BANK OF ENGLAND

FSA

The Bank of England, Prudential Regulation Authority

Our approach to banking supervision

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Introduction

1. This publication has been produced jointly by the Bank of England and the Financial Services Authority (FSA). Its aim is to set out how the Prudential Regulation Authority (PRA), which is currently expected to be created by the end of 2012 as a subsidiary of the Bank of England, will approach the delivery of its statutory objective. The document complements HM Treasury's February 2011 consultation document *A new approach to financial regulation: building a stronger system*, and the forthcoming white paper and draft Bill, which lay out the legislative framework. The intention of this document is to inform public debate and facilitate engagement with relevant stakeholders as the PRA's approach to supervision is further refined and more detail is put into place.

2. The PRA will be responsible for supervising both insurance companies and deposit-takers.(1) Recognising that the risks posed by insurers are different from those posed by deposit-takers, a companion paper will be produced in the summer to cover the PRA's approach to regulating insurance companies.

Overview

3. **The PRA's role will be to contribute to the promotion of the stability of the UK financial system. It will have a single objective — to promote the safety and soundness of regulated firms — and will meet this objective primarily by seeking to minimise any adverse effects of firm failure on the UK financial system and by ensuring that firms carry on their business in a way that avoids adverse effects on the system. As recognised in its statutory objective, it will not be the PRA's role to ensure that no PRA authorised firm fails. That responsibility lies with each firm's management, board of directors and shareholders.**

Principles underlying the PRA's approach

4. Supervision encompasses three potential elements: policies and rules on firms' resilience (covering such areas as capital, liquidity and leverage); supervisory assessments and interventions; and policies and mechanisms to support resolution.

5. The Bank and the FSA believe that in order to be effective in meeting the PRA's objective, the PRA's supervisory regime will need to combine all three elements. Regulatory standards alone cannot eliminate, without unacceptable cost to the economy, the risk that common shocks or low probability high impact events will lead to firm failure. Equally, the resolution regime alone should not be relied upon as a sole risk mitigant, particularly for large complex institutions, given the inherent uncertainty in any complicated resolution process.

6. **The PRA's approach to regulation will thus consist of policy making to guard against a range of possible outcomes and the application of that policy through effective supervision. All firms will be subject to a baseline level of supervisory oversight designed both to reduce the probability of failure and, as it is not the PRA's role to prevent firm failure in all circumstances, to ensure that if a firm does fail, it does so in an orderly manner.**

7. An effective regulatory framework for financial stability needs to combine firm-specific supervision with oversight and risk management of the financial system as a whole. So the PRA will work closely with the rest of the Bank, including the Financial Policy Committee (FPC). The FPC will have responsibility for reducing risks to the financial system as a whole and will, among other things, be able to recommend changes to PRA policies and rules on a 'comply or explain' basis.

8. Since firm failure is always possible, it will be essential for the PRA to foster a regime in which firms are able to fail in an orderly manner without material harm to the stability of the system. In consequence, the need to understand and to minimise the adverse impact that a firm's failure may have on the stability of the financial system will be central to the PRA's approach.

9. The PRA's assessment of impact will capture impairment to the capacity of the financial system as a whole to carry out activities important to the functioning of the economy. That does not of itself extend to preventing direct losses to uninsured depositors and other creditors. The PRA will recognise that deposit guarantee arrangements operated by the Financial Services Compensation Scheme (FSCS) play an important role in reducing the impact of firm failure, and that surviving firms themselves will have to bear the cost of FSCS payouts.

10. That firms should be allowed to fail, so long as failure is orderly, reflects the view that financial firms should be subject to the disciplines of the market. **Consistent with its statutory objective, the PRA will not view the failure of an institution in an orderly manner as regulatory failure, but rather as a feature of a properly functioning market.** This is an

(1) As described in Box 1, in addition to regulating all deposit-takers and insurance companies, the PRA will regulate a small number of 'investment firms' that could present significant risks to the stability of the financial system. The PRA's approach to regulating these firms will be broadly analogous to its approach to regulating deposit-takers. In the interests of brevity, references in this document to deposit-takers should in general, and unless otherwise stated, be taken also to include investment firms designated for regulation by the PRA.

important change to the statutory basis of prudential supervision. The PRA will seek to ensure that firms disclose sufficient information to enable the market to make judgements about risk and return. The existence of a credible resolution regime, run by the Bank's Special Resolution Unit (SRU), is designed to enhance market discipline.

11. The PRA will have an obligation to monitor the capital adequacy, liquidity and large exposures of the firms it regulates — reflecting internationally agreed standards and rules and as an input into assessing safety and soundness. **Although the PRA's approach to prudential supervision and monitoring of safety and soundness will vary according to the risk to financial stability posed by a firm, baseline prudential supervision will be undertaken for all firms.** This reflects both the role of supervision to ensure adherence to standards, including resolution frameworks, and inherent uncertainty about whether a firm, or groups of firms, can fail without impact on the system.

Judgement-based supervision

12. The PRA's style of supervision will be judgement-based. It will have several elements:

- **The nature and intensity of the PRA's supervisory approach will be commensurate with the level of risk a firm poses to the stability of the system.** Resources will be focused on those institutions and issues which will have the greatest impact on the stability of the UK financial system. Reflecting this, supervision will be tailored to different firms and sectors: it will not be driven by a one-size-fits-all approach but will vary according to risk, and so according to changes in the risks facing the system.

- **Supervisors will focus on the 'big picture' and on understanding where the main risks to the stability of the financial system lie.** The test of materiality for points raised with firms will be high, and supervisory interventions will be clearly and directly linked to reducing risk to the stability of the system.

- **The PRA will be forward-looking, seeking to assess whether, on the balance of risks, there are vulnerabilities in firms' business models, capital and liquidity positions, governance, risk management and controls that cast into doubt their future financial soundness.** The focus of supervision will go beyond assessing compliance with rules.

- **Where potential threats to the safety and soundness of an institution are identified, the PRA will take supervisory action at an early stage to reduce the probability of disorderly failure.** A Proactive Intervention Framework will be introduced. This will clearly set out both the remedial actions expected to be taken by a firm as its financial position deteriorates, and the actions expected to be taken by the authorities to prepare for a firm's resolution, should it become necessary. The PRA will focus on risk mitigation, not just risk assessment.

13. The PRA will aim to build highly qualified supervisory teams and robust analytical frameworks based on high-quality data. Its approach will require clear decision-making procedures and constructive but challenging relationships with the firms that it regulates.

14. The PRA will make clear to firms what it expects of them through straightforward, clear communication of its policies and rules. Firms will be expected to consider the underlying purpose of PRA rules — the spirit — when managing their businesses. The PRA will expect the firms it regulates not to engage in 'creative' compliance with its rules and policies and not to engage in regulatory arbitrage designed to mask the riskiness of their activities or financial exposures.

Delivering the PRA's approach

15. The PRA's proposed approach has, at its centre, supervisors making judgements, when needed, about current and future risks to an institution's safety and soundness and about the action it should take to address these risks. It is recognised that this will mean that, at times, the supervisor's judgement will be at variance with that of the institution. Furthermore, there will be occasions when events will show that the supervisor's judgement, in hindsight, was wrong. This is inherent in a forward-looking system. **The PRA will ensure that major judgements involve its most senior and experienced individuals, using a process which is both rigorous and well-documented.**

16. Domestically, co-ordination with other parties will be essential to the PRA's success. There will be arrangements in place to ensure strong underlying co-operation between: the PRA and the Financial Conduct Authority (FCA); between the PRA and the FSCS; and between the PRA, the FPC and the rest of the Bank covering macroprudential analysis, market intelligence, oversight of infrastructure, and the work of the SRU.

