

# The Prudential Regulation Authority's approach to banking supervision

October 2018



BANK OF ENGLAND  
PRUDENTIAL REGULATION  
AUTHORITY



## Contents

|   |           |
|---|-----------|
| <b>Foreword by the CEO</b>                                | <b>1</b>  |
| <b>Introduction</b>                                       | <b>3</b>  |
| <b>1 Our objectives</b>                                   | <b>4</b>  |
| <b>2 Our approach to advancing our objectives</b>         | <b>8</b>  |
| <b>3 Identifying risks to our objectives</b>              | <b>11</b> |
| <b>4 Supervisory activity</b>                             | <b>28</b> |
| <b>5 Tailored application of the supervisory approach</b> | <b>36</b> |
| <b>Annex</b>  | <b>40</b> |

Updated

## Foreword by the CEO

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More than a decade on since the global financial crisis, we are approaching full implementation of the post-crisis reforms. One of these reforms was the formation of the Prudential Regulation Authority (PRA) in April 2013 as the UK's prudential regulator of deposit-takers, insurers and major investment firms.

The PRA was given two primary objectives: a general objective to promote the safety and soundness of the firms it regulates, focusing on the adverse effects that they can have on the stability of the UK financial system; and an objective specific to insurance firms, to contribute to ensuring that policyholders are appropriately protected. The PRA also has a secondary objective to act in a way (so far as is reasonably possible) to facilitate effective competition in the markets for services provided by PRA-authorised firms.

This approach document sets out how we pursue these objectives in respect of deposit-takers and designated investment firms (a second document sets out our approach for insurers). The three principles underpinning our core approach have remained constant over the past years: our supervisors rely on judgement in taking decisions; we assess firms not just against current risks, but also against those that could plausibly arise further ahead; and we focus on those issues and firms that are likely to pose the greatest risk to our objectives. Across these three principles we continue to apply proportionality to ensure our interventions do not go beyond what is necessary in order to achieve our objectives.

Nevertheless, the way we supervise our firms is evolving over time to take account of new developments. This document is therefore updated regularly. A detailed overview of all changes since the last update in March 2016 can be found in the annex, but let me draw out a few key areas.

First, having successfully implemented a ring-fence to separate retail banking from global trading, we will now police the fence as an integral part of our supervisory approach. We will ensure there is continued compliance with restrictions on activities performed by the ring-fenced banks and independence from the rest of the group. In particular, we will closely monitor governance arrangements, seeking evidence that they can identify conflicts of interest and are able to make decisions on their own.

Second, in a context of firms' increasing reliance on digital systems and platforms and the risk of cyber-attacks, operational resilience is on track to become as embedded in our supervisory approach as financial resilience. In this area, we are primarily focused on the continuity of the business services that a firm's customers and the wider economy rely upon. We will prioritise our interventions proportionally based on safety and soundness and any potential financial stability implications of potential operational disruptions.

Third, having fully embedded the Senior Managers Regime for banks (and soon also for insurers), individual accountability has become a key tool through which we deliver our

supervisory approach. We expect firms to identify the most senior individuals responsible for key areas and activities, including the delivery of supervisory priorities, and to document their responsibilities. We can and will take supervisory or enforcement action if our red lines are crossed.

Fourth, we are working with the aim of ensuring that the transition to the UK's new relationship with the EU is as smooth as possible in financial services in order to minimise risks to our objectives, through mechanisms such as the Temporary Permissions Regime (TPR) which will allow us to bridge incoming EU27 firms for three years while they seek an authorisation to continue business in the UK.

Across these various individual changes, we also need to defend the new regulatory framework we've put in place. Whilst this doesn't require changes to our overall approach, it does mean that supervisors are vigilant for any sign of regulatory arbitrage (behaviour that is intended to comply with the letter but defy the spirit of our rules), in particular in areas where firms have natural incentives to maximise their room for manoeuvre above regulatory requirements.

I hope this document will prove a useful way for people to understand how we approach our role here at the PRA.

**Sam Woods**  
October 2018

Updated

## Introduction

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**We, the Prudential Regulation Authority (PRA), as part of the Bank of England ('the Bank'), are the UK's prudential regulator for deposit-takers, insurance companies, and designated investment firms.**

1. This document sets out how we carry out our role in respect of deposit-takers and designated investment firms (referred to collectively in this document as 'firms'); a second document relates to our supervision of insurers.<sup>1</sup> It is designed to help regulated firms and the market understand how we supervise these institutions, and to aid accountability to the public and Parliament. The document acts as a standing reference that will be revised and reissued in response to significant legislative and other developments that result in changes to our approach.
2. This document serves three purposes. First, it aids accountability by describing what we seek to achieve and how we intend to achieve it. Second, it communicates to regulated firms what we expect of them, and what they can expect from us in the course of supervision. Third, it is intended to meet the statutory requirement for us to issue guidance on how we intend to advance our objectives. It sits alongside our requirements and expectations as published in the PRA Rulebook and our policy publications.<sup>2</sup>

### **EU withdrawal**

3. Our approach to advancing our objectives will remain the same as the UK withdraws from the EU. Our main focus is on trying to ensure that the transition to our new relationship with the EU is as smooth and orderly as possible in order to minimise risks to our objectives.

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<sup>1</sup> 'The Prudential Regulation Authority's approach to insurance supervision', October 2018, available on the Bank's website at <https://www.bankofengland.co.uk/prudential-regulation/supervision>.

<sup>2</sup> The way we make policy and links to our policy publications are available on the Bank's website at <https://www.bankofengland.co.uk/prudential-regulation/policy>.

# 1 Our objectives

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## **Our governing statute is the Financial Services and Markets Act 2000 (as amended) (the Act).**

### **Our primary objectives**

4. Under the Act, we have two primary objectives: i) a general objective, to promote the safety and soundness of the firms we regulate; and ii) an objective specific to our regulation of insurers, to contribute to the securing of an appropriate degree of protection for those who are or may become policyholders.

5. The Act requires us to advance our general objective primarily by seeking to:

- (i) ensure that the business of the firms we regulate is carried on in a way that avoids any adverse effect on the stability of the UK financial system; and
- (ii) minimise the adverse effect that the failure of one of the firms we regulate could be expected to have on the stability of the UK financial system.

6. From 1 January 2019, the way we advance our general objective will be amended to reflect the aims of structural reform (also referred to as ring-fencing). This will require us to discharge our functions in a way that seeks to:

- (i) ensure that the business of ring-fenced bodies (RFBs) is carried on in a way that avoids any adverse effect on the continuity of the provision in the UK of core services;
- (ii) ensure that the business of RFBs is protected from risks (arising in the UK or elsewhere) that could adversely affect the continuity of the provision in the UK of core services; and
- (iii) minimise the risk that the failure of a RFB or of a member of a RFB's group could affect the continuity of the provision in the UK of core services.

7. The ring-fencing aspects of the PRA's objective relates to safeguarding the continuity of core services (retail deposits and related payment and overdraft services). The amendment is a refinement to provide a particular focus on ring-fencing and will be a central element of the advancement of our general objective of safety and soundness.

### **Our secondary objective**

8. We also have a secondary objective to act, so far as is reasonably possible, in a way that facilitates effective competition in the markets for services provided by the firms we regulate when they carry on regulated activities. This applies when we are making policies, codes, and rules in pursuit of our primary objectives.

9. Effective competition can be said to exist where suppliers offer a choice of products or services on the most attractive and sustainable terms to customers; where customers have the confidence to make informed decisions; and where firms enter, expand, and exit from the market.



10. Our primary and secondary objectives are usually fully aligned. However, cases may exist where some options available to us would not deliver the maximum benefits to safety and soundness, but would deliver significantly greater benefits to competition. The secondary competition objective means that we should consider (but are not required to adopt) those options that may deliver greater benefits to competition. This approach recognises that we may have limited policy choices, for example where we are bound by other domestic or international law.

11. Regulation designed to improve financial stability can facilitate effective competition. For example, regulation can ensure that firms' and investors' decision making appropriately reflects the social cost of risk-taking, reducing incentives to compete in a way that harms others in the financial system such as taking unsustainable levels of risk only to expose others to losses through failure and loss of confidence. A robust minimum prudential regulation standard can also provide customers with greater confidence in the financial soundness of new banks, enabling entrants to gain a foothold in the market and to expand.

### **Safety and soundness and the stability of the UK financial system**

12. 'Safety and soundness' involves firms having resilience against failure, now and in the future, and avoiding harm resulting from disruption to the continuity of financial services.

13. We are required by statute to promote safety and soundness by seeking to avoid adverse effects on financial stability. We supervise a large and diverse population of deposit-takers. Some of these are large UK banking groups containing RFBs, whose contribution to, and potential impact on, the UK economy is significant.

14. In some cases these firms are also systemically important financial institutions globally. Other firms we supervise are overseas firms, ranging from global investment banks to small retail operations. In addition we supervise mutuals, both building societies and many hundreds of credit unions, the majority of which operate in a particular locality.

15. Some prudential issues are common to all these firms. They generally undertake maturity transformation and are levered (ie have debt in their capital structure), leaving them inherently vulnerable to a loss of confidence. This underlies our objective to promote their safety and soundness, so that they are financially sound, and run in a prudent manner, which we advance by setting out policies those firms should meet in spirit and to the letter.

16. Our approach is necessarily determined in an international context. Banking is an international industry, with firms supervised on a co-operative international basis, and the prudential policy framework for supervision to a large extent agreed internationally. Given the international nature of UK banking, effective international co-operation, in relation to individual firms and general policy, is essential to us meeting our objectives.

### **Firm failure**

17. The Act is explicit that it is not our role to ensure that no firm fails. Therefore, a key principle underlying our approach is that we do not seek to operate a zero-failure regime. We work with the Bank of England (Bank) as UK resolution authority to ensure that any firms that fail do so in an orderly manner.

18. Prudential regulation is necessary to address the risks that 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 via the capital markets, meaning that bank failures or financial weakness can severely affect the supply of credit to the economy as a whole. Considering the impact of firm failure, and acting pre-emptively to ensure either recovery or orderly resolution, is a core aspect of our supervisory approach and we work to deliver this with the rest of the Bank through our supervisory strategy for individual firms. Our ability to ensure firm failure is orderly depends on both the efficacy of the UK's statutory resolution regime and ensuring firms are structured, and operate, in a way that is compatible with the Bank's preferred resolution strategy under UK resolution powers. The Resolution Directorate (RD) of the Bank sets the preferred resolution strategy for all firms. The RD works with institutions to ensure that any impediments to an orderly resolution are addressed. Resolvability assessments, and the actions flowing from them, form a key part of resolution planning on a 'business-as-usual' basis before an institution actually encounters distress.

