BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

Annual Report and Accounts **2016**

Prudential Regulation Authority
Annual Report and Accounts for the year ended 29 February 2016

Presented to Parliament pursuant to paragraphs 19(4) and 23(3) of Schedule 1ZB of the Financial Services and Markets Act 2000 as amended by the Financial Services Act 2012.

Ordered by the House of Commons to be printed on 30 June 2016.

HC12

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

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This report is made by the Prudential Regulation Authority (PRA) under the Financial Services and Markets Act 2000 (FSMA) as amended by the Financial Services Act 2012. It is made to HM Treasury and covers the year ended 29 February 2016.

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

HM Treasury has issued an accounts direction; disclosures relating to this can be found on page 66.

The PRA's audited accounts for the reporting year ending 29 February 2016 are set out on pages 75–90.

Additional material can be found on the Bank of England website at www.bankofengland.co.uk/pra

Consultation

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

– *Annual Report*;

– way in which the PRA has discharged, or failed to discharge, its functions during the period to which the report relates; and

– extent to which, in their opinion, the PRA's objectives have been advanced and the PRA has considered the regulatory principles to which it must have regard when carrying out certain of its functions (contained in section 3B of FSMA), and facilitated effective competition in the markets for services provided by PRA-authorised firms in carrying on regulated activities.

Please address any comments or enquiries to:
Strategy, Planning and Change
Prudential Regulation Authority
20 Moorgate
London
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020 3461 8860

The consultation closes on 30 September 2016.


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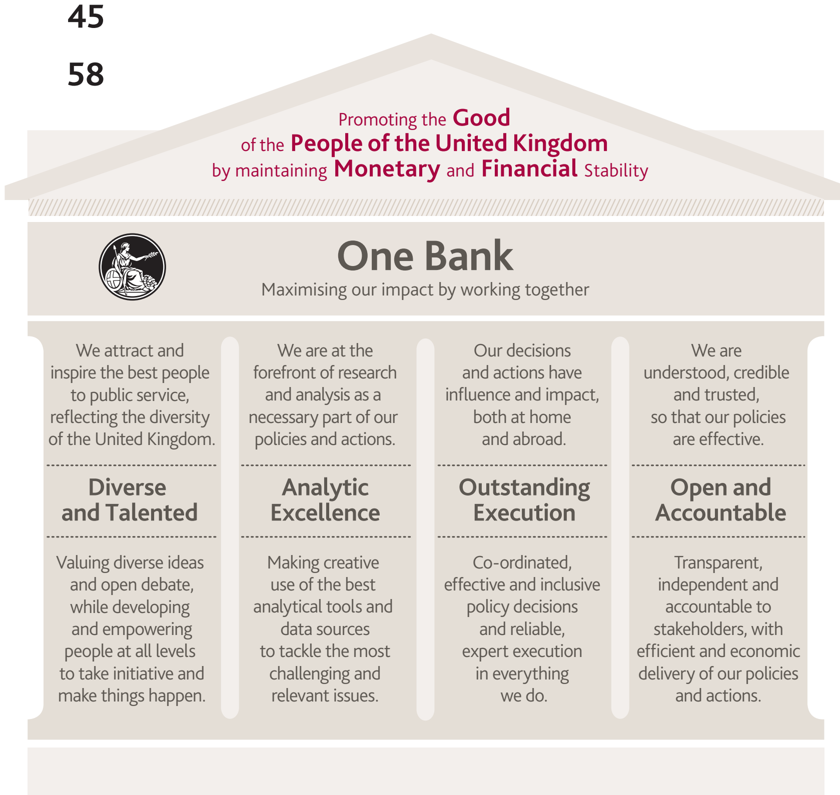


Promoting the Good
of the People of the United Kingdom
by maintaining Monetary and Financial Stability
One Bank
Maximising our impact by working together
We attract and inspire the best people to public service, reflecting the diversity of the United Kingdom.
Diverse and Talented
Valuing diverse ideas and open debate, while developing and empowering people at all levels to take initiative and make things happen.
We are at the forefront of research and analysis as a necessary part of our policies and actions.
Analytic Excellence
Making creative use of the best analytical tools and data sources to tackle the most challenging and relevant issues.
Our decisions and actions have influence and impact, both at home and abroad.
Outstanding Execution
Co-ordinated, effective and inclusive policy decisions and reliable, expert execution in everything we do.
We are understood, credible and trusted, so that our policies are effective.
Open and Accountable
Transparent, independent and accountable to stakeholders, with efficient and economic delivery of our policies and actions.


BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Abbreviations used in this *Report*

ARCo	Audit and Risk Committee
BAME	Black, Asian and Minority Ethnic individuals
Bank	Bank of England
BCBS	Basel Committee on Banking Supervision
BRRD	Bank Recovery and Resolution Directive
CEO	Chief Executive Officer
Court	Bank's Court of Directors
CP	Consultation Paper
CRD	Capital Requirements Directive
CRD IV	CRR and CRD collectively
CRR	Capital Requirements Regulation
D-SIB	Domestic systemically important bank
Defra	Department of Environment, Food and Rural Affairs
DGSD	Deposit Guarantee Scheme Directive
EBA	European Banking Authority
ECB	European Central Bank
EEA	European Economic Area
EIOPA	European Insurance and Occupational Pensions Authority
ESRB	European Systemic Risk Board
EU	European Union
FCA	Financial Conduct Authority
FPC	Financial Policy Committee
FSA	Financial Services Authority
FSB	Financial Stability Board
FSCS	Financial Services Compensation Scheme
FSMA	Financial Services and Markets Act 2000 (as amended)
G-SIB	Global systemically important bank
G-SII	Global systemically important insurer
GDP	Gross domestic product
HLA	Higher loss absorbency
IAIS	International Association of Insurance Supervisors
ICS	Insurance Capital Standard
IEO	Bank's Independent Evaluation Office
IFRS 9	International Financial Reporting Standard 9
IMF	International Monetary Fund
LCR	Liquidity Coverage Requirement
LTI	Loan to income
MoU	Memorandum of understanding
MREL	Minimum requirement for own funds and eligible liabilities
NED	Non-executive Director
NSFR	Net Stable Funding Ratio
O-SIIs	Other systemically important institutions
PRA	Prudential Regulation Authority
PRC	Prudential Regulation Committee
SCO	Secondary competition objective
SIMR	Senior Insurance Managers Regime
SMR	Senior Managers Regime
TLAC	Total loss-absorbing capacity

Foreword by the Chair

Mark Carney
Governor,
Chair of the PRA Board

The comprehensive overhaul of bank regulation is now largely complete. Major bank capital requirements have risen tenfold, liquid asset buffers are up fourfold, trading assets are down by a third and interbank exposures have shrunk by two thirds.

By 2016 Q1, the banking system as a whole had a capital ratio of 13½% — in line with the level judged by the Financial Policy Committee as the appropriate baseline level of capital on currently measured risk weights.

With their design now substantively complete, the Prudential Regulation Authority has turned to the implementation of the post-crisis reforms.

In the banking sector, for example, the PRA has been increasingly focused on the implementation of bank structural reform as proposed by the Independent Commission on Banking. Structural reform will further increase the resilience of ring-fenced banks so that they can continue to provide the services that we all use on the high street or online, regardless of volatility in the global financial system. It will also help to ensure that banks can be resolved in an orderly manner without adversely impacting critical economic functions. Work on implementing structural reform is now well advanced with some banks already making changes to the way they are structured to meet ring-fencing requirements. Over the course of the coming year, the PRA will issue further guidance and policy to ensure the industry is on track for the 2019 deadline.

2015 also saw the Bank complete its second round of concurrent stress testing, a key plank in promoting the safety and soundness of our major banks and ensuring resilience of the UK financial system. The 2015 exercise which focused on an emerging market stress, complemented the 2014 stress test which had focused much more on domestic risks. The stress-test results indicated that the UK banking system would have the capacity to continue to lend to the real economy under such a severe scenario and testify to the benefits of the progress UK banks have made to rebuild capital and confidence. We have also re-evaluated our general approach in a way that will mesh with the FPC's need to set countercyclical macroprudential policy effectively.

The UK insurance sector completed its transition to Solvency II, a new prudential regulatory regime, by the start of 2016. Transitioning to Solvency II represented the culmination of immense effort from both sides of the regulatory fence. Solvency II is a once in a generation reform of insurance regulation, modernising the EU regulatory landscape, harmonising what had become a patchwork of requirements across the EU and will support our own forward-looking, judgement-based supervision to protect insurance policyholders.

This year, for the first time, the PRA is publishing an *Annual Report* setting out how it is delivering against its secondary competition objective (SCO) that came into force in 2014. Although good progress has been made, the PRA recognises that there is more to be done to embed the SCO, including for example implementing the recommendations of the Bank's Independent Evaluation Office which has also been published.

We have also overseen the implementation of the Senior Managers Regime (SMR) in the past year. The new regime will ensure that the most senior executives and non-executives will be held clearly accountable for the areas that they are responsible for. It will bring much needed clarity to the standards that are expected in our regulated firms. In line with our commitment to transparency and to hold ourselves publically to the same high standards as we demand of our regulated firms, the Bank and the PRA published its own application of the SMR. These documents set out how we intend to apply the core principles of the SMR to ourselves.

The PRA has forged ahead with our One Bank strategy over the past year. This aims to ensure the Bank of England operates as a unified, diverse, and talented institution. Bank-wide, 75% of the milestones set out in this three year plan had been completed by the end of the second year. The PRA has made crucial contributions to the Bank's macroprudential and monetary policy work over the past year. For example, following the FPC's concerns on the growth of buy-to-let lending, the PRA has clarified its expectations for underwriting standards and introduced new guidelines for minimum stressed interest rates to be used when lenders test affordability. Similarly, the Monetary Policy Committee has benefited from the PRA's assessment of the possible effects of cutting Bank Rate below 0.5%. This was integral to the MPC's conclusion that the scope for prospective downward adjustments in Bank Rate reflects, in part, the fact that the UK's banking sector is operating with substantially more capital now than it did in the immediate aftermath of the crisis; and therefore less likely to have undesirable effects on the supply of credit to the UK economy than previously judged. Flowing the other way, the PRA itself has benefited from insights of other areas of the Bank — from the collection of market intelligence, macroeconomic and sectoral analysis, and ensuring that it has access to high-quality, professional central services.

Looking ahead, the coming year will see the coming into effect of the Bank of England and Financial Services Act, which will reinforce the transformation of the Bank and our strategy and place the Bank's three major policy committees on the same statutory footing. This will involve the de-subsidiarisation of the PRA and creation of a new committee to be known as the Prudential Regulation Committee (PRC). The new PRC will entirely retain its independence in order to carry on its statutory functions as the microprudential authority.

In addition, the PRA had developed extensive contingency plans ahead of the European Union referendum. Following the vote on 23 June 2016 for the United Kingdom to leave the European Union, the PRA will implement the plans including continued heightened monitoring of firms and will continue to work with the wider Bank to consider the implications of this outcome on the PRA's statutory objectives.

Finally, I would like to take this opportunity to reflect upon the service that Andrew Bailey has provided over some 30 years working at the Bank. Andrew is an extraordinary public servant who has devoted his entire professional life to serving the people of the United Kingdom. During his career, he has worked across all of the Bank's policy areas, combining leadership and innovation to deliver consistently the Bank's policy objectives. His work in helping to manage the crisis and then to develop the post-crisis regulatory framework has been exemplary. He has made the PRA a highly respected and effective regulator and built a team of exceptionally dedicated colleagues. I would like to thank Andrew for his counsel and support since I joined the Bank and wish him every success in steering the FCA at this vital time in its history. I admire his commitment to ensuring the UK's financial system serves its real economy and I look forward to continuing to work closely with him in future.

Correspondingly, I am delighted that Sam Woods will succeed Andrew to be the next Deputy Governor for Prudential Regulation and CEO of the PRA. Sam is a dedicated public servant, a forward-looking policymaker and a natural leader. His broad experience and personal qualities will be vital in building on Andrew Bailey's extraordinary contributions since the creation of the PRA in 2013. My colleagues and I look forward to working closely with Sam as the Bank of England continues its important mission of promoting the good of the people of the United Kingdom by maintaining monetary and financial stability.

27 June 2016

Report by the Chief Executive

Andrew Bailey
Deputy Governor, Prudential Regulation and Chief Executive of the PRA

The PRA was created in the wake of the damage done by the global financial crisis. It came into being three years ago with different objectives to its predecessor and a very clear commitment to forward-looking judgemental prudential supervision built around a strong framework of regulations which should allow this essential exercise of judgement.

I find this statement of our purpose obvious, but the reality is that before the financial crisis the prevailing consensus was supportive of weaker standards for regulation and less active supervision. During the course of the last year, with the FCA, we completed the review into the failure of HBOS in 2008, and in doing so we documented the serious shortcomings in the firm which were the ultimate cause, and the failures of the regulator. The HBOS report is once again a reminder of how bad the consequences can be, and thus the importance of our task.

The PRA is both a regulator and a supervisor of firms. Frequently, and mistakenly, these terms are used interchangeably. That's wrong. Regulation is to do with the framework of rules and guidance that put the structure around our objectives, which come from Parliament in statute. The PRA has a primary objective common to all firms that we authorise, namely their safety and soundness, expressed in terms of the stability of the financial system. In addition, we have a second primary objective for insurers, in terms of the protection of policyholders. And, we have a secondary objective, which came into force on 1 March 2014 which states that when discharging its general functions in a way that advances its objectives, the PRA must so far as is reasonably possible act in a way which, as a secondary objective, facilitates effective competition in the markets for services provided by PRA-authorised persons. All of these objectives are very important to us. I welcome the work done by the Bank's Independent Evaluation Office over the last year, which involved reviewing the implementation and effectiveness of the secondary competition objective. I believe the review, which was published in March, provides reassurance that we are taking the right steps to ensure that prudential supervision can be effective alongside the PRA facilitating effective competition. In the coming year, the IEO will review the implementation of our insurance policyholders objective, and I welcome this initiative.

Supervision is about how we pursue our objectives in practice, in the front line of dealing with firms. It is a skill — in fact it is quite a few skills. The essence of the task is to understand risk in firms which threaten our objectives, and where necessary to step in and point out risks and their significance when the firm appears to have failed to notice; or, to point out that while a firm may have identified a risk, it has failed to understand or calibrate its significance.

Our assessment of risks can differ from that of firms because our objectives represent the public interest, and there are externalities inherent in some risks which can affect the public interest in ways that do not register with a definition of private interest. The financial crisis sadly reminds us of this distinction. It means that we have a duty to be clear on what is in the public interest, and thus why we do our job.

Risk is therefore our business, and in the PRA every day we are dealing with risks that can be highly complex and challenging. I read too often the criticism of supervision around the world that the authorities cannot understand the risks of the firms that they authorise, and so we should give up all hope of doing so and resort to a non-risk based approach which is attractive for its simplicity. Non-risk based tools are very helpful to supervisors, and for banks that is why we have supported work internationally and domestically to develop a leverage ratio approach which provides another view of the firm. But, such tools do not remove the basic fact that supervision is about understanding how firms take and manage risk.

Supervision is a very important skill. I believe we are very fortunate in the PRA to have such talented colleagues who combine high levels of technical and interpersonal skills, so that when necessary they can get firms to do the thing they had not intended, to change course and in doing so recognise the public interest. Of course, we have to provide supervisors with the frameworks to operate, and that is where we benefit from very close working between our firm supervisors, specialist supervisors who focus on particular areas of risk, and our policy staff who work to create the frameworks of rules and guidance within which supervision operates. Much, but not all, of our policy is made at the international level, in the EU, and in the global bodies, notably the Financial Stability Board, the International Association of Insurance Supervisors and the Basel Committee of Banking Supervision.

In the aftermath of the crisis, we are now reaching the point where the emphasis of our work is shifting to the implementation of policy rather than the creation of new policy. Over the last year, the major milestone for implementation in the PRA was completion of Solvency II for insurance firms. The programme of work to ensure successful implementation was substantial and it is a great credit to colleagues in the PRA that it was completed successfully and has gone into operation as planned. The test of all such policy change is how the framework of rules is put to work in practice. No one I know would describe Solvency II as the finished article, but it is a big step forward and is providing important tools to improve supervision.

There is important work underway to assess and refine the framework of prudential regulation for banks, both in the Basel Committee and the EU. These are welcome initiatives, because there is I am afraid a very low probability that such a complex framework could be landed perfectly first time round. It is therefore important that we have the means to refine and improve our regulatory framework without upsetting unduly the necessary business planning of firms which has been undertaken with a view of what we see as the sensible steady state prudential regime for banks. Of course, our work to interpret and refine the regulatory standards will never stop because the precise forms of risk-taking will continuously evolve.

When I have stepped back and looked at the causes of the financial crisis, I would observe that in the United Kingdom I don't think we saw a major prudential failure of capital or liquidity which did not have a governance and management story at its root. Moreover, the system of regulation and supervision was poor at creating the right incentives for good outcomes. Good regulation and supervision involves creating and overseeing these incentives. It is not just about doing things to firms. It is also about creating the conditions for firms to do this right thing in the first place. Let me give three examples of what we are doing in this respect.

First, we have been much more active in remuneration policy and practice, notably for banks. We want to ensure that remuneration is compatible with firms meeting their capital requirements (so it can be varied to do so) and that variable remuneration is deferred and can be withdrawn, and is thus compatible with creating the right incentives by putting that remuneration at risk if the firm fails to conform with the objectives of safety, soundness and good conduct of business. I am not in favour of limiting variable pay in the way European legislation has done through the so-called bonus cap because it reduces the opportunity to create the right incentives. We then supervise firms to ensure those incentives remain in place.

The second example relates to senior individuals in firms. Earlier this year we introduced the new Senior Managers Regime. The aim of this regime is to establish clear responsibilities for senior managers, including chairs of board committees. This is not to create new responsibilities, but rather to be clear on what those responsibilities are, and then to supervise to hold individuals to those responsibilities. In the previous regime, we had too many examples of individuals shirking their responsibilities. My strong view is that senior figures cannot delegate responsibilities. We will then direct our supervision to support this new regime operating effectively.

The third example concerns the supervision of governance, executive and board level. We are in the process of revamping our approach here, recognising that too many problems of the past have had their roots in ineffective governance. This is probably the prime area where supervision is distinct from regulation, because there is very little regulation, rightly so. Supervising governance is inherently a matter of judgement based on evidence.

This is my last *Annual Report* as CEO of the PRA. The work began in 2010 to create the PRA, and it has been a privilege to lead that work and then serve as the first CEO of the PRA. Prudential regulation and supervision may not be something that people should always enjoy, but for me it has been a pleasure throughout. The most important thanks for that goes to my colleagues and fellow board members. The PRA is fortunate to have such talent. The PRA did not come into being to do easy things. It came into being to do something that history has shown to be difficult, and to be a new kind of prudential regulator and supervisor.

There is still much to be done, but I am sure that the PRA is in good hands with Sam Woods and his colleagues.

27 June 2016

Board of the Prudential Regulation Authority

Members as at 1 June 2016

Top row, left to right

Mark Carney
Governor,
Chair of the PRA Board

Andrew Bailey*
Deputy Governor, Prudential Regulation and Chief Executive of the PRA

David Belsham
Appointed NED
Term: 1 May 2015 – 30 April 2018

Sandy Boss
Appointed NED
Term: 1 September 2014 – 31 August 2017

Middle row, left to right

Norval Bryson
Appointed NED
Term: 1 September 2015 – 31 August 2018

Sir Jon Cunliffe
Deputy Governor,
Financial Stability

Tracey McDermott
Acting Chief Executive, Financial Conduct Authority

Charles Randell
Appointed NED
Term: 20 February 2014 – 19 February 2017
First appointed:
20 February 2013

Bottom row

Dame Minouche Shafik
Deputy Governor,
Markets and Banking

David Thorburn
Appointed NED
Term: 1 September 2015 – 31 August 2018

Mark Yallop
Appointed NED
Term: 1 December 2014 – 30 November 2017

The Prudential Regulation Authority is a subsidiary of the Bank of England (the Bank). In April 2013, it became the United Kingdom's prudential regulator for banks, building societies and credit unions (collectively known as deposit-takers), insurers and major investment firms.

The PRA's objectives are set out in statute, in FSMA. The PRA has three statutory objectives:

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

The PRA's most significant supervisory decisions are taken by its governing body, the PRA Board. It is chaired by the Governor of the Bank and three of its other members are Bank staff — the Deputy Governor for Prudential Regulation, the Deputy Governor for Financial Stability and the Deputy Governor for Markets and Banking. The CEO of the Financial Conduct Authority (FCA) is also a member. Appointed members are chosen by the Bank's Court of Directors with HM Treasury's approval. A majority of the Board must be Non-executive members.

The PRA's strategy is set by its Board, in consultation with Court. Under FSMA, the PRA is required to determine and publish annually its strategy in relation to how it will deliver its statutory objectives. The strategy can be found in the Strategic Report section on page 21.

* From 1 July 2016 Andrew Bailey will sit on the Board as Chief Executive of the FCA and Sam Woods will sit on the Board as Deputy Governor, Prudential Regulation and Chief Executive of the PRA.

The Bank of England and Financial Services Act 2016

The Bank of England and Financial Services Bill began its passage through Parliament in October 2015. It was introduced in the House of Lords and passed through for introduction in the House of Commons in January 2016. It received Royal Assent in May 2016, becoming the Bank of England and Financial Services Act 2016 ('the Act'). Its provisions will be brought into force by way of Commencement Orders made by HM Treasury.

The Act follows the proposals in *Transparency and Accountability at the Bank of England*, the Bank's response to the Warsh review, published in December 2014,[1] and HM Treasury's Technical Consultation published in July 2015.[2]

Among various reforms in the Act to further strengthen the Bank's governance, transparency and accountability, there are provisions to simplify and strengthen the governance of the Bank and the PRA. The Act includes provisions to end the PRA's status as a subsidiary and fully integrate the PRA into the Bank, while recognising the PRA's operational independence, in line with the Basel Core Principles on Supervision, and maintaining the strong and distinctive identity of the PRA. This will continue the process of building a unified institution that can better share knowledge, expertise, and analysis. To implement this change, the PRA's functions will be transferred to the Bank itself, and a new Prudential Regulation Committee (PRC) will be established within the Bank with responsibility for exercising them.

Like the PRA Board, the new PRC will entirely retain its independence in making rules, policies and supervisory decisions. The statutory objectives of the PRA, which underpin its forward-looking, judgement-based approach to supervision, will remain unchanged, as does the Financial Policy Committee's (FPC's) macroprudential role in respect of the PRA. The new arrangements will reinforce the accountability of the PRC and the PRA's Chief Executive Officer (the Deputy Governor for Prudential Regulation) for the PRA's functions. The PRA functions of the Bank will continue to be funded by the PRA levy, with the PRC responsible for consulting on and setting the level. A separate account will be prepared on the use of levy funds, alongside the information in the Bank's financial accounts.