17. The PRA's policies and supervisory actions will be set within an international context. The open nature of the international financial system and, in particular, the single internal market in the EU mean that a high degree of co-ordination is necessary between national regulatory authorities to reduce the risk of collective financial instability.

Box 1
Lessons from previous regulatory failures

The Bank acknowledges that simply transferring responsibility for banking supervision to the Bank will not guarantee successful regulatory outcomes. Indeed there were a number of high-profile instances of regulatory failure around individual firms in the past when the Bank was previously responsible for banking supervision.

In the Bank and the FSA's judgement, the key lessons from those failures — namely Johnson Matthey, BCCI and Barings — centre on: the importance, for internationally active banks, of a home supervisor being ready and able to conduct effective consolidated supervision of all activities (regulated and unregulated) within a group; the requirement for banking group structures to enable supervisors to form a clear view of how business is conducted; the need for ongoing dialogue between bank management, its auditors and supervisors; and the importance of understanding the underlying source of a bank's earnings and the risks to which it is exposed, including where there are substantial operations outside the United Kingdom. In addition, there were lessons which were relevant both to management and to the authorities as a whole on the need to be vigilant and inquisitive with regard to potential evidence of wrong-doing and fraud, and the willingness of the authorities to use supervisory powers to minimise these risks.

Consideration has also been given to the significant bank 'failures' which have occurred since 1998 during the period of supervision by the FSA — namely Northern Rock, HBOS and RBS.

The FSA published a detailed audit report on its supervision of Northern Rock in 2008, followed by a more general report '*The Turner Review*' in 2009, which looked at the high-level supervisory lessons to be learned. The FSA also intends to publish a review of its supervisory practices as part of the announced report on the failure of RBS.

The principal general regulatory lessons are nevertheless apparent in the material already in the public domain. The central failing behind the global crisis was that of the Basel standards for capital and national liquidity regimes, which proved inadequate. This issue of inadequate prudential standards is now being addressed by the Basel Committee.

In addition to flaws in the design of international regulatory regimes, the prevailing supervisory approach in the United Kingdom was also found to be inadequate. The FSA's supervisory approach prior to the financial crisis of 2007 rested on three assumptions. First, that the Basel capital framework was suitably calibrated and thus adherence to its capital standard would ensure an institution's stability; second, that access to wholesale market liquidity could always be achieved; and third, that senior management judgement and market discipline should not be 'second guessed' by supervisors. The FSA's supervisory focus was thus on ensuring that firms had credible systems and controls to equip management to exercise its responsibility. The presumption was that supervisors should not be exercising judgement on what might happen in the future; this was for management. So supervisors limited their interventions to requiring compliance with detailed standards only if they were technically breached. In other words, the supervisory approach was in essence reactive and it was designed and built around the premise that regulators should only intervene following observable failings relative to a set of rules rather than seek to prevent potential failure in the future.

The pre-crisis regime also lacked the necessary tools to support the orderly failure of a bank. There was no bank resolution regime and the deposit protection regime was not sufficient to ensure depositor confidence. Both of these two failings have been addressed in recent legislation.

We have aimed to reflect in this paper, lessons from both these periods of supervision in the United Kingdom, as well as recommendations from recent international experience as captured in the Financial Stability Board's report into the intensity and effectiveness of supervision of systemically important financial institutions.(1)

(1) See www.financialstabilityboard.org/publications/r_101101.pdf.

But it will also be important for the PRA to ensure that its approach to supervision is not compromised by developments in the international regulatory environment. **With the rest of the Bank and other UK authorities, the PRA will play an active and constructive role in shaping the development of the common framework for regulation and supervision at a global level and in the EU.**

18. **The PRA will recognise that accountability to the public is of utmost importance.** It will therefore be fully committed to being transparent and accountable in delivering its public policy objective set by Parliament, and in delivering its objective in an efficient and cost-effective manner.

Structure of this paper

19. Section II provides background on the deposit-takers to be regulated and supervised by the PRA. Section III outlines the PRA's risk assessment framework. Section IV sets out how the PRA plans to put its judgement-led approach into practice through the supervision of firms. Section V articulates the PRA's approach to policy making, designed to support a judgement-led approach to supervision, while Section VI defines the PRA's approach to authorising firms and approving individuals. The paper concludes with the next steps.

II The PRA's scope

20. The PRA will be responsible for the prudential supervision of over 2,000 firms, of which around half will be deposit-takers. On current data, it will regulate 157 UK-incorporated banks (of which over 60% form part of overseas banking groups), 48 UK building societies, 652 UK credit unions[1] and 162 branches of overseas banks, split roughly equally between the European Economic Area (EEA) and elsewhere (**Table 1**).

Table 1 UK deposit-takers

	UK-incorporated deposit-takers (including subsidiaries of overseas banks)			Branches of overseas banks
	Banks	Building societies	Credit unions	
Number of firms	157	48	652	162
of which, UK	*60*	*48*	*652*	–
of which, other EEA	*18*	–	–	*82 (passported)*
of which, non-EEA	*79*	–	–	*80*
		857		162
Total number of deposit-takers			1,019	

Note: Investment firms are excluded from this table.

Source: FSA as at 31 March 2011.

21. As explained in Box 2, in addition to deposit-takers, the PRA will also be responsible for the supervision of a number of investment firms that could present significant risks either to the stability of the financial system or to one or more PRA-supervised entities within the firm's group. It is envisaged that this will be a relatively small number.

22. Through its supervision of UK-authorised deposit-takers, the PRA will be responsible for the prudential regulation of firms holding £9 trillion of assets in the United Kingdom and globally, equal to around seven times UK GDP. And within this total, UK-owned banks alone hold assets equal to five times UK GDP. In addition, the PRA will be responsible under relevant European law for its limited part in the prudential supervision of passported branches of EEA banks, which together hold a further £2 trillion of assets in the United Kingdom.

23. As well as being large in aggregate, the banking system in the United Kingdom is highly concentrated, with a few firms — a number of which form part of overseas banking groups — representing a relatively large proportion of the financial system as a whole (**Table 2**). Concentration in retail financial services is especially marked. Approximately 85% of personal current accounts are provided by the largest five firms.

Table 2 Total assets of largest UK deposit-takers

UK groups	Assets (global group £ billions)	Per cent	UK subsidiaries of international banks[a]	Assets (UK group £ billions)	Per cent	UK branches of international banks[b]	Assets (UK branch £ billions)	Per cent
HSBC	1,619	14.1	Credit Suisse	557	4.9	Deutsche (EEA)	391	3.4
Barclays	1,476	12.9	Goldman Sachs	474	4.1	UBS	366	3.2
Royal Bank of Scotland	1,441	12.6	Morgan Stanley	331	2.9	JP Morgan	315	2.7
Lloyds TSB	854	7.5	Santander	303	2.6	Credit Suisse	141	1.2
Standard Chartered	330	2.9	Nomura	203	1.8	Credit Agricole (EEA)	114	1.0
Nationwide	192	1.7	JP Morgan	190	1.7	BNP Paribas (EEA)	107	0.9
The Co-operative	46	0.4	UBS	163	1.4	Citibank	103	0.9
Yorkshire Building Society	30	0.3	Royal Bank of Canada	46	0.4	Bank of America	43	0.4
Coventry Building Society	22	0.2	National Australia	44	0.4	ING (EEA)	43	0.4
Northern Rock plc	19	0.2	Mizuho	33	0.3	National Australia	40	0.3

Source: FSA data as at 2010 H2.

(a) Including bank holding companies.
(b) Excluding Royal Bank of Scotland NV and combining two Credit Agricole branches.

(1) Of this total, 178 credit unions are based in Northern Ireland and are currently supervised by the Department of Enterprise, Trade and Industry (DETI). Responsibility for the regulation of credit unions in Northern Ireland is expected to transfer from the DETI to the FSA and, subsequently, the PRA.