19. Firms should be allowed to fail so long as failure is orderly, that is, so long as a continuity of access to the failed firm's critical functions<sup>3</sup> on which customers rely is maintained (including by transfer to another firm, or by converting or writing down the firm's external creditors). This 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. Prudential regulation can help to address these problems.

20. Under our prudential regulatory regime, firms must maintain a certain level of resilience against failure. This is essential to ensuring confidence in the resilience of the firms that we supervise for us to deliver on our general objective.

### Threshold Conditions

21. 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. They are designed to ensure that firms conduct their business in a prudent manner and are managed by persons with adequate skills, experience and probity, which are necessary to promote safety and soundness, and they are crucial to the operation of our regulatory regime. PRA-authorized firms need to meet both the PRA-specific and FCA-specific Threshold Conditions in Schedule 6 of the Act at all times.<sup>4</sup> We expect firms not merely to meet and continue to meet the letter of these requirements, but also to consider the overriding principle

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<sup>3</sup> Critical functions include core services, defined by Part 9B of the Financial Services and Markets Act 2000, as amended by the Financial Services (Banking Reform) Act 2013. Banking groups subject to ring-fencing must ensure uninterrupted provision of such services through the ring-fenced body. More information on ring-fencing can be found in Chapter 5 'Tailored application of the supervisory approach'.

<sup>4</sup> Available at <https://www.legislation.gov.uk/ukdsi/2013/9780111533802/article/2>.



of safety and soundness. We assess firms against the Threshold Conditions on a continual basis.

### **Fundamental Rules**

22. The Fundamental Rules are high level rules that collectively act as an expression of our general objective of promoting the safety and soundness of regulated firms. Firms must ensure they are compliant with all applicable PRA rules, including the Fundamental Rules, as set out in the PRA Rulebook.<sup>5</sup> The Fundamental Rules require firms to act in accordance with 'safety and soundness' by setting specific high-level requirements on them.

23. A failure to comply with the Fundamental Rules may be relevant to a firm's ongoing compliance with the Threshold Conditions and may result in enforcement or other actions.

### **Regulatory principles**

24. In designing our policies, issuing codes and making rules, we have regard to a number of 'regulatory principles', including those set out in the Act. These cover: using our resources efficiently; proportionality; the desirability of sustainable UK economic growth; senior management responsibility in firms; recognising differences in the nature and objectives of authorised persons; transparency; disclosure of information relating to persons on whom requirements are imposed by or under the Act; and the general principle of customers taking responsibility for their decisions. HM Treasury has made recommendations to the Prudential Regulation Committee (PRC) about aspects of the Government's economic policy to which the PRC should have regard when advancing our general functions.<sup>6</sup>

### **Investigations into regulatory failure**

25. The Financial Services Act 2012 requires us to investigate and report to HM Treasury on events which indicate possible regulatory failure. We have set out, in a policy statement,<sup>7</sup> how we will judge whether and when such failures have occurred. Consistent with our statutory objectives, we are clear that firm failures will not automatically indicate regulatory failure.

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<sup>5</sup> <https://www.prerulebook.co.uk>.

<sup>6</sup> More information about the PRC, and HM Treasury's recommendations, are available on the Bank's website at <https://www.bankofengland.co.uk/about/people/prudential-regulation-committee>.

<sup>7</sup> 'Conducting statutory investigations', April 2013: <https://www.bankofengland.co.uk/prudential-regulation/publication/2013/conducting-statutory-investigations>.

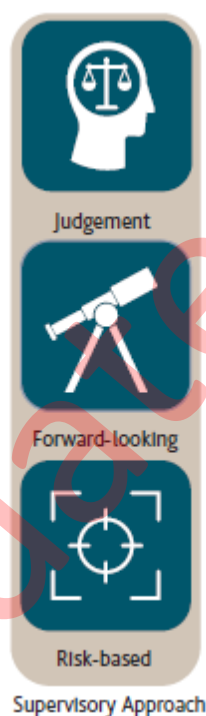
## 2 Our approach to advancing our objectives

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To advance our objectives, our supervisory approach follows three key principles – it is: i) judgement-based; ii) forward-looking; and iii) focused on key risks. Across all of these principles, we are committed to applying the principle of proportionality in our supervision of firms.

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Figure 1: Key principles of our supervisory approach



### Judgement-based

26. Our approach relies significantly on judgement. Supervisors reach judgements on the risks that a firm is running, the risks that it poses to our objectives, whether the firm is likely to continue to meet the Threshold Conditions, and how to address any problems or shortcomings.

27. Our supervisory judgements are 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, we are staffed by teams with strong, relevant skills and experience, and our major judgements and decisions involve our most senior and experienced staff and directors.

28. We also engage with the boards and senior management of firms in forming our decisions, using this dialogue both to ensure that we take account of all relevant information in reaching our judgements, and to communicate clearly the rationale for them. Firms should not, however, approach their relationship with us as a negotiation.

## Forward looking

29. Our approach is forward-looking. We assess firms not just against current risks, but also against those that could plausibly arise further ahead. And where we judge it necessary to intervene to mitigate the risks a firm is creating, we seek to do so at an early stage. To support this, firms should be open and straightforward in their dealings with us, taking the initiative to raise issues of possible concern also at an early stage. We will respond proportionately. In this way, trust can be fostered on both sides.

## Focused on key risks

30. We focus our supervision on those issues and those firms that, in our judgement, pose the greatest risk to the stability of the UK financial system. Consistent with our objectives, we aim to concentrate on material issues when engaging with firms. The frequency and intensity of the supervision applied by us to a particular firm therefore increases in line with the risk it poses our objectives.

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### Box 1: Working with other authorities

Co-ordination with other authorities is essential to our success.

#### The Bank of England

We are a part of the Bank of England, and are therefore connected to the Bank's other functions, including its role as lender of last resort, and its work on market intelligence, oversight of financial market infrastructure, financial sector resilience and the exercise of resolution powers. This facilitates the flow of information between these functions.

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. We therefore work closely with the Bank's Financial Policy Committee (FPC) which has statutory responsibility for reducing risks to the financial system as a whole.

The FPC can make recommendations and give directions to us on specific actions that should be taken in order to achieve the FPC's objectives. We are responsible for responding to FPC recommendations, which may be made 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.<sup>8</sup>

There is a frequent two-way flow of information and exchange of views between us and the FPC. We provide firm-specific information to the FPC, to assist its macroprudential supervision. And the FPC's assessment of systemic risks influences our judgements in pursuit of our own objectives.

Co-ordination between us and the FPC is assisted by the common membership of the Governor of the Bank of England, the Deputy Governor for Financial Stability, the Deputy Governor for Markets and Banking, the Deputy Governor for Monetary Policy, and the Chief Executive Officer (CEO) of the PRA on both our PRC and the FPC.

#### The Financial Conduct Authority (FCA)

The FCA is the conduct regulator for the firms prudentially regulated by us. We have a statutory duty to co-ordinate with the FCA in the exercise of our statutory functions under the Act, including policymaking and supervision. A Memorandum of Understanding (MoU) between us and the FCA describes how the two regulators fulfil this duty to co-ordinate in a way that supports each regulator's ability to advance its own objectives.<sup>9</sup>

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

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<sup>8</sup> See HM Treasury consultation on the FPC's macroprudential tools, published September 2012, available at [www.hm-treasury.gov.uk/press\\_83\\_12.htm](http://www.hm-treasury.gov.uk/press_83_12.htm).

<sup>9</sup> See the MoU: <https://www.bankofengland.co.uk/about/governance-and-funding>.

Conclusions and key information from supervisory activity that is materially relevant to the other regulator's objective(s) will be exchanged. In order to ensure that both ours and the FCA's supervisory judgements about a firm reflect relevant information, we will share information on dual-regulated firms and firms within dual-regulated groups between us.

To support this process, domestic 'supervisory colleges' for individual firms and groups are established as appropriate, with a view to identifying which risks and mitigating actions might have a material effect on the ability of the other regulator to advance its objectives. The frequency of these colleges will reflect the importance of the firm to the other regulator's objectives.

Co-ordination between us and the FCA is assisted by the reciprocal membership of the CEOs on each other's board. This cross-board role focuses on areas of overlap and discussions of material relevance to each CEO's own organisation. Co-ordination between the organisations is also assisted by common membership of CEOs on the FPC.

We and the FCA are also 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.

### **The Financial Services Compensation Scheme (FSCS)**

The FSCS is the UK's compensation fund of last resort for customers of authorised financial services firms. It may pay compensation to depositors in relation to covered deposits if a firm is, or likely to be, unable to pay claims against it. The MoU between us and the FSCS details how the two authorities co-operate and co-ordinate.<sup>10</sup>

We work closely with the FSCS in order to assess and enhance the resolution framework for deposit-takers in order to discharge our primary objective. We will seek to ensure that, through the Proactive Intervention Framework (PIF) (see Chapter 4), the FSCS has reasonable notice of activity where we may require significant involvement of the FSCS.

### **Other UK bodies**

We often need to work with other UK regulators and other UK government agencies, either to pursue our own objectives or to assist them in theirs. This may also include other enforcement agencies.

We have agreements to support the sharing of information and judgements and the co-ordination of actions. Our general approach to these arrangements and the relationships they underpin is focused on:

- enabling all parties to focus on their own objectives;
- the substantive issues of the 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.

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

We participate actively in global and European supervisory forums (working with other institutions such as the European Banking Authority (EBA) and European Commission), playing a full and active role with our counterparts in supervising cross-border firms, and seeking to be an influential and persuasive participant in international policy debates. In particular, we actively participate in the work of the FSB and the BCBS. And we aim to influence and reflect in our approach the work of the European System of Financial Supervision, of which we are a part.

<sup>10</sup> For more information on the MoU between the PRA and the FSCS, see:  
<https://www.bankofengland.co.uk/about/Pages/mous/default.aspx>.

