



BANK OF ENGLAND



The Bank of England, Prudential Regulation Authority

The PRA's approach to banking supervision

October 2012

Foreword



Andrew Bailey Managing Director,
Prudential Business Unit, FSA and Executive Director,
Bank of England

Next year, the Prudential Regulation Authority (PRA) will take up its responsibilities as part of the new approach to financial regulation in the United Kingdom. The PRA, which will be responsible for the prudential regulation of deposit-takers, insurers and major investment firms, will be part of the Bank of England and will make an important contribution to the Bank's core purpose of maintaining financial stability in the United Kingdom.

This document sets out the PRA's intended approach towards regulating deposit-takers and investment firms. A companion document covers insurers. Our approach will be anchored in the objectives that I expect Parliament to give us when the new legislation comes into effect. For deposit-taking and major investment firms the objective will be set in terms of the safety and soundness of firms, thereby reducing the threat they can pose to the stability of the financial system and thus to the continuity of provision of critical financial services.

The financial crisis has powerfully demonstrated the need for a new approach to financial regulation. Our job at the PRA will

be to protect the public's access to critical financial services and thus to contribute to a healthy economy. But we recognise that the threats to safety and soundness of firms and thus to the continuity of financial services can be complex and fast-moving. Moreover, the PRA will come into existence during a period of profound change in the policies governing financial regulation around the world. Our goal at the PRA will be to focus on the things that matter most to achieving our statutory objectives and thus our responsibility to the public.

This document sets out how we intend to implement the PRA's approach in practice. It will be based on setting clear standards for firms which are in line with the Threshold Conditions for authorisation set out in legislation. Our approach will be very clearly based on judgement rather than narrowly rules-based, and it will be forward looking to take into account a wide range of possible risks to our objectives.

The PRA will operate to high standards in pursuing its objectives, and we will expect firms likewise to support and conform to the public policy objectives set by Parliament. Our goal is to ensure that the public can put their trust in a stable and safe financial system.

This document is being issued ahead of the PRA assuming its responsibilities under statute. I very much welcome comments from all interested parties.

A handwritten signature in black ink that reads "Andrew Bailey". The signature is written in a cursive, slightly stylized font.

October 2012

Contents

Foreword	1
----------	---

Executive summary	5
-------------------	---

Introduction	7
--------------	---

I	The PRA's approach to advancing its objective	8
	The PRA's objective	8
	The PRA's approach to advancing its objective	9
Box 1	The PRA's Threshold Conditions	10
Box 2	Underlying economic justification for prudential regulation	13
Box 3	Working with other authorities	14

II	Identifying risks to safety and soundness	16
	Potential impact	16
	External context	17
	Business risk	17

III	Safeguarding safety and soundness	19
	Management and governance	19
	Risk management and controls	22
	Capital	24
	Liquidity	27
	Resolvability	29

IV	Supervisory activity	31
	Assessing risk	31
	Proactive Intervention Framework	33
	Mitigating risk	33
	Using powers in the course of supervision	35
	Enforcement powers	35
Box 4	Authorising new firms	32
Box 5	International approach	36
Box 6	Supervision of firms that pose little individual risk to financial stability	38

V	Making policy to support the PRA's general approach	39
Box 7	Staffing the PRA	40

VI	Next steps	42
-----------	-------------------	-----------

Executive summary

The Prudential Regulation Authority (PRA), as part of the Bank of England, will become the United Kingdom's prudential regulator for deposit-takers, insurance companies and some investment firms in 2013. This paper sets out how the PRA will carry out its role in respect of deposit-takers and investment firms. It is designed to help regulated firms and the market understand how the PRA will supervise these institutions, and to aid accountability to the public and Parliament.

The PRA's objective

The PRA will have a statutory objective to **promote the safety and soundness of firms**. It is required to pursue this primarily by **seeking to avoid adverse effects on financial stability**, and in particular seeking to minimise adverse effects resulting from disruption to the continuity of financial services that can be caused by the way firms run their business or upon their failure. A stable financial system, that is resilient in providing the critical financial services the economy needs, is a necessary condition for a healthy and successful economy.

Seeking to minimise the adverse effect of the failure of a firm does not require the PRA to take steps to avoid any and all such adverse effects or to prevent all instances of failure. The statute is explicit that **it will not be the PRA's role to ensure that no firm fails**. Firm failures will happen, but the PRA will seek to ensure that they do not result in significant disruption to the supply of critical financial services, including depositors' ability to make payments. Assessing and planning to contain the impact of failure will be a core part of the PRA's work. This will depend on the efficacy of the statutory resolution regime, on which the PRA will work with the rest of the Bank.

The PRA's requirements on firms — Threshold Conditions

The requirements that firms will need to meet in order to remain safe and sound will be rooted in the PRA's statutory objective, the statutory Threshold Conditions for authorisation, and UK and EU law. The PRA's new statutory Threshold Conditions, which will set out the minimum requirements that firms must meet in order to be permitted to carry on the regulated activities in which they engage, are designed to promote safety and soundness and will be crucial to the operation of the new regime. In broad terms, they will require firms to have an appropriate amount and quality of capital and liquidity, to have appropriate resources to measure, monitor and manage risk, to be fit and proper, and to conduct their business prudently. **The PRA will expect firms not merely to meet and continue to meet the letter of these requirements, but also to consider the overriding principle of safety and soundness.**

Maintaining safety and soundness will at times require firms to act more prudently than they might otherwise choose. Their incentives can sometimes be to take more risk, and so to impose more risk on the stability of the financial system and economy, than is in the public interest. **It is the responsibility of each firm's board of directors and senior management to manage their firm prudently, with a view to maintaining its safety and soundness, thereby contributing to the continued stability of the financial system.** This will be in firms' collective interest as well as in the public interest. It is vital that boards and senior management understand and uphold this objective, and establish within their firms a culture that supports it.

The PRA's approach to supervision

Within the statutory framework, **the PRA's approach will rely significantly on judgement. The PRA will supervise firms to judge whether they are safe and sound, and whether they meet, and are likely to continue to meet, the Threshold Conditions.** Supervisors will thus reach judgements on the risks that a firm poses to the PRA's objective and how to address any shortcomings.

The PRA's approach will be forward looking; it will assess firms not just against current risks, but also against those that could plausibly arise in the future. Where the PRA judges it necessary to intervene, it will generally aim to do so at an early stage. Firms should be open and straightforward in their dealings with the PRA, taking the initiative to raise issues of possible prudential concern also at an early stage. The PRA, for its part, will respond proportionately. Trust can thus be fostered on both sides.

The PRA will focus on those issues and those firms that pose the greatest risk to the stability of the UK financial system.

Focusing on key risks inevitably implies tailoring activities to a firm's individual circumstances. The PRA's supervision will reflect the nature of the firm, whether a bank, building society, credit union or investment firm. Consistent with its focus on key risks, the PRA will aim to concentrate on material issues when engaging with firms. The frequency and intensity of supervision applied to a particular firm will therefore increase in line with the risk it poses.

The PRA's supervisory judgements will be based on evidence and analysis. It is, however, inherent in a forward-looking system that, at times, the supervisor's judgement will be at variance with that of the firm. Furthermore, there will be occasions when events will show that the supervisor's judgement, in hindsight, was wrong. To minimise such outcomes, the PRA will need to be staffed by teams with strong, relevant skills and experience, and its major

judgements and decisions will involve the PRA's most senior and experienced staff and directors.

The PRA will also engage with the boards and senior management of firms in forming its decisions, using this dialogue both to ensure that it takes account of all relevant information in reaching its judgements, and to communicate clearly the rationale for them. Firms should not, however, approach their relationship with the PRA as a negotiation.

The PRA's regulatory decision-making will be rigorous and well documented, consistent with public law. Its most significant supervisory judgements will be taken by its Board — comprising the Governor of the Bank of England, the Deputy Governor for Financial Stability, the Chief Executive Officer of the PRA, and the independent non-executive members of the Board. The PRA Board will be involved in the most important decisions on general policy and individual cases. The Board will, of course, be accountable to Parliament, in the same way as are the Monetary Policy Committee and Financial Policy Committee, the Bank's other statutory decision-making bodies.

The wider context

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. The PRA will therefore work closely with the rest of the Bank of England, including, crucially, the Financial Policy Committee, which will be able to make recommendations and give directions to the PRA.

The PRA will also co-operate closely with the rest of the Bank on, for example, market intelligence and oversight of critical financial infrastructure, and with the Bank's Special Resolution Unit on resolution and operational resilience.

The PRA will co-operate closely with the Financial Conduct Authority, which will be the conduct regulator for PRA-authorized firms and the conduct and prudential regulator for many other UK firms. As set out in the draft Memorandum of Understanding between the two authorities, this co-ordination will recognise their separate, independent mandates and statutory objectives.

Reflecting the international nature of the banking industry and capital markets, and in particular the United Kingdom's membership of the single market in EU financial services, **the PRA will play a full and active role with its counterparts globally and in the European Union** in developing and implementing prudential standards and in supervising international firms.

Introduction

1. This paper is one of two being published jointly by the Bank of England and the Financial Services Authority (FSA) on the PRA's overall supervisory approach, prior to it assuming its responsibilities under the Financial Services and Markets Act 2000 (as amended by the Financial Services Bill) (FSMA)⁽¹⁾ and under the relevant EU Directives for which it will be a competent authority.⁽²⁾

2. This paper sets out how the PRA will carry out its role in respect of deposit-takers (banks, building societies and credit unions) and designated investment firms;⁽³⁾ the second paper relates to supervision of insurance companies. Separate publications are necessary to capture the differences in the PRA's supervisory approach for these firms, the different risks they pose, and the additional statutory objective that the PRA will have in respect of insurers. The papers provide further detail on the supervisory approach initially set out in *The Bank of England, Prudential Regulation Authority: Our approach to banking supervision* issued in May 2011 and *The Bank of England, Prudential Regulation Authority: Our approach to insurance supervision* issued in June 2011.⁽⁴⁾

3. This paper serves three purposes. First, alongside its insurance equivalent, it is intended to meet the statutory requirement on the PRA to issue guidance on how it intends to advance its objectives. Release of the paper now is designed to facilitate scrutiny of the PRA's proposed approach as the draft legislation establishing the PRA is debated in Parliament. Second, the paper will aid accountability by describing what the PRA will seek to achieve and how it will go about it. Third, the paper communicates to regulated firms what the PRA will expect of them, and what they can expect from the PRA in the course of supervision.

4. This paper is designed to provide the overall description of the PRA and its approach. A final version will be approved for publication by the PRA Board ahead of the PRA taking on its statutory responsibilities for prudential regulation in 2013. Thereafter it is intended to be a standing reference, and will be revised and reissued in response to significant legislative and other developments which require changes to the PRA's approach.

5. This document does not address the recommendations of the Independent Commission on Banking and their implications for the PRA.⁽⁵⁾ These will be covered in an update to this document.

6. The Act will require the PRA to investigate and report to HM Treasury on possible regulatory failures. More details on how, and under what circumstances, the PRA will conduct such investigations will be published in due course.

Structure of this paper

7. Section I describes the PRA's proposed statutory objective under the Act, and its approach to advancing this objective. Section II outlines how the PRA will determine the focus of its supervision in identifying the key risks to its objective. Section III examines the measures that the PRA will expect firms to have in place to ensure their businesses are run in a safe and sound manner, both in guarding against failure and in reducing the adverse effects that their operations could have on financial stability. Section IV sets out more detail on the PRA's supervisory approach. Section V outlines its approach to setting and communicating expectations of firms. Section VI concludes with next steps.

(1) Henceforth 'the Act'.

(2) Specifically the Capital Requirements Directive, the Financial Conglomerates Directive, the Markets in Financial Instruments Directive and the Deposit Guarantee Schemes Directive.

(3) The PRA will regulate a small number of 'investment firms' that could present significant risks to the stability of the financial system. In May 2012, the Bank of England and FSA published an initial statement on the designation of investment firms, available at www.bankofengland.co.uk/publications/Documents/other/financialstability/investmentfirms.pdf. A more detailed policy statement will be published in October 2012.

(4) Available at www.bankofengland.co.uk/publications/Documents/other/financialstability/uk_reg_framework/pras_approach.pdf and www.bankofengland.co.uk/publications/Documents/other/financialstability/uk_reg_framework/pras_approach2.pdf.

(5) As outlined by HM Treasury in its White Paper, *Banking reform: delivering stability and supporting a sustainable economy*, available at www.hm-treasury.gov.uk/d/whitepaper_banking_reform_140512.pdf.

I The PRA's approach to advancing its objective

Summary

8. The PRA will have a general objective to **promote the safety and soundness of firms**, and within this it will **focus primarily on the harm that they can cause to the stability of the UK financial system**. A stable financial system, that is resilient in providing the critical financial services the economy needs, is a necessary condition for a healthy and successful economy, as demonstrated by the costs imposed by the recent financial crisis on society at large.

9. Consistent with the Act, **it will not be the PRA's role to ensure that no firm fails**. Rather, the PRA will seek to ensure that any firms that fail do so in a way that avoids significant disruption to the supply of critical financial services. Nevertheless, failure is not costless and there is inherent uncertainty about whether a firm can fail without damaging the system. Consequently, the PRA will expect a given level of resilience against failure from all firms.

10. To advance its general objective, the PRA will set out policies which it expects firms to meet both in letter and in spirit; and it will supervise firms to judge whether they meet these policies, at the time of assessment and on a forward-looking basis, taking action if they do not.

The PRA's objective

11. Under the Act, the PRA will have a statutory objective to promote the safety and soundness of the firms it regulates. In addition to this general objective, the PRA will have a second objective specific to its regulation of insurers: to contribute to the securing of an appropriate degree of protection for those who are or may become policyholders. This second objective is discussed in the parallel document for insurance.

12. The Act will require the PRA to advance its general objective primarily by:

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

13. **The PRA will thus be tasked with promoting the safety and soundness of all the firms it regulates and will be entitled to prioritise its resources on those firms with the**

greatest potential adversely to affect financial stability, whether through failing or through the way in which they carry on their business.

Safety and soundness

14. 'Safety and soundness' involves firms having resilience against failure now and in the future, and avoiding harm resulting from the disruption to the continuity of financial services, either in the course of business or in the event of failure.

15. The Act will include 'Threshold Conditions', which will set out the minimum requirements that firms must meet in order to be permitted to carry on the regulated activities in which they engage. The Threshold Conditions for which the PRA will be responsible are designed to promote safety and soundness. At a high level, the draft Threshold Conditions require (see Box 1):

- a firm's head office, and in particular its mind and management, to be in the United Kingdom if it is incorporated in the United Kingdom;
- a firm's business to be conducted in a prudent manner — and in particular that the firm maintains appropriate financial and non-financial resources;
- the firm itself to be fit and proper and be appropriately staffed; and
- the firm and its group to be capable of being effectively supervised.

16. Firms must themselves ensure that they meet the Threshold Conditions at all times. The PRA will assess firms against them on a continuous basis.

Stability of the system

17. The PRA will concentrate on avoiding harm resulting from the disruption to the continuity of financial services. It will **aim to avoid developments that impair the capacity of the financial system as a whole to carry out activities important to the functioning of the economy, in particular the provision of payment services (including access to funds), credit and risk transfer.**⁽¹⁾

18. **A firm can adversely affect the stability of the financial system through the way in which it carries on its business in normal times**, including if its activities create the possibility of future stress. Firms can contribute to risky behaviour across the system as a whole by competing for business too

(1) As set out in section 1 in the Act, 'the financial system' refers to 'the financial system operating in the United Kingdom and includes — (a) financial markets and exchanges, (b) regulated activities, and (c) other activities connected with financial markets and exchanges'.

aggressively; or by taking actions when under stress that may cause problems for others. Or a firm may have systems that are insufficiently resilient to provide services to the economy, or impede the development of system-wide financial infrastructure. **Together with the Financial Conduct Authority (FCA) as conduct regulator, and the Financial Policy Committee (FPC) as macroprudential authority where appropriate, the PRA will aim to reduce such effects.**

19. **A firm can also adversely affect the stability of the financial system through failing.** Such effects arise through two broad channels:

- **directly, through the impact on real economic activity or on the soundness of other participants and so the provision of financial services to the economy as a whole.** Real economic activity may be directly affected by the cessation of services. And the soundness of other intermediaries may be affected, for example, by interconnected credit exposures, by pressure on financial asset prices from fire sales following liquidation or mass close-out of positions, or via claims on the deposit compensation fund managed by the Financial Services Compensation Scheme (FSCS); and
- **indirectly, through behavioural effects where vulnerabilities within one firm affect confidence in other firms with similar business models or products.** This is of particular concern for deposit-takers, given their role in providing maturity transformation of deposits and other short-term liabilities into longer-term assets, and the resultant risk of contagion following firm failure.