Box 2
Other firms designated for supervision by the PRA

Under statute, a number of firms that are neither deposit-takers nor insurance companies will be eligible to be designated for supervision by the PRA rather than the FCA, if the PRA determines that the firm could present significant risks either to the stability of the financial system or to one or more PRA-supervised entities within the firm's group.

It is currently envisaged that investment firms authorised to deal in investments as principal on their own account will be eligible for PRA designation. ('Investment firm' is a term used to describe, among other things, a firm undertaking investment banking activities.) Most of these firms are not likely to pose sufficient risk to the stability of the financial system, however, and so the PRA will develop additional criteria for designation. These criteria are likely to include: the size of a firm; the substitutability of its services; the complexity of its activities; and its interconnectedness with the financial system and any PRA-supervised companies within its group. The PRA will consult on its proposed policy in this area in due course.

In addition to establishing clear designation criteria for firms dealing in investment as principal, consideration will be given as to whether it is desirable to recommend changes to legislation, to ensure that the PRA will be able to regulate all firms posing potentially significant risks to the financial system because their activities are in substance analogous to deposit-taking. If necessary, following consultation, the authorities will make recommendations to HM Treasury.

It will also be possible for the FPC to propose revisions to the regulatory perimeter when a particular type of unregulated activity is considered likely to pose potentially significant risks to the stability of the financial system as a whole.

24. Banking contributes 5% of UK GDP, and financial services as a whole 10%. As recent experience has highlighted, failures in prudential supervision can have substantial consequences, both in terms of the stability of provision of financial services to the UK economy and for taxpayers more broadly, given the consequences of recession.

25. **The PRA will thus play an important role in supervising a large, concentrated, internationally diversified population of deposit-takers, whose contribution to, and potential impact on the stability of, the UK economy is significant.**

III Risk assessment framework

26. **The PRA will concentrate its resources and actions on those firms and issues that pose the greatest risks to the stability of the UK financial system.** Risks to the stability of the system will be assessed via the five step risk assessment framework shown below. As illustrated in **Figure 1**, the framework will capture three key elements:

- **potential impact** on the financial system of a firm coming under stress or failing (for example, if the failure of a firm affected the soundness of other intermediaries and so the provision of financial services to the economy as a whole);

- how the macroeconomic and business **risk context** in which a firm operates might affect the viability of its business model (for example, its ability to generate earnings in a low interest rate environment); and

- mitigating factors, including risk management and governance (operational mitigation), a firm's financial strength, including capital and liquidity (financial mitigation), and resolvability (structural mitigation) — which together determine the **safety and soundness** of a firm — that may reduce the potential risk a firm poses to the stability of the financial system.

27. The PRA's risk assessment framework builds on risk assessment models focused on the likelihood of firm failure, by focusing also on the impact of firm failure on the stability of the system and on whether orderly resolution is feasible and credible. Forward-looking analysis on the basis of a balance of risks is also at the core of the framework. These are material, important innovations.

Potential impact: on the financial system

28. **The risk assessment framework will put considerable emphasis on assessing the channels through which a firm might affect the stability of the UK financial system, including in times of wider crisis.**

29. Assessment of impact will capture impairment to the capacity of the financial system as a whole to carry out activities important to the functioning of the economy, in particular the provision of payment services (including access to funds), credit and risk transfer.(1) Impact will reflect an institution's size, substitutability of services and interconnectedness with other parts of the system, and it may arise because a firm has come under stress or failed. The PRA's assessment of impact will draw on the analysis and assessment of systemic risk undertaken in the rest of the Bank, including for the Financial Policy Committee.

30. The impact of a firm on the stability of the financial system will arise through two broad channels:

- directly through the impact of firm failure on real economic activity or the soundness of other intermediaries and so the provision of financial services to the economy as a whole. Real economic activity may be affected via the cessation of services, while the soundness of other intermediaries may be affected via interconnected credit exposures, or by pressure on financial asset prices from fire-sales including following liquidation or mass close-out of positions, or via claims on the deposit insurance fund (the FSCS); and

- through behavioural effects where vulnerabilities within one firm affect confidence in other firms with similar business models or products.

In consequence, assessing impact will not simply be a case of looking at the number of depositors a bank has or the total value of its assets. It will also involve looking at how interconnected it is with other firms.

31. The PRA's role to promote the stability of the financial system includes protecting payments services. The PRA will

Figure 1 The risk assessment framework

Gross risk			Safety and soundness				
1. Potential impact	2. Risk context		3. Operational mitigation		4. Financial mitigation		5. Structural mitigation
Potential impact	External context	Business risks	Risk management and controls	Management and governance	Liquidity	Capital	Resolvability

(1) Consistent with the definition of financial stability described in Bank of England *Annual Reports*.

therefore take account of the loss of access to payment services that would arise were a bank to fail, and it will seek to mitigate these effects, for example through measures to facilitate the transfer of deposit account contracts to other firms. The PRA's objective does not extend to preventing direct losses on deposit accounts, nor other wealth effects, except in so far as those lead to the impairment of the financial system through the effects described above. Ensuring depositors are appropriately compensated is the shared responsibility of the PRA and the FSCS, given their respective roles in making rules and in operating the deposit guarantee scheme.

Risk context: external context and business risks

32. **The PRA will consider whether and how the wider external macroeconomic and business context may affect the execution of a firm's business model in a variety of different scenarios.** This will include a consideration of system-wide risks, for example from low interest rates, excess credit growth or international imbalances, and sectoral risks, for example in commercial real estate. In reaching this assessment, supervisors will draw on the FPC's view of the macroprudential environment, and on market intelligence gathered by other Bank and PRA staff. They will also take into account actions by the FCA which may materially affect the prudential soundness of PRA-regulated firms. This assessment will require a clear understanding of a firm's business model, including how it makes profits and the drivers of, and threats to, its viability.

Mitigating factors: safety and soundness

33. The PRA will assess the factors that have the potential to mitigate the adverse impact a firm may have on the stability of the financial system.

34. Central to this is **resolvability**. If a firm can be resolved in an orderly manner, the overall risk that it poses to the stability of the financial system will be lessened. Working with the Bank's Special Resolution Unit and the FSCS, the PRA will consider whether, and with what impact, a firm could be resolved, using the tools of the statutory resolution framework established in the United Kingdom.

35. The PRA will also consider a firm's **financial strength**. This will include an assessment of the level of capital a firm is holding against uncertainties about the valuation of assets and future risks; as well as the quality of its funding and liquid assets and its approach to liquidity management, including contingency planning.

36. The PRA will also evaluate the quality of a firm's **risk management and governance**. This will include an assessment of the adequacy and integrity of its risk management, systems and controls, culture, governance and the competence of its senior management.

IV Supervision

Approach to supervision

37. Reflecting experience in the crisis and lessons learned in the United Kingdom and internationally, **the PRA's approach to supervisory assessment will be based on forward-looking judgements, with supervisory interventions clearly directed at reducing the major risks to the stability of the system**. A key element of the PRA's approach will be to recognise that management, internal audit, boards, shareholders, creditors and external auditors have an important role to play in ensuring firms are run prudently. And to support that, the PRA will seek to enhance the information available to shareholders and creditors to aid effective discipline over firms (see Box 3). The PRA's interventions will not be designed to reduce risks to shareholders.

38. As a matter of practice, **all firms will be subject to a baseline level of supervisory monitoring**, including those that are expected to be resolved with minimal disruption to the financial system (credit unions or other small deposit-takers for example). This reflects inherent uncertainty about whether a firm can fail without impact on the system — for example as a result of changes to a firm's business model through time, the possibility of wider systemic impact if problems occur simultaneously across a sector, and unavoidable uncertainty in assessing resolvability.

