



BANK OF ENGLAND



Power of Direction Over Qualifying Parent Undertakings by the PRA: consultation on a draft policy statement

December 2012

Implementation of power of direction over qualifying parent undertakings

Overview

1. The Financial Services Act 2012 (the Act) adds new sections 192A to 192N to the Financial Services and Markets Act 2000 (FSMA). These sections grant the Prudential Regulation Authority (PRA) some specific powers in relation to 'qualifying parent undertakings' which are UK-based parent companies of PRA-authorized firms within the scope of consolidated (or supplementary) supervision under EU law. There are three powers that can be applied directly to qualifying parent undertakings: a power of direction; a rule-making power for information gathering; and, a supporting disciplinary power to fine or censure for breaches of a direction or information rule. The powers are available for all qualifying parent undertakings of PRA-authorized firms and investment firms.

2. The purpose of this document is to set out the context of these new powers and to consult on a draft Statement of Policy on the use of the power of direction (set out in Appendix 1). This statement sets out the Bank of England (the Bank) and the Financial Services Authority's (FSA's) views on the PRA's policy on the use of its power to direct a qualifying parent undertaking under section 192C FSMA, as required by section 192H FSMA.⁽¹⁾ The PRA intends to review and approve a final version of this Statement of Policy on or before the date for legal cutover to the PRA.

3. The draft policy statement reflects the current state of law and policy. It does not take into account anticipated changes to domestic legislation (including the proposed Financial Services (Banking Reform) Bill), EU law (including the proposed Recovery and Resolution Directive) and international standards. The policy statement will be reviewed, and if necessary revised, to reflect any relevant legislative or policy changes.

4. Comments are invited and should be sent to parentundertakingsCP@bankofengland.co.uk or parentundertakingsCP@fsa.gov.uk by Friday 1 March 2013.

Background to new powers

5. Most non-mutual⁽²⁾ deposit-takers and insurers in the United Kingdom form part of a group where the ultimate parent undertaking is not an authorised firm.

6. International and European policymakers have long recognised the importance of prudential supervisors having

powers, not only over the banks, insurers and investment firms that they regulate, but also their parent companies.

7. This is because the parent company of an authorised firm will often decide overall group strategy and organisation, group risk management policies, group recovery plans and intra-group flows of capital and liquidity. The ultimate parent company is often the primary listed entity in the group and may have the primary capital and debt raising ability for the group. The ultimate parent company is also usually the only entity that can alter the group structure above and around an authorised firm or remove some barriers to effective resolution.

8. The Act gives the PRA these new powers over qualifying parent undertakings in order to advance its objectives, and for the purposes of effective consolidated supervision.

International standards

Banking

9. The Basel Committee on Banking Supervision (the Basel Committee), in its May 1983 Basel Concordat,⁽³⁾ introduced the concept of consolidated supervision. The Basel Committee recommended that all international banking groups should be supervised by a supervisor that capably performs consolidated supervision.⁽⁴⁾ This requires the consolidated supervisor to monitor the risks to which a banking group is exposed, as well as the adequacy of the capital to support these risks.

10. The Basel Concordat focuses on the risks arising from cross-border banking. However, unregulated parent companies may also impede adequate supervision at a domestic level.

11. On 14 September 2012, the Basel Committee published the latest version of its Core Principles for Effective Banking Supervision (the Core Principles).⁽⁵⁾ One of the 29 core principles is on consolidated supervision, it states that:

'An essential element of banking supervision is that the supervisor supervises the banking group on a consolidated

(1) The Financial Services Authority (FSA) (on behalf of the FCA) is consulting separately on the FCA's statement of policy on its use of these powers in CP12/34. And the Bank of England will publish separately a statement setting out its policy on the use of its power to direct qualifying parent undertakings of recognised clearing houses under section 192C FSMA (as applied to the Bank of England and recognised clearing houses by paragraph 17 of Schedule 17A FSMA).

(2) In certain mutual structures, such as building societies, the ultimate parent undertaking has to undertake regulated activities by definition.

(3) Basel Committee — Principles for the Supervision of Banks' Foreign Establishments (May 1983) (www.bis.org/publ/bcb312.pdf).

(4) Basel Committee — Minimum Standards for the Supervision of International Banking Groups and their Cross-border Establishments (July 1992) (www.bis.org/publ/bcb314.pdf).