The Act also includes various financial services provisions, including provisions to extend the Senior Managers and Certified Person Regime to all authorised firms and to change the underlying 'presumption of responsibility' into a 'duty of responsibility'.

Also, the Bank will be given a duty to publish a Policy Statement setting out the steps it has taken to ensure there is appropriate structural separation and independence between the Bank's resolution functions and its prudential supervision functions, to prevent conflicts of interests, and as a requirement of European Union (EU) law.

The PRC will report annually to the Chancellor on the adequacy of the resources allocated to the PRA functions and the extent to which the exercise of those functions is independent of the exercise of the Bank's other functions.

1 www.bankofengland.co.uk/pra/Documents/publications/ar/2016/pra-links.pdf.
2 www.bankofengland.co.uk/pra/Documents/publications/ar/2016/pra-links.pdf.

Organisational structure
as at 1 June 2016

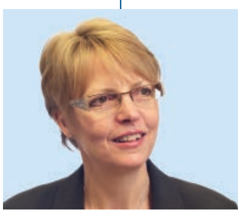
Andrew Bailey*
Deputy Governor,
Prudential Regulation
and CEO of the PRA
(FPC, PRA Board)

David Rule**
Executive Director
Prudential Policy

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

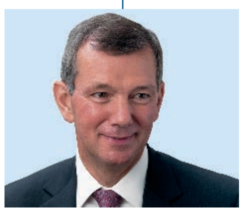
Sam Woods*
Executive Director
Insurance Supervision

Vicky Saporta
Director
Financial Prudential
Policy



Sasha Mills
Director
Cross-Cutting
Prudential Policy

Charlotte Gerken
Director
Supervisory Risk
Specialists



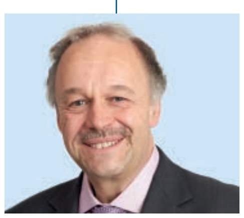
Chris Moulder
Director
General Insurance

* On 1 February 2016 it was announced that Andrew Bailey had been appointed CEO of the Financial Conduct Authority. On 18 April 2016 it was announced that Sam Woods would succeed Andrew Bailey from 1 July 2016.

** Also reports to Deputy Governor, Financial Stability. On 27 May 2016, it was announced that David Rule would become Executive Director of Insurance Supervision from 1 July 2016.

Sarah Breeden
Executive Director
International Banks
Supervision

James Proudman
Executive Director
UK Deposit-takers
Supervision



Andrew Bulley***
Director
Life Insurance

Mike Mitchell
Director
Major Overseas Banks

Martin Stewart
Director
Banks, Building
Societies and
Credit Unions

*** On 2 June 2016, it was announced that Andrew Bulley had resigned from the PRA.

Find out more online
www.bankofengland.co.uk

PRA Strategic Report:
Overview of responsibilities and approach

The PRA is responsible for the prudential regulation of deposit-takers,[1] insurers and the largest investment firms in the United Kingdom. The PRA supervises around 1,600 firms[2] and groups (see Charts 1 and 2). This includes nearly 900 banks, building societies and credit unions and over 600 insurers of all types (general insurers, life insurers, friendly societies, mutuals and the London market).

In discharging its powers the PRA seeks to assess and address risks that the firms it supervises can pose to the stability of the financial system.

The United Kingdom has one of the world's largest centres for financial services. Reflecting this role in international finance, the PRA supervises nearly 200 branches and subsidiaries of foreign banks from 56 different countries. Almost half of the total UK banking sector assets belong to branches and subsidiaries of foreign banks, totalling around £2.75 trillion.

The UK insurance sector is the largest in Europe and the third largest in the world.

Among the population of PRA regulated firms, the PRA is the home state regulator of four UK global systemically important banks (G-SIBs) and two UK global systemically important insurers (G-SIIs). The United Kingdom acts as host regulator to all internationally headquartered G-SIBs and several G-SIIs.

The United Kingdom has one of the world's largest centres for financial services

Chart 1: PRA supervised deposit-takers, as at 29 February 2016

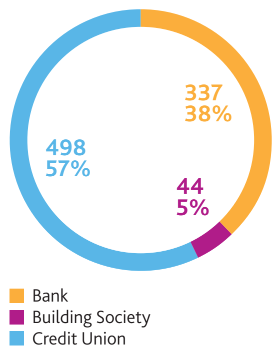
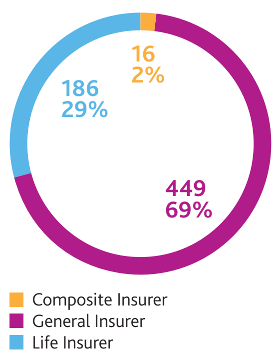
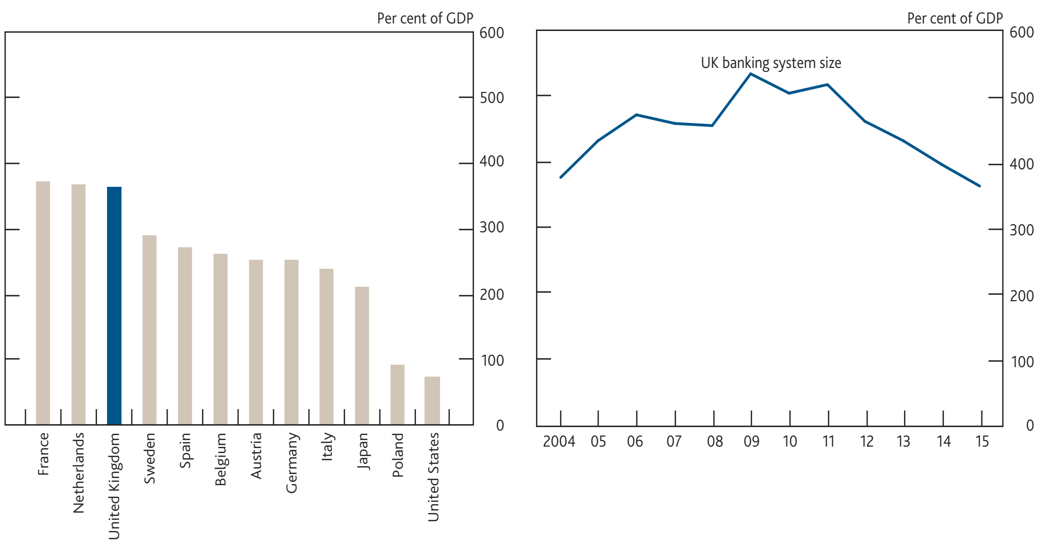


Chart 2: PRA supervised insurers as at 29 February 2016



Charts 3 and 4: How big is the UK banking system?



Sources: Bank of Japan, European Central Bank, Eurostat, Federal Reserve Bank of New York, Federal Reserve Bank of St. Louis and Statistics Bureau of Japan.

1 Banks, building societies and credit unions are the only UK financial institutions which are authorised and regulated to collect deposits from the general public.
2 Over the course of the year the exact number of PRA-authorised firms and groups changes as new firms enter, other firms close or change their permissions, and entities within groups restructure. This total also includes designated investment firms.

The PRA's approach to supervision

The PRA's supervisory approach, as published on the PRA's website,[1] is forward-looking and judgement-based and key to enabling the PRA to meet its strategy. The PRA adopts a proportional approach which focuses on the harm that firms can cause to the stability of the UK financial system. A stable financial system is one in which firms continue to provide critical financial services, and is essential for a healthy economy.

The PRA prioritises its supervisory efforts across a wide and diverse population of institutions, reflecting a number of different factors. These include the PRA's judgement of a firm's potential impact on the stability of the financial system, and therefore its systemic importance; its proximity to failure and its resolvability; and for insurers, the impact on policyholders if the firm were to fail.

Firms judged by the PRA as unlikely, individually, to create disruption to the wider financial system are subject to a baseline level of supervisory activity to ensure that they meet key prudential standards. The PRA makes use of a fuller selection of its supervisory tools for higher impact firms — these firms are subject to continuous assessment by dedicated teams of supervisors.

The PRA advances its objectives and promotes safety and soundness by setting standards — including detailed rules that firms must meet; and through supervision, where the PRA assesses the risks posed to its objectives and takes action to mitigate them. Threshold Conditions set out the minimum requirements firms must meet in order to be permitted to carry on regulated activities.

The areas of focus in assessing risks posed by firms include: the risk context, or how the environment and the business risks a firm faces affects the viability of the firm, and the extent of mitigating factors that may exist such as the governance and management oversight; financial strength; and resolvability of the firm.

The PRA uses quantitative and qualitative analysis to allocate firms to five 'categories' of potential impact. Category '1' represents the most significant firms with a capacity to cause major disruption to the UK financial system, and category '5' represents firms with a capacity to cause almost no disruption. (See **Charts 5** and **6** below).

Chart 5: Distribution of potential impact categories across PRA-regulated firms, category 1 being the highest impact to financial stability

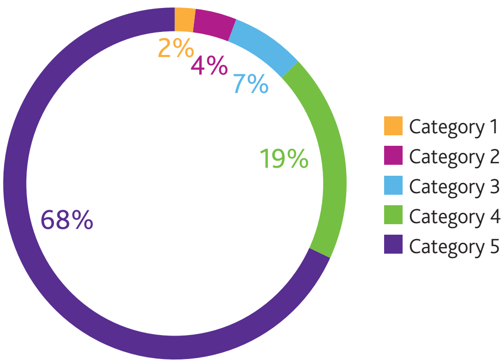
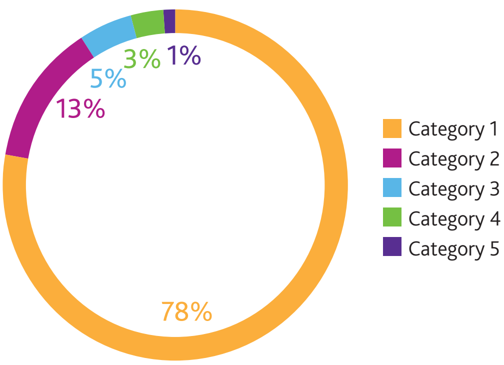


Chart 6: Total potential impact of each category of PRA-regulated firm



The PRA prioritises its supervisory efforts across a wide and diverse population of institutions, reflecting a number of different factors

1 www.bankofengland.co.uk/pra/Documents/publications/ar/2016/pra-links.pdf.

The PRA assesses the 'potential impact' that firms could have on financial stability or policyholders by failing, coming under stress, or the way it carries on its business. The intensity of supervision applied to firms will vary in proportion to this.

An effective framework for financial stability needs to combine firm-specific supervision with work to protect and enhance the resilience of the financial system as a whole. As part of the Bank, the PRA works closely with the FPC to contribute to the identification and assessment of macroprudential risks that could negatively affect the safety and soundness of PRA regulated firms.

The PRA works with other parts of the Bank on areas such as market intelligence and oversight of the critical financial infrastructure. The PRA also works closely with the Resolution Directorate on resolution planning, contingency planning for firm failure and operational resilience — see page 19 for more information on the PRA's role in resolution.

International engagement

The UK banking and insurance industries are highly internationalised.

Many insurers regulated by the PRA have overseas subsidiaries, or parents that are regulated by overseas regulators, and thus the PRA's legal powers and responsibilities will necessarily vary depending on the legal structure of its operations in the United Kingdom. Co-ordination with the relevant overseas regulators is an important part of the PRA's role, and involves regulators from both the developed and the emerging markets. The PRA has been hosting and supporting regulatory colleges for its larger firms and groups for several years and these have now been formalised under Solvency II. In addition to these international colleges, the PRA works directly with international regulators on issues such as the approval of group-wide models, or specific concerns as they arise.

For banks, the supervision of overseas firms operating in the United Kingdom is an important part of the PRA's work. However, the PRA's legal powers and responsibilities vary depending on the location of the parent and the legal form of its operations in the United Kingdom. As a result, prudential standards for overseas firms in the United Kingdom are set by a combination of home and host state supervisory powers.

The types of risks which the PRA will assess in respect of overseas firms are those arising from the parent entity; risks from exposures to overseas jurisdictions; the firm's legal status (branch or subsidiary); the nature of the home country regulatory regime(s) (supervisory and resolution) for non-european economic area (EEA) entities; and the nature and scale of the firm's operations in the United Kingdom, including whether the firm undertakes critical economic functions.

For **subsidiaries** of **overseas firms** the PRA has full powers and responsibilities and treats such firms as equivalent to UK-owned firms, applying the same prudential requirements.

For **UK branches of EEA firms**, the PRA's powers and responsibilities are limited under European law, and prudential requirements are set by the home supervisor. To assure itself that risks to the UK financial system from EEA branches, particularly those considered significant, are adequately managed, the PRA focuses on recovery and resolution planning (along with the Resolution Directorate) and on ensuring that it has access to relevant information on the safety and soundness of the parent firm through collaboration with home authorities.

The PRA works with other parts of the Bank on areas such as market intelligence and oversight of the critical financial infrastructure

For **UK branches of non-EEA firms**, the power to set capital and liquidity requirements sits with the home supervisor. The PRA's authorisation applies to the whole firm. The approach, which applies to both new and existing branches, is centred on an assessment of the UK branch's activities, on the equivalence of the home authority's supervision of the whole firm, and the level of assurance the PRA gains from the home authority over resolution. At the point at which a non-EEA branch seeks initial authorisation in the United Kingdom, the PRA will, as a first step, form a judgement on the adequacy or equivalence of the home regulator and its regulatory regime, including its ability and willingness to share confidential information.

Where the PRA is satisfied on these matters it will also need to have a clear and agreed split of prudential supervisory responsibilities with the home authority. Alternatively, the PRA may consider authorising such a firm as a subsidiary instead, which can help address supervisory concerns or allow the application of UK resolution powers in the event of firm failure.

The PRA maintains co-operation agreements, including memorandums of understanding (MoU), with overseas counterparts to enable the sharing of confidential information on cross-border firms. The PRA currently has over 60 MoUs with non-EEA counterparts. For its largest firms with large international operations, the PRA engages closely with overseas regulators including through participation in supervisory colleges. Colleges of supervisors for EEA banks with subsidiaries or significant branches in other EEA countries occur on a regular basis and include supervisors from non-EEA countries where relevant.

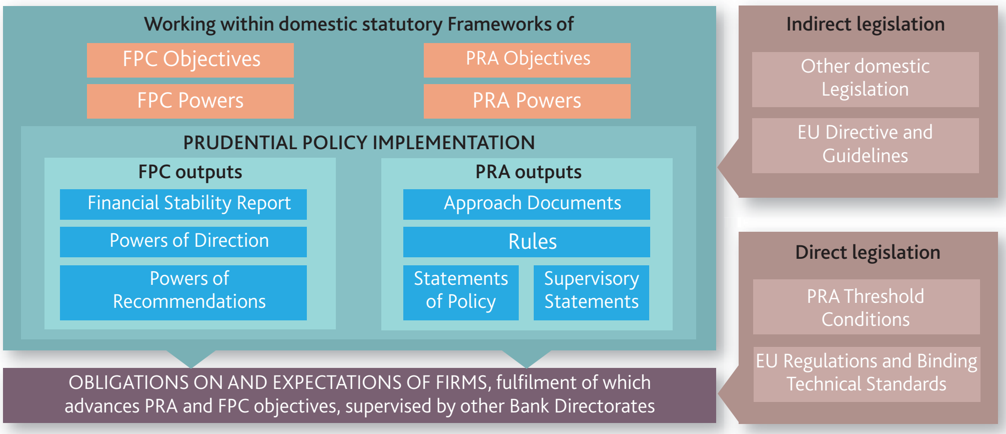
PRA approach to policy

The Bank and PRA make prudential policy within a legal framework, which is set out in **Figure 1**. It means that the PRA is required under law to make policy in pursuit of its objectives and in line with legal obligations.

Prudential supervision is based on policies which ensure that judgements on risks to the PRA's objectives are made within the legal framework. The PRA aims to establish and maintain published policy material that is consistent with its objectives, clear in intent, straightforward in its presentation and as concise as possible, so that it is usable by the senior management of firms.

The PRA aims to establish and maintain published policy material that is consistent with its objectives, clear in intent, straightforward in its presentation and as concise as possible

Figure 1: Prudential policy legal framework



At a global level, the PRA is actively involved in the work of the Financial Stability Board (FSB), the Basel Committee on Banking Supervision (BCBS), the International Association of Insurance Supervisors (IAIS), and the Joint Forum.[1] In Europe, the PRA and other areas of the Bank are active participants in the work of the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Systemic Risk Board (ESRB).

The PRA's role in resolution

A key principle underlying the PRA's approach to supervision is that it does not seek to operate a 'zero failure' regime. Rather, the PRA, working with the Bank's Resolution Directorate, seeks to ensure any firms that fail do so in an orderly way that avoids significant disruption to the financial system or to the supply of critical financial services and does not expose public funds to loss. A firm that is judged to be capable of doing so is considered 'resolvable'.

Both the PRA, as prudential regulator, and the Bank, as resolution authority, have statutory objectives that require action to be taken to ensure that institutions are resolvable. The PRA's approach to banking supervision explicitly states that the PRA may use its powers to require institutions to take action, including restructuring, to improve the feasibility of orderly resolution. The Bank, as the resolution authority, develops resolution plans, carries out the resolvability assessments and has its own powers to direct institutions to address impediments to resolvability.

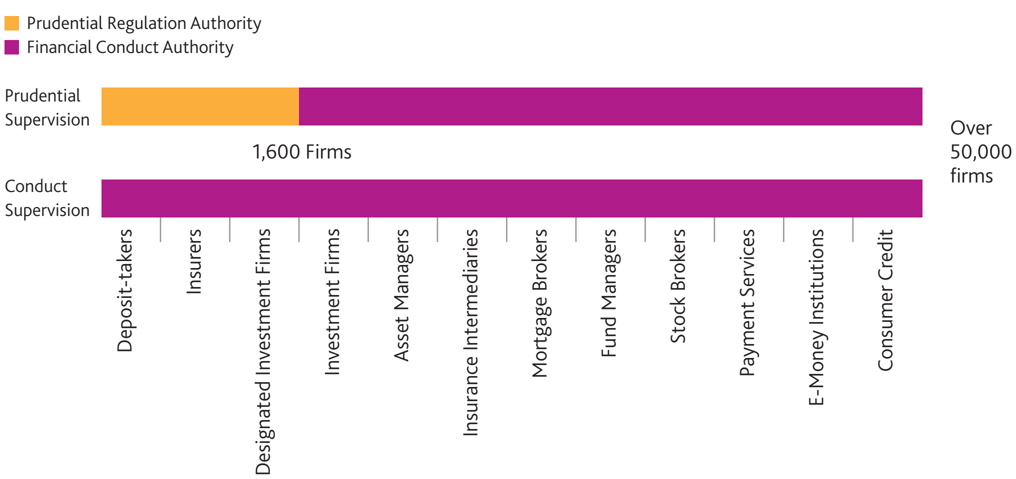
Each authority will consult the other and co-operate closely in exercising these complementary responsibilities and powers.

Working with the FCA

The FCA is responsible for the regulation of conduct of business, with the mandate and tools to protect consumers and market participants including through the promotion of competition. An MoU between the FCA and the PRA describes how the two regulators co-ordinate their duties in a way that supports each regulator's ability to advance its own objectives. A key principle for this co-operation, given the regulators' separate mandates for prudential and conduct

Both the PRA, as prudential regulator, and the Bank, as resolution authority, have statutory objectives that require action to be taken to ensure that institutions are resolvable

Figure 2: Stylised illustration of the split of regulatory responsibilities between the PRA and FCA



1 The Joint Forum deals with issues common to the banking, securities and insurance sector including the regulation of financial conglomerates.

regulation of PRA-authorised firms, is that each authority should focus on the key risks to its own objectives, while being aware of the potential for concerns of the other. The relationship is explained in more detail in the 'Review of 2015/16' section on page 43.

The PRA's relationship with the Financial Policy Committee (FPC)

The FPC is the Bank's macroprudential policy making body. It contributes to the Bank of England's financial stability objective by monitoring, identifying and taking action to remove or reduce systemic risks with a view to protecting and enhancing the resilience of the UK financial system as a whole. It also has a secondary objective to support the economic policy of the UK Government.

The PRA works closely with the FPC to ensure that both bodies can meet their objectives. To meet its objectives the FPC can issue directions and recommendations to the PRA which the PRA implements with reference to its own objectives. There is also a two-way flow of information between the FPC and PRA. The PRA provides the FPC with its assessment of supervisory risks, to assist its macroprudential oversight, while the FPC's assessment of systemic risks influences the PRA's judgements in pursuit of its own objectives.

The 2015 concurrent stress test of major UK banks and building societies took place under the guidance of both the FPC and PRA Board, who jointly agreed the stress scenario. Meanwhile in the Record of its March 2016 policy meeting, the FPC stated that it 'welcomed and supported' the PRA Board's Supervisory Statement on underwriting standards in the buy-to-let market, which would provide a mechanism by which the FPC could set further guidance on the appropriate minimum stressed interest rate to be used in affordability tests, if it deemed it appropriate to do so for macroprudential reasons.

A collaborative relationship is embedded into the Bank's governance since the Governor, Deputy Governor for Financial Stability and Deputy Governor for Prudential Regulation are members of both the PRA Board and FPC. The Deputy Governor for Markets and Banking, currently a member of the PRA Board, will also become a member of the FPC on the commencement of the relevant provisions in the Bank of England and Financial Services Act 2016. In addition, the CEO of the Financial Conduct Authority sits on both the PRA Board and FPC as an *ex officio* member.

PRA Strategic Report:
The PRA Strategy

The PRA's strategy is to deliver a resilient financial sector by seeking: an appropriate quantity and quality of capital; effective risk management; robust business models; and sound governance including clear accountability of firms' management. This supports the PRA's pursuit of its primary safety and soundness, policyholder protection, and secondary competition statutory objectives.

The PRA does not seek to operate a regime in which firms can never fail. When failure does occur, this should be with limited disruption to the provision of core financial services, without spillovers to the wider financial sector, and should not expose public firms to loss.

This strategy will be achieved in close co-operation with other parts of the Bank, the FCA, and European and international counterparts.

In delivering this strategy, the PRA will be forward-looking and judgement-based, proportionate in its actions, and efficient in its allocation of resources.

The PRA's statutory objectives:

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

Shaping the PRA Strategy

Each year the PRA is required by law to determine and publish its strategy setting out how it will advance its statutory objectives.

In addition to its statutory objectives, the PRA's strategy is shaped by its other responsibilities such as the requirement to implement domestic, European and international legislation. Furthermore, as part of the Bank, the PRA contributes to the delivery of the Bank's wider financial stability and monetary policy objectives.

The strategy ensures that the PRA is able to maintain the flexibility to respond to changes in markets, developments in the economy and other risks which can impact the PRA's statutory objectives and priorities, and reprioritise its activities as needed.

The PRA Strategy

The PRA's strategy is set by its Board, in consultation with Court. Under FSMA, the PRA is required to determine and publish annually its strategy in relation to how it will deliver its statutory objectives.