39. Baseline supervisory monitoring will comprise an (at least) annual review of a firm's resolvability, drawing on resolution plans for those firms subject to that requirement; an assessment of the principal risks to financial stability from a firm or its sector; an analysis of a firm's financial position, discussions with senior management at the firm; and ensuring compliance with minimum prudential standards for capital, liquidity and large exposures. It will also include, where appropriate, early interventions driven by the Proactive Intervention Framework ((PIF) — see Box 5). For these firms, the PRA will rely principally on analysis of risks at the sectoral level, supported by analysis, for example of outliers, where appropriate.

40. **For those firms posing greater risk to the stability of the system, the PRA's approach will be more intensive but still focused.** Supervision will include: desk-based analysis of a firm's financial position; ongoing evaluation of a firm's business model, capital and liquidity plans, governance and culture, risk management and controls, to understand key risks to financial stability; stress testing against a range of possible future states of the world; regular assessment of a firm's resolvability and the state of its resolution plans; regular contact between a firm's senior management and senior PRA management; and early and proactive supervisory interventions under the PIF designed to reduce risks to the stability of the system.

41. The PRA will take into account the cost and impact of its approach to ensure that it is justifiable, given the benefits expected from reduced risk to the stability of the system.

42. The PRA will need to have access to sufficient accurate information to enable it to form an independent judgement of the key risks to financial stability posed by a firm. The PRA will periodically validate firms' data, either through onsite

Box 3
Disclosure and market discipline

The PRA will look to the market — to a firm's shareholders, debt-holders and counterparties — as well as the firm's senior management and its board of directors, as a key source of discipline to promote prudent behaviour in firms.

The PRA's policy goal will be for the market to be equipped with the ability to make its own reasonable judgement on the safety and soundness of a firm. The PRA will work from the basis of what is already in place, including the improvements in bank disclosures made over recent years. And in developing policy on firms' own disclosures, the PRA will seek to ensure comparability of disclosures, across firms and through time. As part of its commitment to make market discipline effective, the PRA will, for example, seek to publish some regulatory returns.

The PRA will not routinely disclose its own judgements on a firm. It will work with the FCA in its role as markets regulator towards requiring firms to make available as much information as possible to ensure that investors and other parties can make their own judgements. Throughout, the PRA will be alert to the possible risk that disclosures could act to destabilise rather than stabilise, particularly in times of stress. It will also remain aware that the impact of a particular disclosure might not always be clear *ex ante*. Nevertheless, the PRA will start from the position that encouraging market discipline through disclosure will be a central element in delivering its objective. This is an important and significant area of further work.

inspection by its own supervisory and specialist risk staff or by third parties.

43. The PRA's onsite inspections will not be able to uncover all instances of malpractice. In this sense, the PRA will not seek to be a 'fraud regulator': this role is filled by other authorities.

44. **The PRA will put in place the necessary management and oversight processes to support the judgements required from supervisors in its approach.** The work of supervisors and risk specialists will be closely integrated in order to deliver robust analysis, focused on key risks. PRA senior management will oversee risk assessment and supervisory interventions for firms. And formal assessments, as well as proposed remedial actions, will be subject to rigorous review by those not directly involved in a firm's supervision — including risk specialists, independent advisers and relevant participants from the rest of the Bank, such as the Special Resolution Unit (SRU).

45. The most important supervisory messages, including actions expected of a firm, will be clearly communicated by PRA senior management to a firm's senior management, including where appropriate to its board. A formal series of regular meetings between PRA senior management and the Chief Executives of major banks will be set up. In consequence, the PRA's most senior supervisors will be closely and routinely involved in supervision of the most significant firms. The PRA will speak with one voice to the firms it regulates.

Supervisory assessment

46. For UK firms, the PRA's assessment will cover all relevant entities within the consolidated group. Its approach to the supervision of international banks is outlined in Box 4.

Business risk

47. Supervisors will assess business risk at the level of the sector or of the firm as appropriate. They will seek to understand the extent to which a firm's business model is sustainable, or vulnerable to specific events which have the potential to create systemic consequences. This might include unsustainable expectations of growth of market share in order to meet profitability targets without due regard to risks taken, or specific vulnerabilities (for example to significant consequences following change(s) in its own credit rating).

48. For those firms posing the greatest risk to the stability of the system, the analysis will include a review of the drivers of profitability, firms' risk appetite and performance targets, and the assumptions under which these targets have been set. It will include analysis of the balance sheets of individual firms and sectors, including as an input into an assessment of risks to the system as a whole.

49. Peer analysis will form an important part of this assessment. This will provide a diagnostic tool to highlight where individual institutions may be outliers relative to their sector and which might warrant further analysis. It will also provide an understanding of sectoral risks that have the potential to affect the stability of the system, and where action from the FPC may be warranted.

Financial strength

50. The PRA will regularly assess the key elements which determine a firm's financial strength in relation to the size and type of business it carries out.

51. The PRA will, for example, examine the quantity and quality of **capital** that a firm needs to support its activities on a forward-looking basis, including in times of stress when asset valuations (including in trading portfolios) may become strained. It will include a review of a firm's approach to provisioning and valuations of trading assets, designed to identify where it is out of line with peers; specific comparison will sometimes be made. And, as described below, as part of the regular supervisory process, the PRA will use its judgement to determine whether a firm needs to hold additional capital to ensure that the risk it poses to financial stability is reduced.

52. The PRA will also examine the adequacy of a firm's **liquidity** in quantitative and qualitative terms, in order to assess its ability to meet its liabilities (actual and contingent) on an ongoing basis. This will include an assessment of a firm's ability to fund itself in times of stress based on its Contingency Funding Plan, drawing on the Markets area of the Bank. Again, where there are concerns about the risk to financial stability posed by a firm, the PRA will use its judgement to determine whether additional liquid assets or changed funding strategies are required.

53. As part of this process, the PRA will assess the robustness of a firm's internal systems and controls and senior management oversight in relation to capital and liquidity management. It will assess **concentrations of risk**, both of assets (including large exposures) and funding strategies.

54. Forward-looking **stress testing** has an important role to play in helping the PRA make judgements about a firm's financial soundness in an uncertain future. It will cover the quality of lending portfolios, the robustness of asset valuations and provisions, and liquidity and valuations of trading portfolios. Stress tests will not be 'pass/fail' exercises but will instead be used to assess the balance of risks arising.

55. Stress testing will be undertaken — where appropriate — by the PRA and by firms. The PRA will undertake two types of stress testing: bottom-up idiosyncratic stress tests of individual banks, tailored to those firms' particular risks and drawing on macro scenarios from the Bank where appropriate; and system or sector-wide stress tests undertaken to support the FPC or other authorities such as the European Banking Authority and the International Monetary Fund (IMF).

56. Firms will be expected to implement reverse stress testing to identify those scenarios most likely to cause financial distress or to cause their current business model to become unviable. This will require firms' senior management and boards to explore more fully the vulnerabilities of business models. The PRA will recognise that it will always be possible to identify a stressed scenario in which a firm fails; and it is not the PRA's intention to ensure that firms can withstand all such events. The PRA will consider it important, however, for firms' senior management and boards to have an explicit understanding of the circumstances in which a firm might fail, for them to consider that risk to be acceptable, and to mitigate that risk within limits.

57. Firms' **recovery plans** — designed to return firms to a stable, sustainable position following idiosyncratic or market-wide stress — will be an important input into the PRA's assessment of financial strength in future states of the world. Plans will include options to address capital shortfalls, liquidity pressures and profitability pressures (building on Capital Restoration Plans and Contingency Funding Plans), as well as appropriate governance processes and triggers to ensure timely implementation of recovery options in stress. Plans will be developed and owned by firms, with the PRA forming a judgement on the plan's credibility, supported as appropriate by the rest of the Bank including the SRU (as resolution authority) and the Markets area (reflecting its role operating the Bank's liquidity insurance facilities). Under the Proactive Intervention Framework (see Box 5), as a firm's financial position deteriorates, the PRA will ensure that concerns are elevated and that remedial actions — including those specified in recovery plans — are taken at an early stage.