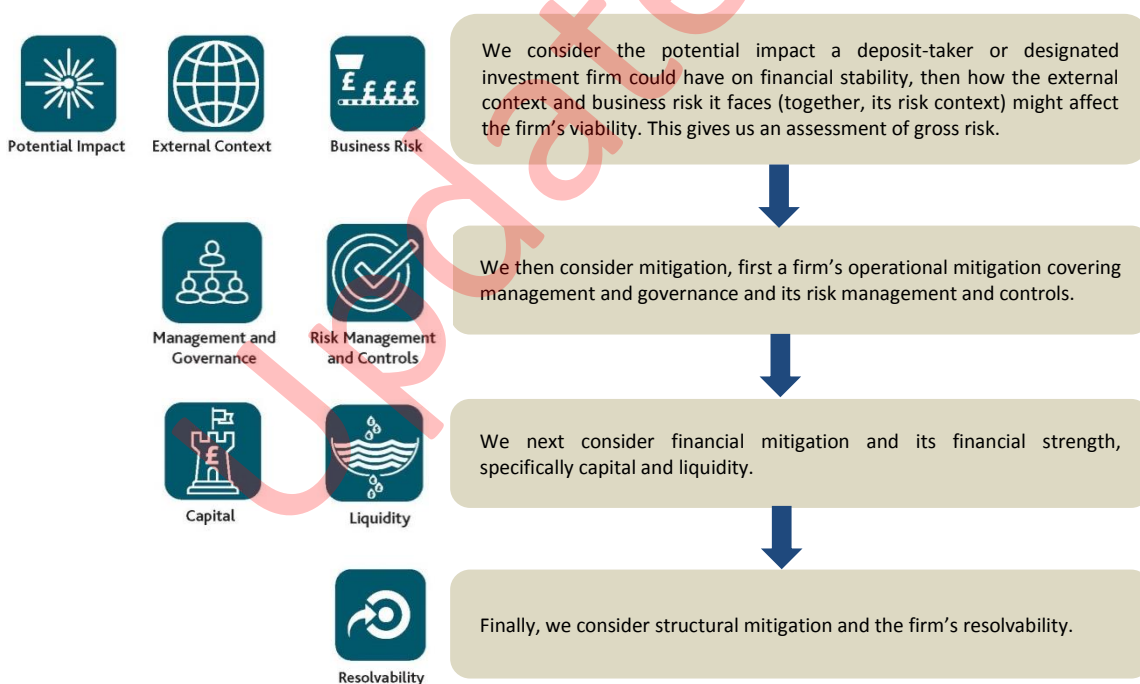
### 3 Identifying risks to our objectives

The intensity of our supervisory activity varies across firms. The level of supervision principally reflects our 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, described later), its resolvability, and our statutory obligations. Other factors that play a part include the type of business carried out by the firm, and the complexity of the firm’s business and organisation.

#### Our risk assessment framework

31. We take a structured approach when forming our judgements. To do this we use a risk assessment framework – see Figure 2.

Figure 2: Our risk assessment 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         |

## Potential impact

32. A core part of the risk assessment is the potential impact assessment. We assess the significance of a firm to the stability of the UK financial system. This 'potential impact' reflects a firm's potential to affect adversely the stability of the system by failing, coming under operational or financial stress, or because of the way in which it carries out its business. We divide all deposit-takers and designated investment firms we supervise into the five 'categories' of impact below:

- Category 1** The most significant deposit-takers or designated investment firms 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.
- Category 2** Significant deposit-takers or designated investment firms 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.
- Category 3** Deposit-takers or designated investment firms 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, but where difficulties across a whole sector or subsector have the potential to generate disruption.
- Category 4** Deposit-takers or designated investment firms 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.
- Category 5** Deposit-takers or designated investment firms 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.

33. We also consider the substitutability of the services that the firm provides, and the extent to which this could mitigate the impact of failure, including in stressed circumstances.

34. We use quantitative and qualitative analysis to allocate firms to categories. Numerical scoring based on firms' regulatory reporting provides a 'suggested' categorisation which supervisors review in light of qualitative analysis to confirm that it presents a full picture of a firm's potential impact.

35. Firms are told which category they have been assigned, providing a broad indication of the level of supervisory interaction to expect.



### **External context**

36. Any assessment of the risks facing firms, including their financial and operational risk, requires an appreciation of the external context in which they operate. Our assessment therefore includes consideration of system-wide risks, for example from low interest rates, excess credit growth, or international imbalances, and sectoral risks, for example financial risks in commercial real estate, concentration risk arising from outsourcing, or the evolving cyber threat.

37. We 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 draws upon both market intelligence and, where appropriate, standardised information from firms. We also consider actions by other regulators, including the FCA, that might materially affect the prudential soundness of PRA-authorised firms.

### **Business risk**

38. Business model analysis forms an important part of our supervisory approach. We 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 includes an assessment of where and how a firm makes money, the risks it takes in doing so, and how it funds itself. Firms are assessed at the level of the firm or the sector as appropriate.

39. For those firms posing greater risk to the stability of the system, the analysis is more detailed; we include a review of the drivers of profitability, risk appetite, performance targets and underlying assumptions, and a firm's own forecasts and their plausibility. We use this analysis to form a projection of the firm's ability to achieve its business and capital plans 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, guide our work in assessing the adequacy of the management actions the firm has available to mitigate risk. For example, our forward-looking view of the firm's prospects informs our judgement on the level of capital a firm requires, and the complexity of the firm's business informs judgements about that firm's risk management procedures. If we believe that mitigating measures alone cannot adequately reduce material risks to the safety and soundness of the firm, the firm will be required to change its plans.

40. Peer analysis forms 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 also supports an understanding of common sectoral risks that have the potential to affect the stability of the system.

### **Management and governance**

41. 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.

42. Boards and senior management must understand the kind of behaviour that will deliver an acceptable level of safety and soundness from the perspective of the financial system, and

act accordingly. This includes following our 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.<sup>11</sup>

43. Diversity plays an important role in promoting good governance. There is a risk that groupthink undermines good governance in firms, leading to decisions that undermine the safety and soundness of firms. The board must include diversity of skills, approach and experience to provide effective challenge. Firms should consider diversity when recruiting members to the management body.

44. The requirement for a firm and those managing its affairs to be 'fit and proper' is in addition to the need for a firm to comply with all applicable laws and regulations. These latter obligations are extensive and not limited to the laws and regulations enforced by us. 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. In addition the senior managers and directors of the firm must observe all the conduct rules or standards that apply to them.

#### Culture and behaviour

45. We expect firms to have a culture that supports prudent management. We do not have any 'right culture' in mind when making our assessment; rather we focus on whether boards and management clearly understand the circumstances in which the firm's viability would be under question, whether accepted practices are challenged, and whether action is taken to address risks on a timely basis. In particular, we want to be satisfied that designated risk management and control functions carry real weight within firms and that consideration is given to the wide range of risks facing firms.

46. The Senior Managers and Certification Regime (SM&CR) establishes the link between seniority and accountability strengthening individual accountability and also reinforces collective responsibility. Accordingly, we expect firms to allocate clear responsibilities to individuals performing Senior Management Functions (SMFs) and to document them in a clear, concise and effective manner. SMFs are subject to a number of statutory and regulatory requirements designed to strengthen their accountability internally and vis-à-vis the PRA and FCA. This includes a 'duty of responsibility' whereby they are required to take reasonable steps to prevent or stop regulatory breaches in their area of responsibility; and a requirement to ensure that any delegation of their responsibilities is to an appropriate person and that they oversee the discharge of the delegated responsibility effectively. Moreover, senior management committees (and other similar forums) should operate in a spirit of collective responsibility, rather than simply placing the burden on the committee chair who holds the SMF responsibility. We expect firms to have in place sufficient controls to minimise incentives

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<sup>11</sup> Supervisory Statement (SS) 5/16 'Corporate governance: Board responsibilities' sets out further information for the boards of PRA-regulated firms on those aspects of governance to which we attach particular importance and may devote particular attention in the course of our supervision: <https://www.bankofengland.co.uk/prudential-regulation/publication/2016/corporate-governance-board-responsibilities-ss>.

for excessive risk-taking by management and staff. Remuneration and incentive structures should reward careful and prudent management.

### Competence

47. Firms must be run by people who are competent to fill their roles. This 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. Boards are also required to possess adequate collective knowledge, skills and experience to be able to understand the institution's activities, including the main risks. As a firm grows and changes, and as the challenges it faces change, it may need different board members and management.

48. It is the responsibility of a firm's board to ensure that individuals appointed to SMFs are competent to fill them.

### Structures

49. We 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 remain accountable for the actions of those to whom they delegate responsibilities, including where firms use third parties in respect of outsourced functions.

50. 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. There are also expectations of additional governance requirements applied to RFBs to ensure they are able to take decision independently.

51. Not all legal entities within groups are necessarily directly authorised by us. 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 that have the potential to create risks for the group as a whole and therefore for authorised firms. We expect all boards of legal entities within groups, as a result of the responsibilities of their holding companies and their regulated affiliates to have regard to our objectives.

52. These requirements on the boards and executive management of legal entities within groups apply equally to overseas firms that establish separately incorporated entities within the UK. In particular, we expect boards and senior management of these firms to have proper regard to our objectives, both for the group as a whole and for individual firms (and subgroups) in the UK, since issues at the parent or group level could have an effect on the PRA-authorised entity and our objectives more generally.

53. Firms are able to operate in the UK as branches of overseas legal entities, meaning that there is no separate legal entity in the UK. Such branches can take one of two forms: those where the legal entity overseas is located within the European Economic Area (EEA); and those located outside the EEA. Regardless of the corporate structure and location of the parent, we expect all UK branches, like UK subsidiaries, to act responsibly in a manner that is consistent with safety and soundness. We expect the branches to appoint a senior individual with

authority to act as a primary contact with us in relation to their affairs. This individual should also act as a channel for communication with the parent.

### Senior Managers and other individuals performing key functions

54. We have the power under the Act to require individuals in senior roles in firms, ie those roles most critical to the advancement of our objectives (known as SMFs), to seek our approval before taking up their position. Approval is granted only if we, as prudential regulator, and the FCA, as conduct regulator, are both satisfied that an individual is fit and proper. In addition, firms themselves should carry out appropriate checks and satisfy themselves that individuals seeking to perform an SMF are fit and proper for their intended roles before applying to us and the FCA for approval on their behalf.<sup>12</sup>

### Disciplinary action against individuals

55. We may prohibit any individuals, not just those who currently hold an SMF, from performing functions in relation to a regulated activity carried on by a PRA-authorized firm. We may only do this where it appears to us that an individual is not a fit and proper person to perform such functions. We will consider using this power in appropriate cases.

56. We have disciplinary powers over individuals approved to perform an SMF by us or an equivalent function by the FCA (eg as a member of the governing body) and we are empowered to use these where an individual fails to comply with our Conduct Rules, or has been knowingly involved in a contravention by their firm of a requirement imposed by us. The powers enable us to, among other sanctions, impose financial penalties, censure an individual publicly, withdraw approval from individuals holding SMFs, and prohibit individuals from holding SMFs in the future.

