**Annex A**

In this Annex, the text is all new and is not underlined.

**Part****Ring-fenced Bodies<sup>1</sup>**

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**Chapter content**

- 1. APPLICATION AND DEFINITIONS**
- 2. GENERAL RULES APPLICABLE TO RING-FENCED BODIES**
- 3. BOARD COMPOSITION AND MEMBERSHIP OF RING-FENCED BODIES**
- 4. RISK MANAGEMENT OF RING-FENCED BODIES**
- 5. INTERNAL AUDIT POLICY OF RING-FENCED BODIES**
- 6. HUMAN RESOURCES POLICY OF RING-FENCED BODIES**
- 7. REMUNERATION POLICY OF RING-FENCED BODIES**
- 8. CONTINUITY OF PROVISION OF SERVICES TO RING-FENCED BODIES**

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<sup>1</sup> These draft rules impose requirements upon each ring-fenced body in a group at an individual level. The policy intent is for some of these rules to not apply within a sub-group of ring-fenced bodies and certain undertakings related to ring-fenced bodies, or to apply at the level of such a sub-group. The approach to creating a ring-fenced body sub-group is to be consulted upon in a subsequent consultation paper. The application of these draft rules is subject to the finalisation and implementation of the policy on ring-fenced body sub-groups.

## 1 APPLICATION AND DEFINITIONS

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1.1 Unless otherwise stated, this Part applies to a *ring-fenced body*.

1.2 In this Part, the following definitions shall apply:

*Chairman of Audit Committee function*

is the function of having responsibility for chairing, and overseeing the performance of the role of, the audit committee of a *ring-fenced body*.

*Chairman of Remuneration Committee function*

is the function of having responsibility for chairing, and overseeing the performance of the role of, the remuneration committee of a *ring-fenced body*.

*Chairman of Risk Committee function*

is the function of having responsibility for chairing, and overseeing the performance of the role of, the risk committee of a *ring-fenced body*.

*Chief Internal Audit function*

is the function of having responsibility for management of the internal audit function of a *ring-fenced body* and for reporting directly to the *management body* of the *ring-fenced body* on the internal audit function.

*Chief Risk function*

is the function of having responsibility for overall management of the risk controls of a *ring-fenced body*, including the setting and managing of its risk exposures, and reporting directly to the *management body* of the *ring-fenced body* in relation to its risk management arrangements.

*dedicated intragroup services entity*

means an entity within the same *group* as the *ring-fenced body*, whose only business is to provide services or facilities to other entities within its *group*.

*extraordinary vacancy*

means a vacancy on the *governing body* of a *ring-fenced body* arising from the resignation, dismissal or death of an independent non-executive *director* before the expiry of his or her term of appointment as a *director*.

*remuneration*

means any form of remuneration, including salaries, discretionary pension benefits and benefits of any kind.

*statutory audit*

means any audit required by or under the Companies Act 2006 or any other legislation.

1.3 For the purposes of this Part:

- (1) a *director* is not regarded as independent if he or she:
  - (a) has been an *employee* (other than holding an appointment as a non-executive *director*) of the *ring-fenced body* or of any other member of its *group* within the period of five years before his or her appointment as a *director*;
  - (b) has, or has had, within the period of three years before appointment, a material business relationship with the *ring-fenced body* or any other member of its *group* either directly, or as a partner, shareholder, *director* or as a member of *senior management* or equivalent of an *undertaking* that has such a relationship with the *ring-fenced body*;
  - (c) has received or receives additional *remuneration* from the *ring-fenced body* or any other member of its *group* apart from a *director's* fee, participates in the *ring-fenced body's* share option or performance-related pay scheme, or is a member of the *ring-fenced body's* pension scheme;
  - (d) has close family ties with any of the advisers, *directors* or *senior management* or equivalent of the *ring-fenced body* or of any other member of its *group*;
  - (e) holds directorships in common with other *directors* of the *ring-fenced body* in any other *undertaking* that is not a member of the *ring-fenced body's group*;
  - (f) has significant links, of a nature that might reasonably be expected to give rise to a conflict of a sort that is to be identified and managed under 2.2, with other *directors* of the *ring-fenced body* through involvement in any other *undertaking* that is not a member of the *ring-fenced body's group*;
  - (g) represents a significant shareholder of a *parent undertaking* (whether an *authorised person* or not) of the *ring-fenced body*; or
  - (h) has served on the *governing body* of the *ring-fenced body* or of any other member of its *group* for more than nine years from the date of first election; and
- (2) a *director* is non-executive if he or she does not hold a *senior management* position in the *ring-fenced body*.