Priorities for 2016/17

The strategy outlines the PRA's intentions over the medium to long term. The Business Plan 2016/17, sets out how the PRA will work towards achieving this strategy over that period. Within the Business Plan, which is detailed later in this *Annual Report* (page 45), the priorities are:

- developing and embedding a medium-term framework for the stress testing of banks and insurers and improving stress-testing processes and data requirements;
- supporting the Bank in developing resolution plans for UK banks, including through loss-absorbing capacity requirements, further implementation of the Bank Recovery and Resolution Directive (BRRD) and developing solvent wind down plans for major international banks;
- continuing to embed Solvency II within the PRA's approach to insurance supervision;
- finalising and implementing the ring-fencing of core UK banking services;
- finalising reforms to international standards for banking regulation, influencing their implementation in European regulation and delivering their implementation in UK regulation and supervision;
- supporting Capital Markets Union in Europe, including the development of sustainable securitisation markets;
- further developing proportionate approaches to banks of different sizes and business models;
- developing a comprehensive approach to operational resilience, IT risk and cyber risk across the Bank and within the PRA;
- improving use of data within the PRA including using advanced analytic tools; and
- implementing the revised approach to supervising firms' governance.

PRA Strategic Report:
Review of 2015/16

The PRA's activities in 2015/16 were directed by the Bank's Strategic Plan and the PRA's Business Plan (as set out in the 2014/15 PRA *Annual Report*).

This section of the *Annual Report* outlines the work completed in pursuit of the PRA's 2015/16 business aims and in support of its statutory objectives. Box 1 provides some examples of how the PRA has delivered its business aims.

Box 1: Some examples of how the PRA delivered its 2015/16 business aims:

1. Continue to develop and implement the forward-looking judgement-based regime:

- conducted stress tests on UK general insurers' resilience and contributed to the development of the EU-wide insurance stress tests;
- published a new approach to stress testing for the UK banking system;
- continued to implement the PRA's policy for supervising international branches; and
- focused on the competition objective with the establishment of the New Bank Start-up Unit.

2. Implement changes to domestic, European and international regulation:

- completed the implementation of Solvency II and embedded the regime into the PRA's supervisory approach;
- consulted on ring-fencing core activities of ring-fenced banks to increase resolvability and resilience;
- finalised the rules for the Senior Managers Regime (SMR) and Senior Insurance Managers Regime (SIMR);
- implemented the Bank Recovery and Resolution Directive and the FPC leverage ratio; and
- published final rules and a Supervisory Statement for the Liquidity Coverage Requirement (LCR).

3. Continuing to devise and influence the post-financial crisis policy agenda:

- responded, together with the wider Bank, to the European Commission's *Call for evidence on the EU regulatory framework for financial services* and its public consultation on the possible impact of the Capital Requirement Regulation (CRR) and Capital Requirements Directive (CRD), collectively CRD IV, on bank financing of the economy;
- participated and engaged closely in the work of the Financial Stability Board, the Basel Committee of Banking Supervisors, the International Association of Insurance Supervisors, the European Banking Authority and the European Insurance and Occupational Pensions Authority;
- engaged with the European Central Bank's (ECB's) Single Supervisory Mechanism to establish strong working co-operation and raise awareness of the PRA's approach and objectives;
- worked, together with the IAIS, towards further development of global prudential standards for insurers; and
- completed the PRA Rulebook and launched a new online version.

4. Support the Bank in delivering its financial stability and monetary objectives:

- supported the FPC in delivering its Policy Statement on housing tools and consulted on maintaining the exclusion of second and subsequent charge mortgage contracts from the loan to income limit;
- supported the FPC's review of the appropriate calibration and configuration of capital requirements for UK banks;
- supported the FPC work on the impact of regulation on market liquidity;
- submitted a climate change adaption report to Defra; and
- continued a stocktake of data requirements from banks, building societies and designated investment firms.

5. Ensure the PRA has the right people, infrastructure and governance to deliver its strategy:

- continued work to look at options for technology services shared with the FCA and setting out options for future investment;
- reviewed the PRA's operating model in order to continue its commitment to provide efficiency and effectiveness;
- developed strategic recruitment campaigns to attract high-quality people in a range of disciplines and with the right technical expertise; and
- continued to co-ordinate with the FCA across a range of supervisory and policy matters.

Business aim 1: Continue to implement the forward-looking judgement-based regime

Stress tests: informing PRA and FPC decision-making on capital resilience

Together with other directorates of the Bank, the PRA delivered the second concurrent stress test of the UK banking system (refer also to the Bank's *Annual Report*). This covered seven major UK banks and building societies ('the banks') and is a key example of the PRA's work in support of its statutory objective to promote the safety and soundness of the firms it regulates.

Unlike the 2014 stress test, which focused largely on domestic risks, the 2015 concurrent stress test examined the resilience of the UK banking system to a severe global stress scenario which adversely affects the United Kingdom.

In developing and analysing results of the 2015 stress test, the PRA assessed the integrity of each bank's starting position, carried out a detailed asset quality review, assessed both the quantity and quality of capital, and considered the feasibility of proposed management actions. The exercise delivered both an assessment of the strength of banks' capital positions and an opportunity to consider in detail banks' risk management frameworks and stress-testing capabilities.

The PRA Board judged that this stress test did not reveal capital inadequacies for five of the seven banks, given their balance sheets at year end-2014. For the other two banks, the PRA Board decided that, given continuing improvements to their resilience over the course of 2015 and plans to increase capital, the banks should not be required to submit a revised capital plan.

Stress testing is not reserved only for use in the supervision of the largest banks and building societies, but is used as a tool to assess capital adequacy and vulnerabilities across banks, building societies, investment firms and groups of firms.

Stress tests: the insurance sector

The PRA conducted a stress test for UK general insurers that covered over 60% of the market by premium. The test was designed to: assess resilience to market-wide events and firms' consequential reliance on reinsurers; investigate the ability of the insurance industry to measure and assess complex risks such as cyber threats; and assist in the development of future stress-test exercises by requesting details of events that could impact firm solvency.

The main findings were:[1]

- in aggregate, the insurers were resilient against specific market-wide stresses;
- the economic stress-test scenario resulted in the largest adverse impact, which arose mainly from a fall in the value of corporate bonds;
- the complex stress tests (eg liability, cyber stresses) indicated that common terminology and a common framework for the assessment of exposure is required before a wider assessment of firm and sector resilience can be determined on a consistent basis; and
- no systemic risks or common causes of a market-wide catastrophe were identified through firms' own identified stress scenarios.

The results will be used to inform the design and implementation of future exercises.

Together with other directorates of the Bank, the PRA delivered the second concurrent stress test of the UK banking system

1 www.bankofengland.co.uk/pra/Documents/publications/ar/2016/pra-links.pdf.

Box 2: New approach to stress testing in banking

In October 2015 the Bank published its approach to stress testing the UK banking system.[1] The framework is designed to support the FPC and the PRA in meeting their statutory objectives.

Stress testing is a core part of the capital framework which sits alongside risk-based capital and leverage requirements. These tests provide an integrated forward-looking assessment of resilience and aim to ensure that banks can continue to support the real economy even in difficult economic conditions.

Publishing the approach provides clarity for firms and the wider public about the PRA's plans until 2018. It has been informed by the lessons learnt during the concurrent stress tests conducted in 2014 and 2015 and feedback to a Discussion Paper published by the Bank in 2013.[2]

The three key features of the approach are:

i) the introduction of an annual cyclical scenario that will systematically link the severity of the test to the financial cycle. This scenario will include domestic, global and market elements. Its severity is likely to be greater in an upswing, for example when growth in credit is rapid or asset prices unsustainably high;

ii) A biennial exploratory scenario covering risks unrelated to the financial cycle that policymakers' judge to be emerging or latent threats to financial stability or risks to individual banks; and

iii) A systematic and transparent hurdle rate framework with clear rates for each firm reflecting minimum capital requirements and additional requirements for systemically important banks.

1–2 www.bankofengland.co.uk/pra/Documents/publications/ar/2016/pra-links.pdf.

Stress testing is a core part of the capital framework which sits alongside risk-based capital and leverage requirements

At a European level, the PRA has contributed extensively to the EIOPA plan to hold EU-wide stress tests of insurers in 2016.

IMF Financial Sector Assessment: the Bank's contribution

The International Monetary Fund (IMF) delivered its five-yearly Financial Sector Assessment Programme (FSAP) of the United Kingdom in June 2016. The assessment covered a range of areas which fall under the remit of the PRA and the Bank, including: stress testing, systemic risk oversight, insurance, securities, financial market infrastructures (FMI), crisis management and bank resolution, and the liquidity framework. The IMF also carried out a full assessment of the United Kingdom's adherence to the Basel Core Principles (BCPs).

The FSAP assessed three key components of financial stability:

i) The soundness of banks and other major financial institutions, which includes stress tests;

ii) The macroprudential framework and the quality of financial system oversight, including banking, securities and insurance where the sectors are systemically important; and

iii) The ability of policymakers and financial safety nets to withstand cases of deep financial stress and respond effectively.

The UK authorities welcomed and supported the IMF's comprehensive review of the UK's supervisory and regulatory framework and its acknowledgement of the significant progress made since the last FSAP in 2011 through the adoption of a more rigorous, hands-on and systemically focused approach to banking supervision.

International bank branches: continuing to implement the PRA's strategy

Internationally headquartered banks can operate in the United Kingdom either as subsidiaries or as branches. The PRA has a clear framework that takes into account the different legal requirements for the types of firm it supervises.

The PRA has continued to implement its policy for supervising branches of international banks, which was published in 2014.[1] This has involved negotiating a formal split of prudential supervisory responsibilities on a jurisdiction-specific basis. The agreement of responsibilities with overseas regulators is a long-term project and the PRA's initial focus has been with the key jurisdictions.

In addition, the PRA has engaged in direct discussions with firms, and the relevant home state supervisors, where branches undertake activities that are outside the PRA's published risk appetite.

Following a consultation and successful pilot exercise, the PRA introduced a twice-yearly Branch Return which will provide the PRA with information about the activities of such branches in the United Kingdom.[2]

Competition objective: continuing focus on the PRA's secondary objective

The PRA's first *Annual Competition Report* (ACR) has been published alongside this *Annual Report*. The ACR sets out further detail about:

- the PRA's secondary competition objective (SCO), to facilitate effective competition; and
- specific actions the PRA has taken in support of this objective.

Since the SCO was introduced the PRA has made significant progress in embedding the objective in its processes, governance and infrastructures, with clear results in policy and supervisory decisions.

Key examples include the introduction of the New Bank Start-up Unit (see Box 3), the PRA's application of proportionality across a broad range of policies, and proactive engagement in international negotiations. Examples of proportionality include, but are not limited to:

- fewer functions requiring pre-approval by the PRA for credit unions, banks and building societies with assets under £250 million ('small banks'), incoming non-EEA branches, insurance special purpose vehicles, and small non-directive firms (NDFs);
- allowing smaller, less complex firms to outsource some of their functions (such as Internal Audit) to external service providers, subject to the firm having adequate oversight arrangements in place of the provider; and
- the PRA has adopted a proportionate approach to the Solvency II remuneration requirements with more granular expectations of compliance from significant firms and groups.

Examples of engagement include responses to the European Commission's *Call for evidence on the EU regulatory framework for financial services*[3] and its public consultation on the possible impact of CRD IV on bank financing of the economy.

The PRA worked closely with the Competition and Markets Authority (CMA), as part of the CMA's market inquiry into retail banking, to understand the effect of risk weights on mortgage pricing. The CMA inquiry group referred to the PRA's research in its addendum to provisional findings on the regulatory capital requirements regime published in April 2016.

Since the SCO was introduced the PRA has made significant progress in embedding the objective in its processes, governance and infrastructures

1–3 www.bankofengland.co.uk/pra/Documents/publications/ar/2016/pra-links.pdf.

Box 3: New Bank Start-up Unit

In January 2016 the PRA along with the FCA introduced the New Bank Start-up Unit to enhance the authorisation process for new and prospective banks in support of its secondary competition objective. It is primarily aimed at new UK start-ups but also includes useful information for other new entrants, such as non-EEA branches.

New dedicated webpages[1] give information on a number of key areas for those considering setting up a bank in the United Kingdom including sections on whether to be a bank or not, pre-application, the application process and life as a bank post-authorisation.

A dedicated phone number and email address have been set up to assist prospective applicants. An introductory seminar was held in March 2016: feedback from that event and from queries received will inform future engagement.

1 www.bankofengland.co.uk/pra/Documents/publications/ar/2016/pra-links.pdf.

The Bank's Independent Evaluation Office (IEO) carried out an assessment of the PRA's approach to the SCO, with a view to facilitating oversight of the strategy adopted: the report was published in March 2016.[1] The PRA welcomed the review and accepted the findings and recommendations of the evaluation in full.[2]

Management and governance assessments: enhancing consistency

In 2015/16 the PRA reviewed the governance arrangements of a wide spectrum of firms to assess the strength of their corporate governance and to assess any consequential threats to the PRA's objectives. As a result of the reviews, the PRA has made a number of recommendations designed to improve firms' governance.

Authorisations

Firms wishing to carry out PRA regulated activities, or make changes to the activities they undertake, must apply for authorisation to ensure they meet the standards expected of the regulatory system and are fit to operate in the United Kingdom.

The average time to authorisation in 2015/16 was 235 days. The PRA also held 48 pre-application meetings with over 25 prospective banks, and 6 meetings with other types of applicant firms.

Auditors of systemically important UK deposit-takers: closer engagement

The PRA looks to auditors to contribute to effective supervision by engaging directly with supervisors in a proactive and constructive manner. In January 2016, the PRA published its final rules on the imposition of financial penalties on auditors and actuaries of PRA-authorised persons.[3] These rules set out a requirement for written reporting to the PRA from the external auditors of the largest UK-headquartered deposit-taking institutions that are not subsidiaries of non-UK firms. The regime will commence during the audit cycle for financial reporting periods ending on or after 1 November 2016.

The PRA's engagement with external auditors has included firms' implementation of the International Financial Reporting Standard 9 (IFRS 9).[4] The PRA has had productive discussions with external auditors[5] on classification and measurement rules, hedge accounting, loan loss impairment provisioning and the subsequent prudential implications. These discussions have fed into supervisory risk assessments and will continue to do so, in particular while firms work on implementing IFRS 9.

Number of new authorisations

5
Banks

4
Insurers

2
Credit unions

2
Lloyd's managing agents

1–3 www.bankofengland.co.uk/pra/Documents/publications/ar/2016/pra-links.pdf.

4 A new set of accounting rules for financial instruments issued as part of the post-crisis reforms.

5 The section on Complying with FSMA (page 58) contains further information on the PRA's meetings with auditors.

Business aim 2: Implement changes to domestic, European and international regulation

Completing Solvency II implementation and embedding the regime into the supervisory approach

A key objective for the PRA was met with the implementation of the new Solvency II regime on 1 January 2016 and the regime's incorporation into insurance supervision.

Solvency II is a once in a generation modernisation of insurance regulation. It replaces the previous patchwork of national policy regimes in Europe with a single, consistent rulebook and introduces maximum-harmonised standards for risk-based capital requirements, and requirements for firms' governance, risk management and disclosures.

The Directive requires a considerable increase in the volume and frequency of data submission from insurance firms and retains many of the fundamental principles of the PRA's existing forward-looking and judgement-based supervisory approach.

Solvency II is a once in a generation modernisation of insurance regulation

Box 4: Implementation of Solvency II

The implementation of Solvency II involved a significant and co-ordinated effort across the Bank over several years of EU policy negotiations. Major milestones met in 2015 included:

- The Solvency II Directive was transposed into the PRA Rulebook in advance of the 31 March 2015 deadline. This provided the final set of rules implementing Solvency II. The PRA set out its expectations of firms by publishing finalised Supervisory Statements, which clarified how firms should approach compliance with various aspects of the new Rulebook.

- The PRA engaged closely in Solvency II policy development at EIOPA and chaired or vice-chaired committees on equivalence, internal models, and financial requirements. The PRA also supported EIOPA in its implementation work streams, especially in areas critical for effective supervision of the UK sector.

- All insurers who submitted an internal model for approval received a decision ahead of the implementation date of 1 January 2016, with 19 models being approved in early December.

- In addition to internal models, the PRA received over 400 applications for approvals or waivers, including applications to use the matching adjustment and transitional measures. All statutory deadlines were met ahead of the implementation deadline.

- The first regulatory reporting took place for around 100 firms in July and December 2015 on a new Bank of England Electronic Data Submission (BEEDS) platform. All firms were able to report both quarterly and annual submissions successfully. The PRA has developed an analytical system to interpret and use this information as part of its ongoing supervisory activity.

- The PRA has reviewed firms' Own Risk and Solvency Assessments (ORSA) submitted in 2015. These documents, which are produced and reviewed annually by firms, should provide a comprehensive overview of firms' forward plans and will assist the PRA in setting its forward-looking supervisory strategies.

Banking structural reform: continued progress

A key example of the PRA's activity in support of its statutory objective to promote the safety and soundness of firms is the work, with the FCA, towards implementing ring-fencing of core UK financial services and activities.

The changes brought about by structural reform are intended to protect ring-fenced banks from shocks that originate in the rest of their banking group or the financial system in order to minimise disruption to the continuity of the provision of core services and facilitate orderly resolution.

To date, the work to prepare for structural reform has included Policy Statements on ring-fencing policy in relation to governance arrangements, legal structure, and the continuity of services and facilities;[1] and consultations on prudential requirements, intragroup arrangements and the use of financial market infrastructures have been published.[2]

The PRA also published its proposed approach to ring-fencing transfer schemes.[3] A further consultation on reporting for ring-fenced banks is planned during the course of 2016.

In parallel, the PRA continued to engage actively with firms and to review banks' ring-fencing plans.

During 2015/16 the PRA set up a Structural Reform Programme to provide appropriate governance for its internal work on ring-fencing.

Improving senior management accountability in the financial sector and better aligning risk and reward

The PRA, jointly with the FCA, developed and finalised the rules for the Senior Managers Regime and Senior Insurance Managers Regime, which came into force on 7 March 2016 for UK banks, building societies, credit unions and insurers.[4]

The SMR and SIMR constitute a significant overhaul of the PRA's supervision of firms' governance and include strengthened individual accountability through clear individual responsibilities and with more focused pre-approval, supervision and enforcement by the regulators.

The Bank of England and Financial Services Act 2016 amends aspects of the SMR and SIMR. Andrew Bailey gave evidence on the changes in the legislation to the Treasury Select Committee on 20 October 2015.[5] Following Royal Assent in May 2016, the PRA and FCA may be required, or find it appropriate, to consult in due course on modification to rules and expectations already consulted on and published.

The PRA published a joint Policy Statement with the FCA in June 2015 which included key changes to remuneration rules.[6] These rules included extended deferral and clawback periods for performance on or after 1 January 2016 and strengthened requirements on risk adjustment, applicable from 1 July 2015.

The PRA contributed to developing the EBA Guidelines on sound remuneration policies, which are effective from 1 January 2017. However, the PRA maintained the principle of proportionality by not accepting the requirement in the guidelines that the bonus cap should apply to all firms regardless of their size and systemic importance.

The SMR and SIMR constitute a significant overhaul of the PRA's supervision of firms' governance

1–6 www.bankofengland.co.uk/pra/Documents/publications/ar/2016/pra-links.pdf.

Box 5: Advancing accountability

Last year saw significant advances in the PRA's ability to hold senior managers to account for past failures, and to prevent these failures in the future. Looking back this included high profile enforcement cases against CEOs, and the publication of the joint PRA and FCA report into the failure of HBOS. Looking forward, it focused on the introduction of the Senior Managers Regime (SMR) and Senior Insurance Managers Regime (SIMR).

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

While the PRA's approach to supervision is forward-looking and seeks to prevent prudential risks from crystallising, it recognises the importance of taking robust and decisive action where firms and individuals fall short of its expectations.

The PRA has taken enforcement action against a number of firms during the last financial year for a series of failings that potentially put those firms' safety and soundness at risk:

- In August 2015, the PRA publically censured the Co-operative Bank plc for a number of serious and wide-ranging failings in its control and risk management framework. The PRA concluded that a financial penalty of £121.8 million would have been warranted. However, it took the view that — in the particular circumstances of the firm — it would not impose a financial penalty on the firm because to have done so would not have advanced the PRA's safety and soundness objective.

- In November 2015, the PRA imposed a financial penalty of £1.27 million on R. Raphael & Sons plc for potentially putting its safety and soundness at risk by failing to properly manage its outsourcing arrangements. The PRA found that, as a result of the failings around its outsourcing, the firm had inadequate oversight and control over its regulatory capital position.

- In February 2016, the PRA imposed a financial penalty of £2.8 million on Millburn Insurance Company Limited for a number of serious failings in its risk management framework that had a significant impact on the firm's safety and soundness and the protection of its policyholders. Millburn is in administration and its financial position is uncertain. The PRA has reviewed the recoverability of this penalty at the year-end and has written it down in line with applicable accounting rules. The enforceability of the penalty debt is unaffected by this process. As stated in the Final Notice issued to the firm, the PRA will keep Millburn's financial position under review, and will seek to collect the penalty if it is appropriate to do so, bearing in mind the interests of policyholder creditors and the Financial Services Compensation Scheme (FSCS).

In addition, a key strand of the PRA's enforcement activity in this financial year has been to hold senior managers in regulated firms accountable for failings in those firms:

- In January 2016, the PRA imposed financial penalties of £173,802 and £88,890 respectively on Mr Barry Tootell, former CEO of the Co-operative Bank plc, and Mr Keith Alderson, former MD of the Corporate Banking Division, because they failed to exercise due skill, care and diligence in carrying out their roles at the firm. The PRA noted that the actions of Mr Tootell and Mr Alderson posed an unacceptable threat to the safety and soundness of the firm, and as a result it also issued its first ever prohibition orders — prohibiting Mr Tootell and Mr Alderson from holding senior positions in PRA-authorised firms in the future.

- Following its enforcement action against Millburn Insurance Company Limited in February 2016, the PRA also found that Mr Colin McIntosh, the CEO of Millburn, had fallen significantly short of the standards it expected from senior managers. It therefore prohibited him from holding senior positions in PRA-authorised firms in the future, and levied a financial penalty on him of £25,173.

Report into the failure of HBOS Group

The PRA and the FCA published a report into the failure of HBOS Group in November 2015.[1] The review analysed the causes of the firm's failure and highlighted lessons for the future for both the industry and the regulatory system as a whole.

The report concluded that ultimate responsibility for the failure of HBOS rested with its board and senior management. They failed to set an appropriate strategy for the firm's business and failed to challenge a flawed business model that placed inappropriate reliance on continuous growth without due regard to the risks involved.

Andrew Green QC provided an independent assessment of whether the decisions taken on enforcement by the former regulator, the Financial Services Authority (FSA), were reasonable. Following his recommendation that the PRA and the FCA should consider whether any former senior managers of HBOS should now be the subject of an enforcement investigation, both regulators decided to open up investigations into certain former HBOS senior managers.