57. We will take disciplinary action where it is appropriate to do so. In assessing whether to take disciplinary action against a senior manager or director, we consider a variety of factors, including:

- the impact the individual's behaviour has had, is having, or could have on us advancing our objectives, including the behaviour of other persons in the firm over whom the individual should exercise control, and whether that behaviour calls into question the person's fitness and properness (be it an isolated incident or a course of conduct);
- whether taking action will serve to deter the person who committed the breach, and others who are subject to our requirements, from committing similar or other breaches; and
- the individual's behaviour towards us, including the level of co-operation and openness with which the individual deals with us, and the appropriateness of the individual's actions in response to concerns raised.

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<sup>12</sup> We set out our expectations of firms and individuals in SS28/15 'Strengthening individual accountability in banking': <https://www.bankofengland.co.uk/prudential-regulation/publication/2015/strengthening-individual-accountability-in-banking-ss>.

## Risk management and controls

58. Firms should have robust frameworks for risk management, including for financial and operational risks. Controls should be commensurate with the nature, scale and complexity of their business, and promote the firms' safety and soundness. Competent and, where appropriate, independent control functions should oversee these frameworks. Boards should ensure they receive adequate and timely information on key risks and variances from the firm's agreed risk appetite to enable them to monitor and challenge executive management.

59. We expect firms to articulate 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 our objectives, and the firm should pay appropriate attention to identifying, measuring and controlling risks, including those arising in unlikely but very severe scenarios.

60. We recognise that it is not always possible to identify a financial stress scenario in which a firm fails, or all the operational stresses that would cause the firm's business to be disrupted, and we do not expect firms to be able to withstand all such events. We consider it important, however, for firms' senior management and boards to have an explicit understanding of the circumstances in which their firm might fail and effective processes to identify, manage, monitor, and report the risks it is, or might be, exposed to.

61. We 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

62. 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. We 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).

63. We 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 its critical services in the event of financial stress or failure. Firms are expected to comply with standards for resilience, including where they outsource material operational functions to third parties.

64. We 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 to control the business within agreed limits and tolerances, and should be produced in a sufficiently timely manner. It should be able to be accessed and analysed 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 operational and financial risks to which the firm is exposed.

65. While quantitative models can play an important role in supporting firms' risk management, we 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 any 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. We expect senior management to have a clear understanding, and to advise the board, 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.

66. 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. We 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, financial and other control arrangements.

#### Operational resilience

67. Operational resilience refers to the ability of firms to keep going operationally as well financially. In a context of firms' increasing reliance on digital systems and platforms, and the risk of cyber-attacks, our supervisory approach in this area is evolving.

68. A discussion paper, published jointly in July 2018 by the PRA, FCA and Bank,<sup>13</sup> signalled that our supervisory approach in this area will primarily be focused on the continuity of the business services that a firm's customers and the wider economy rely upon. As part of this, we expect firms to develop impact tolerances. These should acknowledge that disruptive events will happen. Firms need to be able to recover within their set tolerance for a wide range of severe but plausible scenarios.<sup>14</sup>

69. Most banks and insurers may well decide to set their impact tolerance tighter than required by us. They are likely to experience private costs before their safety and soundness is at risk. Nevertheless, in line with our statutory obligations (see Chapter 1), firms doing activity where operational disruption could have a financial stability impact, will be held to higher standards (including more prudent impact tolerances) than smaller firms. Firms' operational resilience is the responsibility of their boards. We require firms to have clear lines of accountability for their operational resilience, through responsibility for the internal operations and technology of the firm. Boards should ensure there is sufficient challenge to the executive and that they have access to people within the business with appropriate technical skills.

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<sup>13</sup> For more information see DP1/18 'Building the UK financial sector's operational resilience': <https://www.bankofengland.co.uk/prudential-regulation/publication/2018/building-the-uk-financial-sectors-operational-resilience-discussion-paper>.

<sup>14</sup> See 'Good cop/bad cop' – speech by Sam Woods, the Deputy Governor for Prudential Regulation and the Chief Executive of the PRA at <https://www.bankofengland.co.uk/speech/2018/sam-woods-mansion-house-city-banquet>.



## Capital

70. 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 creditor confidence. This 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 quality form of capital, gives owners a greater interest in the firm being run prudently.

71. As with all elements of its approach, we expect firms in the first instance to take responsibility for ensuring that the capital they have is adequate. However, 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 us as prudential regulator to specify a minimum amount of capital. 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 our limited resource means that we may not identify and account for every element of the risks that firms may face.

## Quality of capital

72. We expect the most 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. In addition, firms may meet some of their requirement in the form of Additional Tier 1 (AT1) instruments.

73. We expect all capital to be capable of absorbing losses in the manner indicated by its place in the capital structure. To this end, all capital instruments must meet the internationally agreed criteria around the definition of capital. We expect firms to comply with these criteria in spirit as well as to the letter when structuring capital instruments. Reflecting this, we expect firms to refrain from innovations to structure new capital instruments intended to contribute to meeting their regulatory requirements if these are ineffective, or less effective, in absorbing losses. We 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.

## Double leverage

74. Double leverage occurs when one or more parent entities in a group funds some of the capital in its subsidiaries by raising debt or lower forms of capital externally.<sup>15</sup> The use of double leverage introduces payment and maturity mismatch risks for the parent companies. Excessive double leverage can threaten the safety and soundness of PRA-authorized entities in a group. We expect firms to manage carefully any risks arising from use of double leverage and to take appropriate mitigating actions where necessary.

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<sup>15</sup> For more information see PS9/18 'Groups policy and double leverage': <https://www.bankofengland.co.uk/prudential-regulation/publication/2017/groups-policy-and-double-leverage>.

### Location of capital

75. We are mindful that capital resources are not always freely transferable around a group when it matters most. Creditors' and counterparties' claims are on specific legal entities, not on groups. Should a firm fail, its orderly resolution will be facilitated if individual legal entities, and UK subgroups, hold capital commensurate with their risks. Therefore, capital resources required on a consolidated basis should be pre-positioned close to risk to ensure entities within the groups are capable of absorbing losses or meeting liabilities as they fall due. In order to support the integrity of individual regulated entities, we will limit their intragroup exposures.

### Level of capital

76. We 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.

77. We form judgements about how much capital individual firms need to maintain, given the risks to which they are exposed and uncertainties about the values of assets and liabilities. Our judgements should inform firms' own assessments, but we 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 if these are inappropriate for the risks to which they are exposed. And they should not rely on aggressive interpretations of accounting standards, especially in calculating asset valuations and loan loss provisions.

78. We expect all 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, we 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, we ensure the stresses applied are appropriately prudent.

79. Firms are expected to identify and develop, as a matter of routine, management actions they could take in response to stress scenarios. Firms undertake recovery planning so that they can stabilise their financial position and recover from financial losses following firm-specific, market-wide, or combined stress. Recovery plans should include options to address capital shortfalls through generating capital internally and externally, and taking into account possible liquidity and profitability pressures. Recovery plans are 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 could include restricting dividends and variable remuneration. We assess the adequacy of firms' recovery plans in terms of the range of recovery options and the amount of recovery capacity they can deliver and the triggers and governance to implement them.

## The framework for determining regulatory capital

80. For all firms we determine a minimum regulatory capital level and buffers on top of this, as applicable, expressed in terms of the Basel and EU risk-weighted framework. The UK capital framework comprises four 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 imposed by us reflecting estimates of risks either not addressed or only partially addressed by the international standards for Pillar 1 (eg interest rate risk in the banking book, or risks associated with firms' own pension schemes).
- CRD IV buffers, as applicable – these comprise the capital conservation buffer and the countercyclical capital buffer, which are relevant to all firms. For globally systemically important institutions (G-SIIs), the G-SII buffer will also be relevant, and for domestic systemic firms the systemic risk buffer will be relevant. Where a firm is subject to both a G-SII buffer and a systemic risk buffer at the same consolidation level, the higher of the two requirements may apply.
- The PRA buffer, as applicable – some firms may be subject to a PRA buffer which is an amount of capital that firms should hold in addition to their minimum level of regulatory capital (Pillar 1 plus Pillar 2A) to cover risks and elements of risk not covered elsewhere, and losses that may arise under a stress.

81. Pillars 1 and 2A together represent what we regard as the minimum level of regulatory capital a firm should maintain at all times to cover adequately the risks to which it is exposed and to comply with the overall financial adequacy rule.

82. Supervisors may exercise judgement and, where it is deemed appropriate, reduce variable capital add-ons (ie Pillar 2A requirements) for firms using the standardised approach (SA) for credit risk, therefore reducing the likelihood that capital standards are overly prudent for these firms. It is estimated that around a third of UK banks and building societies will have lower minimum capital standards.<sup>16</sup> In assessing capital needs, supervisors will take into account the greater degree of conservatism that may apply to risk weights derived under the SA compared to those from internal ratings based (IRB) models for certain types of exposure, using so-called IRB credit risk benchmarks. These are average risk weights for different types of exposure across firms that use IRB models.

## Internal capital models

83. Firms that have obtained the appropriate permissions may use internal models to help to quantify their Pillar 1 capital requirements for the types of risks and exposures covered by those permissions. We are generally sceptical that this approach on its own can provide an

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<sup>16</sup> See Part 1, paragraph 1.1 ii) of the PRA Annual Competition Report – June 2018, available in the PRA Annual Report on the Bank's website at <https://www.bankofengland.co.uk/prudential-regulation/publication/2018/annual-report-2018>.

appropriate basis to calculate capital requirements. There are inherent difficulties in measuring risk using models, including limitations from their structure and complexity, the quality and availability of data used as inputs and the underpinning assumptions.<sup>17</sup>

84. Our overarching principle is that we expect firms to maintain, at all times, an amount of capital that adequately reflects the risks to which they are exposed. As a consequence, if firms use internal models in calculating their regulatory capital requirements, we expect the models to be appropriately conservative. Where we judge the conservatism applied in internal models not to be sufficient, we will take appropriate action to remediate the situation, which can include: requiring methodological adjustments or recalibration; setting capital floors or imposing adjustments to modelled capital requirements; or withdrawing model approval.

85. Importantly, 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.

86. A firm should use a model as the basis for its capital calculation only where model calibration, controls, and governance arrangements are adequate, with the model and its output subject to effective, ongoing, and independent validation to ensure that it is performing as anticipated. We expect firms not to use internal models for particular asset classes where we judge that it is not possible to measure risk to a sufficient degree of confidence, notably because of a lack of data.

#### The leverage ratio framework

87. To complement the risk-weighted capital regime, firms should take into account the risk of excessive leverage when assessing the adequacy of capital levels. In particular, we expect firms to consider whether their degree of leverage is appropriate against the internationally agreed measure of leverage on a non-risk weighted basis.