## 2 GENERAL RULES APPLICABLE TO RING-FENCED BODIES

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- 2.1 A *ring-fenced body* must, in carrying on its business, ensure that it is able to take decisions independently of other members of its *group*.
- 2.2 A *ring-fenced body* must establish and maintain arrangements to identify and manage any conflicts between:
  - (1) the duties a *director* or a member of *senior management* owes to the *ring-fenced body*; and
  - (2) any interests of the *director* or member of *senior management*.

- 2.3 A *ring-fenced body* must take all reasonable steps to identify and manage any conflict between its interests and those of one or more members of its *group*.
- 2.4 A *ring-fenced body* must be able to demonstrate to the *PRA* its compliance with *ring-fencing rules*.

### 3 BOARD COMPOSITION AND MEMBERSHIP OF RING-FENCED BODIES

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- 3.1 A *ring-fenced body* must ensure that at least half of the positions on its *governing body* are filled by independent non-executive *directors*.
- 3.2 For the purposes of 3.1:
- (1) the chairperson of a *ring-fenced body's governing body* is not to be counted as one of the number of independent non-executive *directors* or as one of the total number of positions on the *governing body*; and
  - (2) where an *extraordinary vacancy* arises which, if not filled, would cause the *ring-fenced body* to fail to comply with 3.1, that position is to be treated as filled by an independent non-executive *director* provided the *ring-fenced body* meets the test in 3.1 without relying on this provision as soon as reasonably possible after the *extraordinary vacancy* has arisen.
- 3.3 A *ring-fenced body* must ensure that the *person* performing the *Chairman function* of its *governing body*:
- (1) is independent and non-executive; and
  - (2) does not chair the *governing body* of any other member of the *ring-fenced body's group*.
- 3.4 A *ring-fenced body* must ensure that no more than one-third of the members of its *governing body* are *employees* of or *directors* of any other member of the *ring-fenced body's group*, unless that other member is a *ring-fenced body*.
- 3.5 A *ring-fenced body* must ensure that it publicly advertises every vacancy for an independent non-executive *director* so as to bring the existence of the vacancy to the notice of those members of the public who might reasonably be expected to seek nomination.
- 3.6 3.5 does not apply if an *extraordinary vacancy* arises in the office held by the chairperson of the *governing body* of a *ring-fenced body*.
- 3.7 A *ring-fenced body* must ensure that none of its *senior management* who is a member of its *governing body* is an *executive member* of the *governing body* of any other member of the *ring-fenced body's group* carrying out any activity that is:
- (1) excluded by or under section 142D of *FSMA*; or
  - (2) prohibited by any order made under section 142E of *FSMA*.
- 3.8 For the purpose of 3.7, '*executive member*' means a *person* who performs any executive function in the relevant member of the *ring-fenced body's group*.

#### 4 RISK MANAGEMENT OF RING-FENCED BODIES

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- 4.1 A *ring-fenced body* must ensure that its risk committee is chaired by a chairperson performing the *Chairman of the Risk Committee function*.
- 4.2 A *ring-fenced body* must ensure that the chairperson of its risk committee does not chair any committee whose functions include oversight of the risk function of any other member of *the ring-fenced body's group*.
- 4.3 A *ring-fenced body* must ensure that:
- (1) its risk management function has sufficient resources and that they are at all times identifiable as performing the risk management function for the *ring-fenced body*; and
  - (2) these resources enable the *ring-fenced body* to take decisions independently of other members of its *group*.
- 4.4 A *ring-fenced body* must ensure that a *person* performing the *Chief Risk function* for the *ring-fenced body* is not also a *person* performing the function equivalent to the *Chief Risk function* (howsoever designated) for any other member or members of the *ring-fenced body's group* or for the *group* as a whole.