Senior Managers Regime and Senior Insurance Managers Regime

The PRA and FCA have developed the new Senior Managers Regime and the PRA has developed the Senior Insurance Managers Regime to support a change in culture at all levels of firms through a clear identification and allocation of responsibilities.

This is an important element of the PRA's approach to the assessment of management and governance at firms, and forms an important part of its forward-looking, risk-based approach to supervision.

1 www.bankofengland.co.uk/pra/Documents/publications/ar/2016/pra-links.pdf.

The PRA also played an active role in advancing the work of the FSB on remuneration, including reviewing the effectiveness of compensation tools in addressing misconduct risks and whether additional measures were needed.

The PRA and the FCA have worked towards finalising their rules on regulatory referencing requirements for all PRA regulated firms. To formalise existing best practice, the PRA published rules on whistleblowing[1] to provide individuals with the knowledge and means to raise their concerns in the manner in which they feel most comfortable.

Bank Recovery and Resolution Directive: implementation

The BRRD[2] provides a common framework for the resolution of banks and large investment firms and improves the tools for dealing with bank crises. Its incorporation into the PRA's supervisory programme is an important step towards improving the resolvability of UK firms.

The PRA provided general feedback on firms' first round of recovery plans under the BRRD in 2015 and set out guidance. The PRA also continued work on the implementation of Article 55 of the BRRD, which requires firms to include in non-EU law contracts governing liabilities a term by which the creditor recognises that the liability may be bailed in by the Bank as the resolution authority. Responding to concerns raised by firms that there may be circumstances where compliance with the requirement was impracticable, the PRA published a modification by consent in November 2015 which disapplied the rules for a subset of liabilities where compliance would be impracticable. The modification expires on 30 June 2016 and the PRA has consulted on amending its rules to make these changes permanent from 1 July 2016.

1–2 www.bankofengland.co.uk/pra/Documents/publications/ar/2016/pra-links.pdf.

Box 6: Implementing the Liquidity Coverage Requirement

On 1 October 2015, the Liquidity Coverage Requirement (LCR) was implemented in EU law, introducing a significant change to the PRA's prudential liquidity regime. The final rules and Supervisory Statement covered phasing in the LCR; liquidity reporting and disclosure; liquidity risk management; and supervisory review.

The LCR is part of the 'Basel III' package of changes to international prudential standards agreed by the Basel Committee in response to the financial crisis. It replaced the PRA's previous standard, the Individual Liquidity Adequacy Standards regime, introduced by the Financial Services Authority in 2009.

The LCR requires firms to hold sufficient liquid assets to cover net 30-day liquidity outflows under stressed conditions.

Under the PRA approach to the LCR:

- each firm is responsible for the effective management of liquidity and funding risks;
- firms should consider a range of risk drivers as well as systemic and idiosyncratic stress scenarios;
- High-Quality Liquid Assets (HQLA) should be immediately convertible into cash at little or no loss of value through sale or repurchase agreement (repo) markets; and
- firms may draw down their liquid asset buffers in times of stress.

PRA regulated firms: improving resolvability

The PRA's work in 2015/16 focused on two key areas of bank resolution: i) issues arising from the BRRD requirement that all firms meet 'minimum requirement for own funds and eligible liabilities' (MREL); and ii) removing operational barriers to resolution through proposals on operational continuity for services supporting critical economic functions.

The PRA consulted on the relationship between MREL and the PRA's regulatory framework, considering the relationship between MREL and regulatory buffers and between MREL and the Threshold Conditions. In October 2015 the PRA consulted on proposals for ensuring operational continuity in resolution for PRA-authorised banks, building societies and investment firms which have critical economic functions. The proposals are aimed at ensuring that firms structure their operations so that the critical economic functions they provide continue to operate effectively in resolution. This aligns closely with the FSB's consultation on guidance on arrangements to support operational continuity in resolution.[1]

The Bank published its Statement of Policy on directing institutions to address impediments to resolvability under the BRRD in December 2015. This stressed that the Bank will co-ordinate with the PRA and FCA on issues pertaining to resolvability and recognised that where there are common impediments to resolvability, the PRA could require the impediments to be addressed through rules of general application made pursuant to its statutory rule-making powers, or the Bank could give a direction with general effect or with respect to a particular class of institutions.[2]

The FPC leverage ratio: implementation

In December 2015, the PRA published final rules[3] introducing a leverage ratio framework from 1 January 2016 for major UK banks and building societies with global retail deposits over £50 billion which the PRA expects to address the risk of excessive leverage for UK G-SIBs and other major UK banks and building societies.

1–3 www.bankofengland.co.uk/pra/Documents/publications/ar/2016/pra-links.pdf.

This implemented the FPC's Direction and Recommendation for a leverage ratio framework for major UK banks and building societies. It includes a minimum leverage ratio requirement of 3% Tier 1 capital and two buffers: the supplementary or additional leverage ratio buffer for G-SIBs, set by reference to the applicable G-SIB buffer rate; and the countercyclical leverage ratio buffer, set by reference to the countercyclical buffer rate.

Calculating the leverage ratio on an 'averaged' basis is intended to reduce incentives to adjust this ratio on any specific date. The PRA has published a Supervisory Statement with guidance on the daily averaging rule which says that firms can comply with the rule on a 'best estimates' basis.

The PRA also set out associated reporting (FSA083/FSA084) and disclosure requirements which aim to address potential risks arising from aggressive quarter-end balance sheet management by firms.[1]

Improving the liquidity management regime

The PRA's prudential liquidity regime changed significantly with the introduction of the LCR as its core prudential liquidity standard (see Box 6). Ahead of the LCR's introduction on 1 October 2015, the PRA published final rules and a Supervisory Statement setting out its approach to supervising liquidity and funding risks.[2] In these publications, the PRA indicated its intention to review its approach to setting additional liquidity requirements (Pillar 2 liquidity) and is now consulting on a revised approach.[3]

The PRA continued to contribute to the development of the prudential liquidity regime at EU level, including revisions to LCR reporting and the EBA report to the European Commission on if and how it would be appropriate to ensure that institutions use stable sources of funding.

Market liquidity

The PRA is also supporting work by the FPC on the impact of regulation on market liquidity. The FPC considers the regulations to be an important part of the post-crisis reform agenda to build the resilience of the core of the global financial system. While these regulations may reduce the normal level of market-making services provided by core intermediaries, they should also enhance the resilience of that provision in times of stress, promoting the effectiveness of markets.

However, the FPC judges that some market developments motivate careful review and consideration of whether there are any possible refinements to internationally agreed post-crisis regulations that could further promote market effectiveness without compromising the resilience of the core of the financial system. The FPC is undertaking such a review and intends to publish its assessment later in 2016.

Depositor and policyholder protection: a review

The European Deposit Guarantee Scheme Directive (DGSD) required the PRA to review its deposit protection limit on 3 July 2015, and at least every five years subsequently, to ensure it corresponds to the sterling equivalent of €100,000.

In line with this requirement, the PRA reviewed the level of depositor protection provided by the Financial Services Compensation Scheme (FSCS) and amended it to £75,000 in July 2015. To ensure a smooth transition, and protect depositors from a sudden change in the amount of compensation available, HM Treasury put in place legislation that maintained the previous limit of £85,000 until 31 December 2015 and the PRA made rules to support the smooth transition to the new limit. This provided depositors who were previously protected by the FSCS with time to transition to the new limit.

The PRA's prudential liquidity regime changed significantly with the introduction of the LCR as its core prudential liquidity standard

1–3 www.bankofengland.co.uk/pra/Documents/publications/ar/2016/pra-links.pdf.

The PRA suggested in its response to the European Commission *Call for evidence on the EU regulatory framework for financial services*[1] that any future revision to the €100,000 coverage limit should take into consideration the impact on non-euro Member States and their ability to ensure depositor confidence.

The Directive extended deposit protection to some categories of depositors that were not previously protected by the FSCS, such as large corporates. The changes made by the PRA also put in place a greater level of protection for depositors with temporary high balances, which will be covered up to £1 million, to ensure protection for specific events such as house sales.

In insurance, the PRA contributed to its statutory objective to secure an appropriate degree of protection for policyholders through increased limits for policyholder protection in the event of an insurer failing. These changes increased the FSCS compensation limit to 100% of cover for all long-term policies, professional indemnity insurance, and claims arising from death or incapacity. This reflects the potential for significant adverse consequences of cover being disrupted, to both policyholders and the wider financial system.

Business aim 3: Continue to devise and influence the post-financial crisis policy agenda

Parliamentary accountability

Throughout 2015/16, Andrew Bailey and other members of the PRA Board gave evidence to the Treasury Select Committee on the work of the PRA. The topics covered included:

- regular evidence sessions[1] and the PRA annual accounts;[2]
- the Bank of England Bill and the implementation of the Senior Managers Regime and Senior Insurance Managers Regime;[3]
- the failure of HBOS;[4] and
- the economic and financial costs and benefits of UK membership of the EU.[5]

1–5 www.bankofengland.co.uk/pra/Documents/publications/ar/2016/pra-links.pdf.

The DGSD extended deposit protection to some categories of depositors that were not previously protected by the FSCS

1 www.bankofengland.co.uk/pra/Documents/publications/ar/2016/pra-links.pdf.

Continuing to influence the international policy agenda

Given the urgency, scale and inter-linked nature of post-crisis regulatory reforms, it is to be expected that there may be places where some adjustment is appropriate, where reforms may not be working as intended, or where there may be conflicts between different elements of the framework. The PRA and Bank therefore supported the European Commission's *Call for evidence on the EU regulatory framework for financial services*, while sharing Lord Hill's[1] view that this stocktake should not lead to a weakening of the overall legislative framework. The PRA's joint response with the Bank set out areas where, based on robust evidence, amendments could be introduced to existing regulation.[2]

These amendments should include:

- the Bank's work with the ECB and European Commission on developing the securitisation framework to help diversify funding sources and unlock capital for lending;
- a more differentiated approach to banking regulation proportionate to the size of firms, which could facilitate competition, growth and stability;
- support for the leverage ratio, while noting the possible unintended consequences of inclusion of client clearing and central bank reserves;
- the importance of maintaining the flexibility in the existing CRD IV macroprudential framework and the desirability of introducing macroprudential tools into Solvency II;
- improving the incentives for stable, long-term investment under Solvency II, and maintaining a resilient insurance sector with consistent application; and
- ensuring bank capital buffers can be used in stress, following evidence that firms may not use the combined buffers as intended.

In the past year, the BCBS has agreed standards which will strengthen regulation and supervision, and enhance financial stability. These include the Net Stable Funding Ratio (NSFR), the large exposure framework and a new framework for market risk (fundamental review of the trading book). The FSB has agreed standards for minimum haircuts for securities financing transactions.

The FSB also issued the final total loss-absorbing capacity (TLAC) standard for G-SIBs. The TLAC standard defines a minimum requirement for the instruments and liabilities that should be readily available for bail-in within resolution at G-SIBs, but does not limit authorities' powers under the applicable resolution law to expose other liabilities to loss through bail-in or the application of other resolution tools.

Working towards consistent implementation of international regulation

The PRA actively engages with relevant EU institutions and regulators and is involved in the continuing development and implementation of the single market in financial services.

Throughout 2015/16 the PRA has participated and engaged closely in the work of EBA and EIOPA, particularly where technical standards and guidelines applicable at EU level are developed.

This has included:

- contributing to the EIOPA advice to the European Commission on the identification and calibration of infrastructure investment risk categories;
- contributing to EBA Guidelines on sound remuneration policies and playing an active role in advancing the work of the FSB on remuneration;

The PRA actively engages with relevant EU institutions and regulators and is involved in the continuing development and implementation of the single market in financial services

1 European Commissioner for Financial Stability, Financial Services and Capital Markets Union.

2 www.bankofengland.co.uk/pra/Documents/publications/ar/2016/pra-links.pdf.

- engaging closely in Solvency II policy development at EIOPA, and supporting its implementation work streams;
- helping develop the EIOPA stress-test framework and scenarios;
- contributing to the EBA report for the European Commission on whether and how it would be appropriate to ensure that institutions use stable sources of funding; and
- maintaining engagement and participation in the EU rule-making process and, with the EBA and EIOPA, emphasising the importance of consistency in implementation.

The PRA has worked closely with European counterparts to implement European directives and regulations including Solvency II, the BRRD and DGSD into the UK framework.

The Single Supervisory Mechanism: ensuring co-operation with supervisory counterparts

The ECB assumed supervisory responsibilities for the most significant Eurozone banks in November 2014 through the Single Supervisory Mechanism. The PRA has engaged with ECB colleagues to establish strong co-operative relationships and raise awareness of the PRA's approach and objectives.

The PRA has focused on building a strong reciprocal relationship with the ECB, and ensuring the PRA's concerns are on the ECB's supervisory agenda, particularly for those Eurozone banks most significant to the UK financial system, and that the ECB's concerns are reflected for relevant firms where the PRA has prudential responsibility.

Focusing on addressing 'too big to fail' — banking

Working together with the Bank, the PRA consulted on three key interlinked initiatives which provide the Bank with powers either to 'bail-in' shareholders and creditors of a failed firm to allow its critical economic functions to continue, or to transfer these critical economic functions to an acquirer:

i) ring-fencing: ring-fencing of core activities which support bank resolvability and increase the resilience of ring-fenced bodies (RFBs) to risks originating in other parts of their group or the global financial system;

ii) operational continuity: supporting the resilience and resolvability of banks, building societies and PRA-authorised investment firms by seeking to ensure critical economic functions are arranged in a way that facilitates continuity in the event of a failure; and

iii) MREL: working alongside the Bank to require UK banks, building societies and certain investment firms to maintain sufficient capital and liabilities that are capable of credibly bearing losses in stress and resolution.

Under the UK government's implementation of the CRD, other systemically important institutions (O-SIIs) are not required to maintain additional capital buffers (O-SII buffers). Instead, higher loss absorbency (HLA) requirements for domestic systemically important banks (D-SIBs) are implemented via the systemic risk buffer, which only applies to ring-fenced banks and large building societies.

The PRA has worked closely with European counterparts to implement European directives and regulations including Solvency II, the BRRD and DGSD into the UK framework

Focusing on addressing 'too big to fail' — insurance

The IAIS finalised its approach to HLA requirements for G-SIIs, with confidential reporting to supervisors due to commence in 2016. Following the 2015 designation exercise, the FSB published its annual identification of G-SIIs, with the nine identified including two UK-based firms.

Further development of the approach to G-SII identification is taking place during 2016, including a review of concept of non-traditional non-insurance products.

Enhancing capital standards for insurers

A priority in 2015/16 for the PRA was further development of global prudential standards for insurers, led by the IAIS. The ultimate aim is for these standards to be incorporated in Solvency II and other existing national frameworks, analogous to the global Basel standards applicable to banks.

The IAIS further developed the Insurance Capital Standard (ICS) for international insurance groups at the request of the FSB. The ICS will provide a global solvency standard for international insurance groups, enabling enhanced supervisory co-operation between countries, and supporting decision-making by investors and policyholders alike. It is due to be agreed in 2019.

The first field test of the requirements in 2015 involved several volunteer firms from the United Kingdom, and a second exercise will take place this year with a focus on testing options for liability valuation and refinements to the 2015 ICS design. These field tests allow the IAIS to address the impact of different options on firms, markets and supervisors and propose refinements to address any issues that are identified. An interim (version 1) of the standard is planned to be reported on a confidential basis to supervisors as of 2017.

During the year, Vicky Saporta, the PRA's Director of Financial Prudential Policy, was elected chair of the IAIS's Executive Committee.

Buy-to-let lending: a review

A key example of the PRA's work in support of its statutory objective to promote the safety and soundness of the firms it regulates was its review into underwriting standards in the buy-to-let sector.[1]

The review covered 31 firms and over 90% of the market and highlighted concerns that firms could relax their underwriting standards, and therefore weaken their safety and soundness, in order to meet their growth plans; these concerns suggested a need for microprudential action.

Following this review, the PRA is consulting on a Supervisory Statement which sets out an expectation of minimum standards that lenders should use to underwrite buy-to-let mortgage contracts in a prudent manner, curtail inappropriate lending and reduce the potential for excessive credit losses. These standards include:

- having regard to a minimum increase of 2% in buy-to-let mortgage interest rates, and any prevailing FPC Recommendation or Direction on the appropriate interest rate stress tests. However firms should assume a minimum borrower interest rate of 5.5%;
- having adequate risk management and controls specifically for buy-to-let lending. This includes the requirement for risk appetite limits and the monitoring of the risk profile of new buy-to-let lending, as well as the portfolio stock;

A priority in 2015/16 for the PRA was further development of global prudential standards for insurers, led by the IAIS

1 www.bankofengland.co.uk/pra/Documents/publications/ar/2016/pra-links.pdf.

- an assessment as to whether the rental income derived from the property will be sufficient to support the stressed monthly interest payment, future tax liabilities plus other costs associated with owning the property, for example maintenance costs; and
- the requirement to verify personal income and expenditure, where this is also being considered to support the mortgage request.

PRA Rulebook

The PRA published the last in a series of Policy Statements which reshaped the Handbook material inherited from the FSA into a PRA Rulebook containing only PRA rules.

As part of this process the PRA created a new credit unions part of the Rulebook and new parts for friendly societies over the course of 2015/16.

Alongside the new rules, clearly drafted Supervisory Statements and Statements of Policy will facilitate a more comprehensive understanding of the PRA's requirements and help firm compliance.

The new Rulebook significantly reduced the number of rules and a new Rulebook website was launched in August 2015.[1]

1 www.bankofengland.co.uk/pra/Documents/publications/ar/2016/pra-links.pdf.

Business aim 4: Support the Bank in delivering its financial stability and monetary objectives

Improving lender resilience through implementation of FPC housing tools

The FPC recommended in June 2014 that the PRA and the FCA should ensure that mortgage lenders with residential mortgage lending in excess of £100 million or 300 mortgages per annum should not extend more than 15% of their total number of new residential mortgages at loan to income (LTI) ratios at or greater than 4.5.

In 2015/16, the PRA contributed to the HM Treasury consultation on whether to grant power of direction to the FPC for tools in respect of buy-to-let lending, including interest coverage and loan to value ratios.

The PRA also consulted on continuing to exclude second and subsequent charge mortgage contracts from the LTI limit,[1] and will consult on including these loans in the LTI flow limit when loan level data becomes available in 2017. The PRA will continue to work together with the FCA to keep the size of the second and subsequent charge mortgage market under review.

Contributing to FPC review of capital in the banking system

The PRA, working together with other parts of the Bank, contributed to the FPC's review of the appropriate calibration and configuration of capital requirements for UK banks.[2]

The FPC review delivered a comprehensive analysis of the macroeconomic costs and benefits of UK banks' capital requirements, and updated previous international work by both tailoring the analysis to the United Kingdom and incorporating progress towards credible resolution regimes and strategies.

In 2015/16, the PRA contributed to the HM Treasury consultation on whether to grant power of direction to the FPC for tools in respect of buy-to-let lending

1–2 www.bankofengland.co.uk/pra/Documents/publications/ar/2016/pra-links.pdf.

The UK banking capital framework aligns firms' resilience standards with their importance to the functioning of the financial system and their provision of critical services to the UK economy through a 'systemic risk buffer' for systemically important firms.

The PRA supported the FPC's work on a policy framework for this capital buffer and worked with the Bank on its design and calibration.

To ensure that the capital framework can deliver its objectives, the PRA is considering ways to mitigate the potential for residential mortgage risk weights to vary procyclically over the economic cycle. And the PRA is also pursuing reforms internationally at the BCBS to address deficiencies in the measurement of risk weights.

The PRA also contributed to a review into the interaction of capital buffers which fed into the FPC's decision on the setting of the countercyclical capital buffer in times when risks are judged to be neither subdued nor elevated. The PRA Board concluded that existing PRA buffers should be reduced to ensure that risks are not double counted.

Cyber and operational resilience

With technological advances, operational resilience has become ever more important in the financial sector. Substantial technological failure or operational disruption represents a key risk to individual institutions and a potential threat to the overall stability of the financial system. The Bank is currently considering its approach to firm and sector operational resilience.

In the meantime the PRA has continued to address operational risk issues with firms as part of its general supervisory approach. The Bank has continued its programme of testing cyber security using the new CBEST framework for testing cyber vulnerabilities, and has been working with the FCA to review the progress of major UK retail firms to improve their management of critical infrastructure and technology risk.

Being smarter with data

The PRA has continued to work with the rest of the Bank on the implementation of a Bank-wide data strategy. The strategy covers the entire lifecycle of data and the PRA has focused on two issues:

i) specifying the supervisory, risk and policy questions that the PRA needs to answer and the information required to help to answer them; and
ii) making effective use of the available data.

To address the first issue, the PRA continued its ongoing stocktake of data requirements from banks, building societies and designated investment firms. It involves all supervision areas, risk specialists, policy experts and financial stability staff in the Bank.

Based on this stocktake, the PRA consulted on proposals to:

- make the reporting of balance sheet and profit or loss information more consistent with financial reporting templates as specified by the EBA;
- collect forecast information on key elements of balance sheet and profit or loss; and
- formalise the reporting of forecast capital resources through a PRA rule.

The PRA also invited responses on potential further amendments to PRA regulatory returns when the new IFRS 9 is introduced and proposed to discontinue several existing reporting forms.

To address the second issue, the PRA is improving the tools available to supervisors so that the data collected can be used more effectively and efficiently in forward-looking analysis.

To ensure that the capital framework can deliver its objectives, the PRA is considering ways to mitigate the potential for residential mortgage risk weights to vary procyclically over the economic cycle

Climate change and financial stability

Under the UK Climate Change Act 2008, the Prudential Regulation Authority (PRA) received an invitation from the Department for Environment, Food & Rural Affairs (Defra) to submit a Climate Change Adaptation Report. The PRA report to Defra[1] indicated that there were three broad channels in which climate change could affect financial stability:

i) physical risks: the impacts today on insurance liabilities and the value of financial assets that arise from climate and weather-related events, such as floods and storms that damage property or disrupt trade;

ii) liability risks: the impacts that could arise tomorrow if parties who have suffered loss or damage from the effects of climate change seek compensation from those they hold responsible; and

iii) transition risks: the financial risks which could result from the process of adjustment towards a lower-carbon economy.

On 29 September 2015, the Governor delivered a speech at Lloyd's of London[2] which highlighted that the effects of climate change have already been felt by the industry. Since the 1980s the number of registered weather-related loss events has tripled and inflation-adjusted insurance losses from these events have increased from an annual average of around US$10 billion in the 1980s to around US$50 billion over the past decade.

The Governor warned that the combination of the weight of scientific evidence and the dynamics of the financial system suggest that, in the fullness of time, climate change will threaten financial resilience and longer-term prosperity.

1–2 www.bankofengland.co.uk/pra/Documents/publications/ar/2016/pra-links.pdf.