Risk management and governance

58. Experience suggests that an important test of firms' competency in running their business is the ability to marshal data on risk exposures and respond quickly to any deterioration in key indicators. The PRA's supervisors will therefore assess the quality of a firm's **risk management functions**, including via spot checks designed to assess a firm's ability to respond to unforeseen events. The PRA will also take a view on the strength of a firm's **governance** arrangements, including an assessment of governance around activating elements of a firm's recovery plan. The PRA will, for example, judge the calibre of a firm's control functions and the level of oversight by senior management. It will want to be satisfied that designated 'risk' functions do actually carry weight within firms.

59. Related to that, the PRA will take account of a firm's **culture**, given the underlying role that it has in influencing business strategy. The PRA will expect firms' governing bodies to embed and maintain a firm-wide culture that supports the safe and sound management of the firm. The PRA will not have any 'right culture' in mind when making its assessments; rather it will focus on whether a firm is achieving the right regulatory outcomes. Where these are not being achieved, however, the PRA will expect a board to reconsider the culture of the firm and make any necessary changes to improve regulatory outcomes.

Resolvability

60. Creating a regime in which the authorities can deal with firms failing without unacceptable costs to the financial system will be fundamental to the PRA's approach. Resolvability analysis and the development of credible and effective **resolution plans** will therefore form a key part of the PRA's assessment process.

61. In assessing resolvability, the PRA will consider whether the domestic and, if relevant, overseas authorities have in place a resolution plan for a firm; whether that resolution plan is both feasible and credible, including in times of market stress; and what the likely impact of executing the resolution plan will be on the financial system, in particular whether the firm can be resolved in a manner that deals appropriately with critical economic functions (such as deposit-taking).

62. Firms will be required to provide information and analysis to enable the PRA, working with the SRU, to identify critical economic functions and assess the extent to which the firm's legal and operational structure allows these functions to be separated in a resolution. The nature and scope of the resolution plan will depend on a number of factors, including the size and complexity of the firm and the extent to which it has cross-border operations. Where firm-specific barriers to orderly resolution are identified, the PRA will work with firms to eliminate them.

63. At a minimum, all firms will be expected to be able to demonstrate to the authorities that they can produce a single, consistent view of depositors' funds to enable the FSCS to implement rapid payout, and to protect connectivity to payment systems. This 'single customer view' is essential in order to ensure that the FSCS is able rapidly to recompense

insured depositors, minimising the adverse effect of firm failure on the stability of the financial system.

64. Enhancing the resolvability of firms will also require further improvements in the scope and adequacy of the UK resolution framework, and of its overseas counterparts. While the United Kingdom has already put in place comprehensive arrangements to support the resolution of banks (set out in the Banking Act 2009), the PRA will support — and, where appropriate, actively influence — domestic and international initiatives to improve resolvability. Given the international nature of many financial services firms, the new European Crisis Management Framework (currently under discussion) will be important in this regard. Working with HM Treasury, two early priorities for the United Kingdom will include the consideration of the need for enhanced arrangements to support the resolution of systemically important investment firms, and actively pursuing the introduction of statutory powers to 'bail-in' (restructuring of debt by means of a mandatory write-down and/or conversion into equity), once a firm enters the resolution regime. The PRA will not place sole reliance on contractual arrangements that may not provide an adequate and complete substitute for the statutory resolution regime.

Supervisory assessments: supporting tools

Use of third parties

65. As a complement to the work of its own risk specialists, **the PRA will enhance the role of third parties in mitigating prudential risk and preserving financial stability**.

66. **Auditors** can and should play a role in supporting prudential supervision. In particular, they can identify and flag to the regulator potential weaknesses in: a firm's controls and in the quality of the financial data which form the basis of management and board decisions; the prudential information used to supervise firms; and the data upon which market discipline is built. Full, regular and timely dialogue between auditors and supervisors forms an essential part of supervision.

67. The PRA will operate in accordance with, and seek further to develop, the Code of Practice for the relationship between the external auditor and the supervisor jointly produced by the Bank of England and the FSA.(1) The Code aims both to improve audit effectiveness and to ensure that supervisors are better informed about, and able to challenge, the firms they regulate, in order that auditors provide more robust mitigation against prudential risk in firms. The PRA will increase the level of formal and informal dialogue with auditors, at senior and working level, in an open and collaborative way. It will share relevant information, for example where it views a firm's valuations of less liquid assets or its approach to provisioning to be significantly out of line with peers, and it will encourage auditors to increase their disclosure to regulators of emerging concerns within firms. A genuine bilateral dialogue between a firm's auditors and supervisors, covering current and potential risks, will strengthen both the audit process and the supervision of firms.

68. The PRA will also require a firm's **finance, risk, compliance and internal audit functions** to monitor the implementation of corrective action to address minor issues identified as part of supervisory assessment and to self-certify to the PRA when identified risks have been mitigated.

69. The PRA will actively engage with a firm's audit committee and its non-executive directors on progress made in addressing the most significant risks.

70. The PRA will maintain its own in-house specialists, including staff with particular expertise in risk management and risk modelling. The PRA will draw on these risk specialists, who work with supervisors of firms as an integral part of supervision, when making judgements about the safety and soundness of firms. As a complement to this, the PRA will look to take advantage of external parties' knowledge and market expertise. Reports by third parties will be used, for example, to verify regulatory returns and, where appropriate alongside the SRU, to carry out the forensic analysis required to verify resolution plans.

Use of data to inform judgements

71. In forming supervisory judgements, the PRA will draw on a broad suite of information, including regulatory data, financial accounting and other published information, firm management information and market data.

72. A key component of the PRA's information set will be regulatory data. **Data submitted to the PRA should be of the highest quality given that they will form the basis of the PRA's supervisory approach and will form a key input to analysis for the FPC.** The PRA will put in place appropriate quality assurance mechanisms covering data submitted to it. In addition, to further encourage the submission of high-quality data, and in addition to supporting effective market discipline, the PRA expects to require firms to publish some regulatory returns.

73. The PRA will review the content and frequency of data sets submitted to it with the aim of focusing only on the data that it will use regularly to support supervisory analysis or judgements and to ensure compliance with international regulatory standards. Firms will be expected to have wide

(1) www.fsa.gov.uk/pages/Library/Policy/guidance_consultations/2011/11_05.shtml.

data sets, beyond what is regularly submitted, available for PRA supervisors to call upon at short notice, if judged necessary for the assessment of risk or as a 'spot check'.

74. The PRA's approach to data management will, however, have to take into account the framework determined by the European Banking Authority and the European Supervisory Authorities (ESAs) as a whole. The European data strategy continues to evolve but seems likely to be at variance to some degree with the PRA's preferred approach. In particular, the early signs are that the ESAs will be less willing to operate a proactive data strategy where the regulator uses its judgement to request information rather than operating within a pre-agreed data set that is reported regardless of circumstance. In that case, the PRA's approach will supplement that of the ESAs. If that is not possible, the Bank will ensure that this is recognised publicly so that the PRA's role is not misunderstood.

Supervisory interventions

75. Subsequent to risk assessment, the PRA will identify those key areas where further action is required by the firm given potential risk to the PRA's objective. Any less significant issues that have arisen — and of which the PRA felt the firm should be aware — will be conveyed to the firm, but with the onus on the firm itself to address these, with self-certification (by the Chief Financial Officer, internal auditor or chair of the Audit Committee) that issues have been closed.