20. Promoting financial stability includes protecting depositors' ability to make payments. It does not include preventing direct losses to depositors or other creditors, except where they could lead to the impairment of the financial system as described above. Ensuring that depositors retain access to their funds in the event of firm failure, either through a transfer of their accounts to a different institution, or by compensation from the FSCS where deposits are eligible, will be an important means of minimising such effects.

Firm failure

21. **As recognised in the Act, it will not be the PRA's role to ensure that no firm fails. It will thus be a key principle underlying the PRA's approach that it will not seek to operate a zero-failure regime.** Rather, the PRA will seek — as far as possible with the resolution arrangements in place — to ensure that any firms that fail do so in a way that avoids significant disruption to the supply of critical financial services. Considering the impact of firm failure, and acting

pre-emptively to ensure either recovery or orderly closure, will be a core aspect of the PRA's approach. Putting in place appropriate resolution arrangements for the largest institutions is a key objective of the Bank of England, and the PRA will take its decisions in light of the resolution regime in place.

22. That firms should be allowed to fail so long as failure is orderly — that is, so long as a failing firm's provision of critical financial services is preserved or wound down in an orderly manner (including by transfer to another firm) — reflects the view that firms should be subject to the disciplines of the market. It is important for firms to be able to fail in an orderly way without public funds being put at risk since, apart from being an unwarranted subsidy, the public provision of solvency support to a firm (or its creditors) can create an expectation of future assistance. This 'moral hazard' in turn increases the risk of future financial instability, as it provides incentives for excessive risk-taking and reduces market discipline.

23. Although it will not be the PRA's role to ensure that no firm fails, **a certain level of resilience against failure will be required of all firms.** Failure is not costless. And, while failure of an individual firm is a feature of a properly functioning market, it will be essential for the PRA to ensure confidence in general in the firms that it supervises in order for it to deliver on its objective.

The PRA's approach to advancing its objective

24. The PRA will supervise a large number of very diverse deposit-takers, whose contribution to, and potential impact on, the UK economy is significant.

25. In total the PRA will supervise around a thousand deposit-takers — some 330 banks, 50 building societies and 600 credit unions, as well as a small number of investment firms that have the potential to present significant risk to the stability of the financial system.

26. It will supervise a handful of very large UK-headquartered firms that are both systemically important financial institutions globally and significant to the stability of the financial system domestically. And it will supervise many hundreds of credit unions, the majority of which operate in a particular locality. It will supervise both mutuals and shareholder-owned firms.

27. The PRA will supervise UK-headquartered and international firms. And the legal structures it will be responsible for supervising will include passported branches

Box 1

The PRA's Threshold Conditions

The Threshold Conditions are the minimum requirements that firms must meet at all times in order to be permitted to carry on the regulated activities in which they engage. Firms will need to meet both the PRA-specific and FCA-specific Threshold Conditions. This box sets out the draft PRA-specific Threshold Conditions that will apply for banks, building societies, credit unions and designated investment firms.⁽¹⁾

Introduction

5A. If the person concerned ('D') carries on, or is seeking to carry on, PRA-regulated activities which do not consist of or include a regulated activity relating to —

- (a) the effecting or carrying out of contracts of insurance,
- (b) managing the underwriting capacity of a Lloyd's syndicate as a managing agent at Lloyd's, or
- (c) arranging, by the Society, of deals in contracts of insurance written at Lloyd's,

the threshold conditions which are relevant to the discharge by the PRA of its functions in relation to D are the conditions set out in paragraphs 5B to 5F.

Legal status

5B. If D carries on or is seeking to carry on a regulated activity which consists of or includes accepting deposits or issuing electronic money, D must be —

- (a) a body corporate; or
- (b) a partnership.

Location of offices

5C. (1) If D is a body corporate constituted under the law of any part of the United Kingdom —

- (a) D's head office and,
- (b) if D has a registered office, that office,

must be in the United Kingdom.

(2) If D is not a body corporate but D's head office is in the United Kingdom, D must carry on business in the United Kingdom.

Business to be conducted in a prudent manner

5D. (1) The business of D must be conducted in a prudent manner.

(2) To satisfy the condition in sub-paragraph (1), D must in particular have appropriate financial and non-financial resources.

(3) To have appropriate financial resources D must satisfy the following conditions —

- (a) D's assets must be appropriate given D's liabilities;
- (b) the liquidity of D's resources must be appropriate given D's liabilities and when they fall due or may fall due; and
- (c) D must be willing and able to value D's assets and liabilities appropriately.

(4) To have appropriate non-financial resources D must satisfy the following conditions —

- (a) D must have resources to identify, monitor, measure and take action to remove or reduce risks to the safety and soundness of D;
- (b) D must have resources to identify, monitor, measure and take action to remove or reduce risks to the accuracy of D's valuation of D's assets and liabilities;
- (c) the business carried on by D must be, to a material extent, managed effectively; and
- (d) D's non-financial resources must be sufficient to enable D to comply with —

- (i) requirements imposed or likely to be imposed on D by the PRA in the course of the exercise of its functions; and

- (ii) any other requirement in relation to which the PRA is required to maintain arrangements under section 2J.

(5) The matters which are relevant in determining whether D satisfies the condition in sub-paragraph (1) or (2) include —

- (a) the nature (including the complexity) of the regulated activities that D carries on or seeks to carry on;
- (b) the nature and scale of the business carried on or to be carried on by D;
- (c) the risks to the continuity of the services provided or to be provided by D;
- (d) the effect that the carrying on of the business carried on or to be carried on by D might be expected to have on the stability of the UK financial system;
- (e) the effect that D's failure might be expected to have on the stability of the UK financial system; and
- (f) whether D is a member of a group and any effect which that membership may have.

Suitability

5E. (1) D must be a fit and proper person, having regard to the PRA's objectives.

(2) The matters which are relevant in determining whether D satisfies the condition in sub-paragraph (1) include —

- (a) whether those who manage D's affairs have adequate skills and experience and act with probity;
- (b) whether D has complied and is complying with obligations imposed by the PRA in the course of the exercise of its functions, or requests made by the PRA relating to the provision of information to the PRA; and
- (c) if D has so complied or is so complying, the manner of that compliance.

Effective supervision

5F. (1) D must be capable of being effectively supervised by the PRA.

(2) The matters which are relevant in determining whether D satisfies the condition in sub-paragraph (1) include —

- (a) the nature (including the complexity) of the regulated activities that D carries on or seeks to carry on;
- (b) the complexity of any products that D provides or seeks to provide in carrying on those activities;
- (c) the way in which D's business is organised;
- (d) if D is a member of a group, whether membership of the group is likely to prevent the PRA's effective supervision of D;
- (e) whether D is subject to consolidated supervision required under any of the relevant directives; and
- (f) if D has close links with another person ('CL') —
 - (i) the nature of the relationship between D and CL;
 - (ii) whether those links or that relationship are likely to prevent the PRA's effective supervision of D; and
 - (iii) if CL is subject to the laws, regulations or administrative provisions of a territory which is not an EEA State ('the foreign provisions'), whether those foreign provisions, or any deficiency in their enforcement, would prevent the PRA's effective supervision of D.

(3) D has close links with CL if —

- (a) CL is a parent undertaking of D;
- (b) CL is a subsidiary undertaking of D;
- (c) CL is a parent undertaking of a subsidiary undertaking of D;
- (d) CL is a subsidiary undertaking of a parent undertaking of D;
- (e) CL owns or controls 20% or more of the voting rights or capital of D; or
- (f) D owns or controls 20% or more of the voting rights or capital of CL.

(1) HM Treasury will consult on an Order to introduce these Threshold Conditions in October 2012.

from within the European Economic Area (EEA), branches from other countries and UK-owned subsidiaries of international firms, including some that are systemically relevant in their own right. Reflecting the heritage of the City, the PRA will supervise firms from all around the globe from a total of 60 countries.

28. Some issues will be common to all these firms. All undertake maturity transformation and are levered, leaving them inherently vulnerable to a loss of confidence. This underlies the PRA's objective to promote their safety and soundness — so that they are financially sound, and run in a prudent manner — which the PRA will advance by setting out policies that firms should meet in the spirit as well as to the letter.

29. The PRA will supervise firms to judge whether they meet these policies, at the time of assessment and on a forward-looking basis, and will take action where needed to restore safety and soundness. Recognising the wide diversity of firms' businesses, the PRA will tailor its supervision to their particular firm.

30. The PRA's approach is necessarily determined in an international context. Banking is an international industry, with firms supervised on a co-operative international basis and the policy framework for supervision to a large extent agreed internationally. Given the international nature of UK banking, effective international co-operation, on individual firms and on general policy, will be essential to the PRA's success.

The PRA's expectations of firms — policies

31. **Advancing the PRA's objective will ultimately rely on firms conducting their businesses in a safe and sound manner.** This will often require them to act more prudently than they would otherwise choose, in the presence of incentives to take more risk, and thus to impose more risk on the stability of the financial system, than is in the public interest. Countering this tendency is the primary role of a prudential regulator (see Box 2 on the underlying economic justification for prudential regulation).

32. The criteria against which firms' safety and soundness will be assessed will be rooted in the PRA's statutory objective, the statutory Threshold Conditions for authorisation, and UK and EU law. The Threshold Conditions require firms to: have an appropriate amount and quality of capital and liquidity; have appropriate resources to measure, monitor and manage risk; be fit and proper; and conduct their business prudently.

33. **The PRA will set out clearly, including in this document, the criteria against which it will judge the safety and**

soundness of firms, so that firms can understand what the PRA expects. This paper sets out high-level policies that elaborate on the Threshold Conditions and which will be supported in many cases by more detailed material published by the PRA and directly applicable rules set at EU level. Firms should refer to these also for further elaboration on what is expected of them.⁽¹⁾

34. In general, the PRA will inherit the prudential aspects of the FSA's detailed policy framework. However, in the light of its objective and the new Threshold Conditions, and as explained in this document, in assessing firms the PRA will place greater emphasis on certain criteria than the FSA has in the past done. In addition, in some specific cases, this document sets out new expectations which have not previously been expressed to firms.

35. Rules will set out some of the requirements that a firm must meet in order for its business to be conducted in a safe and sound manner. But the PRA will expect firms not merely to meet the letter of the requirements, nor indeed to game them by engaging in 'creative' compliance or regulatory arbitrage designed to mask the riskiness of activities or business models. Rather, **firms should maintain sight of the overriding principle of their safety and soundness and act accordingly.** Support for this objective should be embedded in every firm's culture. So that there are no ambiguities about its intended outcomes, the PRA will set out, in this document and elsewhere, the purpose and principles of its approach.

The PRA's approach to supervision

36. The PRA will supervise firms to judge whether they are acting in a safe and sound manner, and so whether they meet, and are likely to continue to meet, the Threshold Conditions.

37. **The PRA will weight its supervision towards those issues and those firms that, in its judgement, pose the greatest risk to the stability of the UK financial system.** The frequency and intensity of the supervision experienced by firms will thus increase in line with the risks they pose. The PRA will aim always to focus on material issues when engaging with firms.

38. **The PRA will be forward looking, assessing safety and soundness not just against current risks, but also against those that could plausibly arise further ahead.** And where the PRA judges it necessary to intervene to mitigate the risks a firm is creating, it will seek to do so at an early stage. To support this, firms should be open and straightforward in their

(1) Detailed requirements will be set out in PRA rules, including transposition of the Capital Requirements Directive relevant to all deposit-takers and investment firms except credit unions, and specific 'Sourcebooks' relevant for example to building societies and credit unions.

Figure 1 The PRA's risk framework

Gross risk			Mitigating factors				
Potential impact	Risk context		Operational mitigation		Financial mitigation		Structural mitigation
Potential impact	External context	Business risk	Management and governance	Risk management and controls	Capital	Liquidity	Resolvability

dealings with the PRA, taking the initiative to raise issues of possible concern also at an early stage. The PRA, for its part, will respond proportionately. Trust can thus be fostered on both sides.

39. The PRA's approach will rely significantly on judgement.

Supervisors will reach judgements on the risks that a firm is running; the risks that it poses to the PRA's objective; whether the firm is likely to continue to meet the Threshold Conditions; and how to address any problems or shortcomings identified. And, in particular, supervisors will need to decide which risks are the most material and must be pursued. A judgement-based approach is necessary in a forward-looking regime, where the future state of the world is inherently uncertain. Use of judgement is also necessary in the context of a complex financial system where compliance with detailed rules is, on its own, unlikely to secure acceptable outcomes.

40. The PRA's supervisory judgements will be based on evidence and analysis. Nevertheless, it is inherent in a forward-looking system that, at times, the supervisor's judgement will be at variance with that of the institution. Furthermore, there will be occasions when events will show that the supervisor's judgement, in hindsight, was wrong.

41. In order to minimise such outcomes, the PRA will need to be staffed by people with strong, relevant skills and experience (see Box 7 on staffing the PRA). And its major judgements and decisions will involve the PRA's most senior and experienced staff and directors. The PRA will engage with the boards and senior management of firms in forming its decisions, using this dialogue both to ensure that it takes account of all relevant information in reaching its judgements and to communicate clearly the rationale for them. Firms should not, however, approach their relationship with the PRA as a negotiation.

42. The PRA will ensure that it recognises promptly when its concerns appear subsequently to be unjustified, and so when its actions need to be adjusted.

The PRA's risk framework

43. The PRA will take a structured approach when forming its judgements. The framework used, which is illustrated in Figure 1, will capture three key elements:

- the *potential impact* that a firm could have on financial stability, both by the way it carries on its business and in the event of failure (as described in paragraphs 17–20 above);
- how the external context in which a firm operates and the business risks it faces (together, its *risk context*) might affect the viability of the firm; and
- *mitigating factors* including: a firm's management and governance and its risk management and controls (operational mitigation); its financial strength, specifically capital and liquidity (financial mitigation); and its resolvability (structural mitigation).

44. The intensity of the PRA's supervisory activity will vary across firms. The level of supervision will principally reflect the PRA's judgement of a firm's potential impact on the stability of the financial system; its proximity to failure (as encapsulated in the Proactive Intervention Framework, which is described below); and its resolvability. Other factors, including the complexity of the firm's business and organisation, will also play a part.

45. The following sections: examine in more detail the individual elements of this risk framework; describe the work the PRA will do to support its judgements; and set out what the PRA will expect of firms in these areas. Box 3 sets out how the PRA will interact with other authorities both domestically and internationally in support of its approach.

Box 2

Underlying economic justification for prudential regulation

It is likely that, in the absence of prudential regulation, deposit-takers and investment firms would take more risk and be less safe and sound, with the financial system as a whole in consequence less stable, than is in the public interest. This box explains the key factors which account for this, and which prudential regulation aims to counter.

Because of the typically liquid nature of their liabilities, it is possible for deposit-takers, and to some extent investment firms, to be subject to 'runs', even if they are solvent (with their assets worth more than their liabilities). This destroys economic value. Deposit guarantees and central bank liquidity insurance exist to address this problem. But they in turn reduce the incentives for firms to manage their business in a prudent manner ('moral hazard'), creating the potential for excessive risk-taking. Prudential regulation can help to address this.