88. For major banks and building societies subject to the UK leverage ratio framework we require a minimum leverage ratio be met at all times and expect firms in scope to have regulatory capital that is equal to or greater than any applicable leverage ratio buffers on a consolidated basis. For the purposes of capital requirements this is based on a modified version of the internationally-agreed leverage exposure measure, to exclude qualifying central bank reserves. That exclusion is intended to ensure that the leverage ratio does not act as a barrier to the effective implementation of any policy measures that lead to an increase in claims on central banks. We have also consulted on a proposal to apply the framework to major banks RFBs on a sub-consolidated basis.

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<sup>17</sup> For more information on extending the use of the IRB approach to smaller firms see Box 1 in the PRA Annual Competition Report 2017: <https://www.bankofengland.co.uk/prudential-regulation/publication/2017/pr-annual-competition-report-2017>.

89. The framework comprises four parts:

- (i) a 3.25% leverage ratio minimum requirement, denominated in Tier 1 capital, that must be met with at least 75% Common Equity Tier 1 (CET1) capital;
- (ii) an additional leverage ratio buffer. This is applicable to UK global systemically important institutions (G-SIIs) identified by us, with the buffer rate calibrated at 35% of a relevant firm's G-SII capital buffer rate, which must be met with CET1 capital. We also consulted on applying the additional leverage ratio buffer to UK domestic systemically important institutions identified by us and, where applicable, we expect firms to hold capital on a group consolidated basis to address RFB group risk;
- (iii) a countercyclical leverage ratio buffer of CET1 capital, calibrated at 35% of a relevant firm's countercyclical capital buffer rate and rounded to the nearest 10 basis points; and
- (iv) additional reporting and disclosure requirements of a bank's average exposures throughout the reporting quarter.

90. The FPC intends to conduct a review of the UK leverage ratio framework in light of revised international standards, including the finalised Basel standard (known as Basel III) and European Capital Requirement regulation (known as CRR2). In particular, this review would set out the approach to extending leverage ratio requirements and buffers to other PRA-regulated firms, and to entities below the consolidated group.

### Liquidity

91. We expect all firms to take responsibility for ensuring that there is no significant risk that they cannot meet their liabilities as they fall due. Reflecting, however, that firms may not take full account of the public interest in them running their business in a prudent manner, there is a clear role for us, as prudential regulator, in ensuring that firms have an appropriate degree of resilience to liquidity stresses.

### Funding profile

92. We expect firms to have a prudent funding profile, taking into account both the expected behavioural and contractual maturities of liabilities. We 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, we 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.

### Liquid assets

93. We 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 stress scenarios covering institution-specific, market-wide, and combined stress scenarios over different time periods. This gives a firm's counterparties confidence that it will be able to repay depositors

and creditors on demand and gives a 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.

94. As with capital, we reach our own view on the appropriate size and composition of the liquidity buffer that firms should hold in normal, unstressed conditions except in the case of credit unions, which must simply abide by our minimum prudential standards for these firms. The liquidity coverage ratio (LCR) is the starting point for our assessment. But we 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.

95. To support their judgements on the appropriate size and composition of liquidity buffers, we 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. We will consider whether the stresses applied by the firm are prudent.

96. We are mindful that liquidity resources are not always freely transferable around a group when it matters most. We 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. We recommend that firms should regularly assess their ability to convert their buffers or liquid assets into cash in a short timeframe. Regular 'turn over' of liquid assets in size in the market can reduce the risk of firms encountering problems in trying to monetise these assets in times of stress. Beyond monetising the buffer of liquid assets, firms' recovery plans should include a wide range of credible options to raise liquidity in times of stress. We will assess the adequacy of firms' range of liquidity recovery options and the amount of recovery capacity they can deliver and the triggers and governance to activate them. We may sometimes require firms to hold additional liquidity where we anticipate a specific stress event.

97. Firms' liquid asset buffers are intended to be used. We are clear that firms may draw down their liquid asset buffer as required in times of stress; there is no expectation that firms should hold buffers-on-buffers of liquidity. When a firm uses its liquid asset buffer, we will be content for the buffer to be rebuilt over a reasonable period of time, subject to a credible plan being provided to supervisors. The plan should include actions already documented in the firm's recovery plan.

### Liquidity insurance

98. Firms are encouraged to take account of the range of liquidity insurance facilities offered by the Bank. These include the regular monthly market-wide Indexed Long-Term Repo (ILTR) auctions aimed at firms with a predictable need for sterling liquidity, the bilateral on demand Discount Window Facility (DWF) designed for addressing firm-specific or market-wide liquidity shocks and, if activated by the Bank, the Contingent Term Repo Facility (CTRF).

99. Eligible firms that are not currently members of the Sterling Monetary Framework are encouraged to discuss whether an application would be appropriate. Firms with access should familiarise themselves with the liquidity insurance facilities available, factor the availability of these facilities into liquidity planning, ensure that sufficient collateral is pre-positioned at the



Bank to be able to use the facilities, and ensure that operational capacity is maintained by conducting periodic test trades with the Bank.

### **Resolvability**

100. Interruption to the critical functions provided by firms to their customers is one of the key channels through which the failure of firms can adversely affect financial stability. To mitigate this risk, the failure of any firm should be orderly, ie it should be feasible and credible for the firm to fail without excessive disruption to the financial system, interruption to the provision of critical functions or exposing public funds to losses. Orderly failure for smaller firms can typically be achieved through an insolvency process, whereby the firm's business is wound up after covered depositors have either been paid by the FSCS, or had their account transferred by the liquidator to another institution. Where this is not possible, for example in the case of larger, more complex firms, managing the failure may require the use of statutory powers by the Bank. A firm's 'resolvability' refers to the level of assurance around the ability to manage its failure in an orderly manner.

101. Our objective is not to avoid all instances of failure, but to minimise the adverse effects of the failure of a firm by taking appropriate actions to promote the resolvability of the firm. Making banks more resolvable also facilitates market exit and should encourage effective competition by reducing the implicit subsidy received by banking groups and the associated funding advantages. Drawing up resolution plans and assessing resolvability for all UK firms are statutory responsibilities of the Bank as resolution authority. The Bank, therefore, sets a resolution strategy for every firm.<sup>18</sup> As set out in more detail in the Bank's approach document on resolution,<sup>19</sup> these strategies can be grouped into three categories: bail-in of a firm's shareholders and creditors, partial transfer of its business to a purchaser or insolvency. The designation of the preferred resolution strategy is made on the basis of the resolution planning for each firm. This designation is made by the Bank, working with us, the FCA, and relevant overseas authorities.

102. Where, as in the case of smaller deposit-taking firms, the preferred resolution strategy for failure is insolvency, the Bank and we will need to determine whether the firm's systems are able to provide the information needed by the FSCS for a rapid pay-out or transfer of protected deposits (within a target of seven days in relation to pay-out for the majority of customers). We require relevant firms to be able to produce a single, consistent view of each depositor's funds: this 'Single Customer View' (SCV) is essential to ensure that the FSCS is able to recompense depositors rapidly in relation to covered deposits, minimising the adverse effect of firm failure on the stability of the financial system.

103. The disorderly failure of larger and more complex firms, with highly interconnected legal and operational structures, is likely to have a systemic impact and to be highly detrimental for

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<sup>18</sup> This section does not apply to credit unions, for which no special insolvency or resolution regime currently applies. Credit unions are, however, expected to meet the requirements for a 'single customer view' (SCV), as explained in paragraph 102.

<sup>19</sup> 'The Bank of England's approach to resolution': <https://www.bankofengland.co.uk/paper/2017/the-bank-of-england-approach-to-resolution>.

the continuity of critical functions. As a result of this, the resolution strategy for those firms is likely to involve the use of a partial transfer tool or a bail-in tool.<sup>20</sup>

### Resolvability assessments

104. As part of resolution planning for a firm, the Bank as resolution authority undertakes 'resolvability assessments', in consultation with us.<sup>21</sup> These assessments involve identifying potential impediments to the effectiveness of the resolution plan. A number of impediments to resolution – for example, the need for a firm to have sufficient financial resources that can bear losses in resolution – are generic and therefore the subject of international principles or standards. We, and the Bank, set domestic policies reflecting these international principles and standards which allow a period of time for firms in scope to implement and meet the relevant requirements.

105. In support of our general objective to promote the safety and soundness of firms, we have published a number of rules and supervisory statements intended to remove impediments to resolvability that may affect the generality of firms. Our ring-fencing requirements seek to facilitate orderly resolution in the event that a RFB or member of its group fails by ensuring the provision of core services (ie services related to accepting deposits) is supported.<sup>22</sup> We require firms in scope of operational continuity requirements to ensure they have operational continuity of critical services to facilitate resolution planning, recovery actions, orderly resolution and post-resolution restructuring.<sup>23</sup> In addition, we also expect firms to ensure that any new financial contracts or liabilities they enter into that are not subject to UK or EEA law contain contractual terms requiring the counterparty to recognise the application of the UK resolution regime.<sup>24</sup>

### Removing impediments to resolvability

106. We expect firms to co-operate fully with us and the Bank, in particular by taking actions to remove impediments to their resolvability and by providing the information needed to facilitate resolution planning.<sup>25</sup>

107. If a firm does not take steps to remove barriers to resolvability, the Bank has powers to

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<sup>20</sup> The largest UK banks are required by UK law to have separate core retail banking services from their investment and international banking activities by 1 January 2019. This is known as ring-fencing. Ring-fencing aims to support the resolvability of those banks through the ex-ante separation of the entities providing core retail banking services (the RFB) from the other group entities.

<sup>21</sup> The Bank has committed to publishing summaries of major UK firms' resolution plans and its assessment of their effectiveness, as noted in the Bank's response to the Independent Evaluation Office's evaluation of its resolution arrangements, available at <https://www.bankofengland.co.uk/report/2018/independent-evaluation-office-report-evaluation-of-the-boes-resolution-arrangements>. As noted in a speech made by Jon Cunliffe, Deputy Governor Financial Stability, in June 2018 (<https://www.bankofengland.co.uk/-/media/boe/files/speech/2018/central-clearing-and-resolution-learning-some-of-the-lessons-of-lehmans-speech-by-jon-cunliffe.pdf>), we envisage that it will require major UK banks to conduct a self-assessment of their resolvability – measured against the policies and standards that have been established nationally and internationally. We may also require that elements of firms' self-assessments are made public. We would then publish our assessment of resolvability for these firms.

<sup>22</sup> More detail can be found in the SS8/16 'Ring-Fenced Bodies': <https://www.bankofengland.co.uk/prudential-regulation/publication/2016/ring-fenced-bodies-ss>.