#### 5 INTERNAL AUDIT POLICY OF RING-FENCED BODIES

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- 5.1 A *ring-fenced body* must establish an audit committee and ensure that the audit committee:
- (1) is chaired by a chairperson performing the *Chairman of the Audit Committee function*;
  - (2) is composed of members of the *management body* who do not perform any executive function in the *ring-fenced body*; and
  - (3) has appropriate knowledge, skills and expertise in relation to audit, controls, control frameworks and reporting matters.
- 5.2 A *ring-fenced body* must ensure that the chairperson of its audit committee does not chair any committee whose functions include oversight of the audit function of any other member of *the ring-fenced body's group*.
- 5.3 A *ring-fenced body* must ensure that the responsibilities of its audit committee include:
- (1) monitoring the financial reporting process;
  - (2) monitoring the effectiveness of the *ring-fenced body's*:
    - (a) *internal controls*;
    - (b) internal audit function; and
    - (c) risk management systems;



- (3) monitoring the *statutory audit* of the accounts of the *ring-fenced body*; and
  - (4) reviewing and monitoring the independence of *persons* conducting the *statutory audit*.
- 5.4 A *ring-fenced body* must ensure its audit committee develops and maintains formal terms of reference.
- 5.5 A *ring-fenced body* must ensure that:
- (1) its internal audit function has sufficient resources and that they are at all times identifiable as performing the internal audit function for the *ring-fenced body*; and
  - (2) these resources enable the *ring-fenced body* to take decisions independently of other members of its *group*.
- 5.6 A *ring-fenced body* must ensure that a *person* performing the *Chief Internal Audit function* for the *ring-fenced body*:
- (1) is not also a *person* performing the function equivalent to the *Chief Internal Audit function* (howsoever designated) for any other member or members of *ring-fenced body's group* or for the *group* as a whole; and
  - (2) is able to have direct access to the *management body* of the *ring-fenced body* where necessary.
- 5.7 A *ring-fenced body* must ensure that its *management body* and its audit committee have adequate access to the internal audit function and to external expert advice.

## 6 HUMAN RESOURCES POLICY OF RING-FENCED BODIES

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- 6.1 A *ring-fenced body* must ensure that its nomination committee is chaired by a chairperson.
- 6.2 A *ring-fenced body* must ensure that the chairperson of its nomination committee does not chair any committee whose functions include nomination for any other member of *the ring-fenced body's group*.
- 6.3 A *ring-fenced body* must ensure as far as reasonably practicable that, in carrying on its business, it does not depend on any *employee* who may cease to be available to undertake work for the *ring-fenced body* in the event of the insolvency of any other member of its *group*.

## 7 REMUNERATION POLICY OF RING-FENCED BODIES

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- 7.1 A *ring-fenced body* must establish a *remuneration* committee that comprises only members of its *management body* who do not perform any executive function in the *ring-fenced body*.
- 7.2 A *ring-fenced body* must ensure that its remuneration committee is chaired by a chairperson performing the *Chairman of the Remuneration Committee function*.

- 7.3 A *ring-fenced body* must ensure that the chairperson of its remuneration committee does not chair any committee whose functions include remuneration for any other member of the *ring-fenced body's group*.
- 7.4 When establishing, implementing and maintaining *remuneration* policies, practices and procedures for its *employees*, a *ring-fenced body* must ensure that these *remuneration* policies, practices and procedures:
- (1) are consistent with and promote the sound and effective risk management of the *ring-fenced body*;
  - (2) do not encourage risk-taking that exceeds the level of tolerated risk of the *ring-fenced body*;
  - (3) are in line with the business strategy, objectives, values and long-term interests of the *ring-fenced body*; and
  - (4) are not influenced by any factors relating to any other member of its *group* or of the *group* taken as a whole where their levels of tolerated risk, business strategy, objectives, values or long-term interests are different.