Prudential regulation is also necessary to address the risks that deposit-takers and investment firms can pose more widely to the stability of the system. The failure of deposit-takers can disrupt the payment system and so depositors' ability to undertake economic activity. And some of the lending provided by banks (for example to small and medium-sized companies) may be difficult to substitute from capital markets, meaning that bank failures or financial weakness can severely affect the supply of credit to the economy as a whole.

Compounding this, deposit-takers and investment firms are also more vulnerable to failure than other types of firm. They tend to be more interconnected, for example through credit exposures, than other types of firm, increasing the risk that the failure of one institution will lead to the failure of others. And the failure of one firm can also affect confidence in others with similar business models, triggering runs as described above.

At an individual level, firms have no incentive to take into account such system-wide effects, but collectively they share an interest in a stable financial system. They thus face a 'collective action' problem. And, crucially, the risk that the failure of a firm could cause wider disruption to the financial system underpins expectations of the state providing solvency support to them. This moral hazard again compounds incentives for excessive risk-taking and reduces market

discipline. Prudential regulation can help to address these problems.

Another factor which can contribute to firms being less safe and sound and the financial system less stable than is in the public interest is that it can be difficult for the owners of a deposit-taker or investment firm to control the firm effectively. This problem exists for all firms where ownership and control are separate, but is particularly acute for financial firms because of the opacity of the value of their assets and liabilities. Compounding this, it is difficult for owners (who can be a diverse and numerous set of shareholders or members) to co-ordinate themselves to acquire the information that they would need to monitor management's activities more effectively. Managers can have their own objectives, different to those of the firm's owners, and this may result in them taking excessive risk, for example through pursuing growth in the interests of short-term reward. A further problem can exist between senior management and individual risk-takers (such as traders); with the latter having incentives to take excessive risk outside the formal control structures of the firm.

In addition, when a firm is owned by private shareholders whose stake is leveraged through borrowing from depositors and other creditors, the owners will tend to have an incentive to take on more risk than is in the interests of the firm's creditors. That is because shareholders, although the first bearers of loss, typically have limited liability in the event of failure but enjoy the unlimited upside associated with successful risk-taking. So maximising the expected return on equity in the interests of shareholders will tend to mean taking on more risk than is in the interests of creditors, particularly given shortcomings in creditors' ability and incentives to exert discipline over firms or expectations of state solvency support.

Box 3

Working with other authorities

Co-ordination with other authorities will be essential to the PRA's success. This box outlines the PRA's approach to interaction with these other bodies.

Bank of England and FPC

The PRA will be a part of the Bank of England, and will therefore be connected to its other functions — including its role as lender of last resort, and its work on market intelligence, oversight of financial market infrastructure, prudential policy, financial sector resilience and resolution. This will facilitate the flow of information between these functions.

The PRA's objective of promoting the safety and soundness of firms, focusing primarily on the harm that they can cause to the UK financial system, will complement the Bank's wider objective to 'contribute to protecting and enhancing the stability of the financial systems of the United Kingdom'. And the PRA's focus on minimising the adverse effects of firm failure will complement the special resolution objectives under the Banking Act 2009 which the Bank, as Special Resolution Authority, shares with other authorities.

An effective regulatory framework for financial stability also needs to combine firm-specific supervision with work to protect and enhance the resilience of the financial system as a whole. The PRA will therefore work closely with the FPC, within the Bank, which will have statutory responsibility for reducing risks to the financial system as a whole.

The FPC will be able to make recommendations and give directions to the PRA on specific actions that should be taken in order to achieve the FPC's objectives. The PRA will be responsible for implementing FPC recommendations on a 'comply or explain' basis, and for complying with the FPC's directions in relation to the use of macroprudential tools, specified by HM Treasury in secondary legislation.⁽¹⁾ The PRA will report to the FPC on its delivery of these recommendations and directions.

There will be a frequent two-way flow of information and exchange of views between the PRA and the FPC. The PRA will provide firm-specific information to the FPC, to assist its macroprudential supervision. And the FPC's assessment of systemic risks will influence the PRA's judgements in pursuit of its own objective.

Co-ordination between the PRA and the FPC will be assisted by the common membership of the Governor of the Bank of England, the Deputy Governor for Financial Stability and the Chief Executive Officer (CEO) of the PRA on both the PRA Board and the FPC.

FCA

While the PRA will regulate firms for prudential purposes, the FCA will act as firms' conduct regulator. The PRA will have a statutory duty to co-ordinate with the FCA in the exercise of its public functions, including policymaking and supervision. A Memorandum of Understanding (MoU) between the FCA and the PRA will describe how the two regulators will fulfil this duty to co-ordinate in a way that supports each regulator's ability to advance its own objectives.⁽²⁾

A key principle for this co-operation, given the regulators' separate mandates for prudential and conduct regulation, will be that each authority should focus on the key risks to its own objectives, while being aware of the potential for concerns of the other.

In some cases, the two authorities will have a direct interest in the same issue, but from different perspectives, or at different levels of detail. For example, the PRA will want to understand risks to a firm's capital and profitability if sums are due as redress for a conduct matter, but it will not need to be close to the details of the remedial action, as the FCA will.

In other cases, there will need to be closer co-operation. For example, the FCA and the PRA will share their respective views on key conduct and prudential issues facing a firm. Public actions such as enforcement cases will be carefully co-ordinated to assess the potential for more significant prudential implications. And from an operational perspective, structured data routinely collected by one regulator will be readily accessible to the other.

Co-ordination between the PRA and the FCA will also be assisted by the membership of their CEOs on each other's board. This cross-board role will focus on areas of overlap and discussions of material relevance to each CEO's own organisation. Co-ordination between the organisations will also be assisted by common membership of their CEOs on the FPC.

The PRA and the FCA will also be party to other MoUs with the Bank as a whole and HM Treasury on international

engagement, and the rest of the Bank on the oversight of financial market infrastructure.

Other UK bodies

The PRA will often need to work with other UK regulators, either to pursue its own objective or to assist them in theirs; this may also include other enforcement agencies.

The PRA will have agreements to support the sharing of information and judgements, and the co-ordination of actions. The PRA's general approach to these arrangements and the relationships they underpin will be focused on:

- enabling all parties to focus on their own objectives;
- the substantive issues of potential co-ordination;
- avoiding where possible a detailed, prescriptive approach, to ensure that judgement and flexibility are not lost; and
- provisions for regular review, ensuring that MoUs remain current and embedded within the organisations.

International co-operation

Banking is an international industry. Many UK firms have operations overseas, and many firms domiciled overseas have subsidiaries or branches in the United Kingdom.

Deposit-takers and investment firms are therefore supervised on a co-operative international basis, and the policy framework for this supervision is to a large extent agreed globally, including by the Basel Committee on Banking Supervision (BCBS) and Financial Stability Board (FSB), to ensure that all jurisdictions uphold appropriate standards in their collective interest.

The PRA will participate actively in global and European supervisory fora, playing a full and active role with its counterparts in supervising cross-border firms, and seeking to be an influential and persuasive participant in international policy debates. In particular, the PRA will actively participate in the work of the FSB and the BCBS. And it will aim to influence and reflect in its approach the work of the European System of Financial Supervision, of which it will be a part.

The approach to supervision set out in this document implements the PRA's international obligations and commitments, including the Basel Committee's *Core Principles for Effective Banking Supervision* and its *Concordat on consolidated supervision* and subsequent publications on international supervisory co-ordination.

(1) See HM Treasury consultation on the FPC's macroprudential tools, published September 2012, available at www.hm-treasury.gov.uk/press_83_12.htm.

(2) See the draft Memorandum of Understanding: www.bankofengland.co.uk/financialstability/Documents/overseeing_fs/fca_pra_draft_mou.pdf.

II Identifying risks to safety and soundness

46. The PRA's approach relies on supervisors understanding the significance of individual firms to the stability of the UK financial system, the nature of the firm's business and the wider economic environment, and the potential risks to the PRA's objective that, together, these entail. This section describes how the PRA will assess this.

Potential impact

47. As a core part of its work, **the PRA will assess the significance of a firm to the stability of the UK financial system.** This 'potential impact' will reflect a firm's potential to affect adversely the stability of the system by failing, coming under stress, or the way it carries on its business. **The PRA's assessment will:**

- help to **determine the intensity of supervision for a firm;** and
- **help focus the supervisory strategy,** by identifying particular areas where a firm provides critical economic functions, and so highlighting likely sources of significant risk to the PRA's objective.

48. As described in paragraphs 17–20, the potential for a firm adversely to affect the stability of the financial system will depend both on the functions it provides and its significance within the system. In broad terms, the critical economic functions that firms provide are: payment, settlement and clearing; retail banking; corporate banking; intra-financial system borrowing and lending; investment banking; and custody services. The scale of a firm's potential impact will depend on its size, complexity, business type and interconnectedness with the rest of the system.

49. The PRA will divide all the deposit-takers, investment firms and insurers it supervises into the five 'categories' of impact below:

Category 1

- The most significant deposit-takers, investment firms or insurers whose size, interconnectedness, complexity and business type give them the capacity to cause very significant disruption to the UK financial system (and through that to economic activity more widely) by failing or by carrying on their business in an unsafe manner.
- Insurers whose size (including number of policyholders) and type of business mean that there is very significant capacity

to cause disruption to the interests of a substantial number of policyholders.

Category 2

- Significant deposit-takers, investment firms or insurers whose size, interconnectedness, complexity and business type give them the capacity to cause some disruption to the UK financial system (and through that to economic activity more widely) by failing or by carrying on their business in an unsafe manner.
- Insurers whose size (including number of policyholders) and type of business mean that there is significant capacity to cause disruption to the interests of a substantial number of policyholders.

Category 3

- Deposit-takers, investment firms or insurers whose size, interconnectedness, complexity and business type give them the capacity to cause minor disruption to the UK financial system by failing or by carrying on their business in an unsafe manner, and where difficulties across a whole sector or subsector have the potential to generate disruption.
- Insurers whose size (including number of policyholders) and type of business mean that there is minor capacity to cause disruption to the interests of a substantial number of policyholders.

Category 4

- Deposit-takers, investment firms or insurers whose size, interconnectedness, complexity and business type give them very little capacity individually to cause disruption to the UK financial system by failing or by carrying on their business in an unsafe manner, but where difficulties across a whole sector or subsector have the potential to generate disruption.
- Insurers whose size (including number of policyholders) and type of business mean that there is very little capacity to cause disruption to the interests of a substantial number of policyholders.

Category 5

- Deposit-takers, investment firms or insurers whose size, interconnectedness, complexity and business type give them almost no capacity individually to cause disruption to the UK financial system by failing or by carrying on their business in an unsafe manner, but where difficulties across a whole sector or subsector may have the potential to generate some disruption.

- Insurers whose size (including number of policyholders) and type of business mean that there is no capacity to cause disruption to the interests of a substantial number of policyholders.

50. The PRA will also consider the substitutability of the services that the firm provides, and the extent to which this could mitigate the impact of failure. It will be mindful that the extent to which this is possible may differ in benign and stressed circumstances.

51. The PRA will use quantitative and qualitative analysis to allocate firms to categories. Numerical scoring based on firms' regulatory reporting will provide a 'suggested' categorisation. And supervisors will review categorisations in light of qualitative analysis, to confirm that it presents a full picture of a firm's potential impact.

52. Firms will be told to which category they have been assigned, providing a broad indication of what level of supervisory interaction to expect. The PRA will intend to publish aggregate statistics on the number of firms in each category in its *Annual Report*.

External context

53. **Any assessment of the risks facing firms requires an appreciation of the external context in which they operate.** The PRA's assessment will therefore include consideration of system-wide risks, for example from low interest rates, excess credit growth or international imbalances, and sectoral risks, for example in commercial real estate.

54. The PRA will draw on work by other parts of the Bank, including the views of the FPC on the macroprudential environment. Sectoral analysis to understand key market developments over the medium term will draw upon both market intelligence and, where appropriate, standardised information from firms.⁽¹⁾ The PRA will also consider actions by other regulators, including the FCA, that might materially affect the prudential soundness of PRA-regulated firms.

Business risk

55. **Business model analysis will form an important part of the PRA's supervisory approach.** The PRA will examine the threats to the viability of a firm's business model, and the ways in which a firm could create adverse effects on other participants in the system by the way it carries on its business. The analysis will include an assessment of where and how a firm makes money, the risks it takes in so doing, and how it funds itself. Firms will be assessed at the level of the firm or the sector as appropriate.

56. The PRA will aim to understand a business model's sustainability and vulnerabilities. Vulnerabilities might include: unsustainable expectations of growth; heavy reliance on an inflexible structure of net interest income, with consequent exposure to a low interest rate environment; concentrated funding sources which may dry up in stressed circumstances; or significant consequences following a change in credit rating. The PRA will use this work to focus its supervisory activity.

57. For those firms posing greater risk to the stability of the system, the analysis will be more detailed. It will include a review of the drivers of profitability, risk appetite, performance targets and underlying assumptions, and a firm's own forecasts and their plausibility. The PRA will use this analysis to form a projection of the firm's ability to generate returns and the associated risk and funding profile over the medium term. This projection, and the general picture supervisors form of the nature of the business, will guide the PRA's work in assessing the adequacy of the measures the firm has in place to mitigate risk. For example, the PRA's forward-looking view of the firm's prospects will inform its judgement on the level of capital a firm requires; and the complexity of the firm's business will inform judgements about a firm's risk management procedures. If the PRA believes that mitigating measures alone cannot adequately reduce material risks to the safety and soundness of the firm, it will require the firm to change its business model.

58. **Peer analysis will form an important part of this assessment,** providing a diagnostic tool to highlight where individual institutions may be outliers relative to their sector and so in need of further analysis. Such analysis will also support an understanding of common sectoral risks that have the potential to affect the stability of the system, on which it will involve the FPC.

59. **The PRA's assessment of business risk will also include an assessment of whether the PRA can effectively supervise the activities that a firm carries out** — whether it is possible, with a reasonable amount of effort, for the PRA to form a clear view of the risks posed to the safety and soundness of the firm. Where a firm's business is particularly complex, the PRA will consider whether it is possible to evaluate effectively the prudential risks to the firm arising from it.⁽²⁾ Where the PRA identifies material barriers to effective supervision, it will require remedial action.

(1) That is, information reported in a pre-agreed format by a defined set of firms, using common definitions.

(2) The PRA will take this into account in its assessment of a firm against the 'effective supervision' Threshold Condition, that a firm must be capable of being effectively supervised by the PRA.

60. Other key attributes that will determine whether a firm is capable of being effectively supervised are the organisational structure of its group and its ability to provide sufficient information to the PRA. For example, for firms with operations overseas the PRA will examine the local legal and regulatory regimes in the relevant jurisdictions, particularly where any features of those regimes are not equivalent to UK standards, or are likely to affect the quality or flow of information to the PRA. The criteria for assessing whether a firm can be supervised effectively are considered further in Section III, in respect of the PRA's expectation of firms around management and governance and risk management and controls, and in Section IV, in respect of the PRA's approach to supervision of international firms (see Box 5).

III Safeguarding safety and soundness

61. **The PRA will assess whether a firm has in place adequate measures to safeguard its safety and soundness, in light of the risks the firm poses to the PRA's objective.**

These mitigating measures include: management and governance, risk management and controls, capital, liquidity and resolvability. This section sets out some of the key criteria against which the PRA will assess the adequacy of these measures. It also outlines some specific supervisory activities that the PRA will undertake to assess them; more general supervisory activities are outlined in the next section.

62. **The PRA will expect higher standards of risk mitigation from firms posing greater risks to the stability of the UK financial system.** The forthcoming additional capital buffer for systemically important firms, as agreed as part of Basel III, is an example of this. Similarly, a firm that is highly interconnected or otherwise significant to the financial system may be required to have more effective risk management.