Business aim 5: Ensure that the PRA has the right people, infrastructure and governance to deliver its strategy

Ensure robust IT infrastructure

The PRA continues to work very closely with the Bank's Technology directorate to ensure that it has the best IT infrastructure to achieve the Bank's mission. This includes continuing to work with the FCA on shared technology services, and setting out options for future investment, including new systems and services that will help the PRA improve supervisory processes. The PRA is currently setting out its Operational and Data strategy from which the future IT needs will be established, aligned with the One Bank Data Architecture programme. Services successfully delivered in 2015 to support CRD IV and Solvency II are now moving into a regular operational model.

Review of the PRA's target operating model

In order to continue its commitment to provide value for money, and be able to respond swiftly to changes in the wider regulatory environment, the PRA must ensure that it is operating as efficiently and effectively as possible. In 2015 the PRA undertook a review of its ways of working compared to the target operating model set out before the PRA was created, the approaches taken by some of its regulatory peers, and against the backdrop of the current regulatory environment.

The overarching conclusion of the review was that the PRA's current operating model supports the organisation in achieving its statutory objectives and facilitates good supervisory outcomes, but there are some potential areas for improvement to be delivered in the medium term. These include further enhancing the PRA's IT, data and analytics capability; strengthening supervisory controls and assurance through enhanced management information; refining the practical application of the PRA's supervisory approach to increase its effectiveness; and ensuring that the operational support provided to front-line supervision remains aligned to the evolving needs of the organisation. Initiatives to deliver these improvements are underway, to ensure the PRA continues to operate efficiently and effectively.

Develop the control and assurance framework

In 2015, the PRA reviewed in detail the control and assurance framework around its approach to risk, as part of a wider review of the PRA's operating model. Reviews of such frameworks are essential in ensuring that the PRA continues to have robust checks and processes in place, and that they remain appropriate to support the delivery of the PRA's objectives. As part of this review, the PRA identified some areas for further improvement in management information and frontline controls, and have begun work to strengthen these.

Communications: supporting the PRA's objectives

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

In the 2015/16 financial year the PRA has:

- Updated its approach documents, for both banking and insurance, to reflect how supervision will be delivered in the changing regulatory landscape — including the introduction of Solvency II on 1 January 2016.
- Launched the joint PRA/FCA New Bank Start-up Unit, with information and materials available on the website, with a dedicated helpline and email address for newly authorised banks and those thinking of becoming a new bank in the United Kingdom. The Unit also issued invitations to a seminar held on 22 March 2016.
- Created new dedicated webpages for two key initiatives: (i) Strengthening Accountability; and (ii) Structural Reform. These webpages aim to provide all relevant information in one place on policy and implementation. The PRA continues to provide updates on Solvency II and CRD IV. It has also made improvements to the PRA webpages to assist access and use.
- Published a number of policy documents across the range of its policy development work — including policy aligned with other areas of the Bank and the FCA. It has also published 25 letters and 9 other publications, including the PRA *Climate Change Adaptation Report*[1] in September 2015, and the PRA/FCA Review into the failure of HBOS.[2]

2015/16 policy publications[3]

45 Consultation Papers

40 Policy Statements

69 Supervisory Statements

9 Statements of Policy

1–2 www.bankofengland.co.uk/pra/Documents/publications/ar/2016/pra-links.pdf.

3 For definition of different types of policy publications see www.bankofengland.co.uk/pra/Documents/publications/ar/2016/pra-links.pdf.

In addition to the written word, the PRA has also continued its engagement with firms and other industry participants. It has hosted briefings, and provided speakers and panellists for a number of events hosted by others, including the FCA, overseas counterparts, trade and professional bodies. This has provided a valuable insight and enhanced the PRA's understanding of prevalent issues and the implications of regulatory policy and supervision.

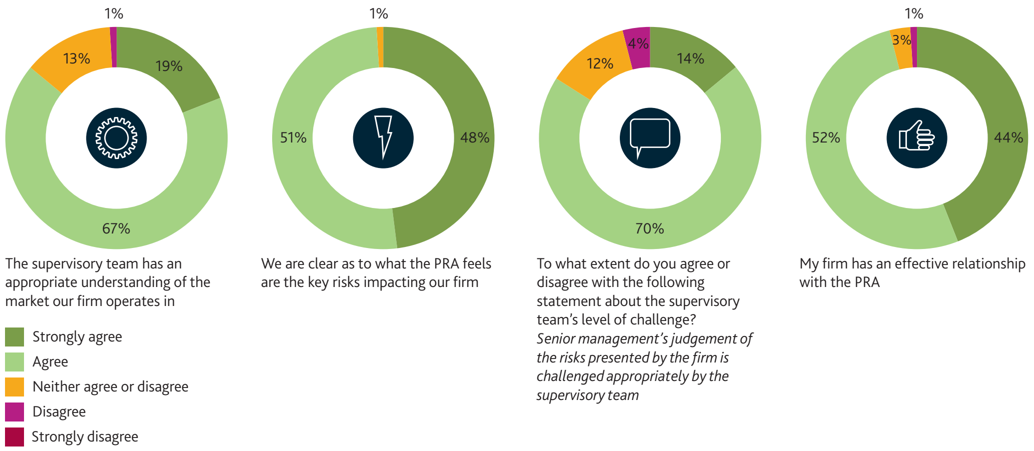
Firm feedback

The PRA asks firms to complete an annual feedback survey. Over the course of the year 69 firms completed the survey and 33 have had a follow-up meeting to discuss the outputs. This process is overseen by the PRA's Supervisory Oversight Function and the meetings are chaired by senior advisors so that independence is maintained. Overall, the feedback suggests that the majority of respondents have a positive view of the PRA (96% of respondents either agreed or strongly agreed that they have an effective relationship with the PRA). Where the survey results are less favourable, the PRA carries out an internal review of the relevant areas.

Figure 3 shows a selection of the survey results reflecting the type of issues on which the PRA sought opinion. The full results are available on the PRA's website.[1]

Overall, the feedback suggests that the majority of respondents have a positive view of the PRA

Figure 3: Selection of firm feedback survey results 2015/16



1 www.bankofengland.co.uk/pra/Documents/publications/ar/2016/pra-links.pdf.

PRA people: our staff

The Bank's greatest asset is the people who work for it.

The ability to recruit high-quality people in a range of disciplines and with the right technical expertise was identified as a risk in last year's PRA *Annual Report*. This has been addressed through the development of strategic recruitment campaigns that run twice a year. Once within the PRA, internal training ensures people are appropriately skilled for their roles.

The Bank offers a range of training frameworks and courses to meet the needs of staff at all stages of their career. These include frameworks to support development of core business skills, IT skills, management skills, supervisory development training and technical skills on central banking and financial regulation.

The PRA, as part of the Bank, holds itself to the highest standards of ethics and conduct. Details of the Bank's corporate social responsibility, including detailed work on diversity, can be found in the Bank's *Annual Report*.

Central Bank Qualification

The Bank is working with Warwick Business School to create a suite of tailor-made postgraduate qualifications in central banking, including a Master of Science and a Master of Research degree awarded by Warwick University. Further details can be found the Bank's *Annual Report*.

Engagement

In 2015, the Bank ran a staff survey — 'Viewpoint' — to receive feedback on making the Bank a more effective and better place to work.

Following these results, the Bank put in place a number of central initiatives to further engage and enable its workforce. The PRA agreed some supplementary actions having considered its specific results:

- **Flexible working** is now further promoted, with divisions discussing what works well and how flexible working can operate successfully at a local level.
- **Encouragement** for opportunities to review and streamline the process in some areas of **decision-making** within the PRA.
- **Reprioritisation of system improvements** will ensure business critical systems are improved in the near future.

Financial Conduct Authority: effective regular co-ordination

The PRA continued to co-ordinate, where appropriate, with the FCA across a range of supervisory and policy matters. The PRA and FCA assess their performance against the statutory PRA-FCA MoU on a quarterly basis. Over the reporting period co-ordination remained strong with any material failures of co-ordination being remediated at the earliest opportunity. In addition the FCA and PRA continue to recognise that with differing objectives and responsibilities, it may sometimes be appropriate to take divergent approaches.

PRA Staff 2015/16

1,267
Total staff (increase of 128)

258
Recruited from the external market (155 into supervision teams)

17.4%
Moved roles across the organisation

9
Senior appointments made

8.9%
Turnover (reduced from 10.6%)

43%
Female

20%
BAME

The regulators have co-ordinated effectively on policy issues such as the Senior Managers Regime, structural reform (ring-fencing of banks) and remuneration, and maintain good relationships at a working and management level. Co-ordination between supervisory, authorisation and specialist teams in both the FCA and PRA has seen an improvement over the reporting period and no material breaches of the MoU have been reported.

Both regulators continue to review the shared FSA IT legacy systems to ensure both organisations have systems which meet their individual needs while supporting a collaborative approach to sharing information.

During 2016 the wording of the MoU will be updated to reflect a number of changes, including the FCA's concurrent competition powers, the Senior Managers Regimes, and changes required as a result of the Bank of England and Financial Services Act 2016. The revised text will need to be discussed and agreed by the Boards of each regulator, communicated to HM Treasury and put before Parliament before being published.

PRA Strategic Report: Business Plan 2016/17

This section sets out the key initiatives that the PRA is planning on taking forward over the coming year to advance its statutory objectives and meet the strategic priorities outlined earlier in the *Report* (page 21).

This plan was developed before the referendum on 23 June 2016, which decided that the United Kingdom will leave the European Union. The PRA continues, together with the wider Bank, to consider the implications of this decision on its strategy and business plan.

Business aim 1: Continue to develop and implement the forward-looking judgement-based supervisory regime

Appropriate quantity and quality of capital in the banking sector:

i) **enhancing the PRA medium-term stress-testing framework**
The annual stress test continues to be a vital component of capital setting for systemically important banks and building societies. This year, a new annual cyclical scenario framework has been introduced, (see Box 2 on page 25) where the stress severity is systematically related to the FPC's assessment of risk levels across markets and regions. Alongside this, the PRA is committed to continuing to enhance its analytical capability, which supports its judgement-based supervisory approach. Over the coming year, the PRA will also work with internal and external stakeholders to improve stress-testing processes and data requirements and support improvements in firms' stress-testing capabilities and analysis.

ii) **the EBA 2016 stress-testing exercise**
The EBA launched its 2016 stress-test methodology and macroeconomic scenarios on 24 February 2016. The stress test is designed to provide supervisors, banks and other market participants with a common analytical framework to consistently compare and assess the resilience of EU banks to macroeconomic shocks. Key features of the scenarios include the common methodology which assesses solvency across all main risk types and the adverse scenario, designed by the ESRB, which reflects four systemic risks that represent the most material threats to the stability of the EU banking sector.

In finalising the EBA 2016 methodology, the PRA has played an active role in its design with a particular focus on market risk and conduct risk.

In the 2016 EBA exercise, UK banks participation (Barclays, HSBC, Lloyds and RBS) remains unchanged from 2014, but the overall sample of banks participating from across the EU has reduced from around 120 to 53 banks.

Appropriate quantity and quality of capital in the insurance sector — the EIOPA 2016 stress-testing exercise

EIOPA has announced its plan to hold European-wide stress tests in 2016. The stress test will include a quantitative and qualitative exercise aimed at assessing the resilience and vulnerabilities of the EU insurance sector to a combination of adverse market risk scenarios in a persistently low interest rate environment. The exercise will target those firms most vulnerable to these types of stress.

The annual stress test continues to be a vital component of capital setting for systemically important banks and building societies

The PRA has contributed to the development of the EIOPA stress tests. The shocks will encompass one event based on a low interest rate environment scenario (stressing currency swap yield curves at all maturities) and a second based on a snapback scenario (using an unusual reverse shock interest rate curve with an upward shock for short term maturities and a downward shock for mid to long-term maturities). Both scenarios will be modelled by firms as one-off instantaneous shocks to their balance sheet. The exercise will be conducted from May-November and the results will be published by EIOPA in December 2016.

Recovery and Resolution — further implementation of the BRRD and development of solvent wind down plans for international banks

The PRA is working with the Resolution Directorate on the Bank's approach to implementing the BRRD's MREL for firms. Part of this work is supporting the Bank on the development of its MREL policy and developing policy on the relationship between MREL, threshold conditions and buffers. Supervisors will continue to review recovery plan submissions prepared under the standards set out in the BRRD.

In 2015 the largest international investment banks submitted the first iteration of solvent wind down plans for their UK activities. These plans show how the banks would wind down their balance sheets in normal market conditions, and would assist the authorities if there was the need to resolve a bank with a large trading book. The PRA will work with firms over the next few years to improve their methodologies for calculating exit costs and introduce more stressed environments to make the plans more useable in a range of scenarios.

For insurers, we will continue to work at a domestic and international level to review, assess and enhance the resolution arrangements.

Implementation of the PRA's approach to branches and subsidiaries of international banks

Internationally headquartered banks can operate in the United Kingdom either as subsidiaries or as branches, and the PRA has a clear framework that takes into account the different legal requirements for the types of firm it supervises. The PRA will continue to clarify its supervisory approach to overseas firms and its expectations of how these firms should operate in the United Kingdom.

The strategy for branches will continue to be implemented as set out in Supervisory Statement 10/14.[1]

Discussions with firms, and relevant home state supervisors, are taking place where branches undertake activities that are outside the PRA's risk appetite.

The PRA is also planning to set out its approach to the supervision of UK subsidiaries of overseas banking groups, to expand on the relevant section in the PRA's approach to banking supervision.[2] This will be accompanied by a statement of expectations around the booking arrangements of firms that undertake large scale trading business in the United Kingdom, including principles relating to good risk management.

Continue to embed Solvency II within the PRA's approach to insurance supervision

Solvency II introduced harmonised standards for insurers across the EU, including requirements for risk-based capital, governance, risk management and disclosure. Although the directive introduces a number of new concepts and tools, it is consistent with the fundamental principles of the PRA's

In 2015 the largest international investment banks submitted the first iteration of solvent wind down plans for their UK activities

1–2 www.bankofengland.co.uk/pra/Documents/publications/ar/2016/pra-links.pdf.

judgement-based and forward-looking supervisory approach. Solvency II requirements have been implemented by making modifications to the PRA supervisory approach reissued in March 2016 and adjusting the internal guidance, training and supervisory tools used by supervisors and actuarial specialists from 1 January 2016. Throughout the next year, the PRA will focus on embedding these changes.

The PRA will continue working with firms following the implementation of Solvency II. In particular, the PRA recently published a Supervisory Statement[1] considering the recalculation of the transitional measure on technical provisions and will finalise its policy for the change process for approved internal models. Furthermore, following its previous indication of its intention to begin a review of equity release mortgages (ERMs) in its 6 November 2015 Solvency II Directors' update,[2] the PRA published a Discussion Paper asking for views on ERM valuation, capital treatment, risk management and associated matters and seeking a range of views on good practices for managing the risks introduced by investing in ERMs. The PRA will proceed to a Consultation Paper if the analysis of responses to the Discussion Paper demonstrates that changes to the supervisory approach are warranted. The PRA will also continue to monitor the ongoing compliance with Solvency II requirements, to finalise its monitoring process and assess applications submitted by firms.

Clear management accountability

Improving standards of governance and management of PRA-supervised firms will continue to be a key priority for supervisors. This work is closely aligned with implementation of the Senior Managers Regime and the Senior Insurance Managers Regime, which came into effect in March 2016. As noted under business aim 3, the Government has indicated that it intends to extend the SMR to a wider scope of financial institutions, including insurers. Through 2016/17 the PRA will continue to develop its supervisory approach to governance to ensure it is consistent with and complements this regime.

Operational resilience within the financial sector

Operational resilience of systems supporting critical functions has become ever more important in the financial sector with improvements in technology. Substantial technological failure or operational disruption represents a key risk to individual institutions and a potential threat to the overall stability of the financial system. Much has been done since the financial crisis to improve the financial resilience of the sector, and it is appropriate that increasing attention should now be paid to improving identification, understanding and mitigation of operational risks to enhance operational resilience. The Bank is currently considering its approach to firm and sector operational resilience.

Within the PRA the focus is on identification of operational risk issues as part of its general supervisory approach, and the PRA has been working with the FCA to review the progress of major UK retail firms to improve their management of critical infrastructure and technology risk. This involves conducting firm specific reviews, along with a small number of focused cross-firm IT risk reviews to assess the effectiveness of firms' management of key IT risks. Assessments in 2016 will include forming judgements on IT strategic plans and the ability of firms to deliver strategic IT change. The Bank continues its programme of testing cyber security using the CBEST framework.

Improving standards of governance and management of PRA-supervised firms will continue to be a key priority for supervisors

1–2 www.bankofengland.co.uk/pra/Documents/publications/ar/2016/pra-links.pdf.

Competition

The *Annual Competition Report* has been published alongside the PRA's *Annual Report*. It sets out examples of where the SCO is expected to inform the work of the PRA in 2016/17. For example, the PRA recognises the potential impact on competition of too wide a gap between standardised and internally modelled capital requirements for prime mortgages and will seek to address this with its international stakeholders.

Although good progress has been made, the PRA recognises there is more to be done to embed the SCO into the PRA's work and to communicate its approach to the SCO both internally and externally.

The *Annual Competition Report* is an important first step in this regard.

Business aim 2: Support the Bank in delivering its financial stability and monetary policy objectives

Appropriate quantity and quality of capital in the banking sector

The FPC finalised its assessment of the overall calibration of the capital framework for the UK banking system in the December 2015 *Financial Stability Report* and its framework for the systemic risk buffer for ring-fenced banks and large building societies in May 2016.[1] Over the coming year the PRA will set out its approach to implementing the systemic risk buffer — including how it will apply the FPC framework — when the PRA's powers under HM Treasury's regulations come into force. The PRA will consider the Recommendation issued to it by the FPC. More broadly, the PRA will also support the Bank's work, as necessary, for the Inquiry announced by the Treasury Select Committee in April 2016 on capital standards for UK banks.

One issue identified by the FPC from the 2014 annual stress test was procyclicality of risk weights generated by some mortgage credit risk internal models. The PRA will take steps to reduce this cyclicality by setting expectations that will lead to more consistent modelling approaches across firms.

Over the coming year the PRA will set out its approach to implementing the systemic risk buffer

1 www.bankofengland.co.uk/pra/Documents/publications/ar/2016/pra-links.pdf.

Upcoming policy consultations 2016/17	Q1 Mar–May	Q2 Jun–Aug	Q3 Sep–Nov	Q4 Dec–Feb
Underwriting standards for buy-to-let mortgage contracts				
Supervising building societies' treasury and lending activities				
Revising the Pillar 2 Liquidity Regime for banks				
Regulatory reporting of financial statements, forecast capital data and IFRS 9 requirements				
Solvency II: further guidance				
Structural reform: further proposals on ring-fencing				
Operational continuity in resolution: reporting				
The PRA's approach to supervising overseas bank subsidiaries				
Delivering accountability: amendments to the Senior Managers' and Certification Regime; and extension of the regime to insurers				

Housing market risks

The PRA will also support the FPC in its review of risks in the housing market, in particular, its annual review of the FPC Recommendation for owner-occupied lending and monitoring risks from the UK buy-to-let market. In addition, HM Treasury has consulted on giving powers of direction to the FPC on buy-to-let lending and the PRA will support the FPC in its consideration of the use of such powers if approved by Parliament.

FPC review of market liquidity

The FPC is reviewing the liquidity of dealer-intermediated markets. The FPC judged that some market developments warranted careful review and consideration of whether there were any possible refinements to internationally agreed post-crisis regulations that could further promote market effectiveness without compromising the resilience of the core of the financial system. The PRA is supporting the FPC in its assessment which will be published later in 2016.

Insurance risks

The PRA will also contribute to the FPC's review of risks in the insurance sector. The review will cover a number of different risks including procyclicality, substitutability of insurance services and contagion through reinsurers. It will also consider the role of insurers as long-term investors in the real economy.

Business aim 3: Implement changes to domestic, European and international regulation

Appropriate quantity and quality of capital and liquidity in the banking sector

The next year forms part of the transition period to full implementation in 2019 of the framework of capital requirements and buffers under Basel III and the EU Capital Requirements Regulation. The capital conservation buffer is being phased in for all firms and will be offset against existing PRA buffers set by supervisors under Pillar 2. Additional buffers for G-SIBs are being introduced in stages to 2019. Firms will also be subject to countercyclical buffers for the countries in which they operate and PRA supervisors can apply an additional PRA buffer to cover firm-specific risks. The PRA will seek to ensure a smooth transition to the new framework.

The PRA has implemented the FPC's leverage framework requiring major UK banks and building societies to satisfy a minimum leverage ratio of 3%, together with buffers set at 35% of risk-weighted systemic and countercyclical buffers. Over the coming year, the PRA will focus in particular on the implementation of daily-average reporting for the leverage ratio.

The EU Liquidity Coverage Requirement came into effect in October 2015, implementing the international standard for holdings of high-quality buffer assets against liquidity risks. The PRA is working closely with firms and the EBA on transitional issues, such as reporting.

The PRA is considering what liquidity requirements it should set to complement the LCR as part of a Pillar 2 framework for liquidity: for example, to capture liquidity risks not included in the LCR measure. The first of two planned Consultation Papers on the Pillar 2 framework for liquidity was published in May 2016 with the second expected to be published in 2017.

The PRA is considering what liquidity requirements it should set to complement the LCR as part of a Pillar 2 framework for liquidity

Structural reform

Large UK banks are due to ring-fence their core UK services by 2019, as required by amendments to FSMA under the Financial Services (Banking Reform) Act 2013 (the Act). The Act's objectives are to insulate ring-fenced banks from international or investment banking shocks, to minimise the risk of disruption to the provision of core services, and to facilitate orderly resolution of ring-fenced banks. The PRA is required to make rules to implement ring-fencing. A second ring-fencing Policy Statement is planned for mid-2016, which will cover primarily the financial elements of the ring-fence following consultation. Firms will then have the key information they need to finalise their restructuring plans. The PRA plans a final Consultation Paper in the summer focused on reporting requirements for ring-fenced banks.

Banks have submitted plans to the PRA setting out how they intend to separate their activities inside and outside the ring-fence. Supervisors are reviewing these plans.

Clear management accountability in banking and insurance

The SMR and SIMR came into force on 7 March 2016. These require firms to allocate key responsibilities to senior managers and to regularly assess their fitness and propriety. They are complemented by the Certification Regime for banking firms, which requires firms to assess the fitness and propriety of employees who could pose a risk of significant harm to the firm or any of its customers.

The Bank of England and Financial Services Act 2016 amends aspects of the SMR for banking sector firms and extends it to all firms approved under FSMA. The PRA has made progress towards the extension of the SMR to insurers through the introduction of the SIMR and will consult on further rules.

The Act also introduces a 'duty of responsibility', superseding the 'presumption of responsibility', which obliges individuals to ensure that they take reasonable steps to prevent regulatory breaches in the areas of the firm for which they are responsible. It also allows the PRA and FCA to apply conduct rules to all executive and non-executive directors regardless of whether they are in scope of the SMR/SIMR or employees of the firm.

On remuneration, the PRA will finalise rules to enable buy-outs to be subject to malus and clawback in banking. It will also publish a Supervisory Statement on its expectations of insurance firms in implementing the Solvency II remuneration requirements.