<sup>23</sup> More detail can be found in the PS21/16 'Ensuring operational continuity in resolution': <https://www.bankofengland.co.uk/prudential-regulation/publication/2014/ensuring-operational-continuity-in-resolution>.

<sup>24</sup> More detail can be found in PS25/15 'Contractual stays in financial contracts governed by third-country law': <https://www.bankofengland.co.uk/prudential-regulation/publication/2015/contractual-stays-in-financial-contracts-governed-by-third-country-law>. The PRA has separately set requirements through PS17/16 'The contractual recognition of bail-in: amendments to Prudential Regulation Authority rules': <https://www.bankofengland.co.uk/prudential-regulation/publication/2016/the-contractual-recognition-of-bail-in-amendments-to-pra-rules>.

<sup>25</sup> We remain the primary point of contact for PRA-regulated firms in relation to going-concern prudential matters.

direct the firm to take action where the existence of the barrier is viewed as a substantive impediment to the resolution of the firm.<sup>26</sup> We, as competent authority, also have powers to require institutions to address specific impediments to resolvability in support of our general objective, as well the potential for using our group restructuring powers in relation to ring-fencing objectives. We will consult with the Bank and co-operate closely in exercising these complementary responsibilities and powers.

### Overseas firms

108. International co-operation with other supervisory and resolution authorities is crucial in delivering credible resolution plans for cross-border groups and helps to reduce the risk of uncoordinated actions if part of a group fails. We, with the Bank, have co-operation agreements in place with overseas authorities for the largest firms, which set out roles and responsibilities in resolution planning and processes for information sharing before and during resolution.

109. Where the UK is a host of a subsidiary of an overseas firm, the Bank expects to co-ordinate closely with the home resolution authority in developing and implementing a group resolution plan. Where firms operate as branches in the UK, we expect them to have robust resolution plans in place and will ensure, in consultation with the Bank, that the resolution arrangement for the firm and its UK operations are appropriate. For all firms with substantial operations outside the UK, we retain an appropriate degree of co-operation with the relevant overseas authorities in order to ensure that our statutory objectives are achieved.

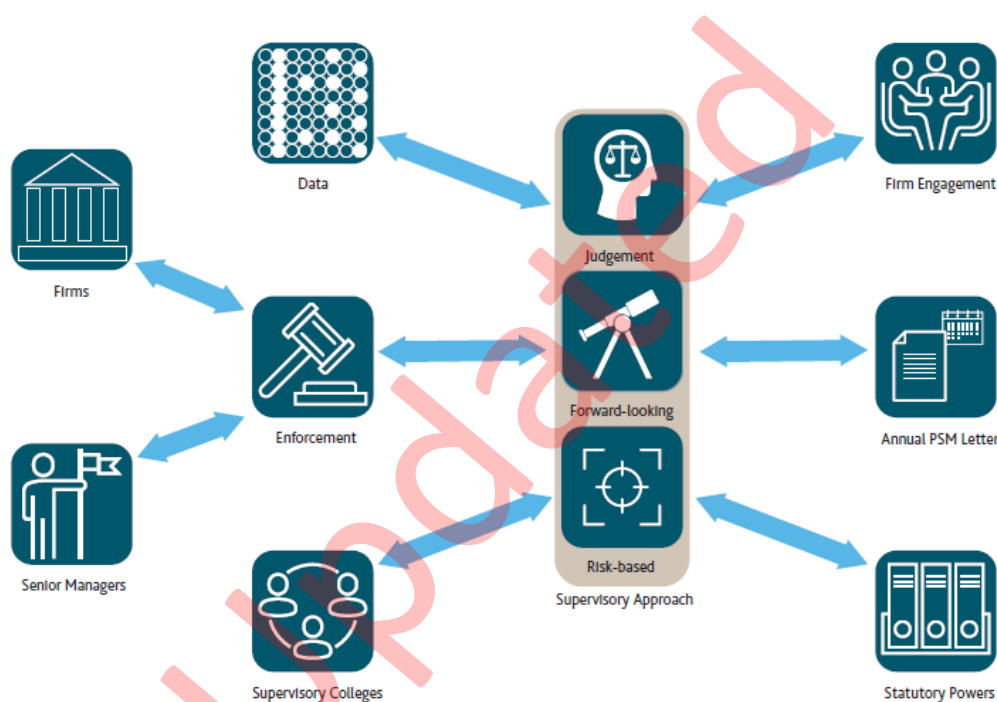
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<sup>26</sup> More detail is available in the Statement of Policy 'The Bank of England's power to direct institutions to address impediments to resolvability': <https://www.bankofengland.co.uk/paper/2015/the-boes-power-to-direct-institutions-to-address-impediments-to-resolvability-sop>.

## 4 Supervisory activity

This section describes how, in practice, we supervise firms, including information on our highest decision-making body (see Box 2) and our approach to authorising new firms (see Box 3). As part of this, it describes the Proactive Intervention Framework (PIF) and our high-level approach to using our legal powers. For UK firms, our assessment covers all entities within the consolidated group.

Figure 3: Supervisory activity



110. Our supervision involves engagement with firms at all levels of seniority. At a senior level, boards as a whole, and the non-executive directors in the absence of executive management, should expect regular dialogue with us, either in groups or on an individual basis. We always focus on material issues in our engagement with firms.

111. We are not formulaic about the supervisory activity we perform, since the focus on key risks means that this activity depends inevitably on a firm's particular circumstances. Nonetheless, our supervisory work comprises a selection of possible activities described below.

### Supervisory activities and tools

112. In forming supervisory judgements, we draw on a broad set of quantitative and qualitative information and data. Supervisors require firms to submit sufficient data, of appropriate quality, to inform their judgements about key risks. Given the importance of this,

we periodically validate firms' data, either through onsite inspection by our supervisory and specialist risk staff, or by third-parties.

113. We gather and analyse information on a regular basis, for example through regulatory returns. We also gather and analyse relevant information in the public domain, for example firms' annual reports and disclosures.

114. To support our detailed information gathering and analysis, we require firms to participate in meetings with supervisors at a senior and working level. Some discussions are strategic in nature, while other interactions focus on information gathering and analytical work.

115. We also, as appropriate, conduct detailed onsite testing or inspections of a particular area. In-depth, focused reviews, for example of a firm's proprietary trading desk or our approach to valuations or risk weightings, involve discussions with staff, reviews of internal documents and some testing. In addition, we may review a firm's approach to stress testing, or undertake bespoke stress testing of our own. We involve our risk specialists and other technical staff in onsite work, stress testing, and other assessments. Where we feel we can rely on their effectiveness, we may use firms' risk, compliance, and internal audit functions to identify and measure risks.

116. Firms' external auditors can and should play a role in supporting prudential supervision, given their ability to identify and flag to us current and potential risks in a firm. As required by the Act, we maintain arrangements to provide a firm's external auditors with relevant data and information, for example, if we consider a firm's valuation of less liquid assets or its approach to provisioning to be significantly out of line with its peers, as well as exchanging opinions with those auditors on the implications of such information. We expect to work with firms' external auditors in an open, co-operative and constructive manner, and will maintain rules setting out the duties external auditors will have to co-operate with us in connection with our supervision of PRA-authorised firms. We expect auditors to disclose to us emerging concerns within firms, where this would assist us in carrying out our functions. We have published a Code of Practice detailing the arrangements we will maintain with firms' external auditors in order to promote a mutually beneficial and constructive relationship.<sup>27</sup> The Act requires us to meet at least once a year with the auditors of each deposit-taker and investment firm that is, in the opinion of us, important to the stability of the UK financial system.

117. To assist with its risk assessment, we may at times use our statutory powers, in particular, our information gathering power and our powers to commission reports by Skilled Persons on specific areas of interest (under sections 165, 165A, 166 and 166A of the Act). Such reviews can be undertaken where we seek additional information, an assessment, further analysis, expert advice and recommendations, or assurance around a particular subject. We may enter into a contract with a Skilled Person directly, following a transparent and consistent approach to selecting and appointing them, or we may allow the regulated firm to contract

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<sup>27</sup> For more information see Legacy Supervisory Statement 7/13 'The relationship between the external auditor and the supervisor: a code of practice': <https://www.bankofengland.co.uk/prudential-regulation/publication/2013/the-relationship-between-the-external-auditor-and-the-supervisor-a-code-of-practice-ss>.

with the Skilled Person. We are always regarded as the end user of a Skilled Person report regardless of the appointment approach taken.

118. We also makes use of the FCA's findings on firms' key conduct risks, including money laundering, and any material prudential risks in relation to FCA-authorized subsidiaries of dual-regulated groups where they are materially relevant to our objectives.

119. We are not a 'fraud' regulator; this role is filled by other authorities. Our onsite inspections are not therefore designed to uncover all instances of malpractice. Rather, we aim to assess the adequacy of a firm's control framework in preventing operational risk (including serious fraud) that could threaten its safety and soundness, drawing to the attention of the relevant authorities any suspicion or information that may be of material interest to them.

### **Using powers in the course of supervision**

120. We have a variety of formal powers available to us under the Act, which we can use in the course of our supervision, if deemed necessary to reduce risks. These include powers by which we can intervene directly in a firm's business. For example, we 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. The Act confers a number of powers on us with respect to group restructuring powers where we may exercise these powers to enforce a restructuring of a ring-fenced bank group, or its unregulated UK-incorporated holding company. This power is subject to a number of conditions, including that the actions of the RFB are having an adverse effect on our ability to advance our objectives. We may also, as noted above, use our powers to require information from firms.

121. While we look to firms to co-operate with us in resolving supervisory issues, we will not hesitate to use formal powers where we consider them to be an appropriate means of achieving our desired supervisory outcomes. This means that, in certain cases, we will choose to deploy formal powers at an early stage and not merely as a last resort. This can include addressing serious failings in the culture of firms.

122. We consider when and how to use our formal powers, and assess the particular facts and circumstances, on a case-by-case basis. In all cases, we are 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 our requests without the use of powers;
- our view of the firm's proximity to failure, as reflected in its position within the PIF; and
- the likely impact, including systemic implications, of the firm's failure.

123. In addition, we may use our 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, we may use our powers to refuse such requests.



124. We have a power to impose a requirement under Part 4A, section 55M of the Act on a firm to undertake or cease a particular action. One of the grounds for exercising this power is if it appears to us that it is desirable to exercise the power to advance any of our objectives.

125. There is substantial flexibility for us to tailor requirements specific to the circumstances of a firm and the nature of our concerns, including serious cultural failings.