63. Where possible, the PRA will take an integrated view of the elements of mitigation that a firm has in place. This might mean that supervisors may want a firm temporarily to hold additional capital to make up for perceived shortcomings in risk management. Nevertheless, **firms must meet a minimum level of adequacy across all areas** in the long term: high levels of capital cannot act as a long-term substitute for sub-standard management, for example.

64. The PRA will expect firms to meet its expectations on both a consolidated basis for groups headquartered in the United Kingdom, for UK subgroups of wider global groups, and at the level of regulated legal entities. A regulated firm's relationships with other entities in the group may affect its prudential soundness, for example through access to capital, intra-group exposures or contagion.

65. As well as setting expectations of firms, the PRA will advance its objective by taking action to improve the wider environment within which firms operate. In particular:

- The PRA will work with the FCA and the Financial Reporting Council where appropriate to improve the quality and usefulness of information disclosed on firms' safety and soundness. This includes key information on financial risk and accounting judgements, on a consistent basis across firms, and regulatory returns as necessary. Disclosure of such information assists creditors in judging the risk they

take in lending to the firm. This in turn improves firms' own incentives to mitigate those risks. As it becomes more feasible for the authorities to allow firms to fail, market discipline should become a more powerful force on firms.

- Making rules for the FSCS in respect of deposits. The existence of deposit guarantees can reduce the risk of 'runs' on firms and therefore of contagion, provided they are widely understood. The design of the scheme, including for example its funding arrangements, its capacity to support firm resolution and the arrangements for publicising the extent of cover under the scheme, are key to reducing risks to financial stability.

Management and governance

Overall approach

66. **It is the responsibility of each firm's board and management to manage the firm prudently, consistent with its safety and soundness, thereby contributing to the continued stability of the financial system.** This goes beyond complying with the letter of the PRA's detailed requirements, for example, on adequate capital and liquidity and risk management and controls, and it will often mean firms acting more prudently than they would otherwise choose. It also goes beyond core responsibilities for all boards and management, such as ensuring that individuals appointed to senior management positions are competent to fill such roles, setting the firm's strategy and policies clearly, and ensuring that these are applied throughout the organisation, with responsibilities clearly apportioned.

67. The boards and management of regulated firms must understand the kind of behaviour that will deliver an acceptable level of safety and soundness from the point of view of the financial system, and act accordingly. This includes following the PRA's policies in line with their spirit and intended outcome — not managing the business only to the letter, or gaming the rules. And it includes embedding the principle of safety and soundness in the culture of the whole organisation. Without such effective, prudent management and governance, it is not possible for firms to ensure their own safety and soundness.

68. For a firm to be permitted to carry out regulated activities, the firm as a whole must be 'fit and proper'. At initial authorisation, the PRA will take into consideration the record of the firm itself where appropriate and those who manage its affairs, including the existence of any record of past misconduct.⁽¹⁾

(1) This includes the existence of any spent and unspent convictions, regulatory investigations and enquiries, prior refusals of authorisations and/or connections with unsuitable persons.

69. This requirement, for the firm and those managing its affairs to be 'fit and proper', is in addition to the obvious need for a firm's board and senior management, and in particular its Chair, to have regard to the need for the firm to comply with all applicable laws and regulations. These obligations are extensive and not limited to the laws and regulations enforced by the PRA. This is because other laws and regulations — for instance, conformity with tax laws — could affect a firm's fitness and properness, and the probity and reputation of its management.

70. This section elaborates on these broad expectations. In many cases these expectations will be directly reflected in PRA rules. More generally they elaborate on the 'prudent conduct', 'suitability' and 'effective supervision' Threshold Conditions. They are broken down into: culture and behaviour, competence and structures.

Culture and behaviour

71. The PRA will expect firms to have a **culture that supports their prudent management**. The PRA will not have any 'right culture' in mind when making its assessment; rather it will focus on whether boards and management clearly understand the circumstances in which the firm's viability would be under question, whether accepted orthodoxies are challenged, and whether action is taken to address risks on a timely basis. The PRA will want to be satisfied in particular that designated risk management and control functions carry real weight within firms.

72. Individuals, whatever their position in the firm, will have to take responsibility for acting in a manner consistent with its safety and soundness.

73. The PRA will expect firms to have in place sufficient controls to **minimise incentives for excessive risk-taking** by management and risk-taking staff. Remuneration and incentive structures should reward careful and prudent management.

74. The PRA will expect firms and individuals within them to **deal with the PRA (and other regulators as appropriate) in an open and co-operative manner**. That includes taking the initiative to disclose anything relating to the firm, and financial stability more generally, of which the PRA would reasonably expect notice, and providing the PRA with the information it requests on a timely basis. Boards and senior management will be expected to ensure that all staff comply with this requirement.

75. The PRA will expect a **firm's board to take responsibility for establishing, embedding and maintaining the type of culture described above**.

76. More generally, a **firm's board should hold management to account for conducting the firm's business in line with the board's expectations**. That should include the board (and its committees) engaging with management to test the robustness and prudence of the assumptions in the business plan and strategic initiatives, the adequacy and integrity of controls, and the consistency of implementation of the board's decisions. To do this, the board needs to be provided with high-quality management information, both quantitative and qualitative.

77. The PRA considers the **responsibility of board members to be individual, as well as collective**. This means that, should any director have concerns about the firm or its management and governance, the PRA will expect them to press for action to remedy the matter and, if those concerns are not addressed, to alert the PRA. A firm's culture should be encouraging of this.

Competence

78. Firms must be **run by people who are competent to fill their roles**. That means ensuring that individuals have appropriate expertise and experience, and (in the case of non-executive directors) give sufficient time to fulfil their obligations to a high standard.

79. It is the **responsibility of a firm's board to ensure that individuals appointed to senior management positions are competent** to fill them. As a firm grows and changes, and as the challenges it faces change, it may need different board members and management. The Chair and independent directors should stand ready to have an open exchange of views with the PRA on the performance of senior management, as should the Senior Independent Director on the performance of the Chair.

80. The **board should have a mix and balance of skills so that collectively it can understand the breadth of the business**. The PRA will expect many on a firm's board to have expertise in financial services, though this will not be a pre-requisite for all members. The PRA will expect all board members, either at the outset or after a set period of time, to develop an understanding of the different areas of the business and the main prudential risks and controls and so to be able to engage in an informed conversation with the PRA. The PRA will expect more than one independent director to understand major lines of business and risk controls, in order to avoid undue reliance on individuals by the board as a whole.

Structures

81. The PRA will expect firms to have in place **clear structures of accountability and delegation of responsibilities** for

individuals and committees, including checks and balances to prevent dominance by an individual. Senior individuals should remain accountable for the actions of those to whom they delegate responsibilities, including where firms use third parties in respect of outsourced functions.

82. Within a financial group, **boards and senior management of all authorised entities, including those subject to consolidated supervision, should take responsibility for ensuring that the business is conducted in a prudent manner.** Boards cannot delegate this responsibility.

83. Not all legal entities within a group will necessarily be directly authorised by the PRA. Nonetheless, unregulated group entities can be important to the functioning of the group as a whole (for instance, by providing important support services), or can undertake activities which have the potential to create risks for the group as a whole and so for authorised firms. The PRA will expect all boards of legal entities within groups, as a result of the responsibilities of their holding company and its regulated affiliates, to have regard to the PRA's objective. **In cases where the most senior legal entity within a group is a holding company, and so not itself authorised under the United Kingdom's statutory regulatory regime, the PRA will expect to have extensive contact with its board and senior management, and will consider whether the holding company is suitable to exercise control over a regulated firm.** The PRA will expect the holding company to take responsibility for the group as a whole having due regard to the PRA's objective. And the PRA will consider whether the regulated firm's membership of a group affects whether the firm satisfies the Threshold Conditions, including if the ownership structure compromises the ability of the firm to be supervised effectively by the PRA. Further, if the actions of the holding company have or may have a material adverse effect on the authorised firm or the effectiveness of consolidated supervision, the PRA will exercise the power conferred by the Act to direct the holding company.⁽¹⁾

84. **These requirements on the boards and management of legal entities within groups apply equally to overseas firms** which establish separately incorporated entities within the United Kingdom. In particular, the PRA will expect boards and senior management of these firms to have proper regard to the PRA's objective, both for the group as a whole and for individual firms (and subgroups) in the United Kingdom, since issues at the parent or group level could have an effect on the PRA-regulated entity and the PRA's objectives more generally.

85. Firms are able to operate in the United Kingdom as branches of overseas legal entities, meaning that there is no separate legal entity in the United Kingdom. Such branches

can take one of two forms: those where the legal entity overseas is located within the EEA; and those located outside the EEA. Regardless of the corporate structure and location of the parent, the PRA will expect all UK branches, like UK subsidiaries, to act responsibly in a manner that is consistent with safety and soundness. The PRA will expect the branch to appoint a senior individual with authority to act as a primary contact with the PRA in relation to the branch's affairs. This individual should also act as a channel for communication with the parent. Box 5 sets out how the PRA will aim to ensure that its objective is met in respect of overseas firms.

Supervision — Approved Persons

86. The PRA will have the power under the Act to require individuals in identified roles with a significant influence on the affairs of a firm (Significant Influence Function roles) — and who are critical to the advancement of the PRA's objective — to seek PRA approval before taking up their position. Such individuals are known as 'Approved Persons'.

87. Those roles which the PRA will deem to be significant will include the: Chair, CEO, Finance Director, Chief Risk Officer, Head of Internal Audit, and the key non-executive directors, namely the Senior Independent Director and the Chairs of the Audit, Risk and Remuneration Committees.⁽²⁾ In addition, the PRA will wish to be able to consider any other role with responsibility for managing significant parts of the business, where that role is considered significant in the context of the supervision of that individual firm. Approval will only be granted if the PRA as prudential regulator and the FCA as conduct regulator are both satisfied that an individual is fit and proper.⁽³⁾

88. All individuals applying for the above roles will be subject to a basic review of probity, reputation and financial soundness, including criminal record and credit checks. The PRA will also perform an assessment of an individual's competence and capability to carry out the role. Assessing probity and integrity will reduce the risk of behaviour intentionally misaligned with the PRA's objective; assessing competence is necessary given the prime role of these individuals in ensuring the firm's safety and soundness. The nature and intensity of the PRA's assessment will depend on the potential impact of the firm.

(1) The Bank and the FSA will soon issue a consultation paper on the PRA's proposed policy regarding its power of direction over holding companies.

(2) To the extent that they exist as separate roles — where only some of these roles exist within an organisation, for example in a very small firm which has only a CEO and a Chair of the board, the PRA will assess only these individuals.

(3) A consultation paper detailing which functions will be designated by which authority was published on 3 October 2012; see www.fsa.gov.uk/static/pubs/cp/cp12-26.pdf.

89. The PRA may interview individuals applying for the above roles. Interviews will include an assessment of the technical experience of the applicant and his or her understanding of the risks posed to the viability of the firm and the risks posed by the firm to the wider financial system. The PRA will assess whether the firm has conducted an appropriately rigorous recruitment process and will take into account the due diligence done by the firm on the applicant.

90. The PRA will review the fitness and properness of individuals on an ongoing basis, including as part of its supervisory assessment of a firm against the Threshold Conditions.

91. While the PRA's Approved Persons regime applies only to individuals holding certain senior roles, the PRA will, as noted previously, expect all individuals within a firm to act in a manner consistent with its objective.

Disciplinary action against individuals

92. While the PRA's preference will be to use its statutory powers to secure *ex ante*, remedial action, it will also have a set of disciplinary powers which it will use *ex post* if necessary.

93. The PRA will have disciplinary powers over individuals approved to perform a Significant Influence Function by the PRA or FCA and will be empowered to use these where an individual acts in a manner inconsistent with the *Statement of principles and code of practice for Approved Persons*.⁽¹⁾ The powers enable the PRA to impose penalties, to censure an individual publicly, to withdraw approval from individuals holding Significant Influence Functions, and to prohibit individuals from holding Significant Influence Functions in the future.

94. In considering whether to take disciplinary action against Approved Persons, the PRA will consider a variety of factors, including:

- the impact the individual's behaviour has had or is having on the PRA advancing its objective — including the behaviour of other persons in the firm over which the individual should exercise control — and thus whether that behaviour calls into question the person's fitness and properness as an Approved Person (be it an isolated incident or a course of conduct); and
- the individual's behaviour towards the regulator, including the level of co-operation and openness with which the individual deals with the PRA and the appropriateness of the individual's actions in response to concerns raised.

Risk management and controls

Overall approach

95. The PRA will attach particular importance to firms managing risk effectively, because it is the crystallisation of risk, or concerns about risks crystallising in the future, that causes problems for firms' safety and soundness. **Firms should have robust frameworks for risk management and financial and operational control, commensurate with the nature, scale and complexity of their business, and consistent with their safety and soundness.** Competent and where appropriate independent control functions should oversee these frameworks.

96. This section sets out the PRA's expectations for a firm's approach to risk management, its control framework, and its risk management and control functions. In many cases these expectations will be directly reflected in PRA rules. More generally they elaborate on the 'prudent conduct' and 'effective supervision' Threshold Conditions.

Risk management approach

97. **The PRA will expect firms to articulate for themselves the amount of risk they are willing to take across different business lines to achieve their strategic objectives.** This risk appetite should be consistent with the PRA's objective, and the firm should pay appropriate attention to identifying, measuring and controlling risks, including those arising in unlikely but very severe scenarios.

98. The PRA will recognise that it is always possible to identify a stress scenario in which a firm fails, and it will not expect firms to be able to withstand all such events. The PRA will consider it important, however, for firms' senior management and boards to have an explicit understanding of the circumstances in which their firm might fail.

99. The PRA will expect a firm's risk appetite to be integral to its strategy and the foundation of its risk management framework, so that the whole firm operates within this appetite. This requires a **robust risk management framework and its effective and consistent implementation throughout the organisation.** Members of staff in both business and control functions should manage risks as a central part of their role, and responsibility for risk should not be delegated to risk management and control functions. This is a key aspect of a culture — see paragraph 71 — which supports the prudent management of the firm.

(1) Currently within the *FSA Handbook*: <http://fsahandbook.info/FSA/html/handbook/APER>.

100. The PRA will expect key decisions, both on assuming new risks and managing existing ones, to be taken at the appropriate level, including at the level of the board where they are sufficiently important. Risks should be reported to the board and senior management on a timely basis, with risks outside the agreed risk appetite and key sensitivities highlighted.

Control framework

101. A firm's control framework encompasses the processes, delegated authorities and limits that put into effect a firm's approach to risk management and control. The PRA will expect **a firm's control framework to be comprehensive in its coverage of the whole firm and all classes of risk, commensurate with the nature, scale and complexity of the firm's business, and to deliver a properly controlled operating environment** (including, for example, through segregation of duties, reconciliations or through the process to report and act on any breaches of limits).

102. The PRA will expect firms to observe high standards in the management of operational as well as financial risks. For example, **firms should have procedures in place to ensure continuity of critical services**. Firms will be expected to comply with standards for resilience set in this area, including where they outsource material operational functions to third parties.

103. The PRA will expect **firms to have available the information needed to support their control frameworks**. This information should be of an appropriate quality, integrity and completeness, to provide a reliable basis for making decisions and so to control the business within agreed tolerances. It should be produced in a sufficiently timely manner. And it should be able to be accessed and analysed both in aggregate for the business as a whole, across the group, and for each business line and legal entity within it, to facilitate understanding and swift management of the risks to which the firm is exposed. This is relevant also to the Threshold Condition that firms must be capable of being supervised effectively by the PRA. Senior management of a firm and the PRA need to be able, with a reasonable amount of effort, to form a clear view of the safety and soundness of the firm, including the financial position of the rest of its group and the risks posed by other individual entities within it.

104. One key element of having robust information will be sight of the likely path and risks around future earnings. Another will be processes explicitly to assess uncertainties in the valuation of assets and liabilities and so to ensure that material uncertainty is reported to the board and senior management.