76. **There will be a clear link between the PRA's assessment of risks to its objective and the actions it will expect the firm to take in consequence.** Actions will be communicated clearly, and at a senior level, to the firm. The Proactive Intervention Framework will be designed to ensure that, if a firm's financial position deteriorates, concerns are elevated and remedial actions taken at an early stage (see Box 5). Supervisory actions will also influence the PRA's future supervisory approach to a firm — for example, concerns about management or systems and controls will influence the PRA's attitude to the growth of a business, including via acquisition.

77. The PRA's key supervisory interventions will be designed to reduce the likelihood of a firm failing and to ensure that should it fail, it does so in an orderly manner without disruption to the financial system. **An important focus will therefore be on ensuring the credibility of resolution plans.** For example, if an assessment of resolvability indicates that a firm cannot give sufficient information to the FSCS to pay out its insured depositors in a prompt manner, supervisory action will be directed at working with a firm and the FSCS to remedy this. Supervisors might also intervene to request changes to financial or operating or legal structures, so as to reduce or remove impediments to resolution.

78. **The PRA will also seek to reduce the likelihood of firm failure, for example through requiring a firm to alter its business model (for instance exiting a particular business line or not pursuing a merger) or holding greater financial resources.** As a matter of routine, the PRA will judge the adequacy of a firm's capital and liquid assets given its risk profile and determine the idiosyncratic capital and liquidity requirements for that firm.

79. The PRA will be obliged to ensure that models used by firms to calculate capital requirements comply with relevant international standards on an ongoing basis. The primary obligation to ensure those models are appropriate will, however, lie with a firm's management; and the PRA will recognise that model verification does not imply risk is adequately captured by a model. The PRA will assess a firm's understanding of its risk and whether its quantification approach is adequate, and it will exercise judgement as to whether further capital is required including, where appropriate, whether approval of a model should be qualified or withdrawn.

Supervisory powers

80. The PRA will have a range of powers available to it under statute to help it support the stability of the system. **The PRA's preference will be to use its statutory powers to secure *ex-ante*, remedial action (for example through restrictions on the business imposed via variations in a firm's permission to undertake regulated activities).** Successful application of the PRA's approach should mean that enforcement actions will be relatively rare.

81. As described above, supervisors will, as a matter of routine, judge both the appropriate amount of capital and liquidity a firm should hold and any remedial actions necessary to reduce risk to the PRA's objective. As a result of this analysis, the PRA will, in the first instance, request or suggest that a firm makes the changes, giving a clear rationale. Where remedial actions are significant or are not completed within defined time periods, the PRA will require a firm to hold additional financial resources, for example via a Pillar 2 capital add-on. That may be made clear in advance in order to help incentivise remedial action.

82. If a firm does not act on the PRA's request or recommendation, and in order to pre-empt risks before they crystallise, the PRA will, where necessary, look to use its statutory powers to compel firms to take certain actions to address the emergence of risk. It will stand ready to direct a firm to follow a certain course of action, in cases where it judges that the firm's failure to do so could result in a risk to

Box 4
Supervising international banks in the United Kingdom

As highlighted in **Tables 1** and **2**, many overseas banks operate in the United Kingdom and are significant providers of financial services to the UK economy. The PRA's supervisory approach will be based on the principle that all banks, both UK and overseas, operating in the United Kingdom should be subject to the same prudential requirements. The PRA's focus will be on the impact which a firm's failure might have on the stability of the UK financial system, regardless of the location of its ultimate parent and legal form.

Supervisors of international banks will, in consequence, seek to assess the safety and soundness of entities active in the United Kingdom as well as of ultimate parents, with a view to judging the impact on UK financial stability if one or both failed. Supervision will include assessments of resolvability, as well as consideration of whether the failure of the overseas parent would lead to the failure of UK entities. To achieve this, it will be necessary to understand the UK entity in isolation and as part of the global group across a range of issues including: the nature and scale of a firm's operations in the United Kingdom; the importance of its activities to UK markets and the substitutability of its services; its capital and liquidity positions; barriers to resolvability; and intra-group operational and financial dependencies.

In the case of **subsidiaries of overseas banks in the United Kingdom**, the PRA's approach will mirror that for UK banks, reflecting the fact that its prudential powers will be the same. The PRA will, however, assess in addition both a firm's links with, and the viability of, its group as a whole. So supervision of the UK subsidiaries of the most significant global financial institutions will represent an important undertaking for the PRA, as well as being an important input into the consolidated supervision by other regulators of these groups.

International firms that carry out investment banking business in the United Kingdom are likely to pose particular challenges. It may, for example, be more difficult to ensure the orderly resolvability of such subsidiaries given close connections with trading operations elsewhere. Building on work undertaken by the Financial Stability Board, the PRA will engage (in co-ordination with the SRU, if applicable) closely with other jurisdictions, in crisis management groups and supervisory colleges, to maximise cross-border co-ordination, including of recovery and resolution plans.

In respect of **EEA branches**, the PRA's supervisory powers will be more limited under European law. At present, these are restricted to supervising the liquidity of the UK branch, but it is likely that these powers will be removed when new European legislation, currently under discussion, enters into force. The PRA may also have only limited access to group-wide information, which will restrict its ability to assess and act on potential threats to the soundness of the group, despite its potential impact on UK financial stability. Nor is it possible to resolve an EEA branch in the United Kingdom separately from the rest of the firm.

While recognising these constraints, given the importance of EEA branches in the United Kingdom (as shown in **Table 2**), the PRA will seek to assure itself in all cases that the risks posed to the UK financial system by EEA banks that operate in the United Kingdom are being adequately managed. As with its supervision of other international banks, to the extent that it lacks formal prudential powers, the PRA will seek to influence, through collaboration and in a supportive manner, the supervisory approach of the home state at group level where it judges that the group poses a risk to the UK financial system. As a key priority, the PRA will, wherever possible, obtain evidence that home regulators have realistic and up-to-date plans to resolve such firms without adverse impact on the stability of the UK financial system. Where the PRA's role under EU legislation leaves it without much information, it will make that understood publicly so that there is no misunderstanding about what it can do and so that it is clear to depositors that they are protected by the home state regime.

The establishment of the new European Supervisory Authorities and the European Banking Authority (EBA) in particular provides an opportunity for the PRA to influence further the supervision of incoming EEA branches. The PRA will be an active participant in both supervisory colleges and the EBA, including through peer review of other countries' supervisory approaches. It is essential that the European institutional structures, including colleges, are able to provide the PRA with the necessary assurance that its statutory objective is being met.

The PRA also has limited prudential powers in respect of **non-EEA branches**. The PRA will be prepared to allow a branch of a new bank in the United Kingdom only if it is satisfied that the firm will be subject to supervision by its home state that is broadly equivalent to that of the PRA and on which the PRA can rely. If the PRA is not so satisfied, foreign institutions will be required to set up as subsidiaries.

For non-EEA branches already operating in the United Kingdom, the PRA will focus on the development of credible resolution plans and focused information sharing, both bilaterally and in international fora. The PRA will need to build on existing Memoranda of Understanding with many non-EEA regulators so that information is shared on cross-border firms, particularly on supervisory and enforcement issues.

the stability of the financial system. Where necessary, the PRA will remove or restrict a firm's permission to operate.

83. There may also be occasions where prosecution via the courts or through fining firms or individuals (for example for consistently late or inaccurate reporting) is required either to ensure necessary remedial actions are undertaken or to provide an incentive against such behaviour in future.

84. The PRA will consult on its regulatory decision-making and legal intervention procedures in due course. It will aim to adopt procedures which are straightforward and transparent to firms, and are robust, fair and reflect the judgement-based nature of prudential supervision. To ensure transparency and fairness, prior notice will be given of proposed formal decisions and representations will be considered (although as now there may be cases where it will be necessary for the PRA's decision to take effect pending representations). The nature of the external appeal mechanism for contested decisions is being considered by the Government. It is intended that legal interventions will certainly be subject to appeal to an independent tribunal by judicial review or, where appropriate, appeal on the merits.