(5) Basel Committee — Core Principles for Effective Banking Supervision (September 2012) (www.bis.org/publ/bcb230.pdf).

basis, adequately monitoring and, as appropriate, applying prudential standards to all aspects of the business conducted by the banking group worldwide.⁽¹⁾

12. The Core Principles note that, in supervising a bank which is part of a group, it is essential that supervisors consider the bank and its risk profile: (a) on an individual (or 'solo') basis; (b) on a consolidated basis considering the whole of the 'banking group' (ie any bank holding company, the bank and its office, subsidiaries, affiliates and joint ventures, both domestic and foreign); and (c) on a group-wide basis, taking into account the potential risks to the bank posed by other group entities outside the 'banking group'.

13. The Core Principles set out the criteria that a country's legal and regulatory system need to meet in order to satisfy the consolidated supervision core principle. These criteria include that the supervisor:

- (a) understands the overall structure of the banking group and is familiar with all the material activities (including non-banking activities) conducted in the wider group, both domestic and cross-border;
- (b) imposes prudential standards and collects and analyses financial and other information on a consolidated basis for the banking group, covering areas such as capital adequacy, liquidity, large exposures, exposures to related parties, lending limits and group structure;
- (c) reviews whether the oversight of a bank's foreign operations by management is adequate having regard to their risk profile and systemic importance;
- (d) reviews the main activities of parent companies, and companies affiliated with parent companies, that have a material impact on the safety and soundness of the bank and the banking group, and takes appropriate supervisory action;
- (e) can limit the range of activities the consolidated group may conduct and the locations in which activities may be conducted if it determines that: (i) the safety and soundness of the bank and banking group is compromised because the activities expose the bank or banking group to excessive risk and/or are not properly managed; (ii) the supervision by other supervisors is not adequate relative to the risks the activities present; and (iii) the exercise of effective consolidated supervision is hindered.

Insurance

14. In the insurance sector, the International Association of Insurance Supervisors (IAIS) is developing a Common Framework for the supervision of Internationally Active Insurance Groups (IAIGs). A working draft of this Common Framework (ComFrame) was published for comment on 2 July 2012⁽²⁾ and a final consultation is planned in 2013 followed by a programme of impact assessments.

15. Through ComFrame, the IAIS aims to establish a comprehensive framework for supervisors to address group-wide activities and risks of IAIGs. ComFrame is intended to set out the practical application to IAIGs of the IAIS's Insurance Core Principles (ICPs) which were revised and republished on 1 October 2011.⁽³⁾ Of the 26 Insurance Core Principles, ICP 23 requires that insurers are supervised on 'a legal entity and group-wide basis'. Supervisors are responsible for identifying the scope of the group to be subject to group-wide supervision (23.1), which must include (23.2)... 'at least:

- operating and non-operating holding companies (including intermediate holding companies);
- insurers (including sister or subsidiary insurers);
- other regulated entities such as banks and/or securities companies;
- non-regulated entities (including parent companies, their subsidiary companies and companies substantially controlled or managed by entities within the group); and
- special purpose entities.'

16. ICP 23.7 requires that ...at a minimum, the group-wide supervision framework includes, as a supplement to legal entity supervision:

- extension of legal entity requirements, as applicable according to the relevant ICPs, on:
 - i. solvency assessment (group-wide solvency);
 - ii. governance, risk management and internal controls (group-wide governance); and
 - iii. market conduct (group-wide market conduct).
- requirements related to group-wide supervision on:
 - i. complexity of group structure;
 - ii. cross-border/cross-sectoral issues;

(1) *ibid* paragraph 41, Principle 12.

(2) International Association of Insurance Supervisors — Working Draft of the Common Framework for the Supervision of Internationally Active Insurance Groups (2 July 2012) (www.iaisweb.org/view/element_href.cfm?src=1/15764.pdf).

(3) International Association of Insurance Supervisors — Insurance Core Principles, Standards, Guidance and Assessment Methodology (1 October 2011, and amended 12 October 2012) (www.iaisweb.org/view/element_href.cfm?src=1/16689.pdf).

- iii. interplay with legal entity supervision; and
- iv. non-regulated entities.

17. ICP 23.6.10 adds that specific preconditions for group-wide supervision that need to be considered include:

'In accordance with ICP 1 (Objectives, Powers & Responsibilities of the Supervisor) and ICP 2 (Supervisor), the supervisor should have the necessary supervisory powers, legal authority...to carry out group-wide supervision...'