105. While quantitative models can play an important role in supporting firms' risk management, the PRA will expect firms **to be prudent in their use of such models given the inherent difficulties with risk measurement**. Senior management and the board should therefore understand the extent of reliance on models for managing risk, as well as the limitations arising from the structure and complexity of models, the data used as inputs and underpinning assumptions. Models, and their output, should be subject to effective, ongoing and independent validation to ensure that they are performing as anticipated. The PRA will expect senior management to have a clear understanding of the risks that are not adequately captured by the models used, and the alternative risk management processes in place to ensure that such risks are adequately measured and incorporated into the firm's overall risk management framework.

Risk management and control functions

106. Firms should have in place separate risk management and control functions — notably risk management, finance and internal audit — to the extent warranted by the nature, scale and complexity of their business. The PRA will expect these functions to support and challenge the management of risks firm-wide, by expressing views within the firm on the appropriateness of the level of risk being run and the adequacy and integrity of the associated governance, risk management and financial and other control arrangements.

107. To the extent warranted by the nature, scale and complexity of the business, the PRA will expect these functions to be **independent of a firm's revenue-generating functions**, and to possess sufficient authority to offer robust challenge to the business. This will require these functions to be adequately resourced, to have a good understanding of the business, and to be headed by individuals at senior level who are willing and able to voice concerns effectively.

108. An effective **risk management function will ensure that material risk issues receive sufficient attention from the firm's senior management and board**.

109. A firm's finance function — which is responsible for the firm's official books and records — **should deliver an accurate understanding of the firm's financial position**, including through the effective challenge of Front Office valuations.

110. Internal audit should provide **independent assurance over firms' internal controls, risk management and governance**. And, in the absence of an internal audit function, there should be a review performed by an independent third party. The PRA will work closely with professional bodies for

internal auditors to develop a code that sets out expectations for the internal audit function of firms.

111. Senior management and the board should hear and heed the views of these functions. This will mean that they require access to the board and (where a firm has them) the board's Risk and Audit Committees, which should oversee the functions to ensure their independence and effectiveness.

Capital

Overall approach

112. **Firms should maintain appropriate capital resources, both in terms of quantity and quality, consistent with their safety and soundness and taking into account the risks to which they are exposed.** Having enough capital of sufficiently high quality reduces the risk of a firm becoming unable to meet the claims of its creditors, and is therefore crucial for maintaining their confidence, which is particularly important for deposit-takers and investment firms given their liabilities are of shorter maturity than their assets. In addition, where a firm is owned by private shareholders, having more shareholder equity — the highest form of capital — gives owners a greater interest in the firm being run prudently, because it increases the amount that they will lose in the event of failure.

113. **As with all elements of its approach, the PRA will expect firms in the first instance to take responsibility for ensuring that the capital they have is adequate.** But reflecting the incentives firms have to run their business in a less prudent manner than the public interest would indicate, there is also a clear role for the PRA as prudential regulator to specify a minimum amount of capital for firms to hold. This does not however diminish the need for firms themselves to judge the adequacy of their capital position in an appropriately prudent manner, since that is necessary to maintain the confidence of their creditors. Firms should engage honestly and prudently in assessments of capital adequacy, not least because the PRA's limited resource means that it cannot be expected to identify and account for all the risks that firms may face.

114. The rest of this section sets out what, at a high level, the PRA will expect with respect to the quality and quantity of firms' capital, including the main elements of the regulatory framework that will inform the minimum level of regulatory capital that firms are required to maintain. In many cases these expectations will be directly reflected in PRA rules, and more generally elaborate on the 'prudent conduct' Threshold Condition.

115. Reflecting the importance of combining firm-specific supervision with oversight of the financial system as a whole, there will in addition be a macroprudential objective in respect of capital maintained in aggregate by the banking system. This objective, and elements of macroprudential assessment more generally, for example top-down stress tests, will fall under the purview of the FPC.⁽¹⁾

Quality of capital

116. **The PRA will expect a significant part of a firm's capital to be ordinary shares and reserves.** These are the highest-quality form of capital as they allow firms to absorb losses on a going concern basis — that is, without prompting the winding up or legal reorganisation of the firm and consequent disruption and loss of value.

117. **The PRA will expect all capital to be capable of absorbing losses in the manner indicated by its place in the capital structure.** To this end, the PRA will expect all capital instruments to meet the clearly-stated internationally agreed criteria around the definition of capital,⁽²⁾ and it will expect firms to comply with these criteria in the spirit as well as the letter in structuring capital instruments. Reflecting this, the PRA will expect firms to refrain from innovation to structure new capital instruments intended to contribute to meeting their regulatory requirements if these are ineffective (or less effective) in absorbing losses. The PRA will not permit firms to count such instruments as capital where their incentive is to minimise issuance cost and promote the attractiveness to investors at the expense of genuine loss-absorbing capacity.

118. While less valuable in terms of the PRA's objective, lower-quality capital (for example, subordinated loan capital) can play a role if a firm has failed. In these circumstances, such capital can, in combination with an effective and credible resolution regime, assist the authorities to maintain continuity of the critical economic functions provided by a firm. Additionally, it may increase creditors' confidence in the firm insofar as it reduces the amount they would lose in the event of failure. And where deposits are insured by the FSCS, this capital can ultimately absorb some of the losses which the scheme would otherwise incur, thus protecting other surviving firms from which the FSCS would recover these losses.

(1) See HM Treasury consultation on the FPC's macroprudential tools, published September 2012, available at www.hm-treasury.gov.uk/press_83_12.htm.

(2) For banks, building societies and designated investment firms, those set out in the forthcoming Capital Requirements Regulation implementing the Basel Committee standards issued in December 2010; for credit unions, those currently set out in the Credit Union Sourcebook.

Location of capital

119. The PRA will be mindful that capital resources are not always freely transferable around a group when it matters most. Therefore, **the PRA will expect capital to be located in the regulated entities where it is needed.** Creditors' and counterparties' claims are on specific legal entities, not on groups, and should a firm fail, its orderly resolution will be facilitated if individual legal entities, and UK subgroups, hold capital commensurate with their risks. In order to support the integrity of individual regulated entities, the PRA will limit their intra-group exposures.

Level of capital

120. **The PRA will expect firms to take responsibility for maintaining at all times an adequate level of capital, consistent with their safety and soundness and taking into account the risks to which they are exposed.** Capital should be sufficient to absorb unexpected losses, including those arising from uncertainties about provisions and valuations, in a wide range of severe but plausible stresses, both market-wide and firm-specific. Such an approach is designed to maintain the confidence of a firm's creditors even in stressed circumstances.

121. The PRA will itself form a judgement about how much capital an individual firm will need to maintain, given the risks to which it is exposed and uncertainties about the values of assets and liabilities (except in the case of credit unions, which must abide only by the PRA's minimum prudential standards for these firms). The PRA's judgements will inform firms' own assessments. But **the PRA will expect firms in the first instance to take responsibility for determining the appropriate level of capital they should maintain.** Firms should engage honestly and prudently in the process of assessing capital adequacy, and not rely on regulatory minima. And they should not rely on aggressive interpretations of accounting standards, especially in calculating loan loss provisions.

122. **The PRA will expect all banks, building societies and designated investment firms to develop a framework for stress testing and capital management that captures the full range of risks to which they are exposed and enables these risks to be stressed against a range of plausible yet severe scenarios.** In support of this, the PRA will expect all firms to ensure that assets and liabilities are appropriately valued and that provisions are adequate. Firms should also take into account the effect of asset encumbrance insofar as it may reduce loss-absorbing capacity in resolution or liquidation. For its part, the PRA will ensure the stresses applied are appropriately prudent.

123. **Banks, building societies and designated investment firms are expected to develop, as a matter of routine, management actions in response to stress scenarios.**

Recovery plans — designed to return firms to a stable, sustainable position following firm-specific or market-wide stress — should include options to address capital shortfalls through generating capital internally and externally, and taking into account possible liquidity and profitability pressures. Recovery plans will be developed and owned by firms, which should put in place appropriate governance processes and triggers to ensure timely implementation in stress. Plans to generate capital internally should include restricting dividends and variable remuneration. The PRA will assess the adequacy of a firm's recovery plan, in terms of the adequacy of the recovery options it identifies and the triggers and governance to activate them.

The framework for determining regulatory capital

124. **For all banks, building societies and designated investment firms, the PRA will determine a minimum regulatory capital level and a buffer on top of this expressed in terms of the Basel and EU risk-weighted framework.** It will comprise three parts:

- *Pillar 1* — requirements to provide protection against credit, market and operational risk, for which firms follow internationally agreed methods of calculation and calibration.
 - *Pillar 2A* — requirements advised by the PRA reflecting (i) estimates of risks either not addressed or only partially addressed by the international standards for Pillar 1 (for example interest rate risk in the banking book or risks associated with firms' own pension schemes), and (ii) PRA estimates of the capital needed to compensate for shortcomings in management and governance, or risk management and controls (including valuation and accounting practices). The latter is designed to guard against unexpected losses while the deficiencies are addressed, and is not a long-term substitute for adequate standards in the underperforming areas.
- Pillars 1 and 2A together represent what the PRA regards as the minimum level of regulatory capital a firm should maintain at all times in order to cover adequately the risks to which it is exposed.
- *Pillar 2B* — guidance from the PRA reflecting a forward-looking assessment of the capital required to ensure that firms' minimum level of regulatory capital can be met at all times, even after severe but plausible stresses, when asset valuations may become strained. The PRA's

assessment of this 'Capital Planning Buffer' (CPB) will take into account the options a firm has to protect its capital position under stress, for example through internal capital generation.

The CPB is intended to be drawn upon in times of stress. The PRA will therefore expect and allow it to be used in stressed circumstances. If a firm's CPB is used, the PRA will expect the firm to indicate how it plans to rebuild it and over what timescale.

125. This framework will be revised in light of forthcoming changes to European Directives, particularly to the Capital Requirements Directive (CRD IV), which is likely to set out a number of additional requirements for capital buffers. This will include some buffers agreed via the FSB and covered in Basel III that will reflect a firm's size and systemic importance.

Internal capital models

126. **Although firms may use internal models to help to quantify their Pillar 1 capital requirements, the PRA will be generally sceptical that this approach on its own can provide an appropriate basis to calculate capital requirements.** This reflects the misalignment between firms' incentives and the regulator's desired outcomes, and so the potential for firms to use models to game regulatory requirements by masking the inherent riskiness of activities. Models can be complex and time consuming to review, and biases can be well hidden. In addition, and as described in paragraph 105, there are inherent difficulties in measuring risk using models, including limitations from their structure and complexity, the data used as inputs and the underpinning assumptions.

127. The PRA's overarching principle will be that it expects firms to maintain at all times an amount of capital that adequately reflects the risks to which they are exposed. In consequence, **if a firm is to use an internal model in calculating its regulatory capital requirements, the PRA will expect the model to be appropriately conservative.** Where the PRA judges the conservatism applied in an internal model not to be sufficient, it will take appropriate action to address the situation, which may include requiring methodological adjustments or recalibration, setting capital floors or imposing adjustments to modelled capital requirements.

128. Importantly, **the PRA will expect that where internal models are used for regulatory capital purposes, they should contribute to prudent risk management and measurement.** Consistent with this, firms should not select between internal model-based and non model-based 'standardised' approaches to calculating capital adequacy on

the basis of lower capital requirements. Where separate models are used for regulatory capital purposes and for internal purposes, the firm must be able to explain the difference between those models and show that they are reasonable.

129. A firm should use a model as the basis for its capital calculation only where model calibration, controls and governance arrangements are adequate, with models and their output subject to effective, ongoing and independent validation to ensure that they are performing as anticipated. The PRA will expect firms not to use internal models for particular asset classes where, drawing on the experience of the FSA, it judges it not possible to measure risk to a sufficient degree of confidence, notably because of a lack of data.

Leverage and concentrations

130. **To supplement the risk-weighted capital regime, firms should take into account leverage and concentrations of exposures when assessing the adequacy of capital levels.** In particular, the PRA will expect firms to consider whether their degree of leverage is appropriate against the internationally agreed measure of leverage and indicative minimum leverage ratio, and so whether they maintain sufficient capital on a non risk-weighted basis. In addition, it will expect firms to observe prudent limits on large exposures to individual counterparties, to help prevent a serious loss of capital in the event of a single default. More generally, firms are expected to run their businesses without excessive concentrations. These expectations and requirements act as a 'backstop' to the risk-weighted capital regime.

Supervision — Approval of internal models, Individual Capital Guidance and the Capital Planning Buffer

131. Where they are approved by the PRA, UK firms are able in principle to use internal models to quantify Pillar 1 capital requirements. **When approving internal models, the PRA will focus on ensuring that the capital requirements arising from them are appropriate when compared with other approaches, historical experience, other firms and earlier estimates of capital requirements for the same firms.** Firms must have their models approved by the PRA before use, and the PRA will consider withdrawing approval if it ceases to be convinced that the model is meaningfully measuring risk. The PRA may also choose to review a firm's approach to provisioning or its valuations of trading book and other fair-valued assets and liabilities, to identify where it is out of line with peers.

132. For all banks, building societies and designated investment firms the PRA will undertake a regular review of a firm's capital adequacy and its approach to capital

management. As part of this, the PRA will come to a judgement on the amount of supplementary capital required under Pillar 2A to cover risks not covered in Pillar 1 and will issue the firm with 'Individual Capital Guidance' (ICG) expressing this. The PRA may update ICG at any time. At a minimum, it will update its supervisory review of firms' capital adequacy annually, although the nature of the update will vary. For those firms that pose the greatest risk to financial stability, it will typically be reviewed in depth every year. For other firms it will normally be reviewed in depth in alternate years. The PRA will not issue ICG for credit unions. At present, the FSA requires firms to submit to it their proposed Pillar 2A requirement, which the FSA then assesses and amends as appropriate. The PRA's approach to setting Pillar 2A will be consulted on in due course.

133. As part of this review, the PRA will also issue firm-specific Capital Planning Buffer guidance — expressed in terms of a quality and quantity of capital to be held towards Pillar 2B — informed by stress tests and a rounded judgement of firms' business models. Forward-looking stress testing, tailored to firms' particular risks, will play an important part in the PRA's judgements about a firm's financial soundness in the presence of inevitable uncertainty about future risks. Stress tests will cover the quality of lending portfolios, the robustness of asset valuations and provisions, and the liquidity and valuations of trading portfolios. Stress tests will not be 'pass/fail' exercises but will instead be used to assess the balance of risks arising and will inform ongoing supervisory discussions with firms. The PRA will undertake detailed stress tests for the firms with the highest potential impact.

Liquidity

Overall approach

134. **Firms have to be able to meet their liabilities on an ongoing basis with sufficient confidence, including in stressed circumstances, consistent with their safety and soundness.**

135. As with all elements of its approach, **the PRA will expect firms in the first instance to take responsibility for ensuring they are able to meet their liabilities with sufficient confidence.** Reflecting however the incentives firms have to run their business in a less prudent manner than the public interest would indicate, there is a clear role for the PRA as prudential regulator in ensuring that firms have an appropriate degree of resilience to liquidity stresses.

136. The PRA will specify what it regards as an appropriate amount of liquidity (consistent with international standards where appropriate). This does not, however, diminish the need

for firms themselves to determine holdings of sufficient liquidity, since that is necessary to maintain the confidence of creditors and counterparties. Firms should engage honestly and prudently in the process of assessing liquidity risk, not least because the PRA's limited resource and proportionate approach means that it cannot be expected to identify and account for all the risks that firms may face.

137. The rest of this section sets out what, at a high level, the PRA will expect of firms when assessing whether they hold adequate liquidity. In many cases these expectations will be directly reflected in PRA rules, and more generally they elaborate on the 'prudent conduct' Threshold Condition.

138. Reflecting the importance of combining firm-specific supervision with oversight of the financial system as a whole, there will in addition be macroprudential considerations in respect of liquidity held by the banking system as a whole, which will fall under the purview of the FPC.