### **Proactive Intervention Framework (PIF)**

126. Supervisors consider a firm's proximity to failure when drawing up its supervisory plan. Our judgement about proximity to failure is captured in a firm's position within the PIF.

127. Judgements about a firm's proximity to failure are 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 is not sensitive to a firm's potential impact or resolvability.

128. The PIF is designed to ensure that we put into effect our aim to identify and respond to emerging risks at an early stage. There are five PIF stages, each denoting a different proximity to failure, and every firm sits in a particular stage at each point in time (see Figure 4). When a firm moves to a higher PIF stage (ie as we determine the firm's viability has deteriorated), supervisors will review their supervisory actions accordingly. Senior management of firms will be expected to ensure that they take appropriate remedial action to reduce the likelihood of failure and the authorities will ensure appropriate preparedness for resolution.

129. A firm's PIF stage is reviewed at least annually and in response to relevant, material developments.

130. We consider it important for markets and counterparties to make their own judgements on the viability of a firm. We will not therefore routinely disclose to the market our 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. As a result, we do not routinely disclose PIF scores to firms.

**Figure 4: Stages in the Proactive Intervention Framework**

| Stage   | Possible supervisory actions  |
|---|---|
| <b>Stage 1 – Low risk to viability of firm</b>  | <ul style="list-style-type: none"> <li>- Firm subject to the normal supervisory risk assessment process and actions, including recovery and resolution planning.</li> </ul>   |
| <b>Stage 2 – Moderate risk to viability of firm</b><br>Supervisors have identified vulnerabilities in a firm's financial position of deficiencies in its risk management and/or governance practices.   | <p><i>Recovery</i></p> <ul style="list-style-type: none"> <li>- The intensity of supervision will increase. We may set additional reporting requirements, and make use of information gathering and investigatory powers.</li> <li>- We will require the firm to act to address deficiencies identified over a set period.</li> <li>- The firm will be required to update its recovery plan and may need to activate it.</li> </ul> <p><i>Resolution</i></p> <ul style="list-style-type: none"> <li>- With the support of the RD, we will assess the firm's resolvability against the authorities' preferred resolution strategy and identify changes necessary to ensure the resolution plan can be feasibly implemented in the event of firm failure.</li> <li>- The FSCS may be asked to evaluate the quality of data provided to support an SCV, and any obstacles to pay out or deposit transfer.</li> </ul> |
| <b>Stage 3 – Risk to viability absent action by the firm</b><br>Significant threats to a firm's safety and soundness have been identified.  | <p><i>Recovery</i></p> <ul style="list-style-type: none"> <li>- We may require any of the following actions: changes to management and/or the composition of the board; limits on capital distribution (including dividends and variable remuneration); restrictions on existing or planned activities; a limit on balance sheet growth and/or stricter leverage limits; and setting tighter liquidity guidelines and/or capital requirements.</li> <li>- The firm will be required to draw on the menu of options set out in its recovery plan as appropriate.</li> </ul> <p><i>Resolution</i></p> <ul style="list-style-type: none"> <li>- With the support of the RD, we will intensify engagement on contingency planning for resolution and will have all means necessary to obtain the information we consider we need to carry out the task.</li> </ul>  |
| <b>Stage 4 – Imminent risk to viability of firm</b><br>The position of a firm has deteriorated such that we assess 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"> <li>- We will most likely increase the scale of the recovery actions needed (including in relation to liquidity and capital). We will set out a timetable for implementation of recovery actions.</li> <li>- Firm-led recovery actions will need to be affected in short order and the firm will need to demonstrate that these were credible and will produce material results.</li> <li>- Actions initiated following activation of the recovery plan, including on asset disposal (or sale of firm), will need to be completed.</li> </ul> <p><i>Resolution</i></p> <ul style="list-style-type: none"> <li>- Where relevant, the RD and FSCS will confirm that all necessary actions to prepare for the resolution of the firm have been taken, including that relevant data were readily available.</li> </ul>                                      |
| <b>Stage 5 – Firm in resolution or being actively wound up</b>  | <p><i>Resolution</i></p> <ul style="list-style-type: none"> <li>- We will determine the firm no longer meets Threshold Conditions and this is not reasonably likely to be rectified.</li> <li>- Where appropriate the RD will take the firm into the Special Resolution Regime overseeing the resolution or winding-up the firm.</li> <li>- The FSCS may be required to effect depositor pay out and/or to fund deposit transfer, or resolution.</li> </ul>   |

## Mitigating risk

131. There are annual, internal stocktake 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 Chapter 3). There is senior level involvement in these assessments, such that major judgements are made by our most senior and experienced individuals. These formal assessments are also 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 RD.

132. There is a clear and direct link between the risks that we perceive and the actions we expect from firms in consequence. For example, if we have 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, we 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. We 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. Similarly, our assessment may highlight that deficiencies in a firm's governance procedures have resulted in the board not articulating a risk tolerance for outage times as a result of operational disruptions. We may then expect the firm to review its operational risk governance, enhance the quality of management information provided to the board, for the board to consider and state its risk tolerance for operational disruptions, and for the firm to revise its business continuity arrangements, such as its service level agreements, as necessary.

## Conveying supervisory messages

133. We send an annual letter to each firm clearly outlining the key risks that are of greatest concern, and on which we require action. The test of materiality for points raised with firms is high, with a focus on root cause analysis rather than symptoms and with supervisory interventions clearly and directly linked to reducing risks to our objectives. We expect to verify that action is taken on these key risks, and communicate to the firm's board when and how we intend to do this. We send individually tailored letters to all firms, except those with the lowest potential impact where a standard letter outlines issues relevant to all firms in that group, unless specific issues have been identified with a particular firm. We actively engage with a firm's Audit Committee and its non-executive directors on progress made in addressing the most significant risks identified.

134. Firms may sometimes disagree with our decisions: this is inherent given the tensions between the public and private interest. We, in general, discuss issues with firms in reaching our decisions, and carefully consider representations made, not least to ensure that our decisions are made on the basis of all the relevant evidence. However, firms should not approach their relationship with us as a negotiation.

135. Any less significant issues that have arisen, and of which we feel the firm should be aware, are conveyed to the firm but with the onus on the firm itself to address these. We expect confirmation by the most appropriate senior individual within the firm, for example the

Chief Executive Officer, Finance Director, or Chair of the Audit Committee, that issues have been closed.

### Supervisory colleges

136. Where we are the home supervisor, we 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 difficult issues. We seek to adopt this approach when we run colleges and expect other authorities to participate on the same basis. As the lead authority and college chair for major UK firms, we are prepared to tackle instances where we believe that other authorities are not acting in a manner consistent with our objectives. And we encourage other authorities to challenge us if they have concerns. EU processes are increasingly well-developed: it is already a requirement for all European prudential supervisors of pan-European groups to work together to reach a joint risk assessment and decision on capital and liquidity adequacy. We work closely with other European supervisors to reach these joint decisions.

137. We are also an active participant in wider international co-ordination of supervision for major firms. Where invited to do so as host supervisor, we participate in supervisory colleges for all firms with significant operations in the UK, whether a legal entity or a branch.

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#### Box 2: The Prudential Regulation Committee (PRC)

The Prudential Regulation Committee (PRC) was created by the Bank of England Act 1998 and has responsibility within the Bank for exercising the Bank's functions as the PRA, as set out in the Bank of England Act 1998 and the Financial Services and Markets Act 2000.

The PRC makes our most important decisions. It sets the PRA levy, by way of rules, and adopts the budget of the PRA, with the approval of Court. It makes key supervisory decisions in relation to the largest firms we supervise. It has a number of non-delegable responsibilities, including the PRA's high-level strategy and policy-making functions. The PRC is accountable to Parliament, in the same way as the Monetary Policy Committee (MPC) and Financial Policy Committee (FPC), the Bank's other statutory decision-making bodies.

The PRC is chaired by the Governor of the Bank of England. Other members of the PRC are: the Deputy Governors for Financial Stability, Markets and Banking, and Prudential Regulation; the Chief Executive of the FCA; a member appointed by the Governor with the approval of the Chancellor; and at least six members appointed by the Chancellor.

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### Box 3: Authorising new firms

Firms wishing to undertake deposit-taking activities must apply to us for authorisation to do so. The application process is a joint assessment between us and the FCA. We assess applicant firms from a prudential perspective with the focus of the FCA being on conduct. The applicant firm will only be authorised if both regulators are satisfied that the firm will meet each regulator's respective Threshold Conditions, at the point of authorisation and on an ongoing basis. This includes an assessment of whether the applicant firm could be resolved in an orderly way. As provided for in the MoU, we lead and manage a single administrative process, and, as the lead regulator, we will act as the decision maker on the application.

We set out the information that we require firms to supply to complete our assessment. We stand ready to answer questions where necessary, though this does not extend to providing consultancy on completing applications. Along with the FCA, we have committed to engaging with applicants at an early stage in pre-application meetings, which will aim to produce as complete an application as possible.

We take a proportionate approach to the assessment of applications. All applicants are subject to a minimum level of assessment, beyond which work is commensurate with the potential impact of a firm's failure on the financial system.

New banks should also consider the material on the New Banks Start-up Unit webpage at <https://www.bankofengland.co.uk/prudential-regulation/new-bank-start-up-unit>. This is a joint initiative from the regulators aimed at helping new banks to enter the market and through the early days of authorisation.

Our aim through this proportionate approach is for barriers to entry to be kept to the minimum consistent with our objectives, so enabling us to contribute to a competitive market.

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## 5 Tailored application of the supervisory approach

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**We are responsible for supervising a diverse range of firms. This includes low impact firms, international firms and groups containing ring-fenced bodies. Even within these broad categories there is substantial diversity in firm structures and sizes as well as products, which shapes the business models and risks to which these firms are exposed. We tailor our application of the supervisory assessment framework to take account of this diversity.**

### **Low impact firms**

138. 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, it is necessary that each group is subject to appropriate and proportionate supervisory monitoring. First, our general objective is to promote the safety and soundness of all of the firms that we regulate. 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). A robust minimum prudential regulation standard can also facilitate effective competition by providing customers with greater confidence in the financial soundness of new entrants to the market.

### **Non-systemic UK banks and building societies**

139. The supervisory approach and level of engagement is based on the potential impact and PIF stage of the firms, overlaid with our assessment of the key risks facing each individual firm. This is shaped by the four key principles outlined in Chapter 2. The minimum engagement, in addition to monitoring regulatory returns and peer group analysis, is an annual, onsite assessment visit for each firm, covering a high-level review of each of the risk elements in our risk framework described in Chapter 3.