The PRA will continue to support the work of the FSB in addressing misconduct risk. Its Compensation Group is examining the effectiveness of compensation tools such as malus and clawback and, if appropriate, the group will make recommendations on better practice. A working group will also be established with a view to exchange good practice on the use of governance frameworks and to develop supervisory guidelines.

Expected loss provisioning

The introduction of IFRS 9 in 2018 will bring a change from provisioning for incurred losses to provisioning for expected losses, with firms required to make provisions against twelve months expected losses moving to lifetime expected losses if exposures have experienced a significant increase in credit risk. The PRA is working with firms, auditors and global accounting and auditing standard setters to ensure an orderly transition and that firms take prudent and consistent approaches to implementation. For example, the PRA is engaging with colleagues at the EBA on guidelines based on the BCBS 'Guidance on credit risk and accounting for expected credit losses'.[1]

The PRA is engaging in the BCBS and EU to ensure that the bank capital framework is adjusted as necessary in response to the different approach to provisioning. One concern is that the impact on capital ratios may be greater for firms on the standardised rather than internal ratings based approach for credit risk. The PRA is also working to

The PRA has made progress towards the extension of the SMR to insurers through the introduction of the SIMR and will consult on further rules

1 www.bankofengland.co.uk/pra/Documents/publications/ar/2016/pra-links.pdf.

understand the impact of IFRS 9 on its stress testing, Pillar 2, capital planning and data.

Business aim 4: Continue to devise and influence the domestic and international policy agenda

International capital standards for banks

The BCBS is seeking to finalise its post-crisis reforms to bank capital standards by the end of 2016. These reforms mainly concern measurement of risk for the purpose of setting risk-weighted capital requirements. The BCBS is consulting on: the role of internal models for credit risk measurement; possible floors on credit risk model inputs such as probability of default; revisions to the standardised approach for credit risk measurement; the possibility of setting floors for capital requirements based on standardised approaches; and a new approach for measuring operational risk. Data is being collected from banks internationally to quantify the impact of these proposals. The PRA will support the BCBS in delivering on the commitment by the Governors and Heads of Supervision to not significantly raise overall capital requirements.

Alongside these reforms, the BCBS is seeking to finalise a minimum standard for the leverage ratio, including additional buffers for G-SIBs, and decide its capital standard for simple transparent and comparable (STC) securitisations.

International insurance capital standards

The IAIS continues to work towards an insurance capital standard (ICS). The PRA is actively involved in shaping the open technical issues in the development of this framework.

EU legislation on securitisation

The PRA will continue to support the EU legislation to implement simple, transparent and standardised (STS) securitisation, including reforms to capital requirements for banks and insurers. This legislative proposal is currently in the European Parliament following agreement of a position in the EU Council in late 2015.

Future EU banking and insurance legislation

The PRA supports the initiative by the European Commission to develop a legislative proposal to implement remaining post-crisis banking reforms agreed internationally into EU law. These reforms include the leverage ratio, NSFR and the revised market risk framework. New legislation might also address areas where the regulatory framework is not working fully as intended and amendments are needed. The Bank also responded in January to the Commission's *Call for evidence on the EU regulatory framework for financial services*[1] setting out its initial views (see Box 7 on page 53 for details on areas highlighted in the Bank's response).

One particular area is development of proportionate approaches to regulation of banks of different sizes and business models. In particular, the PRA is considering whether the prudential requirements in CRD IV can be applied more proportionately in areas such as regulatory reporting, disclosure, credit risk, and the NSFR.

This work builds on the PRA's submission to the European Commission consultation on the impact of CRD IV, published on 9 November 2015.[2]

In addition, the PRA is preparing for several reviews within the EU on the Solvency II Directive. Key areas include: improving incentives for stable, long-term investment; maintaining a resilient insurance sector; and ensuring consistent application across the EU.

The PRA will continue to support the EU legislation to implement simple, transparent and standardised securitisation

1–2 www.bankofengland.co.uk/pra/Documents/publications/ar/2016/pra-links.pdf.

Figure 4: Key policy initiatives, by intended date of policy finalisation

This diagram highlights some of the major policy work streams that will support the delivery of the PRA's strategy by the intended publication date of the main policy proposals. This includes BCBS, EU and domestic initiatives. Dates may be subject to revision.

Box 7: The PRA policy pipeline beyond the next twelve months

Since the financial crisis the regulatory framework for banks and insurers has been transformed. In general, the work to design new standards is nearing completion and is now moving into the phase of full implementation. Over the coming years, banks will need to meet new requirements to hold additional capital buffers under CRD IV, liquidity requirements under the Liquidity Coverage Requirement and new standards on the calculation of risk-weighted assets. Work is also ongoing to implement UK policy priorities including: i) finalising and implementing ring-fencing and ii) supporting the FPC in its policy consideration of the capital framework, the resilience of market-based finance and risks from the housing market.

For insurance, the PRA will continue to contribute to international work to develop a Common Supervisory Framework and within it an Insurance Capital Standard (ICS) for International Active Insurance Groups with a view to developing comparable and more consistent standards for the supervision of large and internationally active insurance companies. The PRA will also continue to contribute to international work on assessing and mitigating risks from the insurance sector to financial stability

Work is also underway to review whether existing regulation gives rise to unintended consequences on markets and, where it does, consider appropriate solutions. This work builds partially on the Bank's response to the European Commission's *Call for evidence on the EU regulatory framework for financial services.*[1] The review focuses on areas where the reforms are not working as intended, or there are inconsistencies.

Some of the areas highlighted by the Bank for further work include:

- developing a more proportionate approach for aspects of bank regulation;
- improving the incentives for stable, long-term investment under Solvency II;
- ensuring bank capital buffers can be used in stress;
- developing the securitisation framework to help diversify funding sources and unlock capital for lending;
- supporting the leverage ratio while addressing any unintended consequences arising from the inclusion of client clearing and central bank reserves; and
- maintaining the CRR macroprudential framework and considering the desirability of introducing macroprudential tools into Solvency II.

Finally, the PRA is supporting the work of the Financial Stability Board on addressing misconduct risks as it:

- establishes a working group to exchange good practice on the use of governance frameworks, with a view to developing guidelines; and
- examines the effectiveness of compensation tools such as malus and clawback, and if appropriate make recommendations on better practice.

1 www.bankofengland.co.uk/pra/Documents/publications/ar/2016/pra-links.pdf.

Business aim 5: Ensure the PRA has the right people, infrastructure and governance to deliver its strategy

Establish the Prudential Regulation Committee

Following commencement of the Bank of England and Financial Services Act 2016, the PRA will cease to be a subsidiary and will become part of the legal entity of the Bank. Policymaking decisions that were made by the PRA Board will be made by the Prudential Regulation Committee (PRC). Within the coming year the PRA will ensure a smooth transition from PRA Board to PRC and work with other areas of the Bank to wind down the PRA subsidiary.

Establish an independent enforcement decision-making committee

In December 2014, HM Treasury published the outcome of its review of enforcement decision-making at the financial services regulators.[1] The review made a number of recommendations to the PRA, including that it should establish a functionally independent enforcement decision-making process. On 14 April 2016, the PRA published a joint Consultation Paper with the FCA in which the Regulators made a number of proposals in respect of improving the understanding of the enforcement process.[2] The PRA plans to consult later this year on the remainder of HM Treasury's recommendations, including the establishment of a functionally independent enforcement decision-making process.

Focus on developing and implementing the plan for PRA IT, specifically: improving management information on the PRA's assessment of firms; use of outsourced services; and improved data analytical tools

The PRA will continue to ensure it has robust IT infrastructure and data systems, as part of the Bank's overall operational architecture. Over the coming year the PRA will focus on improving the use of management information on its assessment of firms; use of cloud services within regulated institutions; and improved data analytical tools in particular.

Develop and implement an improved control and assurance framework

In 2016 the PRA will continue its work to improve frontline controls and management information, to ensure these are more closely aligned to supervisory priorities and the core supervisory activities undertaken across all regulated firms on a periodic basis.

Risks to delivering the Business Plan

There are of course risks to the delivery of the Business Plan. These risks are monitored, actively mitigated against (where possible), managed, and reported to the PRA Board and Executive Committee on a regular basis.

Unforeseen events

The nature of the PRA's environment means it deals with unforeseen events that may arise internationally and domestically and which require a swift regulatory response. Depending on the scale and nature of these events, they can lead to significant re-prioritisation of Business Plan deliverables. Following the recent UK decision to leave the European Union, the PRA will work with the wider Bank to consider the impact of this on deliverables.

In 2016 the PRA will continue its work to improve frontline controls and management information

1–2 www.bankofengland.co.uk/pra/Documents/publications/ar/2016/pra-links.pdf.

The crystallisation of risks within firms can place additional constraints on the delivery of day-to-day supervisory activity, possibly impacting on the safety and soundness of firms, and may lead to re-prioritisation of deliverables.

Any adverse change in the economic environment, or other changes within or outside the United Kingdom, may impact the safety or soundness of firms. While recovery and resolution planning and stress testing will reduce the impact of firm failure on financial stability, a large and wide-ranging shock that impacts financial stability remains a clear risk. The Bank's *Financial Stability Report* provides the FPC's and wider Bank view of the current stability of the UK financial system and areas of risk.

Execution risk

The PRA will be managing an extensive landscape of regulatory and legislative change over the next five years and this will place additional constraint on resources which may compromise its ability to carry out its obligations as planned. Key changes that may affect frontline activity include structural reform, stress testing, BRRD, and the PRA's competition objective.

Dependencies

The PRA is reliant on the FCA for the provision of certain IT systems and any degradation of service will impact on the PRA's ability to deliver its obligations. The FCA provides upgrades and fixes to ensure a maintained service.

PRA policymaking is often dependent on overseas authorities who lead on timings and requirements for delivery of legislative and regulatory change. For example, the PRA is dependent on the European Commission's timeline for implementing changes to the Basel accord relating to regulation of trading books. The outcome of international policy negotiation could also differ from current PRA and Bank objectives which, in certain circumstances, could weaken the PRA's current approach. Maintaining external policy relationships is key in ensuring that new policy requirements are in the best interest of providing safety, soundness and financial stability to the United Kingdom and ultimately meet the PRA's statutory objectives.

Internal factors

Insufficient resources in terms of skills, experience and capacity may lead to staff stretch, a failure to deliver the Business Plan to the required standard or a need to re-prioritise planned deliverables.

The PRA needs to be able to recruit high-quality people in a range of disciplines and with the right technical expertise; this is critical to the delivery of work streams such as structural reform and stress testing where expert technical knowledge is required. Furthermore, an increase in demand for specialist staff across a range of disciplines, from resolution experts to IT specialists, places stretch on these staff and presents a risk that some activities are deprioritised or delayed if the specialist resource is not available to deliver them.

The PRA also needs to be able to retain staff through appropriate terms and conditions, training, and development opportunities. The PRA has faced an increase in market demand for expertise, and consequently retention of staff remains challenging. In areas of the PRA where there has been an influx of new staff this reduces the overall experience of the area and can place additional pressure on more experienced staff. However, turnover within the PRA has continued to reduce and was under 10% by the end of the financial year.

The PRA will be managing an extensive landscape of regulatory and legislative change over the next five years

Measuring progress

The PRA draws on a variety of information to monitor the progress of its delivery against its statutory objectives, strategy and business plan on an ongoing basis.

The PRA Board and the Executive Committee receive regular reports comprising quantitative, qualitative and assurance information, to enable assessment of delivery against the Business Plan and the quality of PRA outputs. The Board periodically draws information from these reports together, with external feedback, to form an overall view of assurance around achievement of the statutory objectives. The PRA's successes in relation to these objectives are generally market sensitive, and not public.

Table 1 provides examples of the sources of information used by the PRA. The measurement framework and metrics largely remain the same year on year.

Table 1: Sample of measures and indicators used to monitor the PRA's performance against its statutory objectives, strategy and business plan

Objective to be assessed	Sources of assurance
Financial stability and protection of policyholders	• the quantity and quality of capital and liquidity held by PRA-regulated firms; • the strength of firms' arrangements for effective management and governance as reflected in supervisory assessments; • the ability of insurance firms to meet claims from and material obligations to policyholders; and • the quality of the PRA's supervisory tools as measured by, for example, the quality of supervisory outputs and internal audit reviews.
The success of the PRA's forward-looking, judgement-based supervisory model	• self and peer reviews — this entails staff assessing their own performance and receiving independent challenge at regular intervals, as well as reviews carried out by other bodies (such as the IMF); • regular review of how firm-specific risks are being managed — these measures cover both the core supervisory judgements (for example, business model analysis, and key risks), the approval of the supervision strategy and execution (that is assurance the supervision strategy is 'on track'); • assessment of the capability of staff to make the right judgement about the course of action to reduce the probability of risks to the statutory objectives through a supervisory competence framework; and • firm feedback and external reviews (for example, IMF's Financial Sector Assessment Programme).
The effectiveness of prudential policy initiatives	• the outcomes from negotiation of European and international policy; • macroprudential policy outcomes; and • feedback on influence in key committees and with overseas regulators and central banks.
Operational performance	• people-related indicators such as length of service of staff, staff turnover and diversity; • quality and performance of information technology systems; and • quarterly review of breaches of the MoU between the PRA and FCA.

Complying with FSMA

This section covers a number of issues that the PRA takes into account when carrying out its duties or has an obligation to report on.

These include:

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

Complying with FSMA

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

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

The PRA takes these principles into consideration when carrying out its functions, including when making policy.

Further, in carrying out its functions during the reporting period, the PRA was required to, so far as is reasonably possible, act in a way which facilitated effective competition in the markets for services offered by PRA-authorised persons in carrying on regulated activities (section 2H(1) of FSMA). There are several examples of how meeting this requirement is achieved on pages 26–27 and 48. The *Annual Competition Report*, published in June 2016, provides further examples of how meeting this requirement has been achieved.

Details of how the PRA has met its general duty to consult (under section 2L of FSMA) can be found on page 41, which also explains how the PRA engages with firms more generally. These arrangements include the establishment and maintenance of the PRA Practitioner Panel (the Panel).[1] The Panel is an independent body representing the interests of the financial services industry. It plays an important role in PRA policymaking by providing appropriate challenge and scrutiny. As well as PRA policies, the Panel also considers items from other directorates within the Bank of England whose policies have a potential prudential impact.

1 www.bankofengland.co.uk/pra/Documents/publications/ar/2016/pra-links.pdf.

In 2015/16 the Panel met eight times and provided the PRA Board and senior management from across the PRA and Bank with feedback on topics including the secondary competition objective, the proportionality of EU financial regulation, the Senior Managers Regime and structural reform.

The PRA and FCA have a duty to ensure a co-ordinated exercise of functions (under section 3D of FSMA) and details of how this has been managed effectively is covered on pages 19 and 43.

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

The PRA is considering how it will meet its new requirement in paragraph 19 of schedule 1ZB of FSMA to report on ring-fenced bodies.

Section 354B of FSMA outlines the PRA's duty to co-operate with other persons who have functions similar to the PRA or have functions relevant to financial stability. Details of how the PRA has complied with this duty is set out on pages 19 and 43.

Regulators' principles and code[1]

The PRA, when exercising its functions, is required to have regard to the following regulators' principles and code.

Regulators' Principles

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

Regulators' Code

- Regulators should carry out their activities in a way that supports those they regulate to comply and grow.
- Regulators should provide simple and straightforward ways to engage with those they regulate and hear their views.
- Regulators should base their regulatory activities on risk.
- Regulators should share information about compliance and risk.
- Regulators should ensure clear information, guidance and advice is available to help those they regulate meet their responsibilities to comply.
- Regulators should ensure that their approach to their regulatory activities is transparent.

PRA's complaints scheme

As part of the statutory Complaints Scheme, the PRA is responsible for ensuring formal complaints against it are dealt with in an efficient and effective manner. During 2015/16 the PRA received nine complaints, one of which was upheld. Of the remaining eight complaints, three were withdrawn by the complainants, one was excluded as it was outside the scope of the Scheme, and the remaining four were investigated but not upheld. The complaint upheld by the PRA related to an inadequate response received by an individual in relation to comments made about regulatory reporting; and following a complaints investigation, the PRA issued an apology to the individual.

The Complaints Commissioner received one complaint about the PRA during the year which challenged the transparency of decision-making by the PRA and requested quantitative rationale for decisions taken. The complaint was investigated by the PRA but not upheld and is currently being considered by the Commissioner.

1 www.bankofengland.co.uk/pra/Documents/publications/ar/2016/pra-links.pdf.

The Complaint Commissioner's Annual Reports can be found on the Office of the Complaints Commissioner website.[1]

Section 166 reports by skilled persons

Section 166 (s166) of FSMA provides a regulatory tool which gives the PRA the powers to obtain an independent expert review of aspects of a firm's activities. Such reviews can be undertaken where the PRA seeks additional information, further analysis, expert advice and recommendations, an assessment, or assurance around a particular subject.

Update to Supervisory Statement 7/14 — 'Reports by skilled persons'

On 30 September 2015 the PRA updated the Supervisory Statement[2] to provide greater clarity on the use of skilled persons in its supervisory approach. The update highlights that the power to commission reports by skilled persons is a discretionary supervisory tool and the use of skilled persons in an enforcement context is extremely rare.

In 2015/16 s166 was used by the PRA in 20 cases (2014/15: 42 cases). Eight (2014/15: eight) were commissioned by the PRA contracting directly with the skilled person. The reviews mainly covered risk management, systems and controls, capital adequacy and governance and culture. The reviews fell within the areas shown in **Table 2**.

The total estimated cost of commissioned s166 reviews was £4.9 million (2014/15: £15.2 million)[3] and the cost per review ranged from £60,000 to £0.6 million (2014/15: £22,500 to £1.8 million). Of this total the cost of the eight commissioned where the PRA contracted directly with the skilled persons is estimated to be £2.0 million (2014/15: eight at a cost of £1.4 million[4]). The costs disclosed include actual costs incurred by the firms or an estimate where actual costs are not yet available.

Meeting with auditors

Pursuant to section 339A(2) of FSMA the PRA must issue and maintain a code of practice which includes arrangements on: (i) the sharing with auditors of PRA-authorised persons of information that the PRA is not prevented from disclosing; and (ii) the exchange of opinions with auditors of PRA-authorised persons. The PRA published the code of practice in April 2013.[5] Pursuant to section 339B of FSMA the PRA must make arrangements for meetings to take place at least once a year between the PRA and the auditor of any PRA-authorised person to which section 339C of FSMA applies.
39 (2014/15: 37) firms fell within the scope of section 339B FSMA during the reporting period and the PRA conducted 54 (2014/15: 69) meetings with the auditors of these firms.

At least one meeting with the auditor of each such firm was held during the reporting period.

Table 2: Section 166 reviews by areas of focus

Lot	Total for 2014/15	Total for 2015/16
Governance, controls and risk frameworks	23	10
Data and IT infrastructure	2	1
Prudential — deposit-takers and recognised clearing houses	6	0
Prudential — insurance	11	9
Total	**42**	**20**

1–2 www.bankofengland.co.uk/pra/Documents/publications/ar/2016/pra-links.pdf.

3 The figure provided is the cost reported in the 2014/15 *Annual Report*. Since its publication all actual costs have become available resulting in a total actual cost of £15 million in 2014/15.

4 £1.1 million of this total estimated cost has been incurred in 2015/16, with the remaining £0.9 million expected to be incurred in 2016/17.

5 www.bankofengland.co.uk/pra/Documents/publications/ar/2016/pra-links.pdf.

The PRA looks to auditors to contribute to effective supervision by directly engaging in the PRA in a proactive and constructive way.

The PRA reports to its Board annually on the quality of the relationship between auditors and supervisors.

In May 2015, it was noted that the relationship was reasonable, but that there was still room for improvement.

By order of the Board

Mr M Carney
Chairman
27 June 2016

Directors' Report

The Directors present their report and the audited financial statements of the Prudential Regulation Authority for the year to 29 February 2016.

Principal activity and future developments

The PRA is a wholly-owned subsidiary of the Bank. It became the United Kingdom's prudential regulator for deposit-takers, insurers and major investment firms, with statutory responsibilities under FSMA, on 1 April 2013. The PRA's regulatory activities during the year are described in the Review of 2015/16 on pages 23–44.

Details of proposed future developments, including changes to the status of the PRA as a subsidiary of the Bank, can be found within the Business Plan section on pages 45–57.

Financial results

The PRA's financial statements for the period to 29 February 2016 are presented on pages 75–90.

Governance

The PRA is required under FSMA to 'have regard to such generally-accepted principles of good corporate governance as it is reasonable to regard as applicable to it'.[1] As a private limited company the PRA is not obliged to comply with the UK Corporate Governance Code (the Code), but the Board considers that the PRA complies with the Code as far as is appropriate to the PRA. The PRA's governance arrangements are described below.

The Board

The PRA is led by its governing body, the Board. FSMA provides that the Governor of the Bank is Chair of the PRA; the Bank's Deputy Governor for Prudential Regulation is the Chief Executive; the Deputy Governor for Financial Stability and the Chief Executive of the Financial Conduct Authority are members of the Board; and that additional members are to be appointed by the Bank's Court of Directors, with the approval of HM Treasury,[2] who may be executive or non-executive. A majority of the Board must be made up of members who are not employed by the PRA or the Bank.

To guide the process of appointing Board members, the Bank's Court has adopted a policy on conflicts of interest. This is published on the Bank's website.[3] The key requirement is that, other than in exceptional circumstances, Board members should have no continuing association with a PRA-regulated firm. Appointed NED members are appointed for renewable terms of three years, though some initial appointments were for shorter periods to stagger rotation.

During the year the Board met 24 times. There were also three joint meetings with the Financial Policy Committee. Attendance at Board meetings is set out in **Table 3** on page 63.

1 Section 3C of FSMA.
2 Paragraph 6 of Schedule 1ZB of FSMA.
3 www.bankofengland.co.uk/pra/Documents/publications/ar/2016/pra-links.pdf.

Table 3: PRA Directors 2015/16

		Date of first appointment	Expiry of current term	Attendance at Board meetings (24)
Mark Carney	*Ex officio*	1 July 2013	30 June 2021	19
Andrew Bailey[a]	*Ex officio*	20 February 2013	31 March 2018	24
Sir Jon Cunliffe	*Ex officio*	1 November 2013	31 October 2018	19
Martin Wheatley[b]	*Ex officio*	20 February 2013	12 September 2015	8/13
Tracey McDermott	*Ex officio*	12 September 2015	–[c]	9/11
David Belsham	Appointed NED	1 May 2015	31 April 2018	20/20
Sandy Boss	Appointed NED	1 September 2014	31 August 2017	24
Norval Bryson	Appointed NED	1 September 2015	31 August 2018	11/12
Iain Cornish	Appointed NED	20 February 2013	Resigned 31 March 2015	1/2
Paul Fisher	Appointed Bank	1 September 2015	1 March 2016	11/12
Charles Randell	Appointed NED	20 February 2013	19 February 2017	22
Dame Minouche Shafik	Appointed Bank[d]	1 September 2014	31 July 2019	22
David Thorburn	Appointed NED	1 September 2015	31 August 2018	12/12
Mark Yallop	Appointed NED	1 December 2014	30 November 2017	23

Board members have declared the following interests, and where these may involve potential conflicts these have been noted and approved by the Board:

Mr Belsham
David Belsham Consulting Ltd

Oakmead Residents Association Limited

Ms Boss
Non-executive director, member of Compensation Committee and Nominating and Governance Committee, Enstar Group.