Liquid assets and maturity mismatch

139. The PRA will expect firms to hold an appropriate stock of liquid assets given the degree of maturity mismatch on their balance sheets and the potential for a wide range of severe but plausible short-term stresses.

140. **The PRA will expect firms to observe a prudent maturity-mismatch profile,** taking into account the expected behavioural as well as contractual maturities of liabilities. The PRA will expect firms not to be reliant on funding from a narrow set of sources, or to rely excessively on short-term wholesale funding sources that may prove difficult to secure during times of stress, taking into account that even access to secured funding can dry up if counterparties have concerns over a firm's solvency. Firms should also avoid reliance on maintaining particular credit ratings in securing and maintaining funding. In considering behavioural maturity, the PRA will expect firms to take account of the risk that asset encumbrance poses to unsecured funding and therefore the risk that unsecured funding is withdrawn rapidly in the event of stress.

141. **The PRA will expect firms to hold a buffer of high-quality, unencumbered assets that can reliably be traded or exchanged in private markets, including in stressed circumstances.** This buffer should enable a firm to withstand a wide range of severe but plausible stresses, both market-wide and firm-specific. This will give its counterparties confidence that it will be able to repay depositors and creditors on demand and give the firm a period of time to take action to deal with liquidity concerns without undue reliance on the Bank of England and other central banks.

142. As with capital, the PRA will reach its own view on the appropriate size and composition of the liquidity buffer that an individual firm should hold in normal, unstressed conditions (see Individual Liquidity Guidance below) except in the case of credit unions, which must simply abide by the PRA's minimum prudential standards for these firms. But it will expect firms in the first instance to take responsibility for determining the appropriate size of that buffer, taking into consideration the risks they face. Firms should engage honestly and prudently in the process of assessing liquidity risk, and not rely on regulatory minima.

143. **To support their judgements on the appropriate size and composition of liquidity buffers, the PRA will expect firms to develop a framework for managing liquidity risk that captures the full range of liquidity risks to which they are exposed and to stress test these risks and proposed management actions against a range of plausible yet severe scenarios.** For its part, the PRA will ensure the stresses applied are appropriately prudent. Beyond monetising the buffer of liquid assets, firms' Contingency Funding Plans (part of recovery plans more generally) should include a wide range of credible management actions to raise liquidity in times of stress. And firms should regularly 'turn over' their liquid assets in size in the market to reduce the risk that they encounter problems in trying to monetise them in times of stress.

144. The PRA will be mindful that liquidity resources will not always be freely transferable around a group when it matters most. The PRA will expect firms to take account of this in **ensuring that liquidity is available without impediment to the regulated entities where it is needed, including in stressed times.**

145. **A firm's liquid asset buffer is intended to be used.** In stressed circumstances, the PRA will therefore expect and allow deviation from the guidance that it issues. And it will expect firms to have credible options in their recovery plans for restoring their liquid asset buffers following firm-specific or market-wide stress. During periods of market stress, the PRA will allow firms that experience a reduction in their liquid assets as a result of the stress an appropriate period of time to rebuild their buffers fully. In addition, the activation by the Bank of England of the Extended Collateral Term Repo Facility (part of its permanent Sterling Monetary Framework) has demonstrated that additional liquidity will be made available to the market in response to actual or prospective market-wide stress to mitigate risks to financial stability. And its Discount Window Facility (DWF) will provide liquidity on a bilateral basis to any solvent and viable bank, with pre-positioned collateral, on demand. The PRA will therefore

allow firms, within limits, to take account in their liquid asset buffer of collateral pre-positioned in the DWF. The details of this will be for discussion with individual firms, taking into account their specific circumstances.

146. The PRA will expect eligible firms to sign up for the DWF and the Bank of England's liquidity insurance facilities more generally. Firms should pre-position collateral with the Bank and test their access regularly. The Bank's liquidity insurance operations are designed to encourage firms to manage their liquidity needs safely in the market rather than to turn to the Bank as a matter of routine.

147. The regulatory liquidity regime is subject to ongoing international debate. As soon as is practical, the PRA will outline a transition path from the current regime to new international standards.

Supervision — Individual Liquidity Guidance

148. For all banks, building societies and designated investment firms, the PRA will carry out a periodic review of the adequacy of a firm's liquidity position and of its liquidity risk management practices.

149. On the basis of this review, the PRA will issue each firm with Individual Liquidity Guidance (ILG) regarding the quality and quantity of liquid assets that should make up its buffer in normal times. The guidance will also indicate what the PRA considers to be an appropriate funding profile for the firm, in terms of the composition by different sources and maturities. As noted, the PRA will understand and expect that there may be deviation from the ILG in times of stress.

150. The PRA may update ILG at any time. It will update its liquidity assessment at least annually, although the nature of the update will vary. For those firms that pose the greatest risk to financial stability, it will typically be reviewed in depth every year. For other firms it will normally be reviewed in depth in alternate years. The PRA will not issue ILG for credit unions.

Resolvability Overall approach

151. One of the key channels through which firms can adversely affect financial stability is through disorderly failure which disrupts the supply of critical financial services to the wider economy. To mitigate this risk, **the PRA will aim for a position where the failure of any firm is orderly; that is, where the critical economic functions that the firm performs can be protected or wound down in an orderly way so that disruption is contained.**

152. In moving towards such a position, the PRA will require action from firms. The PRA will also need to collaborate with the Bank's Special Resolution Unit (SRU) in contributing to the assessment and enhancement of the authorities' capabilities and legal powers in dealing with failing firms. This work will need to take full account of any strengthening of UK and international frameworks for resolution, so that they meet the standards agreed in the FSB's *Key Attributes of Effective Resolution Regimes for Financial Institutions*.⁽¹⁾ The PRA will support and actively influence domestic and international initiatives to improve resolvability.

153. Resolvability is about preserving critical economic functions, not preserving firms. A firm's resolvability thus reflects the extent to which it can fail in an orderly manner, preserving critical financial services to the economy as a whole. Analysis and development of credible resolution plans, working with the SRU as resolution authority, will form a key part of the PRA's supervisory process.

154. This section outlines the PRA's expectations of banks and building societies in respect of resolvability. And although, at this time, there is no special resolution regime for the designated investment firms that the PRA will regulate, the expectations in this section apply equally to them. HM Treasury is currently consulting on the introduction of resolution arrangements for systemic firms of this type,⁽²⁾ and the European Commission's proposed Recovery and Resolution Directive is expected to require the introduction of such a regime, consistent with the FSB's *Key Attributes*.

155. The PRA will apply its resolvability requirements to firms incorporated in the United Kingdom, including subsidiaries of overseas firms. It will also be critically important for overseas firms that operate as branches in the United Kingdom to have robust recovery and resolution plans in place. For all firms with substantial operations outside the United Kingdom, the PRA will attach great importance to regular co-operation with the relevant overseas authorities. For global systemically important financial institutions (G-SIFIs) in particular, any resolution would need to be co-ordinated internationally by resolution authorities. The progress of international work by the FSB and others will continue to be highly influential in directing the PRA's work in this area.

156. This section does not apply to credit unions, for which no special insolvency or resolution regime currently applies. Credit unions are expected to meet the requirements for a 'single customer view' (as described below), and very few have uninsured creditors. The urgency for a special insolvency or resolution regime for them is therefore low at present.

157. This section elaborates on these broad expectations. In many cases these reflect the forthcoming requirements on recovery and resolution. And more generally they elaborate on the 'prudent conduct' Threshold Condition.

Expectations of firms

158. The PRA will expect firms to co-operate fully with the PRA and the SRU in their work to assess and enhance firm resolvability. In particular, **the PRA will expect firms to be able to provide the information needed to perform an assessment of their resolvability**, which may include:

- relevant information on the group structure and key entities, and data on interbank and derivatives exposures;
- an analysis of the firm's critical economic functions and, where appropriate, an assessment of how disruptive to financial stability any interruption of those functions might be; and
- more detailed information on any critical functions where disruption might cause financial instability, including information and analysis on how those functions might be protected in a resolution.

159. The PRA will also expect firms to provide any additional information required by the authorities to prepare for their resolution. In particular, **the PRA will require deposit-takers to be able to produce a single, consistent view of each depositor's funds, to enable the FSCS to implement rapid payout (within a target of seven days for the majority of customers)**. This 'single customer view' (SCV) is essential to ensure that the FSCS is able rapidly to recompense insured depositors, minimising the adverse effect of firm failure on the stability of the financial system. For small firms whose failure is unlikely to impact financial stability, rapid payout of depositors followed by winding-up is the likely resolution plan.

160. **Where significant barriers or obstacles to resolvability are identified, firms will be expected to propose and implement adequate changes to remove them.** This may involve changes to business practices or legal and financial structures, and in the future, will reflect reforms in respect of ring-fencing, depositor preference, bail-in powers and loss-absorbency that arise from the Government's response to the Independent Commission on Banking (ICB), and which are intended to reduce the complexity and costs of resolution.

(1) See www.financialstabilityboard.org/publications/r_111104cc.pdf.

(2) See www.hm-treasury.gov.uk/d/condoc_financial_sector_resolution_broadening_regime.pdf. A Special Administration Regime currently applies for investment firms, as introduced by HM Treasury in 2011. While this has strengthened the United Kingdom's ability to manage the failure of the majority of investment firms, it is not suitable for managing the failure of a systemic investment firm.

The PRA will expect firms to implement these recommendations in the spirit as well as to the letter.

161. Even with an effective resolution regime for all firms, failure will not be costless. As described in paragraph 123, **firms will therefore have to draw up a recovery plan, outlining credible steps that they could take in the event of a stress, to maintain their business and restore it to a stable and sustainable condition.**

Supervision — Resolution plans

162. The PRA, jointly with the SRU, will assess the extent to which a firm is resolvable, taking into account the structure of the group to which the firm belongs, the critical economic functions it carries out, the ability to transfer or replace these functions, and the ability of the FSCS to pay out to eligible depositors. Based on this assessment, the PRA and the SRU (the authorities) will aim to draw up a credible and feasible resolution plan for the firm, designed to cover an extensive range of firm-specific and market-wide stress events. The authorities will own and maintain this plan, updating it if necessary (for example following changes to firm structures following implementation of the ICB's recommendations).

163. In the assessment, the authorities will be mindful of the different types of resolution strategy that can be implemented, and the advantages and disadvantages of each. If a firm is not resolvable without risk to the authorities' objectives, the authorities will direct the firm to take action.

164. The UK authorities will co-ordinate with authorities in other relevant jurisdictions to develop co-ordinated strategies and plans for the resolution of G-SIFIs, and other cross-border firms, in line with the *Key Attributes*. They will enter into firm-specific co-operation agreements, which will (among other things) set out the process for information sharing before and during resolution, and provide an appropriate level of detail with regard to the cross-border implementation of the resolution strategies and plans.

165. In all areas, the PRA will co-operate closely with the SRU, given the SRU's responsibility for implementing a resolution if required. In assessing resolvability, the PRA will also involve HM Treasury, the FCA, the FSCS and other authorities where appropriate.

IV Supervisory activity

166. This section describes how in practice the PRA will supervise firms. As part of this, it describes the PRA's approach to authorising new firms (see Box 4), the Proactive Intervention Framework and the PRA's high-level approach to using its legal powers. For UK firms, the PRA's assessment will cover all entities within the consolidated group.

167. The PRA's supervision will involve engagement with firms at all levels of seniority. At a senior level, boards as a whole, and the independent directors in the absence of executive management, should expect regular dialogue with the PRA, either in groups or on an individual basis. The PRA will always focus on material issues in its engagement with firms.

Assessing risk

168. The PRA will aim to develop a rounded, robust and comprehensive view of a firm, in order to judge whether it is being run in a safe and sound manner. **The PRA will conduct its assessment work on a continuous cycle**, regularly updating its overall view of a firm, the risks it faces and the risks it poses.

169. The PRA will undertake a set of 'core' supervisory activities to inform its overall assessment of a firm. Reflecting the PRA's focus on the biggest risks to its objectives, the exact work making up this core will increase in frequency and intensity in line with a firm's potential impact (ie category). It will also vary with other factors including UK legal status (see Box 5 on international approach). Those firms that are individually unlikely to create disruption to the wider financial system (see Box 6) will be subject to a baseline level of supervisory activity to ensure that they meet key prudential standards, whereas for higher-impact firms the PRA will make use of a fuller selection of its supervisory tools. Although the PRA's approach to the supervision of mutuals will be consistent with the approach adopted for other firms, it will recognise that there are issues that are specific to the mutual sector, for example the statutory restrictions on business and differences in their ability to raise external capital.

170. Additional work beyond this core will be performed where necessary to provide information on particular areas of concern. This will be informed by the issues identified in core work, a firm's viability and resolvability, the prevailing market and economic conditions, and the business model of the firm.

171. Supervisory concerns will influence the PRA's future supervisory approach to a firm. For example, concerns about management or systems and controls will influence the PRA's

attitude to the growth of a business, including via acquisition, or to new appointments to Significant Influence Functions.

172. **The PRA will not be formulaic about the supervisory activity it will perform, since the focus on key risks means that this will depend on a firm's particular circumstances.** Nonetheless, its supervisory work will comprise a selection of the possible activities described below.

Supervisory activities and tools

173. In forming supervisory judgements, the PRA will draw on a broad set of information and data. **Supervisors will require firms to submit sufficient data, of appropriate quality, to inform their judgements about key risks.** Given the importance of this, the PRA will periodically validate firms' data, either through on-site inspection by its own supervisory and specialist risk staff or by third parties.

174. The PRA will gather and analyse some information on a regular basis, for example through regulatory returns. It will also analyse relevant information in the public domain, for example firms' annual reports and disclosures. In addition, it may request additional, firm-specific data from firms (for example management information or forecasts). It is essential, however, that supervisors are not overwhelmed by the amount of information that they have to analyse. Further detail on the PRA's approach to regulatory data will be set out in a discussion paper to be published in November 2012.

175. To support its information-gathering and analysis, the PRA will require firms to participate in meetings with supervisors at a senior and working level. Some discussions will be strategic in nature, while other interaction will focus on information-gathering and analytical work.

176. The PRA will also, as appropriate, conduct detailed on-site testing or inspections of a particular area. In-depth, focused reviews, for example of a firm's proprietary trading desk or its approach to valuations or risk weightings, will involve discussions with staff, reviews of internal documents and some testing. In addition, the PRA may review a firm's approach to stress testing, or undertake bespoke stress testing of its own. The PRA will involve its risk specialists and other technical staff in on-site work, stress testing and other assessments as appropriate. And the PRA may use firms' risk, compliance and internal audit functions to identify and measure risks, where it feels it can rely on their effectiveness.

177. **Firms' external auditors can and should play a role in supporting prudential supervision, given their ability to identify and flag to the PRA current and potential risks in a firm.** The PRA will expect to work with firms' external auditors

Box 4

Authorising new firms

Firms wishing to undertake deposit-taking activities must apply to the PRA for authorisation (permission) to do so. The PRA will assess applicant firms from a prudential perspective, using the same framework that is employed for supervision of existing firms. Thus, the PRA will determine whether, if authorised, an applicant firm would meet the Threshold Conditions, at the point of authorisation and on an ongoing basis. This includes an assessment of whether it could be resolved in an orderly way.

At the same time, the FCA will assess applicants from a conduct perspective. An applicant will be granted authorisation only where both the FCA and the PRA are satisfied that it meets the relevant requirements. As provided for in the MoU, the PRA will lead and manage a single administrative process. This will include co-ordinating the process and transmitting all formal notices and decisions to the applicant firm.

The PRA will set out the information that it requires firms to supply in order to complete its assessment. It will stand ready to answer questions where necessary, though this will not extend to providing consultancy on completing applications.

The PRA will take a proportionate approach to the assessment of applications. All applicants will be subject to a minimum

level of assessment, beyond which work will be commensurate with the potential impact of a firm's failure on the financial system.