Conglomerates

18. For financial conglomerates (ie groups containing both banks and insurers), on 24 September 2012 the Joint Forum comprising the Basel Committee, IAIS and the International Organisation of Securities Commissions (IOSCO) published Principles for the Supervision of Financial Conglomerates.⁽¹⁾ These principles provide that:

'The legal framework for the supervision of financial conglomerates should grant supervisors (including the Group-level Supervisor) the necessary powers and authority to enable comprehensive group-wide supervision'

19. In particular, the principles provide that the legal framework should grant supervisors the necessary power and authority to:

- (a) identify, or set the parameters for the identification of a financial conglomerate and the entities within the scope of supervision, particularly those entities that could pose risks to regulated entities or the broader financial system;
- (b) require appropriate standards for significant owners of financial conglomerates;
- (c) require that financial conglomerates have a sufficiently transparent group structure so as to not impede effective supervision, recovery or resolution;
- (d) enable, in relation to the wider group, an assessment of the risks and support provided by the wider group to the financial conglomerate;
- (e) access the board and senior management of the head of the financial conglomerate and of the other material and relevant entities related to the financial conglomerate, to assess the risks and support available to the financial conglomerate;

- (f) enable a comprehensive range of supervisory tools to be used to ensure timely corrective actions including but not limited to, actions necessary to address deficiencies in corporate governance or risk management, capital and liquidity shortfalls, large exposure concentration limits, and inappropriate group transactions;
- (g) deal with a crisis situation including to address concerns or issues related to resolution and recovery.

Resolution

20. Section 7 of the Financial Services Act 2010 amended FSMA in order to require the UK authorities to make rules requiring UK deposit-takers to produce recovery and resolution plans. Such plans need to encompass the ultimate financial parent companies of regulated firms. This is because barriers to effective resolution may only be capable of being removed fully through regulatory and resolution actions that can be applied at a parent company level as well as to other entities within the group.

21. Given that financial groups are only likely to be resolvable if resolution powers are available in respect of parent companies, the Financial Stability Board's (FSB's) Key Attributes of Effective Resolution Regimes for Financial Institutions,⁽²⁾ which set out the internationally agreed standards for resolution regimes, provide that resolution regimes should extend to the holding companies of regulated firms.⁽³⁾

EU financial services laws

22. EU financial services laws reflect this international concern that banks, insurers and financial conglomerates should be supervised on a group basis. For example:

- (a) for banking groups, the Banking Consolidation Directive provides that consolidated supervision should be applied to all banking groups, and that supervisors should hold the necessary legal powers to be able to exercise such supervision;⁽⁴⁾
- (b) for insurance groups, the Insurance Groups Directive⁽⁵⁾ requires Member States to provide for the supplementary supervision of insurance groups. Once the Solvency II

(1) Joint Forum — Principles for the Supervision of Financial Conglomerates (September 2012) (www.bis.org/publ/joint29.pdf).

(2) Financial Stability Board — Key Attributes of Effective Resolution Regimes for Financial Institutions (October 2011) (www.financialstabilityboard.org/publications/r_111104cc.pdf).

(3) *ibid* paragraph 1.1.

(4) Directive 2006/48/EC, Recital (58).

(5) Directive 98/78/EC.

Directive is applied to insurers, Title III will set out enhanced requirements⁽¹⁾ for insurance groups; and

(c) for financial conglomerates, the Financial Conglomerates Directive provides that supervisors should be able to assess at a group-wide level the financial situation of banks, insurers and investment firms which are part of a financial conglomerate, in particular as regards solvency, and risk concentration of intra-group transactions.⁽²⁾

23. In addition, the 'Post-BCCI' Directive⁽³⁾ imposes an additional requirement for authorisation on banks, insurers and investment firms so, where a firm is part of a group, the group structure must be sufficiently transparent to enable the firm to be supervised effectively. This requirement is reflected in the Threshold Conditions made under FSMA (see paragraph 28 below).

24. Regulators and resolution authorities will also require powers over parent companies in order to implement the EU's new Recovery and Resolution Framework. In its legislative proposal for a new Recovery and Resolution Directive,⁽⁴⁾ the European Commission stated that:

'the powers of resolution authorities should also apply to holding companies where one or more subsidiary credit institutions or investment firms meet the conditions for resolution...'.⁽⁵⁾

25. As part of this proposed framework, the European Commission is proposing that financial groups will be required to develop recovery and resolution plans, both at a group level and for individual institutions with the group. The Commission is also proposing that the authorities should have the power to require regulated firms and groups to take steps in order to facilitate their resolvability.