Mr Bryson
Governor of St Columba's Hospice in Edinburgh

Chairman and Trustee of the University of St Andrews Superannuation & Life Assurance Scheme

Mr Randell
Non-executive director and (from 1 May 2015) Chair of Audit and Risk Committee, Department for Energy and Climate Change

Visiting Fellow in Financial Services Regulation at Queen Mary University of London

Former Partner of Slaughter and May (capital account in course of repayment)

Mr Thorburn
Director of DJT Limited (dormant)

Mr Yallop
Director of Baltic Wharf Limited

Director of Dartmouth Ventures Ltd

Director of Centre for Social Justice (also Chair Audit and Risk Committee)

Partner of TQ9 Partnership LLP

Member of Create the Change Board, The Francis Crick Institute

Chair of Development Board, University College Oxford

Limited Partner, Illuminate Financial Management LLP

Chair of Fixed Income, Currency and Commodities Markets Standards Board (from July 2016)

a It has been announced that Mr Bailey will leave the PRA on 30 June to take up an appointment as Chief Executive of the Financial Conduct Authority.
b In line with para 5 of Schedule 1ZB of FSMA, Mr Wheatley did not attend meetings convened solely to discuss or take decisions about a particular institution or person.
c Ms McDermott is acting Chief Executive of the FCA and her position on the Board will pass to Andrew Bailey on his appointment as Chief Executive of the FCA.
d Dame Minouche Shafik will become an *ex officio* member of the Board following the coming into force of the Bank of England and Financial Services Act 2016.

In addition to statutory functions such as rulemaking, the Board has reserved to itself the making of key decisions in relation to the most significant regulated firms. Matters reserved to the Board include: regulatory policy, strategy and management, recommending the PRA budget to Court and risk management. Other decisions are delegated to the Executive and its committee structure. The Board's delegation matrix is available on the Bank's website.[1]

SMR and SIMR

Following the coming into force of the SMR and SIMR for banks and insurers (page 29), both the PRA and the Bank published details of their own organisations and individual responsibilities in line with the core principles of the SMR/SIMR.[2]

Board effectiveness

During the year the Chairman of the Bank's Court reviewed PRA Board effectiveness, based on a targeted survey and discussions with individual members. Of the areas for improvement identified in the previous review, progress was recognised in recruitment, talent management and IT. There remained concerns about the volume of decisions and papers requiring board approval, and board members welcomed improvements in supervisory management information that would provide better assurance and might enable more delegation. These issues were discussed at an extended board meeting in October, where further measures to provide board members with information on major projects and to make better use of board meetings were agreed.

Regulatory functions and decision-taking

The Board is independently responsible for delivering the PRA's statutory objectives. The PRA pursues its objectives by making policies and rules, supervising authorised firms, giving directions, issuing guidance and carrying out other legislative functions and in doing so acts through its Board. The Board (consulting Court) also sets the PRA's Strategy (see page 21). The Board has delegated some other matters to the PRA's Chief Executive, but has reserved to itself key regulatory decisions relating to the most significant firms.

The Board is supported by a Supervisory Oversight Function, the aim of which is to: assure senior management and the Board on the quality and effectiveness of supervision; promote continuous improvement through the findings and recommendations from its Supervisory Effectiveness Reviews; support supervision and respond to *ad-hoc* requests to conduct reviews; and provide a portfolio-wide view on supervision risk. The Supervisory Oversight Function fulfils this role in a number of ways: by conducting a rolling programme of Supervisory Effectiveness Reviews; high-level analysis of supervisory risk management information; and conducting initial assessments of any potential regulatory failures.

The Bank's IEO, although reporting directly to the Bank's Court, also provides support to the PRA Board. The IEO has conducted an analysis of the PRA's approach to its secondary competition objective,[3] which has been published, and it is planning further reviews in 2016/17.

Accountability

The PRA is required under FSMA to be accountable to stakeholders including the public and practitioners. The PRA consults the public before making rules. Consultation with PRA-authorised persons on general policies and practices is carried out in part through a panel of persons established and maintained by the PRA (the PRA Practitioner Panel) to represent the interests of practitioners. Details of the panel can be found on the Bank's website.[4]

1–4 www.bankofengland.co.uk/pra/Documents/publications/ar/2016/pra-links.pdf.

Management

The PRA's management, personnel, budgetary and financial infrastructure is integrated with the Bank's: the PRA's staff are Bank employees; and common services are provided centrally by the Bank. The PRA's budget is subject to the approval of the Bank's Court, and the Bank has reserved to itself the right to determine remuneration policies, significant changes in the management structure, the most senior appointments, and codes of conduct for staff and Directors. The Bank's Remuneration Committee advises, and the Court or (as appropriate) its Oversight Committee determine, the remuneration of the *ex officio* and the appointed directors of the PRA. The PRA Board receives regular information from the Bank functions on which it relies, including in particular IT, Finance, Internal Audit, and HR.

Risk management

The PRA participates in the Bank's risk management framework. The Bank's Court is responsible for the risk management and internal control systems across the Bank and its subsidiaries. The Bank's risk framework includes risk standards to define the organisation's tolerance of risk, and an incident monitoring system. It is an overarching framework to achieve consistency and transparency in risk management across the Bank and its subsidiaries; it identifies key parties and their roles and responsibilities and risk management policies; it considers strategic risks, financial risks to the Bank's balance sheet and operational risks caused by weaknesses in processes, systems, or through staff and third-party activities.[1]

The PRA Board has put in place robust reporting systems and controls to identify, evaluate and manage risks to the PRA's objectives. The PRA's specific reporting systems and controls include identifying external developments affecting the resilience of regulated institutions as a whole, including the economic environment; competitive pressures and legislative developments in the United Kingdom and internationally; risks arising from interaction with other macroprudential and microprudential regulators, including the FPC, the FCA and international agencies; and risks to the Board's regulatory strategy arising from the regulatory process, the quality of supervision, resource constraints and other operational factors.

The Board's appetite for risk is ultimately determined by the statutory objectives of the PRA and is set out in the PRA's Strategy (on page 21 of this *Report*) and Approach documents. During the year, as part of its review of the PRA's target operating model, the Board has clarified its approach to risks to its objectives, both in terms of tolerance and of continuing monitoring and assessment. Assessments are approved by the Board before being shared with the Bank's risk committees, including Court's Audit and Risk Committee (ARCo), which Board members attend.

Systems and Controls

ARCo assists Court in meeting its responsibilities for an effective system of financial reporting, internal control and risk management. It is responsible for reviewing the findings of internal and external auditors. It is supported by the Bank's internal audit function. The Board participates in ARCo, which is attended by Board members, and in which the PRA's performance and risk profile can be reviewed alongside other parts of the Bank. ARCo also acts as an interface with the National Audit Office, in their role of conducting the audit of the PRA on behalf of the Comptroller and Auditor General.

ARCo makes an annual report on its activities, which is reported in the Bank's *Annual Report*. The PRA is within the scope of the Bank's internal audit function. The Board is consulted on the annual internal audit plan before it is finalised, receives copies of internal audit

1 For further information on the Bank's risk management framework and risk governance, see the Bank's *Annual Report*.

reports relating to the PRA and meets with the Head of Internal Audit on a quarterly basis.

Board remuneration

The PRA Board is appointed under statute and is the governing body of the PRA. Remuneration of appointed members of the Board is determined by the Bank's Remuneration Committee. It is paid by the Bank and the PRA pays consideration to the Bank for the directors' services received. The Bank recharged Mr Bailey's remuneration in full for the year to 29 February 2016. In addition, the Bank received consideration of £442,000 (2014–15: £399,000) for the services provided to the PRA by the Governor, Sir Jon Cunliffe and Dame Minouche Shafik. Their full remuneration is reported in the Bank's *Annual Report*. Mr Wheatley and Ms McDermott received no remuneration from the PRA.

Mr Bailey is a member of the Bank pension fund, but no longer receives pension contributions from the Bank. Included in Mr Bailey's benefits is a 30% salary supplement in lieu of pension contribution.

Board members leaving the PRA are bound by the terms of their contract to accept no new employment that would conflict with their PRA responsibilities for a period of three months, and their fee continues to be paid for that period.

Indemnities

Members of the PRA Board have been indemnified against personal civil liability arising from the carrying out or purported carrying out of their functions, provided they have not acted in bad faith. In addition, under FSMA the PRA and persons acting as members, officers and members of staff of the PRA have immunity from liability in damages.

Other disclosures

HM Treasury

HM Treasury has made a direction under paragraph 22 of Schedule 1ZB of FSMA requiring the PRA to disclose the following:

Fair pay (audited)

The banded remuneration of the highest-paid Director (base salary plus benefits excluding payment in lieu of pension) in the financial year 2016 was £269,926 (2015: £268,126) (salary of £267,946 (2015: £263,986)) as at 29 February 2016 plus non-pension related benefits of £1,980 (2015: £4,140). This was 4.08 (2015: 3.95) times the median remuneration of the workforce, which was £66,139 (2015: £67,952). During 2016, no employees received remuneration in excess of the highest paid Director. Remuneration ranged from £18,578 to £269,926 (2015: £18,578 to £268,126).

Total remuneration includes salary, performance-related pay and other benefits whether monetary or in kind. It does not include severance payments, employer pension contributions and the cash equivalent transfer value of pensions.

Exit packages (audited)

There have been no compulsory redundancies during the year.

There were six exit packages agreed during the year, in the range set out below:

£0–10,000 — 3
£10,001–20,000 — 1
£20,001–30,000 — 1
£30,001–40,000 — 1

Sickness absence

The level of sickness absence within the organisation, calculated as average working days lost per financial year based on the number of full-time equivalent employees, was six days (2015: five days).

Table 4: PRA Board remuneration (audited)

	Mr A J Bailey		Mr Fisher		Mr Cornish		Mr Prettejohn	
	2015/16	2014/15	2015/16	2014/15	2015/16	2014/15	2015/16	2014/15
Base salary	267,946	263,986	103,794	–	34,620	102,326	–	26,762
Salary and fees	**267,946**	**263,986**	**103,794**	**–**	**34,620**	**102,326**	**–**	**26,762**
Taxable benefits	**578**	**2,791**	**6,664**	**–**	**8,118**	**37,750**	**–**	**–**
Payment in lieu of pension	80,384	79,196	42,336	–	–	–	–	–
Pension benefits	**80,384**	**79,196**	**42,336**	**–**	**–**	**–**	**–**	**–**
Other remuneration	1,402	1,349	328	–	–	–	–	–
Total single figure of remuneration	**350,310**	**347,322**	**153,121**	**–**	**42,738**	**140,076**	**–**	**26,762**

	Mrs Gilmore		Mr Randell		Ms Boss		Mr Yallop	
	2015/16	2014/15	2015/16	2014/15	2015/16	2014/15	2015/16	2014/15
Base salary	–	85,272	103,861	102,326	103,861	51,163	103,861	25,582
Salary and fees	**–**	**85,272**	**103,861**	**102,326**	**103,861**	**51,163**	**103,861**	**25,582**
Taxable benefits	**–**	**51**	–	–		–	–	–
Payment in lieu of pension	–	–	–	–	–	–	–	–
Pension benefits	–	–	–	–	–	–	–	–
Other remuneration	–	–	–	–	–	–	–	–
Total single figure of remuneration	**–**	**85,323**	**103,861**	**102,326**	**103,861**	**51,163**	**103,861**	**25,582**

	Mr Belsham		Mr Bryson		Mr Thorburn	
	2015/16	2014/15	2015/16	2014/15	2015/16	2014/15
Base salary	86,551	–	51,931	–	51,931	–
Salary and fees	**86,551**	**–**	**51,931**	**–**	**51,931**	**–**
Taxable benefits	–	–	**32,546**	**–**	**22,973**	–
Payment in lieu of pension	–	–	–	–	–	–
Pension benefits	–	–	**–**	–	–	–
Other remuneration	–	–	–	–	–	–
Total single figure of remuneration	**86,551**	**–**	**84,477**	**–**	**74,904**	**–**

The environment

Key to the Bank's Strategic Plan is a commitment that we will be accountable for our actions and their consequences. This extends to our responsibility to minimise the impact the Bank has on the environment, through reducing our consumption of natural resources and managing our waste production and disposal. To support this commitment the Bank has signed up to RE:FIT London which is an award-winning programme to help make London's non-domestic public buildings and assets more energy efficient.

The Bank uses building management systems (BMS) to control and monitor the status of building services including: lighting, heating, cooling, ventilation and environmental control. During 2015/16 the Bank introduced energy management systems (EMS) to supplement the BMS and optimise performance through enhanced monitoring and measurement of energy use across the institution.

LEDs are an extremely energy efficient form of lighting. They consume up to 90% less power than incandescent bulbs and have a much greater life expectancy resulting in a significant decrease in energy consumption and reduced maintenance. During 2015/16 we have continued to install LEDs across the Bank as older incandescent bulbs require replacement. Our commitment to reduce our consumption of natural resources is reflected through our annual reporting of the carbon reduction commitment (CRC). The CRC is a mandatory scheme aimed at improving energy efficiency and cutting emissions in large public and private sector organisations. Since 2013/14, the Bank has reduced its CO_2 emissions per employee from 7.5 tonnes to 5.7 tonnes, equivalent to a fall of 25% over the period.

Recycling and reusing

The Bank is proud of the systems we have in place to reduce our wastage. More than 98% of waste — equivalent to over 1,100 tonnes — is recycled or reused, with almost half used to produce power at an award-winning 'Energy from Waste' facility.

To reduce our impact on forestry, the Bank's main publications, including this *Annual Report*, are available digitally online. To the extent that they are printed, the paper contains 75% post-consumer recycled fibre and 25% virgin fibre sourced from well-managed, responsible, Forestry Stewardship Council® (FSC) certified forests. Consequently, our publications are certified as a FSC® mixed sources product. The Bank also participates in HM Government's Re-use scheme through which we re-use furniture from UK government departments instead of buying new equipment.

Employee involvement

Details of employee involvement can be found in the Bank's *Annual Report*.

Employment of people with disabilities

Details of employment of people with disabilities can be found in the Bank's *Annual Report*.

Health and Safety

The Bank attaches the upmost importance to the health and safety of its staff. Through its safety management system the Bank delivers a safe working environment and promotes and maintains a positive health and safety culture. The Bank monitors its performance on health and safety at regular review meetings with the Chief Operating Officer and through an annual report to Court.

Bank employees work in a relatively low-risk environment and are not exposed to significant occupational health and safety hazards. During 2016 there were a total of 20 recorded accidents involving employees and one reportable injury under the UK Health and Safety Executive's Reporting of Injuries, Diseases and Dangerous Occurrences.

Disclosure of information to the Auditor

The Directors who held office at the date of approval of this Directors' Report confirm that, so far as they are each aware, there is no relevant audit information of which the PRA's Auditor is unaware; and each Director has taken all the steps that he/she ought to have taken as a Director to make himself/herself aware of any relevant audit information and to establish that the PRA's Auditor is aware of that information.

Statement of Directors' responsibilities in respect of the Directors' Report and the financial statements

The Directors are responsible for preparing the Directors' Report and the financial statements in accordance with applicable law and regulations and with any accounts direction given by HM Treasury. Company law requires the Directors to prepare financial statements for each financial period, and they have elected to prepare the financial statements in accordance with International Financial Reporting Standards as adopted by the EU, and applicable law. The Directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the PRA and of the profit or loss of the PRA for the relevant period. In preparing these financial statements, the Directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- state whether they have been prepared in accordance with International Financial Reporting Standards as adopted by the EU and applicable law;
- prepare the financial statements on a going concern basis unless it is inappropriate to presume that the PRA will continue in business; and
- observe the accounts direction issued by HM Treasury including the relevant accounts and disclosure requirements.

The Directors are responsible for keeping adequate accounting records that are sufficient to show and explain the PRA's transactions and disclose with reasonable accuracy at any time the financial position of the PRA and enable them to ensure that the financial statements comply with the Companies Act 2006. They have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the PRA and to prevent and detect fraud and other irregularities.

Assessment of going concern

The Bank of England and Financial Services Act 2016 transfers the prudential regulatory activities of the company, along with its assets and liabilities, to the Bank of England. The financial statements have therefore been prepared on the break up basis because the Directors have assessed that the company is no longer a going concern. All assets and liabilities have been classified as current as they will be transferred to the Bank of England prior to legal cutover. The carrying value for all assets and liabilities has been assessed as book value.

Auditor

Under provisions of FSMA, the Comptroller and Auditor General is responsible for auditing the PRA's accounts.

Financial Review of 2015/16

Operating costs for 2016 of £253 million (2015: £236 million) were broadly in line with the budget of £255 million, with modest underspend on staff costs.

The increase from 2015 across all areas is primarily attributable to:

- one-off cost uplift arising from harmonisation of staff terms and conditions across the Bank;
- closure of the prior year resourcing gap, expansion of the PRA's responsibilities and implementation of specific new policy initiatives; and
- investment in systems.

Specific initiatives that drove year-on-year operating cost increases include:

- implementation of the Parliamentary Commission on Banking Standard's recommendations through the Senior Managers Regime and Senior Insurance Managers Regime;
- continued implementation of the Solvency II Directive;
- implementation of Capital Requirements Directive for banks, building societies and designated investment firms;
- implementation of banking structural reform (also known as ring-fencing); and
- evolution of the framework to undertake regular stress testing of the UK banking system to assess capital adequacy of the most systematic firms in line with Financial Policy Committee recommendations.

The PRA's budget for 2017 is £253 million, including special project fees of £8 million, which is consistent with 2016 expenditure.

Table 5: PRA expenditure by function

	2016 £m	2015 £m
UK Deposit-Takers Supervision	44	40
International Banks Supervision	19	19
Insurance Supervision	63	57
Prudential Policy	33	33
Supervisory Risk Specialists	41	40
Regulatory Operations	53	47
Total expenditure*	**253**	**236**

*Of total operating costs, £13m (2015: £6m) related to special projects.

Income

Total income for the year, reflecting the level of expenditure incurred, was £253 million (2015: £236 million), and comprised:

- fee income for 2016 of £238 million (2015: £227 million) representing the Annual Funding Requirement (AFR) levied to regulated firms of £243 million (2015: £231 million) less £5 million (2015: £4 million) of levy in excess of expenditure which will be refunded to fee payers during the course of the year;
- Solvency II income of £9 million (2015: £6 million) representing the Solvency II Special Project Fees levied and collected from regulated firms of £13 million (2015: £13 million), less amounts retained for capital expenditure during the year of £4 million (2015: reduction of £4 million);
- special project fee income of £4 million predominantly relating to the Structural Reform Programme;
- other income of £1 million (2015: £1 million) which is made up of other smaller special project fees, interest on deposits and authorisation fees; and
- financial enforcement fee income of £1 million (2015: £1 million).

Balance sheet

Total assets at 29 February 2016 were £71 million (2015: £84 million). Assets include transition costs receivable from fee payers of £30 million (2015: £45 million), cash of £21 million (2015: £23 million) and intangible assets of £16 million (2015: £16 million).

Liabilities include enforcement fines collected in the year of £1 million (2015: £1 million), which is payable to fee payers. Levy income to be refunded is £5 million (2015: £4 million) in relation to the AFR and £nil (2014: £3 million) in relation to Solvency II special project levies. An amount of £56 million (2015: £59 million) is due to the Bank, of which £30 million (2015: £45 million) relates to transition costs and £26 million (2015: £14 million) to corporate services recharges.

The year-on-year fall in total assets and liabilities is attributable to a decrease in transition costs outstanding from fee payers and related transition costs payable to the Bank, offset by an increase in amounts owed to the Bank of England at year-end for corporate services recharges.

By order of the Board

Mr M Carney
Chairman
27 June 2016

The Certificate and Report of the Comptroller and Auditor General to the Houses of Parliament

I certify that I have audited the financial statements of the Prudential Regulation Authority for the year ended 29 February 2016 under the Financial Services and Markets Act 2000. The financial statements comprise the Statement of Comprehensive Income, Statement of Changes in Equity, Statement of Financial Position, Statement of Cash Flows and the related notes. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards as adopted by the European Union. I have also audited the information in the remuneration section of the Directors' Report that is described in that report as having been audited.

Respective responsibilities of the directors and the auditor

As explained more fully in the Statement of Directors' Responsibilities, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. My responsibility is to audit, certify and report on the financial statements in accordance with the Financial Services and Markets Act 2000. I conducted my audit in accordance with International Standards on Auditing (UK and Ireland). Those standards require me and my staff to comply with the Auditing Practices Board's Ethical Standards for Auditors.

Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the company's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the directors; and the overall presentation of the financial statements.

In addition, I read all the financial and non-financial information in the Overview, PRA Strategic Report and Directors' Report to identify material inconsistencies with the audited financial statements and to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by me in the course of performing the audit. If I become aware of any apparent material misstatements or inconsistencies I consider the implications for my certificate.

I am required to obtain evidence sufficient to give reasonable assurance that the expenditure and income recorded in the financial statements have been applied to the purposes intended by Parliament and the financial transactions recorded in the financial statements conform to the authorities which govern them.

Opinion on regularity

In my opinion, in all material respects the expenditure and income recorded in the financial statements have been applied to the purposes intended by Parliament and the financial transactions recorded in the financial statements conform to the authorities which govern them.

Opinion on financial statements

In my opinion:

- the financial statements give a true and fair view of the state of the Company's affairs as at 29 February 2016 and of its result for the year then ended;
- the financial statements have been properly prepared in accordance with International Financial Reporting Standards as adopted by European Union; and
- the financial statements have been prepared in accordance with the Companies Act 2006 and HM Treasury directions issued under the Financial Services and Markets Act 2000.

Emphasis of Matter

Without qualifying my opinion, I draw attention to the disclosures made in Note 1 to the financial statements concerning the management's decision to apply a basis other than going concern in the preparation of the financial statements. This was made following Royal Assent of the Bank of England and Financial Services Act 2016, which contains provision for the transfer of the prudential regulatory activities of the company, along with its assets and liabilities, to the Bank of England.

Opinion on other matters

In my opinion:

- the part of the Directors' Report to be audited has been properly prepared in accordance with HM Treasury directions issued under the Financial Services and Markets Act 2000; and
- the information given in the Annual Report for the financial year for which the financial statements are prepared is consistent with the financial statements.

Matters on which I report by exception

I have nothing to report in respect of the following matters which I report to you if, in my opinion:

- adequate accounting records have not been kept or returns adequate for my audit have not been received from branches not visited by my staff; or
- the financial statements and the part of the Directors' Report to be audited are not in agreement with the accounting records and returns; or
- I have not received all of the information and explanations I require for my audit.