The PRA will ensure that, at the point of authorisation, and consistent with EU requirements, new banks hold capital sufficient to cover the risks that they run, including the risk that their failure could adversely affect financial stability. The PRA will adopt a flexible approach in its assessment of initial capital requirements, recognising that new banks are often small, unlikely to be of systemic importance, and in general straightforward to resolve, for example under the Bank Insolvency Procedure. Such banks should have a credible plan to build up their capital over an agreed period to levels comparable with similar but established authorised firms. This may include accepting constraints on dividend distribution and variable remuneration where appropriate.⁽¹⁾

The PRA's aim through this proportionate approach is for barriers to entry to be kept to the minimum consistent with its objective, so enabling the PRA to contribute to a competitive banking market.

(1) A review of the prudential and conduct requirements for new banks, announced in HM Treasury's White Paper (*Banking reform: delivering stability and supporting a sustainable economy*; see www.hm-treasury.gov.uk/d/whitepaper_banking_reform_140512.pdf), will be published by the FSA in November 2012.

in an open, co-operative and constructive manner and it will abide by and continue to develop the *Code of Practice*, which aims to promote such a relationship.⁽¹⁾ The PRA will share relevant information with auditors, for example where it considers a firm's valuations of less liquid assets or its approach to provisioning to be significantly out of line with peers. And, consistent with the *Code*, it will expect auditors to disclose to the PRA emerging concerns within firms, where this would assist the PRA in carrying out its functions.

178. To assist with its risk assessment, the PRA will at times use its statutory powers — in particular its information-gathering power and its powers to commission reports by Skilled Persons on specific areas of interest (under sections 165 and 166 of the Act respectively). Such reports might cover verifications of regulatory returns or, with the SRU where appropriate, the forensic analysis required to verify

resolution plans. The PRA will be able to enter into contracts with Skilled Persons directly, and will follow a transparent and consistent approach to selecting and appointing them. The PRA will continue to make increased use of section 166 reports as a supervisory tool.

179. The PRA will also make use of the FCA's findings on firms' key conduct risks (including money laundering) and any material prudential risks in relation to FCA-authorised subsidiaries of dual-regulated groups, where they are materially relevant to the PRA's objective.

180. The PRA will not be a 'fraud' regulator; this role is filled by other authorities. The PRA's on-site inspections will not therefore be designed to uncover all instances of malpractice.

(1) See current FSA code www.fsa.gov.uk/pubs/guidance/fg11_09.pdf.

Rather, the PRA will aim to assess the adequacy of a firm's control framework in preventing serious fraud that could threaten its safety and soundness. And it will draw to the attention of the relevant authorities any suspicion or information that may be of material interest to them.

Proactive Intervention Framework

181. Supervisors will consider a firm's proximity to failure when drawing up its supervisory plan. **The PRA's judgement about proximity to failure will be captured in a firm's position within the Proactive Intervention Framework (PIF).**

182. Judgements about a firm's proximity to failure will be derived from those elements of the supervisory assessment framework that reflect the risks faced by a firm and its ability to manage them — namely, external context, business risk, management and governance, risk management and controls, capital and liquidity. The PIF will not be sensitive to a firm's potential impact or resolvability.

183. **The PIF is designed to ensure that the PRA puts into effect its aim to identify and respond to emerging risks at an early stage.** There will be five clearly demarcated PIF stages, each denoting a different proximity to failure, and every firm will sit in a particular stage at each point in time (see **Table A**). As a firm moves to a higher PIF stage — ie as the PRA determines that the firm's viability has deteriorated — supervisors will review their supervisory actions accordingly. Senior management of firms will be expected to ensure they take appropriate remedial action to reduce the likelihood of failure. And the authorities will ensure appropriate preparedness for resolution.

184. A firm's PIF stage will be reviewed at least annually, and in response to relevant, material developments.

185. The PRA will consider it important for markets and counterparties to make their own judgements on the viability of a firm. The PRA will not therefore routinely disclose to the market its own judgement on a firm's proximity to failure, not least given the possible risk that such disclosures could act to destabilise in times of stress. The PRA would prefer to disclose PIF stages to regulated firms as a means of summarising the PRA's overall judgement on safety and soundness. In view of the current disclosure obligations in European legislation, however, the Bank and the FSA have decided not to do so, given the risk that in some cases the firm may be under a legal obligation to disclose its PIF stage publicly. The PRA will engage with HM Treasury to discuss whether it would be appropriate to pursue changes to relevant European legislation to support disclosure of such supervisory judgements to firms but not to the market generally.

186. The PRA will intend to publish aggregate statistics on the number of firms in each PIF stage in its *Annual Report*.

Mitigating risk

187. The PRA will continually review its judgement of the risks to firms' safety and soundness, on the basis of the supervisory activities undertaken. It will communicate these judgements to firms, and require them to take action as a result.

188. As a matter of routine, there will be annual, internal stock-take meetings for all firms to discuss the major risks they face, the supervisory strategy and proposed remedial actions, including guidance about the adequacy of a firm's capital and liquidity (as described in Section III). There will be strong senior level involvement in these assessments, such that major judgements are made by the PRA's most senior and experienced individuals. These formal assessments will also be subject to rigorous review by those not directly involved in day-to-day supervision — including risk specialists, independent advisers and relevant participants from the rest of the Bank, such as the SRU.

189. **There will be a clear and direct link between the risks that the PRA perceives and the actions it will expect from firms in consequence.** For example, if the PRA has identified deficiencies in a firm's forecasts of earnings, or an excessive level of proposed employee remuneration or dividends to shareholders, leading to risks to its financial health, the PRA will require the firm to take steps to tackle this. This may involve direct restrictions on payments, or requirements on the firm to improve its forecasting, systems or governance as appropriate. Or the assessment may have revealed that senior management has an inadequate view of the firm's liquidity risk, compromising the effectiveness of the firm's governance and, in consequence, the firm's soundness. The PRA may then expect the firm to enhance internal systems for monitoring liquidity risk, or to review the design and effectiveness of its governance and reporting lines.

Conveying supervisory messages

190. The PRA will focus on outcomes. **The PRA will highlight issues of concern and the outcomes it wishes to see but, as it is the responsibility of a firm to manage itself, in general the way in which firms achieve these outcomes will be a matter for them.** In some cases the PRA may choose to be directive in terms of the action required, if it considers it necessary in order to reduce risks to its objective.

191. The PRA will send an annual letter to each firm's board, clearly outlining the small number of key risks that are of greatest concern, and on which it requires action. **The test of materiality for points raised with firms will be high, with a**

Table A Stages in the Proactive Intervention Framework

Stage	Possible actions
Stage 1 – Low risk to viability of firm	<ul style="list-style-type: none"> — Firm subject to the normal supervisory risk assessment process and actions, including recovery and resolution planning.
Stage 2 – Moderate risk to viability of firm Supervisors have identified vulnerabilities in a firm's financial position or deficiencies in its risk management and/or governance practices.	<p><i>Recovery</i></p> <ul style="list-style-type: none"> — The intensity of supervision will increase. The PRA may set additional reporting requirements, and/or make use of information-gathering powers. — The PRA will require the firm to act to address deficiencies identified over a set period. — The firm will be required to update its recovery plan and may need to activate it. <p><i>Resolution</i></p> <ul style="list-style-type: none"> — The PRA and the SRU will undertake a joint review of the firm's resolution plan in order to identify and initiate any necessary contingency planning, including information required, for resolution. — The FSCS will evaluate the quality of data provided to support a single customer view and any obstacles to payout or deposit transfer.
Stage 3 – Risk to viability absent action by the firm Significant threats to a firm's safety and soundness have been identified.	<p><i>Recovery</i></p> <ul style="list-style-type: none"> — The PRA may require any of the following actions: a change to management and/or composition of the board; limits on capital distribution (including dividends and variable remuneration); restrictions on existing or planned business activities; a limit on balance sheet growth and/or stricter leverage limits; and setting tighter liquidity guidelines and/or capital requirements. — The firm will be required to draw on the menu of options set out in its recovery plan as appropriate. <p><i>Resolution</i></p> <ul style="list-style-type: none"> — The SRU will intensify engagement on contingency planning for resolution and will have all means necessary to obtain the information it considers it needs to carry out that task.
Stage 4 – Imminent risk to viability of firm The position of a firm has deteriorated such that the PRA assesses that there is a real risk that the firm will fail to meet the Threshold Conditions, but some possibility of corrective action remains.	<p><i>Recovery</i></p> <ul style="list-style-type: none"> — The PRA will most likely increase the scale of the recovery actions needed (including in relation to liquidity and capital). The PRA will set out a timetable for implementation of recovery actions. — Firm-led recovery actions will need to be effected in short-order and the firm will need to demonstrate that these were credible and will produce material results. — Actions initiated following activation of the recovery plan, including on asset disposal (or sale of firm) will need to be completed. <p><i>Resolution</i></p> <ul style="list-style-type: none"> — The SRU and FSCS will confirm that all necessary actions to prepare for the resolution of the firm had been taken, including that relevant data were readily available.
Stage 5 – Firm in resolution or being actively wound up	<p><i>Resolution</i></p> <ul style="list-style-type: none"> — The PRA will trigger use of the SRR and the SRU will oversee its resolution/winding up. — The FSCS may be required to effect depositor payout and/or to fund deposit transfer or resolution.

focus on root cause analysis rather than symptoms, and with supervisory interventions clearly and directly linked to reducing risks to financial stability. The PRA will expect to verify itself that action is taken on these key risks, and will communicate to the board when and how it intends to do this. The PRA will send individually tailored letters to all firms, except those with the lowest potential impact where a standard letter will outline issues relevant to all firms in that group, unless specific issues have been identified with a

particular firm. The PRA will actively engage with a firm's Audit Committee and its non-executive directors on progress made in addressing the most significant risks identified.

192. Firms will sometimes disagree with the PRA's decisions. This is inherent in a forward-looking system. The PRA will in general discuss issues with firms in reaching its decision, and will carefully consider representations made, not least to

ensure that its decisions are made on the basis of all the relevant evidence. But **firms should not approach their relationship with the PRA as a negotiation.**

193. Any less significant issues that have arisen — and of which the PRA feels the firm should be aware — will be conveyed to the firm, but with the onus on the firm itself to address these. The PRA will expect self-certification by the most appropriate senior individual within the firm, for example the CEO, Finance Director or chair of the Audit Committee, that issues have been closed. The link between the issues raised and the PRA's objective will remain clear and direct.

Using powers in the course of supervision

194. The PRA will have a variety of formal powers available to it under the Act, which it can use in the course of its supervision, if deemed necessary to reduce risks. For example, it may vary a firm's permission or impose a requirement under Part 4A of the Act to prevent or curtail a firm undertaking certain regulated activities, which may require a change to a firm's business model or future strategy. It may also, as noted above, use its powers to require information from firms.

195. **While the PRA will look to firms to co-operate with it in resolving supervisory issues, it will not hesitate to use formal powers where it considers them to be an appropriate means of achieving its desired supervisory outcomes.** This means that, in certain cases, the PRA will choose to deploy formal powers at an early stage and not merely as a last resort.

196. The PRA will consider when and how to use its formal powers on a case-by-case basis and will assess the particular facts and circumstances of each case. In all cases, the PRA will be likely to consider a number of factors in connection with the possible deployment of such powers, including:

- the confidence supervisors have that firms will respond appropriately to the PRA's requests without the use of powers;

- the PRA's view of the firm's proximity to failure, as reflected in its PIF stage; and
- the impact — including systemic implications — and proximity of the risk the PRA is aiming to mitigate.

197. In addition, the PRA will be able to use its powers to approve or allow certain changes requested by firms (for example, a change in a firm's controller or in its permissions to perform regulated activities). Where those changes could adversely affect the safety and soundness of the firm, the PRA may use its powers to refuse such requests.

Enforcement powers

198. The PRA's preference will be to use its powers to secure *ex ante*, remedial action, given its approach of intervening early to address emerging risks. If successful, application of this approach should mean that enforcement actions are rare.

199. **The PRA will, however, have a set of disciplinary powers, including the power to impose financial penalties and publish public censures, for cases where such sanction is an appropriate response to the firm failing to meet the PRA's policies. It can also use such powers where directions or restrictions imposed by the PRA are ignored by the firm.**

200. The intention in deploying disciplinary powers might include: reinforcing the PRA's objective and priorities; changing and promoting high standards of regulatory behaviour; the need to send a clear signal to a firm, and to the regulated community more widely, about the circumstances in which the PRA considers a firm's behaviour to be unacceptable; and deterring future misconduct.

201. These powers are additional to those that the PRA will hold in relation to Approved Persons (as detailed in Section III). The Bank and the FSA will consult prior to the PRA's establishment as prudential regulator on its policy and procedures regarding its exercise of disciplinary powers.

Box 5

International approach

Banking is an international industry. Supervision of overseas firms operating in the United Kingdom, and consolidated supervision of international groups operating in the United Kingdom via supervisory colleges will therefore be an important part of the PRA's work.

The PRA's legal powers and responsibilities will vary depending on the location of the parent and the legal form of its operations in the United Kingdom. Regardless of this, the PRA's supervisory approach will be to assess all firms to the same prudential standards. Where the PRA does not have direct powers against such firms, it will raise any concerns that it has with the firm's home state supervisor or at the appropriate international forum.

Supervision of overseas firms operating in the United Kingdom

Many overseas firms operate in the United Kingdom and are significant providers of financial services to the UK economy. As with UK firms, the PRA's supervision of overseas firms operating in the United Kingdom will reflect an assessment of the potential impact of the UK entity on UK financial stability, including via risks from overseas, its legal status (branch or subsidiary), the nature of the home country regulatory regime (where the firm originates from a non-EEA country) and whether or not the firm is a G-SIFI.

For subsidiaries of overseas firms the PRA will have full powers and responsibilities and so its approach will be to treat such firms equivalently to UK-owned firms (applying its full prudential requirements, including for example stress testing for the most significant firms). Consistent with its objective the PRA will assess, and limit as necessary, the (potentially complex) interlinkages with the rest of the group.

For UK branches of EEA firms, the PRA's powers and responsibilities will be limited under European law. In order to assure itself that risks to the UK financial system from such branches are adequately managed, the PRA will focus on resolution planning (along with the SRU) and on ensuring that it has access to relevant information on the safety and soundness of the parent firm via collaboration with home regulators. In particular the PRA will engage in supervisory and resolution colleges, including Crisis Management Groups (CMGs) where applicable. The PRA will take a close interest

in liquidity, focusing, in collaboration with the home regulator, on the position of the whole firm of which the branch is a part.

The PRA will expect UK branches of EEA firms to appoint a senior individual with authority to act as a primary contact with the PRA in relation to the branch's affairs. This individual should also act as a channel for communication with the parent.

Where the PRA is not satisfied regarding the safety and soundness of the branch and the parent firm, it will work with the home authority and promote public understanding of the limits of its powers, including by using whatever tools it can to reduce the impact of these limitations. In emergency situations, consistent with European law, the PRA will take any precautionary measures necessary to protect the interests of depositors, and will inform the home authority of such measures at the earliest opportunity.

In some cases, the PRA may judge that an EEA firm applying to passport into the United Kingdom poses risks to its objective, but does meet the requirements set out by the relevant EU Directives, and thus as a legal matter has a right to conduct business in the United Kingdom. In such cases, the PRA will carefully consider the tools available to it as a host regulator, acting in co-operation with the home regulator, to mitigate the resulting risks.

For UK branches of non-EEA firms, the PRA's authorisation will apply to the whole firm. 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 of the home regulator, including its ability and willingness to share confidential information. Where it considers the home supervisor not to have a regime broadly equivalent to that of the United Kingdom, the PRA will refuse authorisation of the branch. It may instead decide to authorise a stand-alone subsidiary, in which case it may limit the interlinkages with the rest of the group or ring-fence the subsidiary (for example if it considers the home supervisor not to deliver effective consolidated supervision). In assessing a non-EEA firm against the Threshold Conditions, the PRA may also have regard to the opinion of an overseas regulator in a country in which the firm carries on regulated activities. In considering how much weight to attach to such opinions, the PRA must have regard to the nature and scope of the supervision exercised by the overseas regulator.