PRA powers to support consolidated supervision

26. Actions by a parent company of an authorised firm can affect that firm's ability to comply with both its own solo regulatory requirements as well as consolidated or supplemental requirements relevant to its group. There is often a mismatch between the regulatory requirements imposed on an authorised firm and its ability to influence or control decisions taken at a parent company level which might affect the meeting of those requirements. In some cases the incentives of a parent company and its authorised subsidiary are aligned. In other cases they are not or they diverge. When this happens the mismatch can increase the risks to the PRA's objective of promoting the safety and soundness of PRA-authorised persons.

27. In an attempt to mitigate some of these risks, FSMA, as amended by the Act, gives the PRA the following powers for the purposes of solo, consolidated and supplemental supervision. The PRA's intended approach when exercising these powers is set out in the October 2012 publications, 'The PRA's approach to banking supervision'⁽⁶⁾ and 'The PRA's approach to insurance supervision'.⁽⁷⁾

Powers under the Threshold Conditions

28. The Threshold Conditions are the criteria a firm must continually meet in order to be authorised on an ongoing basis. The board of a PRA-authorised firm is responsible for ensuring that an authorised firm conducts its business in a way that complies with the Threshold Conditions. The proposed draft Threshold Conditions for PRA-authorised firms, which the Treasury is currently consulting upon,⁽⁸⁾ recognise that an authorised firm's parent company can affect its ability to comply with both its own regulatory requirements and the requirements of consolidated supervision, and make provision for such matters to be considered as part of the PRA's assessment of whether the firm satisfies the Threshold Conditions. These 'group considerations' are relevant to the Threshold Conditions in three contexts.

29. First, to implement the requirements of the 'Post-BCCI' Directive, the draft Threshold Conditions provide that PRA-authorised firms must be capable of being effectively supervised by the PRA. Relevant to whether the firm satisfies this effective supervision condition is whether the firm's 'close links'⁽⁹⁾ with other entities are likely to prevent the PRA's effective supervision of the firm.⁽¹⁰⁾

30. Second, in considering whether a PRA-authorised firm satisfies the Threshold Condition that the business of a PRA-authorised firm must be conducted in a prudent manner, relevant concerns include whether the firm is a member of a group and any effect which that membership may have on the firm's business.

(1) Directive 2009/138/EC.

(2) Directive 2002/87/EC, Recital (7).

(3) Directive 95/26/EC.

(4) Published on 6 June 2012 (COM(2012) 280/3).

(5) *Ibid* page 9, paragraph 4.4.1.

(6) See paragraph 83.

(7) See paragraph 93.

(8) See the draft Financial Services and Markets Act 2000 (Threshold Conditions) Order [201*], as published in the HM Treasury October 2012 Consultation Paper 'A new approach to financial regulation: draft secondary legislation' (www.hm-treasury.gov.uk/d/condoc_fin_regulation_draft_secondary_leg.pdf).

(9) A PRA-authorised firm has close links with another person (CL) if: (a) CL is a parent undertaking of the firm; (b) CL is a subsidiary undertaking of the firm; (c) CL is a parent undertaking of a subsidiary undertaking of the firm; (d) CL is a subsidiary undertaking of a parent undertaking of the firm; (e) CL owns or controls 20% or more of the voting rights or capital of the firm; or (f) the firm owns or controls 20% or more of the voting rights or capital of CL.

(10) Draft Financial Services and Markets Act 2000 (Threshold Conditions) Order 201*, paragraphs 4F and 5F.

31. Third, again as part of the prudent manner Threshold Condition, relevant matters include the effect that the firm's failure might be expected to have on the stability of the UK financial system. This 'resolvability' consideration concerns not only the firm itself, but also the firm's parent companies and its affiliates.

32. If an authorised firm fails to satisfy one or more Threshold Conditions because of concerns relating to the firm's parent companies, FSMA gives the PRA the power to vary the firm's permissions or impose a requirement on the firm. But these powers can only be exercised directly over the authorised firm itself, not the parent company that has led to the concern.