Report

I have no further observations to make on these financial statements.

Sir Amyas C E Morse
Comptroller and Auditor General

28 June 2016

National Audit Office
157–197 Buckingham Palace Road
Victoria
London SW1W 9SP

Statement of comprehensive income
for the year to 29 February 2016

	Note	2016 £000	2015 £000
Income			
Fee income	4	237,583	227,136
Enforcement fine income	7	1,336	1,355
Income on bank deposits		386	421
Other income	5	13,911	6,937
Total income		**253,216**	**235,849**
Expenses			
Administrative costs	6	(253,138)	(235,760)
Total expenses		**(253,138)**	**(235,760)**
Surplus before taxation		**78**	**89**
Taxation	10	(78)	(89)
Surplus after taxation		**–**	**–**

The notes on pages 79 to 90 are an integral part of these financial statements.

Statement of changes in equity
for the year to 29 February 2016

There were no changes in equity during the period. The entire capital comprising 1 ordinary share of £1 was issued, and fully paid by the Governor and Company of the Bank of England on 21 November 2011.

The notes on pages 79 to 90 are an integral part of these financial statements.

Statement of financial position
as at 29 February 2016

	Note	2016 £000	2015 £000
Assets			
Current assets			
Cash and cash equivalents	11	21,359	22,631
Trade and other receivables	12	34,080	15,690
Intangibles	14	15,872	–
Total current assets		**71,311**	**38,321**
Non-current assets			
Intangibles	14	–	15,939
Trade and other receivables	13	–	29,502
		–	45,441
Total assets		**71,311**	**83,762**
Liabilities			
Current liabilities			
Trade and other payables	15	71,311	54,260
		71,311	54,260
Non current liabilities			
Trade and other payables	16	-	29,502
		-	29,502
Total liabilities		**71,311**	**83,762**
Equity	17	-	-
Total liabilities and equity		**71,311**	**83,762**

The financial statements were approved by the Board on 27 June 2016 and signed on its behalf by:

Mr M Carney Chairman

Sir Jon Cunliffe Director

Company Number: 07854923
Except as provided by section 22 (1) of Schedule 1ZB of FSMA, the PRA is exempt from the requirements of Part 16 of the Companies Act 2006.

The notes on pages 79 to 90 are an integral part of these financial statements.

Statement of cash flows
for the year to 29 February 2016

	Note	2016 £000	2015 £000
Surplus for the year from operations		–	–
Adjustments for:			
Interest received on bank deposits		(386)	(421)
Amortisation of other intangible assets	14	4,550	3,509
Impairment loss on intangible assets	14	294	869
Depreciation of property, plant and equipment		–	2,570
Impairment loss on tangible assets		–	262
Decrease/(increase) in receivables	12, 13	11,112	14,354
(Decrease)/Increase in payables	15,16	(12,451)	(18,213)
Other non cash items		–	5,679
Net cash from operating activities		**3,119**	**8,609**
Investing activities			
Interest received on bank deposits		386	421
Expenditure on software development	14	(4,777)	(4,234)
Purchases of property, plant and equipment		–	(29)
Net cash used in investing activities		**(4,391)**	**(3,842)**
Net increase/(decrease) in cash and cash equivalents		**(1,272)**	**4,767**
Cash and cash equivalents at 1 March	11	22,631	17,864
Cash and cash equivalents at 29 February	**11**	**21,359**	**22,631**

The notes on pages 79 to 90 are an integral part of these financial statements.

Notes to the financial statements

1 Basis of preparation

Form of presentation of the financial statements

The financial statements comprise the statement of comprehensive income, the statement of financial position, the statement of cash flows, statement of changes in equity and related notes.

The Prudential Regulatory Authority's (PRA) financial statements have been prepared in accordance with the requirements of International Financial Reporting Standards and interpretations of the International Financial Reporting Interpretations Committee as adopted by the EU (together, 'adopted IFRS').

The Bank of England and Financial Services Act 2016 has been passed and will transfer the prudential regulatory activities of the company, along with its assets and liabilities, to the Bank of England. The financial statements have therefore been prepared on a break-up basis because the Directors have assessed that the company is no longer a going concern. All assets and liabilities have been classified as current as they will be transferred to the Bank of England prior to legal cutover at some point over the next twelve months. The carrying value of all assets and liabilities has been assessed as book value.

The principal accounting policies applied in the preparation of the financial statements are set out below. These policies have been applied consistently to all the years presented unless otherwise stated.

2 Accounting policies

a Functional and presentational currency

The financial statements are presented in sterling, which is the PRA's functional and presentational currency.

b New and amended standards

The PRA has considered the potential effect of forthcoming EU-endorsed standards which have not been adopted in the financial statements; none of these is expected to materially impact the PRA.

c Intangible assets

Intangible assets primarily consist of computer software and the costs associated with the development of software for internal use. Costs associated with maintaining software programs are recognised an as expense when incurred. Intangible assets are valued at the lower of cost and net realisable value.

i Initial recognition

Costs directly associated with the internal production of unique and separately identifiable software products, which are controlled by the PRA and which will probably generate economic benefits exceeding those costs, and externally purchased software which is controlled by the PRA, are recognised as intangible assets.

ii Subsequent valuation

Subsequent costs are added to an asset's carrying amount or are recognised as a separate asset as appropriate, only when it is probable that future economic benefits associated with the item will flow to the PRA and the cost of the item can be reliably measured.

All other repairs and maintenance are charged to the statement of comprehensive income during the financial period in which they are incurred.

iii Amortisation

Intangible assets are amortised over the expected useful lives of the software, ranging from three to five years, determined on a case by case basis.

iv Impairment

Intangible assets are tested for impairment at each balance sheet date. Intangible assets are also subject to an impairment review if there are events or changes in circumstances that indicate that the carrying amount may not be recoverable.

Notes to the financial statements continued

d Financial assets
Financial assets are receivables from counterparties. They are recognised initially at fair value, which is deemed to be not materially different to amortised cost due to the low value and short maturity. Fair value is therefore used at the reporting date. Appropriate allowances for estimated irrecoverable amounts are recognised in the statement of comprehensive income when there is objective evidence that the asset is impaired. The amount of loss is measured as the difference between the asset's carrying value and the present value of the estimated future cash flows.

e Transition costs
In the two years prior to legal cutover the Bank of England incurred costs in relation to setting up and preparing the PRA for its responsibilities. These were charged to the PRA in the years ending 28 February 2013 and 28 February 2014, and recognised in those years. The Board agreed to recover the costs from fee-payers over a five year period commencing 2013. An amount receivable from fee-payers, and a corresponding amount payable to the Bank of England, have been recognised on the balance sheet.

Following the passing of the Bank of England and Financial Services Act 2016, the remaining transition costs will be transferred to the Bank of England at some point over the next twelve months, and have been recognised as current assets and liabilities.

f Financial liabilities
Financial liabilities are recognised initially at fair value, which is deemed to be not materially different to amortised cost due to the low value and short maturity. Fair value is therefore used at the reporting date.

g Revenue recognition
Most revenue is receivable under FSMA, as amended by the Financial Services Act 2012, and is measured at fair value and represents fees to which the PRA deemed it was entitled to in respect of the financial year.

Fee income
Fee income comprises levy fees collected from regulated firms through the Annual Funding Requirement (AFR) consultation process. This fee income is recognised net of any surplus against expenditure, in the statement of comprehensive income.

Any surplus or deficit against levy income in the year will be held as a payable or receivable on the balance sheet as the intention is to return any surplus or claim any deficit in the following financial year.

Special project fees
Special project fees income is recognised to the value of relevant expenditure, recognised through the income statement.

Solvency II special project fees
Solvency II special project fees are collected from fee payers in anticipation of the total spending requirements in the year. Income is recognised through the income statement against cost incurred. Any surplus or deficit is returned or recovered in subsequent financial years.

Fees collected which relate to capital and not revenue expenditure are deferred to the balance sheet and recognised as income in subsequent periods. This is applicable to both tangible assets which are held on the Bank of England balance sheet, and intangible assets held on the PRA balance sheet.

Enforcement fine income
Enforcement fines are recognised as revenue where they have been levied and received in the financial year. Where enforcement fines specific to a single case exceed its costs, the excess fines received can be used to cover expenditure on other cases in the current period, this is returned to fee payers (excluding those fined) in the following financial year. Any income received in excess of total enforcement expenditure in the current period is paid over to HM Treasury.

Interest income
Interest income is recognised on a straight line basis which approximates the effective interest method.

Sundry income
Sundry income comprises fees for firms and individuals applying to become authorised on PRA regulated activities, and are recognised as incurred. It also includes late payment charges and other miscellaneous items.

h Reserves
The PRA will not hold any accumulated reserves as the intention is to return any surplus to fee payers or collect any deficit from fee payers in the subsequent financial year.

i Cash and cash equivalents
For the purposes of the statement of cash flows, cash and cash equivalents comprise balances with less than three months' maturity from the date of acquisition.

j Provisions
Provisions are recognised when the PRA has a present obligation, legal or constructive, as a result of a past event, where it is probable that an outflow of resources will be required to settle that obligation and the amount can be reliably estimated.

k Equity capital
The entire equity capital comprising one £1 ordinary share is held by the Governor and Company of the Bank of England.

l Taxation
Under the agreement with HM Revenue and Customs (HMRC), the fee paid by regulated institutions for regulatory purposes is not included within the charge to corporation tax, but net interest income on deposits and any other investment income is subject to corporation tax as a non-trade credit.

m Retirement benefit costs
The PRA is a participating employer in the Bank of England pension fund, of which all staff are members unless they have opted out. Within the recharge of staff costs from the Bank of England is a charge for pension costs, to the fund for each individual at a rate equivalent to the service cost. No allowance is made for any interest income or expense on the net pension asset/liability held by the Bank.

Further details of the Bank of England pension fund are reported in the Bank's *Annual Report*.

n Property costs
Office space is provided to the PRA by the Bank of England. Floor space recharges are based on occupancy and building management charges and are transferred to the PRA by the Bank of England.

o Cost recoveries
Costs in relation to section 166, of FSMA, reports are fully recovered directly from the specific entities under review. The recovery of these costs is matched directly to the costs incurred in the income statement within expenditure.

3 Significant accounting estimates and judgements in applying accounting policies
The PRA makes estimates and assumptions that affect the reported amounts of assets within the financial statements. Estimates and judgements are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

a Intangible assets
Management has made judgements when capitalising intangible assets. Various costs incurred in the production of an internal project are capitalised if a number of criteria are met. Management has made judgements and assumptions when assessing whether a project meets these criteria and when measuring the costs and economic life attributable to such projects.

b Staff costs
Staff working in the PRA are employed by the Bank of England and the PRA is recharged the costs monthly. In substance this arrangement reflects that employees are PRA staff members, and as such full staff cost and number disclosures have been made.

Notes to the financial statements continued

c Levy income
Any surplus or deficit of expenditure against levy income will be recognised on the balance sheet. It is the intention of the PRA to return any such surplus or deficit to fee payers in the subsequent financial year, and therefore management have determined that these amounts should be recognised on the balance sheet and not through reserves.

d Deferred income — capital
Special project fees collected in respect of capital expenditure are recognised as deferred income on the balance sheet. Income subsequently recognised in the income statement as the assets are depreciated or amortised.

Where assets linked to special projects are tangible, they are held on the Bank of England balance sheet. Management have determined it appropriate to hold this deferred income and recognise revenue as the PRA is charged for the use of these assets through the corporate services fee.

e Retirement benefit costs
The scheme's actuaries use assumptions when calculating pension costs, which management confirm. Refer to the Bank's *Annual Report*.

4 Fee income

	2016 £000	2015 £000
Fee income	237,583	227,136
Total	**237,583**	**227,136**

5 Other income

	2016 £000	2015 £000
Solvency II income	8,659	6,202
Special project fee income	4,604	224
Other sundry income	648	511
Total	**13,911**	**6,937**

Solvency II income is recognised to the extent of costs incurred during the year on Solvency II activity.

Special project fee income is recognised to match expenditure incurred on activity that has been designated as a special project, for which fees are raised separately.

Other sundry income includes authorisation fees paid by firms and individuals, which is recognised in the income statement as incurred.

6 Administrative expenses

	Note	2016 £000	2015 £000
Staff costs	8	128,287	117,298
Corporate services fee		95,554	94,753
Property costs		18	76
Professional and membership fees		20,462	15,213
Impairment of assets		312	1,131
Information technology costs		219	(0)
Amortisation of intangible assets		4,536	3,509
Depreciation of property, plant and equipment		-	2,570
Travel and accommodation		2,083	1,936
Other administration and general expenses		2,778	2,563
Cost recoveries		(1,111)	(3,289)
Total		**253,138**	**235,760**

Included within administrative expenses is a Corporate Services fee charged by the Bank of England for provision of IT, finance, property and procurement and human resource services. This fee totalled £97.0m, (2015; £97.2m) for the year of which £1.4m (2015; £2.4m), relating to software development was capitalised.

The components of the corporate services fee are disclosed in the table below:

	2016 £000	2015 £000
Staff costs	49,551	49,818
Depreciation	4,718	3,537
Administration expenditure	3,782	2,291
Information technology costs	13,518	14,887
Professional fees	13,402	13,320
Property costs	10,583	10,900
Total	**95,554**	**94,753**

Notes to the financial statements continued

7 Enforcement fine income

	Note	2016 £000	2015 £000
Fines raised in the year	15	4,429	14,000
Financial penalties due to HM Treasury	15	–	(12,645)
Fine receipts due in future years	15	(230)	–
Fines written down/off in the year		(2,863)	–
Fine income recognised		**1,336**	**1,355**

8 Staff costs

	2016 £000	2015 £000
Wages and salaries	96,330	94,003
Social security costs	11,299	10,925
Pension and other post-retirement costs	20,716	12,377
Seconded staff recoveries	(59)	(7)
Total	**128,286**	**117,298**

All staff are employed by the Bank of England. Staff costs are recharged to the PRA on a monthly basis by the Bank of England. Staff costs exclude contingent workers which are recognised in Administrative expenses.

Pension costs include £0.5m (2015: £7.0m) of contributions to the FSA defined contribution scheme. At 29 February 2016 no balance was outstanding. At 1 April 2015 all staff transferred to the Bank of England pension fund and no further contributions were made to the FSA defined benefit scheme after this date.

Contributions to the Bank of England pension fund are made based on the cost of provision of the pension benefit to employees. The contribution made in the year to 29 February 2016 was £20.3m (2015: £5.4m). Full details regarding the Bank of England pension fund can be found in the Bank's *Annual Report*.

Average staff numbers:
The average number of persons employed by the PRA during the year was made up as follows;

	2016	2015
Chief Executive and other members of the Executive Committee	23	20
Managers and Analysts	1,019	934
Other staff	172	153
Total	**1,214**	**1,107**

The number of staff employed by the Bank and working for the PRA (excluding contingent workers) at 29 February 2016 was 1,267, of which 1,116 were full-time staff and 151 were part-time.

Directors' emoluments
The Directors' remuneration is disclosed in the Directors' Report.

9 Audit fees

	2016 £000	2015 £000
Audit fees for the PRA's audit		
Fees relating to current year	90	90
Fees relating to prior year	–	34
Total	**90**	**124**

No non-audit work was undertaken by the auditor.

10 Taxation

	2016 £000	2015 £000
Tax charge on investment income	78	89
Total tax charge on investment income	**78**	**89**

	2016 £000	2015 £000
Interest on cash deposits	386	421
Tax calculated at rate of 20.08% (2015: 21.14%)	78	89
Total tax charge for the period	**78**	**89**

Under the agreement with HM Revenue and Customs (HMRC), the fees paid by regulated institutions for regulatory purposes are not subject to corporation tax, but net interest income on deposits and any other investment income are subject to corporation tax as non-trade credits.

11 Cash and cash equivalents

	2016 £000	2015 £000
Cash balance held at the Bank of England	21,359	22,631
Total	**21,359**	**22,631**

Notes to the financial statements continued

12 Current trade and other receivables

	2016 £000	2015 £000
Fees receivable	4,625	541
Transition costs recoverable from fee payers	29,455	15,149
Total	**34,080**	**15,690**

Transition costs are being recovered from fee payers over a five year period commencing 2013.

13 Non-current trade and other receivables

	2016 £000	2015 £000
Transition costs recoverable from fee payers	–	29,502
Total	**–**	**29,502**

Following the passing of the Bank of England and Financial Services Act 2016, the remaining transition costs will be transferred to the Bank of England at some point over the next twelve months, and have been recognised as current assets and liabilities.

14 Intangible assets

	Intangibles £000	Intangibles work in progress £000	Total £000
Cost			
At 1 March 2015	18,777	3,204	21,981
Transfers from WIP	3,204	(3,204)	–
Additions	4,777	–	4,777
Impairments	(312)	–	(312)
At 29 February 2016	**26,446**	**–**	**26,446**
Accumulated amortisation			
At 1 March 2015	6,042	–	6,042
Charge for the year	4,550	–	4,550
Impairments	(18)	–	(18)
At 29 February 2016	**10,574**	**–**	**10,574**
Net book value at 1 March 2015	12,735	3,204	15,939
Net book value at 29 February 2016	**15,872**	**–**	**15,872**

	Intangibles £000	Intangibles work in progress £000	Total £000
Cost			
At 1 March 2014	14,344	4,345	18,689
Transfers from WIP	4,345	(4,345)	–
Additions	1,165	3,204	4,369
Impairments	(1,077)	–	(1,077)
At 28 February 2015	**18,777**	**3,204**	**21,981**
Accumulated amortisation			
At 1 March 2014	2,741	–	2,741
Charge for the year	3,509	–	3,509
Disposals	(208)	–	(208)
At 28 February 2015	**6,042**	**–**	**6,042**
Net book value at 1 March 2014	11,603	4,345	15,948
Net book value at 28 February 2015	**12,375**	**3,204**	**15,939**

Intangible assets comprise software development to enable the PRA to fulfil its regulatory duties.

There were no additions of intangible assets purchased but not paid for at the balance sheet date (2015: £644,000).

Notes to the financial statements continued

15 Current trade and other payables

		2016 £000	2015 £000
Fees received in advance		4,788	3,479
Fees received in advance – Solvency II		44	2,808
Deferred income – Solvency II		9,626	4,888
Financial penalties due	7	230	–
Financial penalties due to HMT	7	–	12,645
Financial penalties received – payable to fee payers	7	1,336	1,355
Amounts due to the Bank of England – transition costs		29,516	15,154
Amounts due to the Bank of England – management recharge		25,730	13,886
Other payables		41	45
Total		**71,311**	**54,260**

Amounts due to the Bank of England comprise transition cost recoveries payable within one year, recharged expenditure, staff costs and the corporate services fee.

Fees received in advance comprise fees collected in relation to the annual funding requirement and Solvency II, to the extent they exceed related expenditure.

In accordance with the PRA Financial Penalty Scheme, financial penalty monies received are payable to HMT where they are in excess of costs incurred during the year, with the remainder due to fee payers.

16 Non-current trade and other payables

	2016 £000	2015 £000
Amounts due to the Bank of England – transition costs	–	29,502
Total	**–**	**29,502**

Following the passing of the Bank of England and Financial Services Act 2016, the remaining transition costs will be transferred to the Bank of England at some point over the next twelve months, and have been recognised as current assets and liabilities.

17 Capital

The entire capital comprising of one authorised, issued and fully paid ordinary share of £1 is held by the Governor and Company of the Bank of England.

18 Financial risk

The PRA's principal financial assets are cash, together with fee and other receivables.

Credit risk

Credit risk is the risk of loss arising from the failure of a counterparty to meet its financial obligations to the PRA. The credit risk that PRA faces arises when the PRA invoices counterparties from the financial services industry for the collection of regulatory fees.

The Bank of England monitors the credit risk exposures on behalf of the PRA and the collection of fees from counterparties. The PRA has a strong record of collecting fees with outstanding amounts at the year-end almost negligible.

Liquidity risk

Liquidity risk is the risk of encountering difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset. The PRA manages its liquidity risk by monitoring and forecasting the projected income and expenditure related to its day to day business. The PRA also has an overdraft facility in place with the Bank of England should the need for additional liquidity arise.

Interest rate risk

Interest rate risk is the risk of loss as a result of changes in absolute level of interest rates. The PRA is only exposed to interest rate risk on its cash deposits held with the Bank of England which are sensitive to variations in interest rates.

19 Losses and Special payments

There were no reportable losses or special payments in the year.

20 Related party transactions

The Bank of England

The Bank of England is the parent company of the PRA and provides central services and support functions to the PRA, for which it charges a Corporate Services Fee on a monthly basis, during the period these fees totalled £97.0m (2015: £97.2m).

All PRA staff are employed by the Bank of England. During the period staff cost recoveries of £128.3m (2015: £117.3m) were charged by the Bank to the PRA. Included in the staff cost recoveries are PRA contributions to the Bank of England pension fund of £20.3m (2015: £5.4m) on behalf of employees.

The Bank of England meets the cost of direct expenditure for the PRA and recharges the cost. In 2016 this totalled £27.5m (2015: £22.0m).

As at 29 February 2016 £29.5m (2015: £44.7m) of transition costs are due to the Bank of England. A further £25.7m (2015: £13.9m) is due to the Bank of England in respect of the management fee and other recharged costs.

HM Treasury

As part of the HM Treasury group the PRA is a related party to Royal Bank of Scotland, Lloyds Banking Group and the Financial Conduct Authority. The PRA received levy income from both Royal Bank of Scotland and Lloyds Banking Group in the year.

Financial Conduct Authority

The Financial Conduct Authority charges the PRA an administration fee relating to the invoicing and collection of fee and other income from levy payers. Charges for this service totalled £90,000 (2015: £83,000) in the year. The PRA is also charged for the shared use of some FCA software applications to support regulation. The total charge for this service was £7.5m (2015: £7.5m). The PRA had no amounts payable to the FCA (2015: £nil) at the balance sheet date.

Key management

The Directors of the PRA are considered to be the only key personnel as defined by IAS 24. The Directors' remuneration is disclosed in the Directors' Report and in the Bank's *Annual Report*.

All transactions with related parties are entered into on an arm's length basis.

Notes to the financial statements continued

21 Ultimate parent company

The ultimate parent company of the PRA is HM Treasury.

22 Events after the balance sheet date

The Bank of England and Financial Services Act received Royal Assent on 4 May 2016. The impact of this has been discussed in the Director's Report (page 69), and within Note 1 (page 79) with regard to the basis of preparation of the financial statements.

The United Kingdom held a referendum on 23 June on whether or not to remain a member of the European Union. As a result of the decision to leave the EU, the PRA continues, together with the wider Bank, to consider the implications of this decision on its strategy and business plan. Refer to pages 45 and 54 for further details.

There were no further events that had a material effect on the accounts after the end of the reporting period.

23 Preparation of accounts

The accounts were approved for distribution on 28 June 2016.

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PRUDENTIAL REGULATION AUTHORITY

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