For existing UK branches of non-EEA firms where the home regime is not considered to be equivalent, the PRA's supervisory work will be aimed at mitigating the risks of non-equivalence in the relevant areas. Its supervision will focus on issues such as the financial strength of the whole firm, including the adequacy of its liquidity and the resolution plan for the firm (collaborating with the SRU and home authorities to develop such plans in colleges or CMGs as applicable), taking into account the importance of the firm to the PRA's objective.

For UK branches of non-EEA firms where the PRA is satisfied that the home regulatory regime is equivalent, and where the PRA has assured itself over resolution plans and the home regulator's supervisory approach, the PRA will rely where possible on the home supervisor's prudential supervision. In these cases, the PRA will focus on collaboration with home regulators (including via supervisory colleges) and on resolution plans. In addition, the PRA will take a close interest in liquidity and will ensure that there are senior individuals in the United Kingdom that are clearly responsible for management of both the UK operations and business booked in the United Kingdom. The PRA will discuss and agree with the home regulator the areas in which it will seek to rely on the home regulator's supervision.

Supervisory colleges

The PRA will be an active participant in international co-ordination of supervision for major firms. Where invited to do so, it will participate in supervisory colleges for all firms with significant operations in the United Kingdom, whether a legal entity or a branch, and will organise and chair the colleges for UK firms. The PRA will publish on its website a list of those colleges in which it participates and note any cases where, in respect of firms with major UK operations, the lead authority in another country has not invited the PRA to participate.

For UK firms, the PRA will organise and chair the supervisory college. To be fully effective, colleges must operate in a manner that enables supervisors to be open and transparent with each other, and to address the difficult issues. The PRA will seek to adopt this approach when it runs colleges and will expect other authorities to participate on the same basis. As the lead authority and college chair for major UK firms, the PRA will be prepared to tackle instances where it believes that other authorities are not acting in a manner consistent with the PRA's objective. And the PRA will encourage other

authorities to challenge it if they have concerns. EU processes are increasingly well-developed: it is already a requirement for all prudential European supervisors of pan-European groups to work together to reach a joint risk assessment and decision on capital adequacy, and this is likely to extend to joint decisions on whether firms hold adequate liquidity in the future. The PRA will work closely with other European supervisors to reach these joint decisions.

A fuller statement on the PRA's approach to the supervision of overseas firms operating in the United Kingdom will be published in due course.

Box 6

Supervision of firms that pose little individual risk to financial stability

This box summarises the PRA's approach to supervising firms with the lowest potential impact on the stability of the financial system. It is likely that there will be a very large number of firms within this category, made up in practice of small overseas banks (branches or subsidiaries) and credit unions.

At an individual level, these firms have almost no capacity to cause disruption to the UK financial system, either through the way they carry on their business or through idiosyncratic, orderly failure. Nevertheless, two considerations motivate a baseline level of supervisory monitoring for them. First, the PRA's general statutory objective is to promote the safety and soundness of all of the firms that it regulates. And second, there is a risk that problems across a whole sector or subsector could generate some disruption to the continuity of financial services, ie several firms may fail together through a common exposure, with possible wider systemic impact (as occurred in the 1990s' small banks' crisis for example).

Given that such firms are likely to pose risks to financial stability at an aggregate level only, the PRA will supervise them on a portfolio basis. Automated tools, analysing firms' regulatory returns, will issue alerts highlighting outliers and trends, and firms will in general be examined individually only when their regulatory returns trigger such an alert. The PRA will also seek to assure itself that these firms are resolvable, with a particular emphasis on their ability to facilitate depositor payout by the FSCS.

The PRA will also examine individual firms when a risk crystallises (as discovered through, for example, a visit to the firm, or an approach from the firm itself), or in response to authorisation requests from the firm (for example, a request to change its permissions to undertake regulated activities, or to extend the nature or scale of its business).

And the PRA will conduct peer group and trend analysis across sectors as a whole, to develop a clear understanding of the risks posed both by groups of small firms and by typical firms in the sector. The PRA will still conduct annual assessments of firms, but in large peer groups.

In contrast to the higher-impact firms, those in the lowest category will contact the PRA through a centralised firm

enquiries function and will not have an individual, named supervisor.

Small firms will not be visited by the PRA on a fixed, regular schedule. Notwithstanding this approach, all firms, regardless of category, will be subject to on-site work by the PRA — with some period of notice — at any time.

Credit unions

Credit unions will be the major constituent of the lowest-impact category. They will be subject to a specific prudential regime, as set out in the Credit Union Sourcebook, including specific minimum capital and liquidity requirements, their adherence to which will be monitored as described above. Credit unions are not subject to the Capital Requirements Directive, nor will they be issued with individual guidance for capital and liquidity.

Credit unions will be required to meet FSCS standards for rapid payout of depositors, but not otherwise to have recovery and resolution plans. Those individual credit unions posing a risk of contagion to other firms, for example through having uninsured depositors, will be subject to more intensive supervision.

V Making policy to support the PRA's general approach

202. Prudential supervision is based on policies which ensure that judgements about risks to the PRA's objectives are made within a clear and coherent framework.

203. This section sets out the PRA's approach to setting and communicating these policies, common across all the firms that it regulates and both of its statutory objectives.

The PRA's approach to published policy material

204. **The PRA will aim to establish and maintain published policy material which 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.** Taken as a whole, the set of published policy material will set out clearly and concisely what the PRA expects of firms in terms of intended outcomes, so that they can meet these expectations through their own actions. When the PRA judges that it is necessary to take action against a firm to mitigate risks to the PRA's objectives, the basis for its judgement will be clear from its published policies.

205. As noted in Box 3, the policy framework for the PRA's supervision is to a large extent agreed internationally, both at a global level, for example through the BCBS, and within the European Union. In terms of published policy material, the policy framework is increasingly being codified at EU level. Relevant EU Directives will be implemented in the United Kingdom through legally binding PRA rules. Relevant EU Regulations that apply directly to UK firms will not be reproduced in the PRA's rules, but will be part of the PRA's requirements of firms.

206. Where the PRA issues material in areas not covered by EU policy, it will articulate the policy in a manner which is clear in intent and straightforward to understand, whether in the form of rules or otherwise.

207. The PRA will not plan to issue significant amounts of additional, detailed guidance to clarify its policy, whether in the form of general guidance issued publicly or advice given by supervisors to individual firms.

208. When it assumes its responsibilities, the PRA will adopt parts of the pre-existing *FSA Handbook*. It will review the

Handbook after this point, and will replace it with a rulebook, containing only the PRA's rules. Other relevant types of material currently in the *FSA Handbook*, for example procedures manuals, and information on how the PRA itself will act, will be published separately.

What the PRA will do in delivering and maintaining its policy

209. **The PRA will attach great importance to being an influential and persuasive participant in international policy debates and negotiations.** It will seek agreement at both global and EU levels to the policy reforms which will deliver and maintain a strong, coherent and clear prudential framework that allows the PRA effectively to advance its objectives.

210. **The PRA will perform careful analysis to determine whether and what revisions to its set of policies may be appropriate, whether negotiating policy internationally or acting autonomously.** The PRA will only propose or support a policy reform where it is justified by the presence of current or potential market failures relating to its objectives; and where it believes that the net effect will be beneficial and that the particular proposal is on balance the most efficient way of dealing with the identified problem. Quantitative estimates of costs and benefits will be included in its published documents only where they can reasonably or practicably be estimated.

211. The PRA will actively review the continued effectiveness of its policies and their coherence, with the aim of ensuring that as the financial system develops, the prudential regime remains effective and proportionate.

212. **The PRA will solicit constructive comment on policy proposals, for example on the likely impact of proposed reforms and on different ways of achieving its intended policy outcome.** The PRA will have a statutory duty to consult in introducing new rules and a public law duty to consult on any other measures that will significantly affect firms. It will communicate policy proposals (including an analysis of their effect and an explanation of their purpose) to all parties likely to be affected by them. This will usually be done through publication on the PRA's website, in addition to other channels as appropriate. The PRA will carefully consider the representations made to it. The consultation period will normally be twelve weeks, consistent with Government guidelines, unless a different approach is warranted.

Box 7

Staffing the PRA

The PRA’s approach to resourcing will be to employ staff with the necessary skills to carry out the forward-looking, judgement-based approach to supervision necessary to advance its objectives.

The PRA’s approach will be advanced primarily by its front-line supervisors. These will have the right capabilities to make judgements about current and future risks to an institution’s safety and soundness, and to make interventions early before risks crystallise. Their judgements will be grounded in analysis, supervisory experience, and a strong understanding of the sectors they supervise gained through direct exposure to the industry. On this basis they will have credibility with the senior management of firms, and be able to deliver robust messages.

The PRA’s front-line supervisors will be supported by risk specialists. These will provide important knowledge and technical expertise to support analysis and supervisory judgements.

In addition, the PRA will employ policy experts to develop the policies that underpin its supervision. Since, as noted above, the policy framework is to a large extent agreed internationally, the PRA’s policy experts will have the necessary skills and experience to influence international policy debates — at both global and EU levels — to ensure that the PRA’s views are properly represented.

In delivering its objectives, the PRA will ensure that there is an efficient allocation of resources. As illustrated in **Chart A**, over 90% of staff will be directly involved in supervision and policy. Over 60% of staff will be involved in front-line supervision with a further 27% performing policy and risk specialist roles.

The allocation of resources, illustrated in **Table 1**, shows that around one third of supervisory staff will be focused on the 20 or so firms with the highest potential impact (Category 1); a further third will be focused on the next 70 most significant firms (Category 2) while the remaining third will focus on more than 1,500 lower-impact firms (in Category 3 and below).

The PRA’s rank mix will reflect its approach to advancing its objectives, with the highest proportion of senior and

Chart A PRA split by function

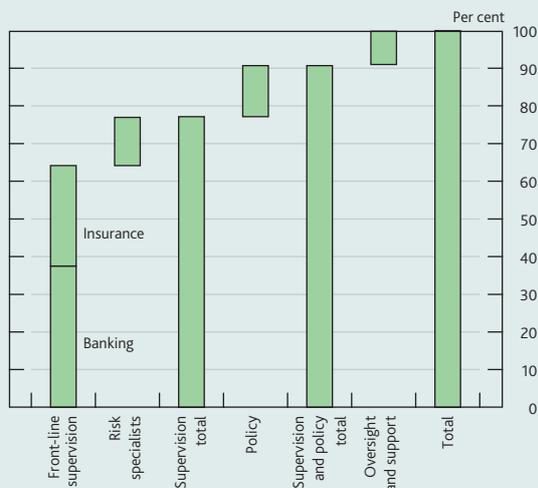


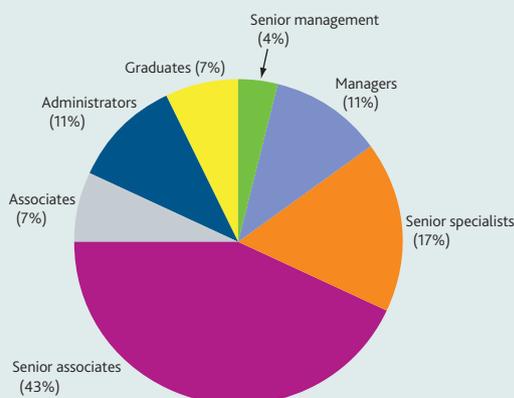
Table 1 PRA resource allocation

Category 1:	c. 20 firms (1% of total), 200 supervisors, average ratio of 10:1.
Category 2:	70–80 firms (4% of total), 200 supervisors, average ratio of 3:1.
Category 3–5:	>1,500 firms (95% of total), 200 supervisors, average ratio of 0.14:1.

experienced supervisors responsible for supervising those firms that present the greatest risk to the financial system (see **Chart B**).

The PRA will have a larger proportion of more experienced and senior supervisors compared with the past. The process for delivering this has already started and implementation will continue. This will involve development of the PRA’s own supervisors as well as external recruitment. Internal career development will be an important aspect of building the PRA’s capability in the long term.

Chart B PRA rank mix

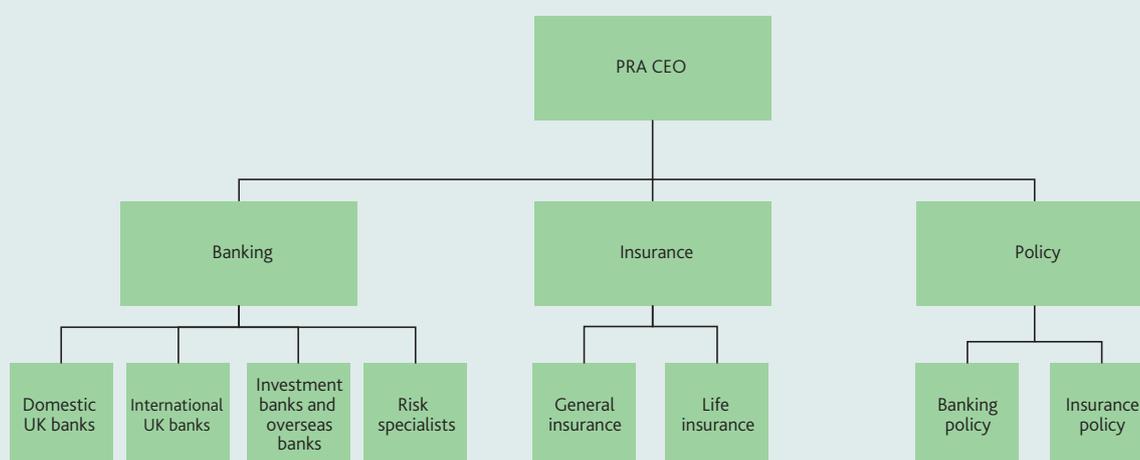


The Bank's recruitment, talent management and career development programmes will be extended across the PRA. The objective will be to ensure that staff have the opportunity to develop to their full potential, and that there is a strong pipeline of talented senior supervisors.

The PRA's focus on prudential supervision will deliver supervisors with in-depth experience of the key issues that pose a risk to the safety and soundness of firms and to advancing the PRA's objectives. It will be important to ensure that this experience is retained for the PRA to benefit fully from their regulatory knowledge and expertise. Retaining staff

will require the PRA to offer compelling careers centred around intellectual challenge and excellence, and a commitment to public service through its public policy objectives. Graduates will undertake a three-year development programme. And staff at all levels will be coached by their managers on the exercise of supervisory judgement. Secondment opportunities to and from the industry and to overseas regulators will be made available to staff. Additionally, staff will have the opportunity to work in other parts of the Bank of England as a way of broadening their knowledge and management experience, and similarly the PRA will be open to staff moving from other parts of the Bank.

Figure A PRA organisation structure



VI Next steps

213. This paper has been published prior to the PRA assuming its responsibilities in order to facilitate scrutiny of the PRA's proposed approach, as the draft legislation is debated in Parliament and as the Parliamentary Commission on Banking Standards conducts its review.

214. It is complemented by other publications on specific aspects of the PRA's regime, including transitional arrangements.⁽¹⁾

215. Interested parties can submit comments on the PRA's proposed approach via email to praapproachdoc@fsa.gov.uk and praapproachdoc@bankofengland.co.uk.

216. Interested parties are also encouraged to attend the public event scheduled for 22 October 2012.⁽²⁾ The intention will be to discuss the details set out in this document, and address the key questions that firms wish to raise, including those submitted in advance.

217. Supervisors will be happy to discuss the contents of this publication with firms.

(1) See Andrew Bailey's letter to firms on 12 September 2012, available at www.fsa.gov.uk/static/pubs/other/pras-transition-letter.pdf.

(2) The booking site for this event, in respect of the PRA's approach to prudential regulation for deposit-takers and designated investment firms, is available at <http://fsa.cvent.com/PRADepositTakers>.

© Bank of England, Financial Services Authority 2012
Printed by Park Communications Limited