Power of direction

33. The power of direction is a power that FSMA has given the PRA for use against the parent company itself. In order for the PRA to be able to make a direction under this power, the statutory conditions for its use need to be satisfied. In particular:

- (a) the parent company is a 'qualifying parent undertaking' of a 'qualifying authorised person'; and
- (b) either the 'general condition'⁽¹⁾ or the 'consolidated supervision condition'⁽²⁾ is satisfied.

34. The draft Statement of Policy, set out in Appendix 1, describes the statutory conditions for the use of the power of direction, before setting out matters the PRA should have regard to when deciding whether to use the power of direction, including a non-exhaustive list of scenarios in which the PRA may consider issuing a power of direction and a non-exhaustive list of possible directions.

Information-gathering powers

35. FSMA gives the PRA the power to make *ad-hoc* information requests. Section 165 FSMA⁽³⁾ provides that the PRA may, by written notice, require a member of an authorised firm's group,⁽⁴⁾ a controller of an authorised firm,⁽⁵⁾ or an officer, manager or employee of an authorised firm,⁽⁶⁾ to provide specified information or documents, or information or documents of a specified description.

36. In addition to this existing *ad-hoc* power, the Act adds a new section 192J to FSMA. This gives the PRA the power to make rules requiring a 'qualifying parent undertaking' to provide to the PRA information or documents of a specified description, that are relevant to the exercise by the PRA of its functions. The rules may make provision about the time within which, and the form in which, information is to be provided, and requirements for the verification of information and authentication of documents.

Legal Intervention Power

37. Section 192K of the Act contains a power to fine or censure a qualifying parent undertaking in the event of a breach of a direction issued under Section 192C or of rules made under Section 192J. This will be part of the PRA Legal Intervention Framework outlined in Consultation Paper CP12/39: 'The PRA's approach to enforcement: consultation on proposed statutory statements of policy and procedure'.

(1) The general condition is that the PRA considers that it is desirable to give the direction in order to advance any of its objectives.

(2) The consolidated supervision condition is that: (i) the PRA is the competent authority for the purpose of consolidated supervision that is required, in relation to some or all of the members of the group of a qualifying authorised person, in pursuance of any of the relevant EU directives; and (ii) the PRA considers that the giving of the direction is desirable for the purpose of the effective consolidated supervision of the group.

(3) See, in particular, subsections (1), (3), (7) and (11) of section 165 FSMA.

(4) Section 421 FSMA.

(5) Section 422 FSMA.

(6) Part I of Schedule 15 FSMA.

Appendix 1: Draft Statement of Policy

Draft Statement of Policy on the use of the power to direct qualifying parent undertakings

Background

1. This [draft] statement sets out the Prudential Regulation Authority's (PRA's) policy on the use of its power to direct a qualifying parent undertaking under section 192C of the Financial Services and Markets Act 2000 (as amended by the Financial Services Act 2012) (FSMA), as required by section 192H FSMA.

Conditions for the exercise of the power of direction

2. The statutory provisions relating to the power of direction are set out in sections 192A to 192I FSMA. In order for the PRA to be able to exercise the power of direction:

- (a) the parent undertaking must be a 'qualifying parent undertaking' of a 'qualifying authorised person'; and
- (b) either the 'general condition' or the 'consolidated supervision condition' must be satisfied.

Parent undertaking must be a 'qualifying parent undertaking' of a 'qualifying authorised person'

3. A parent undertaking is a 'qualifying parent undertaking' of a 'qualifying authorised person' under section 192B FSMA, if:

- (a) it is the parent undertaking of a 'qualifying authorised person' (a 'qualifying authorised person' being a UK-incorporated body corporate that is an authorised person, and is either a PRA-authorised firm or an investment firm);
- (b) it is incorporated in the United Kingdom or has a place of business in the United Kingdom;
- (c) it is not itself an authorised person, recognised investment exchange or recognised clearing house; and
- (d) it is a financial institution of a kind prescribed by the Treasury by Order.

4. In relation to (d) above, the Treasury is currently consulting on a draft of the Order⁽¹⁾ prescribing what is a

'qualifying parent undertaking'. The Order provides that the following are prescribed as 'qualifying parent undertakings':

- (a) insurance holding companies — broadly, companies whose main business is to acquire and hold subsidiary companies which are exclusively or mainly insurance or reinsurance companies;
- (b) financial holding companies — broadly, companies whose principal activities are to acquire subsidiary companies which are either exclusively or mainly credit institutions, investment firms or financial institutions; and
- (c) mixed financial holding companies — companies which have at least one subsidiary which is a credit institution, an insurance undertaking or an investment firm and which, together with their subsidiaries, constitute a financial conglomerate for the purposes of the Financial Conglomerates Directive.