## 8 CONTINUITY OF PROVISION OF SERVICES TO RING-FENCED BODIES

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- 8.1 A *ring-fenced body* may receive services and facilities that it requires on a regular basis in relation to the carrying on of the business of a *ring-fenced body* from an entity in its *group* only where that entity is one of the following:
- (1) a *dedicated intragroup services entity*, or
  - (2) an entity within the same [*ring-fenced body sub-group*]<sup>2</sup> as the *ring-fenced body*.
- 8.2 A *ring-fenced body* must ensure that the agreement or arrangement under which it receives services or facilities that it requires in relation to the carrying on of *core activities* does not permit any other party to terminate, suspend or materially alter the services or facilities or the agreement or arrangement solely as a result of an act, omission or deterioration in the financial circumstances of another entity within the same *group* as the *ring-fenced body*.

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<sup>2</sup> The exact scope of entities that will form a ring-fenced body sub-group has not yet been determined and will be the subject of further consultation.

**Annex B**

In this Annex, the text is all new and is not underlined.

**Part**

## **Prescribed Responsibility for Ring-fenced Bodies<sup>3</sup>**

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**Chapter content**

- 1. APPLICATION AND DEFINITIONS**
- 2. PRESCRIBED RESPONSIBILITIES FOR RING-FENCED BODIES**

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<sup>3</sup> It is intended that these draft rules would form part of the Allocation of Responsibilities Part of the PRA Rulebook. The draft PRA rules on Allocation of Responsibilities to senior managers are contained in Annex 7.3 to the PRA / FCA Consultation Paper, 'Strengthening accountability in banking: a new regulatory framework for individuals', FCA CP14/13 / PRA CP14/14, July 2014. The draft rules at Annex B are intended to be read as future amendments to chapter 1 of the Allocation of Responsibilities instrument in PRA CP14/14 and to add a new chapter to that instrument.

## 1 APPLICATION AND DEFINITIONS

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1.1 Unless otherwise stated, this Part applies to a *ring-fenced body*.

1.2 In this Part, the following definitions shall apply<sup>4</sup>:

*FCA designated senior management function*

means an *FCA controlled function* specified in SUP 10C.4.3R of the *FCA Handbook*.

*PRA senior management function*

means a function specified as a *controlled function* in Senior Management Functions in relation to the carrying on of a *regulated activity* by a *firm*.

*ring-fencing requirement*

means any requirement imposed on a *ring-fenced body* by or under *FSMA*, as a consequence of it being a *ring-fenced body*, including any *ring-fencing rule*.

*ring-fenced body prescribed responsibility*

means the responsibility in 2.3.

*statement of responsibilities*

means a statement of the affairs of a *relevant authorised person* for which it is intended that a *person* who performs (or is subject to an application to perform) a *PRA senior management function* is (or will be) responsible.

## 2 PRESCRIBED RESPONSIBILITY FOR RING-FENCED BODIES

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2.1 A *ring fenced body* must ensure that the *ring-fenced body prescribed responsibility* is allocated to any *person* who:

- (1) performs a *PRA senior management function* or an *FCA designated senior management function*; and
- (2) is responsible for managing any area of the *ring-fenced body's* business that is subject to a *ring-fencing requirement*.

2.2 A *ring-fenced body* must ensure that the *statement of responsibilities* accompanying an application for approval to perform a *PRA senior management function* in relation to it

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<sup>4</sup> The draft definitions for 'FCA designated senior management function', 'PRA senior management function' 'statement of responsibilities' were included in the draft amendments to the PRA Rulebook Glossary in Annex 7.1 to PRA / FCA Consultation Paper, 'Strengthening accountability in banking: a new regulatory framework for individuals', FCA CP14/13 / PRA CP14/14, July 2014. Cross references to SUP 10C and to Senior Management Function should therefore be read in accordance with the corresponding draft rules in Annexes 6 and 7.2 of FCA CP14/13 / PRA CP14/14.

includes any *ring-fenced body prescribed responsibility* allocated to, and which are to form part of the responsibilities of, that *person*.

2.3 The responsibility listed in this rule is a *ring-fenced body prescribed responsibility*:

responsibility for ensuring that those aspects of the *ring-fenced body's* affairs for which a *person* is responsible for managing are in compliance with any *ring-fencing requirement*.