Co-ordination with the Financial Conduct Authority (FCA)

85. **Effective delivery of the PRA's intended supervisory framework will require co-ordination with the FCA.** The principal focus of this co-ordination will be at the firm-specific level where an overarching Memorandum of Understanding and colleges will need to be put into place to ensure that the statutory duty to co-ordinate is made effective in practice and that information relevant to both authorities' objectives is shared. In addition, consideration will need to be given to common standards and rules for risks which are directly relevant to both authorities' responsibilities; for example, governance and systems and controls.

86. The FSA will publish a document on the FCA's prospective supervisory approach in the summer. Further details of how the two authorities will co-operate will be published after that.

87. Careful consideration will be given to interaction with other UK regulatory institutions such as the Financial Reporting Council.

The PRA's role in macroprudential supervision

88. **The premise of this paper is that firm-specific supervision alone is not sufficient to deliver financial stability and that it must be complemented by an effective macroprudential regime.**

89. In the new UK regulatory regime, macroprudential policy and decisions will be the responsibility of the Financial Policy Committee (FPC). As part of the Bank of England, there will be a frequent two-way flow of information and exchange of views between the PRA and the FPC. Although the PRA is charged with making firm-specific decisions, it is inevitable that there will be overlap between such judgements and those which the FPC is making. This will be addressed through some common membership of the PRA board and the FPC: the Governor, the Deputy Governor for Financial Stability and the CEO of the PRA. In addition, the PRA will provide firm-specific information to feed into the FPC's assessment of the macroprudential outlook; and the FPC's analysis of potential systemic risks will help inform the PRA's judgements on specific types of institutions, sectors and asset classes, including its approach to stress testing and its assessments of future vulnerabilities.

90. The FPC will give recommendations and directions to the PRA (and the FCA) on the regulatory tools that should be deployed for macroprudential purposes, including the formulation of those tools. The PRA will be responsible for implementing relevant FPC recommendations on a 'comply or explain' basis, and the FPC's directions in relation to the use of specific macro-tools and for reporting on delivery.

Box 5
Proactive Intervention Framework

The PRA will establish a Proactive Intervention Framework (PIF) to encompass all institutions it regulates.(1) This framework will have two key purposes. First, it will support early identification of risks to a firm's viability and ensure that firms take appropriate remedial action to reduce the probability of failure. Second, it will flag actions that the authorities will need to take in advance to prepare for the failure and resolution of a firm, in co-ordination with the SRU and FSCS as resolution authority and operator of the deposit guarantee scheme respectively. To highlight regulatory forbearance, where actions expected in a particular stage had not been taken, supervisors would report to PRA senior management.

The PIF is expected to have five clearly demarcated stages. The judgement on where to place a firm within a particular stage will be based on an assessment of the firm's viability in both current and future states of the world. There will not be a mechanical reliance on backwards-looking indicators.

The assessment of where a firm sits in the PIF will be undertaken as part of the ongoing supervisory process and will reflect, among other things, a firm's expected financial strength in stressed circumstances. It will be revisited in response to specific concerns arising in the external environment in which a firm operates — for example, in response to a sectoral risk identified by the FPC. Firms will, as a matter of routine, be made aware of where they sit in the framework.

If the PRA judges risks to a firm's viability to be low, the firm will be in Stage 1 of the PIF. This implies a normal level of supervisory monitoring and actions. As a firm moves through each stage of the PIF, the intensity of supervisory monitoring and the intrusiveness of supervisory actions will increase, and contingency planning by the SRU and the FSCS will be stepped up. **Table A** describes how a firm might move through the PIF and the presumed actions that might be taken at each stage.

Table A Stages in the PIF

Stage	Presumed actions
Stage 1 – Low risk to viability of firm	— Firm subject to the normal supervisory risk assessment process and actions, including recovery and resolution planning.
Stage 2 – Moderate risk to viability of firm Supervisors may have identified vulnerabilities in a firm's financial position or deficiencies in its risk management and/or governance practices.	*Recovery* — The intensity of supervision would increase. The PRA might set additional reporting requirements, and/or make use of information gathering powers under a Section 166. — The PRA would require the firm to act to address deficiencies identified over an appropriate timeframe. — The PRA would consider the case for setting restrictions on the firm's business activities until such actions had been taken. — The firm would be required to update its recovery plan and may activate it. *Resolution* — The PRA and SRU would undertake a joint review of the firm's resolution plan in order to identify and initiate any necessary contingency planning, including information required, for resolution. — The FSCS would evaluate the quality of data provided to support a single customer view and any obstacles to payout or deposit transfer.

(1) The approach for foreign, particularly EEA, branches will need to reflect the limited powers available to the PRA.

Stage 3 – Material risk to viability of firm Significant threats to a firm's financial safety or soundness may have been identified.	*Recovery* — The PRA may require any of the following actions: a change to management and/or composition of the board; limits on capital distribution; restrictions on existing or planned business activities; a limit on balance sheet growth and/or stricter leverage limits; and setting tighter liquidity guidelines and/or capital requirements. — The firm would be required to draw on the menu of options set out in its recovery plan as appropriate. *Resolution* — The SRU would intensify engagement on contingency planning for resolution and will have all means necessary to obtain the information it considers it needs to carry out that task.
Stage 4 – Imminent risk to viability of firm The position of a firm may have deteriorated such that the PRA assesses that there is a real risk that the firm will fail to meet threshold conditions for authorisation but some possibility of corrective action remains.	*Recovery* — The PRA would restate the key deficiencies identified and the scale of the recovery actions needed (including in relation to liquidity and capital). The PRA would set out a timetable for implementation of recovery actions. — Firm-led recovery actions would need to be effected in short-order and the firm would need to demonstrate that these were credible and would produce material results. — Actions initiated following activation of the recovery plan, including on asset disposal (or sale of firm) would need to be completed. *Resolution* — The SRU and FSCS would confirm that all necessary actions to prepare for the resolution of the firm had been taken, including that relevant data were readily available.
Stage 5 – Resolution / winding-up under way The PRA has assessed a firm is failing, or is likely to fail, to satisfy the threshold conditions and there is no likelihood of corrective action and withdraws authorisation.	*Resolution* — The PRA would trigger use of the SRR and the SRU would oversee its resolution/winding up. — The FSCS may be required to effect depositor payout and/or to fund deposit transfer or resolution.

V Policy making

91. The PRA's prudential policies will set out the high-level framework and expectations against which a firm is to be judged, and its prudential rules will set the minimum standards by which firms must abide. **Prudential policy will support judgement-based supervision by ensuring that supervisory judgements are made within a clear and coherent framework.** Policies will cover areas such as capital and liquidity adequacy, valuation policies and provisioning, large exposures, risk management, resolvability, and remuneration. The PRA's approach to policy making will take full account of recommendations from the FPC given its remit for macroprudential policy; and it will implement any directions from the FPC.(1)

92. **The PRA will seek to ensure, wherever possible, that its policies and rules are straightforward, clear in intent, robust and support timely interventions.** The PRA's policy documents will explain the underlying purpose of its policies and rules. And the PRA will, wherever possible, include clear statements of purpose when setting rules to ensure that firms and the market more generally understand the reasons behind the policy.

93. **The PRA will expect firms to comply with the spirit as well as the letter of its rules** so that firms implement rules and policies consistent with their underlying purpose.

94. Alongside the rulebook, the PRA will publish a single easily navigable reference document that clearly sets out the PRA's approach to regulation and supervision.