5. In prescribing these categories of firms as 'qualifying parent undertakings', the Treasury has sought to bring within the scope of the power of direction those entities which are within the scope of consolidated (or supplementary) supervision under EU law.

6. The definition of 'qualifying parent undertaking' includes any UK-incorporated parent undertaking (or parent undertaking with a place of business in the United Kingdom) in an ownership chain which meets the definitions contained in the Order, even if the undertaking is not itself the ultimate parent undertaking. In general, the PRA would consider action to be most effective when taken in relation to the ultimate parent undertaking at the head of the ownership chain, as that is usually where most of the power to direct and control the group resides.

7. However, where the ultimate parent undertaking is not a 'qualifying parent undertaking' (for example if the group is headed by a non-UK entity or a non-financial entity) then the PRA will not have the power to direct that ultimate parent undertaking. In such circumstances, the PRA may consider that use of the power of direction over another qualifying parent undertaking in the ownership chain is appropriate.

8. The PRA may also consider taking action in relation to an intermediate qualifying parent undertaking in other cases, for example, if there are restrictions on the powers of the ultimate

(1) The Financial Services and Markets Act 2000 (Prescribed Financial Institutions) Order 2011*, as published in the Treasury's October 2012 Consultation Paper 'A new approach to financial regulation: draft secondary legislation' (www.hm-treasury.gov.uk/d/condoc_fin_regulation_draft_secondary_leg.pdf).

parent undertaking in its constitution, if the ultimate parent undertaking fails to act, or if action is to be taken in relation to the immediate parent of a firm (particularly in cases where there are distinct sub-groups within wider groups).

The 'general condition' and the 'consolidated supervision condition'

9. The PRA can only use the power of direction if either the general condition or the consolidated supervision condition is satisfied:

General condition — The general condition is that the PRA considers that it is desirable to give the direction in order to advance, in the case of the PRA, any of its objectives.

10. The ultimate parent undertaking of an authorised firm can be the centre of power in a group. In that situation, it will usually decide overall group strategy and organisation, including group risk management policies, group recovery plans and intra-group flows of capital and liquidity. The ultimate parent undertaking can be the primary listed entity in the group and may have the primary capital and debt raising ability for the group. A parent undertaking is also usually the only entity that can alter the group structure above and around an authorised firm or remove some barriers to effective resolution (both to ensure an authorised firm is resolvable and if an authorised firm is in resolution).

11. The PRA's general objective is to promote the safety and soundness of PRA authorised firms. FSMA requires the PRA to advance this objective primarily by seeking to:

- (a) ensure that the business of PRA-authorized firms is carried on in a way which avoids any adverse effect on the stability of the UK financial system; and
- (b) minimise the adverse effect that the failure of a PRA-authorized firm could be expected to have on the stability of the UK financial system.

12. The PRA's insurance objective is: contributing to the securing of an appropriate degree of protection for those who are or may become policyholders.

13. The PRA considers that these objectives will be advanced by having suitable requirements (for example, prudential standards or systems of governance and controls) enforced directly at group level. Where action to advance PRA objectives taken at the authorised firm level is considered to be, or likely to be, less effective than action taken at the qualifying parent undertaking level then the PRA will consider

using its power of direction over the qualifying parent undertaking.

Consolidated supervision condition — The consolidated supervision condition is that: (i) the PRA is the competent authority for the purpose of consolidated supervision that is required, in relation to some or all of the members of the group of a qualifying authorised person, in pursuance of any of the relevant EU directives; and (ii) the PRA considers that the giving of the direction is desirable for the purpose of the effective consolidated supervision of the group.