The international dimension

95. The PRA will operate within a global and European institutional framework. In consequence, together with the rest of the Bank, the PRA needs to be an active participant in both international and European institutional structures. The United Kingdom is represented in a large number of international financial regulatory bodies, including the Financial Stability Board (FSB), which co-ordinates the work of national financial authorities and international standard setting bodies, and the Basel Committee on Banking Supervision (BCBS), which sets international capital and liquidity standards. That will remain very important.

96. The presumption of this paper is that the PRA will continue to have the ability to take the action it believes necessary to fulfil its statutory objective to support the stability of the UK financial system through microprudential supervision. **By playing an active and constructive role in shaping the development of international regulatory standards, the PRA will seek to ensure that broader international developments support its judgement-based supervisory approach.**

97. In Europe, there is a clear move towards establishing completely harmonised prudential standards. This is taking place through the implementation of regulatory standards as legally binding European-wide regulations and the increased use of maximum harmonisation of directives. In addition, the European Supervisory Authorities (ESAs) — including the European Banking Authority (EBA) — have the power to set a single European rulebook and binding technical standards, which national supervisors will have to enforce, and to mediate in cross-border disputes.

98. It is important that the EU policy framework leaves scope for supervisors to make informed judgements about risks posed, and action to be applied, within a clear overall policy framework. Such an approach is essential to ensure appropriate risk capture and action, and is thus necessary to ensure effective international action to preserve financial stability.

99. The European agenda includes the introduction of the new Basel capital standards (Capital Requirements Directive IV) and a common framework for crisis management. **The PRA will place particular emphasis on active and constructive engagement with European bodies at senior level and at an early stage.** The PRA will retain discretion to set standards at a higher level where that is necessary, given national circumstances and the PRA's role to support the stability of the UK financial system.

100. The PRA will work with other EU Member States to stress the importance of clarity of purpose in the setting of rules.

Consultation on policy and rule changes

101. **The PRA will recognise the importance of appropriate engagement and consultation with the firms it will regulate. It will not, however, be accountable to regulated firms for delivery of its public policy objective. It will be accountable to Parliament and, within the Bank, to Court. There should not be any perception of regulatory capture.**

102. The PRA's general approach to consultation will be to give industry, other market participants and commentators the opportunity to express views and to ensure that the PRA's

(1) The FPC will have the power to direct how the PRA applies certain policies and rules (to be set out by HM Treasury in secondary legislation) in support of the FPC's macroprudential objective.

judgements are based on as accurate analysis as possible. The PRA will communicate proposed policy and/or rule changes in a clear and straightforward manner, setting out the underlying rationale. A summary analysis of consultation responses will be published, including whether there is a justification for progressing policy proposals.

103. The PRA will take a flexible approach to consulting practitioners. Advice and representations may be sought via a full public consultation or a narrower consultation with experts and relevant stakeholders. The PRA is likely to set up specific expert working groups to advise on particular issues.

104. The PRA will not consult if consultation might be prejudicial to financial stability, for example if policies might otherwise not be introduced in good time.

105. The PRA will continue to analyse the costs and benefits of proposed regulation as an integral part of the policy development process. Quantitative estimates of costs and benefits will not be included in its published documents where such estimates are not meaningful.

106. An increasing amount of detailed regulation will be determined by Europe, which will be subject to consultation and cost/benefit analysis at the European level. The PRA will seek to ensure that, in implementing EU Directives, its approach to assessing costs and benefits is as proportionate as possible, while recognising the United Kingdom's legal obligations. It is also recognised that the most effective point of intervention is in the early stage of the policy development process and, with the rest of the Bank and HM Treasury, the PRA will seek to be effective at that stage.

Remuneration rules

107. The PRA will be responsible for ensuring that the remuneration policies and practices of banks and building societies are aligned with effective risk management and that they do not provide incentives for excessive risk-taking. A revised FSA Code, taking account of the provisions in European legislation, came into force in January 2011.

VI Authorisation of firms and approval of individuals

108. In line with its approach to supervision, the PRA's forward-looking and judgement-based approach will carry over into its role in authorising firms and approving specific individuals as 'fit and proper' to perform certain functions.

109. The allocation of responsibilities for authorisation will follow from the split between prudential and conduct of business responsibilities, reflecting the twin peaks approach to regulation of deposit-takers. Making these decisions will require close co-operation between the PRA and the FCA.

Authorisation of firms

110. Firms must apply to the PRA for authorisation if they wish to undertake an activity, deposit-taking or insurance, that requires them to be regulated by the PRA. **The PRA will administer the application and be responsible for granting authorisation.** Authorisation to carry out regulated activities will not be granted unless both the PRA, as prudential regulator, and the FCA, as conduct regulator, are satisfied that it should be.

111. Before granting authorisation, the PRA will assess whether the firm satisfies relevant statutory threshold conditions. In making this assessment, the PRA will judge whether a firm can meet those threshold conditions in current and future states of the world.

112. Given that the prudential soundness of a firm could be affected by any aspect of a firm's operation, the decision on whether the PRA grants a firm authorisation will be made on a 'whole firm' basis. The PRA will approve applications from a firm only where it is satisfied that the firm will be prudently managed and has a viable business model in relation to all its material activities, and that there are effective controls for risk identification and mitigation.

113. **To reflect the PRA's objective, an assessment of the resolvability of a firm both in current and future states of the world will be embedded into the authorisation process.** Factors that may be taken into account include the ability to repay depositors quickly in the event of firm failure and the complexity of legal structure.

114. The PRA will lead on the authorisation process, and it must obtain the consent of the FCA before granting a permission. The PRA and the FCA will seek to minimise the administrative burden on firms of the new authorisation procedures. There will be a single administrative process with a single application form and a single timetable for decisions. The importance of ensuring the authorisation process is both clear to applicants and handled efficiently is fully recognised.

115. If a firm were already regulated by the PRA but it wished to vary its permission to undertake other types of additional regulated activity, it would need to apply to the PRA.

Approval of individuals

116. It is the responsibility of an institution's board of directors to ensure that individuals appointed to senior management positions are competent to fill such roles. The PRA will be responsible under statute for approving individuals who have a significant influence on the conduct of a firm's affairs. **Given the risks that poor management can pose to the financial soundness of a firm, the PRA will satisfy itself that such approved persons are 'fit and proper' to carry out their roles.** The PRA's assessment will cover not only probity and integrity, but also competence. Assessing probity and integrity will reduce the risk of deliberate non-compliance with PRA policies and rules; assessing competence is necessary given management's prime role in ensuring a firm's safety and soundness.

117. The process for approving individuals to roles with a bearing on the safety and soundness of the firm will be led by the PRA, in close co-ordination with the FCA. The FCA will be responsible for conduct-focused roles. A full list detailing which functions will be approved by each authority will be published in due course.

118. Those roles which the PRA would deem to be significant are likely to include Chairman, Chief Executive, Risk and Finance Directors, key non-executive directors such as the senior independent director and the Chairmen of the Risk, Audit and Remuneration Committees, as well as any other roles with responsibility for managing significant parts of the business or its financial resources. The FSA's historic categorisation would imply across the population of all 2,000 firms to be regulated by the PRA some 12,500 such roles filled by 5,000 individuals. In the year since April 2010, the FSA has authorised around 300 significant influence function roles covering prudential functions in PRA-regulated firms. The PRA will give further consideration to the scope of approved person roles.

119. **The PRA and the FCA will design a simple and transparent process for approving individuals to significant influence functions which minimises the administrative burden on individuals and firms.**

VII Next steps

120. The Government currently envisages putting the new regulatory architecture in place by the end of 2012. In the interim period, the Bank of England and the FSA will continue with the detailed design of the PRA's new operating framework. The Bank of England and the FSA will publish further detail on the PRA's regulatory and supervisory processes, its strategic priorities and its business plan ahead of the formal transfer of responsibilities.

121. The new supervisory approach laid out in this document will represent a significant change to the way in which prudential regulation is conducted in the United Kingdom.

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