14. The PRA's obligation to conduct consolidated supervision arises from the relevant EU Directives (eg the Banking Consolidation Directive,⁽¹⁾ the Insurance Groups Directive⁽²⁾ and the Financial Conglomerates Directive)⁽³⁾ which in turn implement the relevant international standards on consolidated supervision (in particular the standards on consolidated supervision set by the Basel Committee on Banking Supervision in its Core Principles for Effective Banking Supervision,⁽⁴⁾ the International Association of Insurance Supervisors' Insurance Core Principles⁽⁵⁾ and the Joint Forum Principles for the Supervision of Financial Conglomerates).⁽⁶⁾

15. The PRA considers that the purpose of consolidated supervision is to enable supervisors to take necessary action to protect authorised firms from the adverse effects of being part of a group. These adverse effects may include: financial contagion (losses in a group entity impacting on a firm through financial linkages); reputational contagion (an event in one entity impacting adversely on another entity in the group through reputation damage); multiple gearing (ie use of the same capital resources more than once in the same group); upgrading the quality of capital within a group (ie by using funds borrowed by the parent undertaking to create core equity Tier 1 capital within the authorised firm, giving a false appearance of the quality of capital within a firm); barriers to effective resolution (eg complex group structures or intra-group arrangements); and the impact of intra-group relationships on authorised firms (exposures, contingent liabilities etc).

(1) Directive 2006/48/EC.

(2) Directive 98/78/EC.

(3) Directive 2002/87/EC.

(4) Basel Committee on Banking Supervision — Core Principles for Effective Banking Supervision (September 2012) (www.bis.org/publ/bcbs230.pdf).

(5) International Association of Insurance Supervisors — Insurance Core Principles, Standards, Guidance and Assessment Methodology (1 October 2011, and amended 12 October 2012) (www.iaisweb.org/view/element_href.cfm?src=1/16689.pdf).

(6) Joint Forum — Principles for the Supervision of Financial Conglomerates (September 2012) (www.bis.org/publ/joint29.pdf).

16. The application of rules on prudential standards and systems of governance and control on a consolidated basis aims to address many of the risks above. Therefore, where the effectiveness of consolidated supervision would be greater if action was taken by the qualifying parent undertaking then the PRA will consider using its power of direction. For example, a particularly strong case for using the power of direction would be made where any act or omission of a qualifying parent undertaking leads, or could lead, directly or indirectly, to an authorised firm being unable to ensure compliance with rules applied at the consolidated level required by the relevant European legislation. In determining whether there is compliance, the PRA will also take into account the purpose of the rule and its intended effect.

17. A direction placed on a qualifying parent undertaking regarding consolidated supervision will generally support the authorised firms in complying with their obligation to ensure that their consolidation group complies with consolidated requirements, but it will not absolve them of this obligation. In such circumstances action can be taken at both the qualifying parent undertaking and authorised firm level if necessary.

18. There may be occasions when desirability of exercise of the power may be based not solely on a single material concern. Where there have been several causes for concern over a period of time, with each specific issue being insufficient on its own to trigger the use of the power of direction, the cumulative effect of these will be included in the consideration of whether to use the power of direction.

19. Annex 1 to this Statement of Policy contains a non-exhaustive list of possible scenarios in which the PRA may consider exercising the power of direction.

Matters the PRA must have regard to when deciding whether to use the power of direction

20. Section 192C(5) FSMA provides that, in deciding whether to give a direction, the PRA must have regard to:

- (a) the desirability where practicable of exercising its powers in relation to authorised persons rather than its powers under this section, and
- (b) the principle that a burden or restriction which is imposed on a person should be proportionate to the benefits, considered in general terms, which are expected to result from its imposition.

21. Whilst the PRA will consider using its powers over authorised firms to try to achieve its objectives in the first

instance, there are some circumstances where the PRA would usually consider use of the power of direction over the qualifying parent undertaking to be more appropriate, for example:

- (a) where action against the authorised firm fails to remedy the concerns;
- (b) where the PRA considers that action against the authorised firm is likely to fail to remedy the concerns;
- (c) where the authorised firm fails to comply;
- (d) where the PRA considers the authorised firm is likely to fail to comply;
- (e) where the authorised firm does not itself have the ability to effect the desired change;
- (f) where the issue can only be resolved effectively by the qualifying parent undertaking;
- (g) in cases of urgency.

22. In stressed circumstances, the potential conflicts between a parent undertaking and an authorised firm can become heightened. In this case, the likelihood that actions taken in relation to authorised firms alone would be insufficient is increased and the need for the power of direction may be more acute. The power of direction would also be considered as a key tool for use in stressed circumstances where time may be critical.

Content of the direction

23. Section 192D(1) FSMA provides that a direction made under the power of direction may require the parent undertaking either: (a) to take specified action; or (b) to refrain from taking specified action. Section 192D(2) goes on to provide that a requirement may be imposed by reference to the parent undertaking's relationship with: (a) its group; or (b) other members of its group. The requirement would normally be imposed either in relation to whichever relationship(s) are causing the concern, including relationships between sister companies, or by reference to the group generally if the concern relates to group-wide issues.

24. Where desired actions are reserved to the shareholders of the parent undertaking the relevant direction cannot address the shareholders directly. In such cases the direction would instruct the parent undertaking to facilitate the decision of the shareholders, for example by calling a general meeting and proposing the motion required to achieve the desired action.

25. Section 192D(3) provides that a requirement may refer to the past conduct of a parent undertaking (for example, by requiring the parent undertaking to review or take remedial action in respect of past conduct).

26. Additionally, a requirement imposed by the direction may be expressed to expire at the end of a specified period, but this does not affect the power to give a further direction imposing a new requirement. Equally, a requirement imposed by the

direction may have no specified end date. The direction may be revoked by the PRA by written notice to the parent undertaking to which it is given, and/or ceases to be in force if the undertaking to which it is given ceases to be a qualifying parent undertaking.

27. Annex 2 contains a non-exhaustive list of possible directions which the PRA may consider making.

Annex 1: Non-exhaustive list of possible scenarios in which the PRA may consider exercising the power of direction

Examples of scenarios in which the PRA may consider the exercise of its power of direction include, but are not limited to:

- Insufficient quality or quantity of own funds or liquid assets or other assets that are made available to the authorised firms to meet their solo requirements.
- Intra-group transactions and allocation of risks and financial resources (including large exposures, booking practices, other channels of contagion and arrangements for the mitigation of risk such as by reinsurance) which do not meet the standards expected by the PRA.
- Group-wide recovery plans which do not meet the standards expected by the PRA.
- Where there are barriers to the resolution of a firm or group that are most appropriate to mitigate or remove at the level of the parent undertaking.
- Where action at the level of the parent undertaking is required to improve resolvability.
- Group-wide remuneration policies which do not meet the standards expected by the PRA.
- A proposed acquisition by the parent undertaking which may affect compliance with consolidated or group requirements or the solo requirements of any authorised firm in the group.
- Where the actions of the parent undertaking in a recovery or resolution scenario may increase the chance of disorderly failure or the use of taxpayer funds.
- Scenarios where the parent undertaking moves, or may move, impaired, sub-standard or high-risk assets into an authorised firm with a view to allowing that firm to fail or be taken into resolution whilst the rest of the group carries on as a going concern, potentially leaving the failed firm in the group to be supported by taxpayers.
- Where only the actions of a parent undertaking in relation to one of its unauthorised subsidiaries may maintain the stability of the authorised firms, particularly in stressed circumstances (eg where an authorised firm is reliant on services provided by an unauthorised sister company).
- Where risks generated in an unauthorised part of the group could affect the stability of either the authorised firms or the group as a whole.
- Insufficient quality or quantity of own funds or liquid assets or other assets being available to meet consolidated group requirements.
- Insufficient transferability of a group's own funds or liquid assets to support the group's regulated activities.
- Complex or opaque group structures which hinder the authorised firm's and/or the PRA's ability to assess and manage the risks generated by the authorised firm's membership of its group.
- Group-wide risk management or governance arrangements, including those relating to directors, that do not meet the PRA and/or internationally agreed standards.
- Systems and controls to manage group risks which do not meet the standards expected by the PRA.

Annex 2: Non-exhaustive list of possible directions which the PRA may consider making

Directions which may be made by the PRA may include, but are not limited to:

- A requirement to meet specific prudential rules applied at the consolidated level.
- A requirement to improve the system of governance or controls at group level and/or in relation to subsidiary undertakings (including non-UK subsidiaries) where this is necessary for effective consolidated supervision.
- A restriction on dividend payments, or other payments regarding capital instruments, in order to retain capital in the group.
- A requirement to move funds or assets around the group to more appropriately address risks.
- A requirement for the group to be restructured in order to make it more supervisable.
- A requirement to stop or impose restrictions on an acquisition or divesture (taking account of any potential conflict with takeover rules).
- A requirement to ensure the continuity of service is provided between relevant group entities.
- A requirement to include entities (including shadow banking entities, where appropriate) in consolidated calculations.
- A requirement to raise new capital.
- A requirement to take steps to facilitate the removal from office of directors of the parent undertaking who do not meet the PRA's expectations as regards being fit and proper to direct a holding company.
- A requirement to remove barriers to resolution.
- A requirement to issue debt suitable for bail-in.