140. The diversity of firm structures, sizes, and business models are considered thoroughly as part of our supervisory assessment framework in order to apply the principles of proportionality, and deliver against our secondary competition objective to facilitate effective competition. Two recent policy examples of this are the refinements to the Pillar 2A capital framework and Internal Rating Based (IRB) model accessibility. We also adopt a risk-based approach in our ongoing supervisory work to reflect the different size and complexities of a firm. For example, major firms are subject to annual capital and liquidity reviews while for most non-systemic firms, this is done on a two or three year cycle.

### **Credit unions**

141. Credit unions are the major constituent of the lowest impact category; they are not subject to the Capital Requirements Directive, nor are they generally issued with individual



guidance for capital or for liquidity. Instead, they are subject to a specific prudential regime, as set out in the Credit Union section of the PRA Rulebook, including prescribed minimum capital and liquidity requirements. They are supervised, and their adherence to the prescribed financial standards is monitored, as described below, and from time-to-time they are required to engage in supervisory thematic reviews.

142. Given that such credit unions are only likely to pose risks to financial stability at an aggregate level, we supervise them on a portfolio basis. Automated tools that analyse their regulatory returns issue alerts highlighting outliers and trends, and they are, in general, examined individually only when their regulatory returns trigger such an alert.

143. We also examine individual credit unions 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).

144. In addition, we conduct peer group and trend analysis across the credit union sector as a whole to develop a clear understanding of the risks posed both by groups of very low-impact credit unions and by typical individual credit unions. We still conduct annual assessments of these credit unions, but in large peer groups. Credit unions in this category are not visited by us on a fixed, regular schedule but, notwithstanding this approach and regardless of category, all are subject to onsite work by us at any time, but typically with a period of notice.

145. In contrast to higher-impact credit unions, those in the lower categories contact us through a centralised firm enquiries function and do not have an individual, named supervisor.

146. We also seek to ensure that all credit unions are resolvable, with a particular emphasis on meeting standards for rapid pay out of depositors by the FSCS. They are not otherwise required to have recovery and resolution plans. Those individual credit unions posing a risk of contagion to other firms, for example through having uninsured depositors, are subject to more intensive supervision.

### **Ring-fenced bodies**

147. Ring-fencing is intended to safeguard the continuity of the provision of core services (ie deposits, payments, overdrafts) by seeking to ensure that the activities of a RFB are restricted and that the RFB has a degree of protection from shocks that originate from the RFB itself, in other parts of its group or the global financial system. Ring-fencing also facilitates orderly resolution in the event that either an RFB or another member of its group fails and supports the continuity of core services thereafter.

148. Ring-fencing legislation is effective from Tuesday 1 January 2019 and results in a broader set of legislative and regulatory requirements for groups within scope.

149. From 2019, our general objective will be amended to require us to ensure that RFBs are protected from risks that could affect the provision of core services, and that ring-fenced banks – in going or gone concern – do not threaten the provision of these services. The

amendment is a refinement to provide a particular focus on ring-fencing as part of our existing safety and soundness objective.

150. Ring-fencing legislation changes the supervisory perimeter in that RFBs have to be supervised for compliance with more requirements than other banks; establishes special supervisory powers (ie group restructuring power whereby we may exercise the power to enforce a restructuring of an RFB's group or its unregulated UK holding company); and provides for particular scrutiny in relation to ring-fencing (ie our annual report requirements to provide an opinion on RFBs' compliance with ring-fencing requirements.)

151. Our forward-looking, judgement-based approach to assessing the risk posed by firms to our general objective remains appropriate for RFBs. Ultimately firms will have primary responsibility for compliance with ring-fencing legislation. While there are supervisory activities to ensure that RFBs are prudentially sound, capable of independent decisions and comply with the new legislative and regulatory requirements, these will be mapped into the existing framework and form one aspect of our risk-based and forward-looking approach. We will continue prioritising our supervisory interventions focusing on the issues that represent the most significant risks to our objectives.

#### **International banks**

152. Banking is an international industry and the UK is a significant international financial centre. Many international banks operate in the UK in order to provide financial services to the UK economy and to access the global financial markets located here. They may do so either through UK subsidiaries of groups headquartered abroad, or branches of foreign banks.

153. As is the case for UK firms, our approach to the supervision of international firms operating in the UK reflects an assessment of the nature and potential impact of the firm on UK financial stability. The intensity of our supervision will be greater where the activities of the firm in the UK are of greater significance to UK financial stability.

154. Similarly, given the nature of the risks presented by foreign banks, it is necessary for us to have assessed the equivalence of the home state regulatory and supervisory regime, and to have an appropriate degree of co-operation with the home state supervisor in order to ensure that our objectives are achieved.

155. However, our legal powers and responsibilities vary depending on the legal form of a firm's operations in the UK.

156. For subsidiaries of overseas firms, we apply the same regulatory requirements and follow the same supervisory framework as for a UK headquartered firm. Additionally, our supervisory approach must take account of the links between the subsidiary and the rest of the group of which it forms part.

157. A branch of a foreign bank forms part of a legal entity incorporated outside the UK. A branch does not have its own capital or board of directors. It follows that its operations are necessarily dependent on those of the legal entity as a whole. We are open to hosting branches of international banks, recognising the efficiency benefits this brings.

158. In the case of UK branches of EEA firms, our powers and responsibilities are limited under European law. The home state supervisor rather than us is responsible for the prudential supervision of the firm, although we have certain powers to act in exceptional circumstances. Subject to the outcome of the negotiations between the UK and the EU, and in particular absent some new agreement in relation to EEA firms, these firms will have to apply for authorisation in order to carry on PRA-regulated activities after the UK withdraws from the EU. They would then be treated in the same way as other international bank branches. Firms that are authorised to carry on a regulated activity in the UK under the EU passporting regime can enter into the temporary permissions regime if, prior to exit day, they notify us or the FCA (as applicable) or they have made an application for permission under Part 4A of the Act.<sup>28</sup> We will assess the potential impact that international firms may have on UK financial stability, be they in the form of branches and/or subsidiaries, and adjust the intensity of our supervisory approach accordingly.

159. Many subsidiaries of international firms have close financial and operational inter-linkages to the wider group of which they form part. The financial strength of these entities is often reliant on the overall financial strength of the group, and similarly the financial position of the group may be significantly affected by the performance of the subsidiary.

160. We will therefore work closely with the home state supervisor to assess these linkages, and the group's recovery and resolution plans. Where there are significant linkages between the UK subsidiary and the rest of the group, and where the firm may have a significant impact on UK financial stability we will expect an appropriate degree of co-operation with the home state supervisor in order for us to understand the nature and extent of risks to the wider group to the extent they affect the UK subsidiary.

161. Our general approach to branch authorisation and supervision, which applies to all branches, is anchored by an assessment of a range of factors including the degree of equivalence of the home state supervisor's regulatory regime and the supervisability of an international bank that operates in the UK through a branch. These factors are relevant both at the time of authorisation and on an ongoing basis during supervision.<sup>29</sup>

162. In general we will not be content for branches to undertake deposit-taking activities from retail and small company customers in excess of certain de minimis levels. Once a firm is undertaking material deposit-taking activity, we need to have greater supervisory influence over that firm and this is only possible if that firm is operating as a subsidiary.

163. In the case of branches undertaking wholesale activity, we will undertake an assessment of their systemic importance. We will identify wholesale branches as systemically important where their size, complexity, and interconnectedness indicate that the failure of the firm could have significant consequences for financial stability in the UK.

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<sup>28</sup> See our dedicated page on EU withdrawal for further information: <https://www.bankofengland.co.uk/eu-withdrawal>.

<sup>29</sup> For more information see SS1/18 'International banks: the Prudential Regulation Authority's approach to branch authorisation and supervision': <https://www.bankofengland.co.uk/prudential-regulation/publication/2018/international-banks-pras-approach-to-branch-authorisation-and-supervision-ss>.

## Annex

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**October 2018:** This issue of 'The Prudential Regulation Authority's approach to banking supervision' contains amendments to simplify and improve readability. The document has also been updated to reflect recent developments in policies and approach. The key changes are outlined below.

- Removal of Executive Summary to remove duplication of information in the Executive Summary, Foreword, and Introduction.
- New foreword from Sam Woods, PRA CEO and Deputy Governor for Prudential Regulation at the Bank (pages 1-2).
- Addition of text regarding the UK's withdrawal from the EU (page 3).
- Addition of text regarding Structural Reform/ring-fencing (pages 4, 5, 15, 22, 23, 26, 37-38).
- Updates made to 'Our objectives' section to remove duplicative information and to make content clearer (pages 4-7).
- New section 'Safety and soundness and the stability of the system' added incorporating some content from Chapter 1 in the March 2016 issue of this document (page 5).
- Removal of Threshold Conditions box, with key information remaining. Addition of link to FSMA, Schedule 6 where the full Threshold Conditions can be viewed (page 6).
- Removal of Fundamental Rules box, with key information remaining. Addition of link to Policy Statement 5/14 'The PRA Rulebook' where the full Fundamental Rules can be viewed (page 7).
- Removal of 'The PRA's expectations of firms – policies' section as now the PRA is an established regulator, a lot of policy is published separately on the Bank's website which individually sets out the expectations of firms for each policy.
- New section added 'Regulatory principles' to highlight that we have regards to a number of 'regulatory principles' set out in the Act (page 7).
- Updates made to 'Our approach to advancing our objectives' section (pages 8-10).
- Updates made to Box 1 'Working with other authorities', including addition of text on domestic supervisory colleges (pages 9-10).
- Addition of new chapter 'Identifying risks to our objectives', incorporating sections taken from Chapters 1 and 2 of the March 2016 issue of this document (pages 11-27).

- Updates made to 'Management and Governance' section including updates to 'Senior Managers and other individuals performing key functions' section, removing duplicative information published on the Bank of England website (pages 13-16).
- Updates made to 'Risk Management and Controls' section, including merging of information from the 'Control Framework' and 'Risk Management and Control functions' sections of the March 2016 issue of this document, under title 'Control framework' (pages 17-18).
- Addition of new section on operational resilience (page 18).
- Updates made to 'Capital' section (pages 19-23), including a new sub-section on 'double leverage'.
- Update made to 'Liquidity' section, including removal of 'Supervision – Individual Liquidity Guidance' sub-section (pages 23-25).
- Update made to the 'Resolvability' section, including addition of new sub-sections 'Resolvability assessments', 'Removing impediments to resolvability' and 'Overseas firms' (pages 25-27).
- Updates made to the 'Supervisory activity' section (pages 28-35).
- New box added giving information on the PRA's Prudential Regulation Committee (page 34).
- New chapter added 'Tailored application of the supervisory approach', incorporating content from a similar section in the March 2016 issue of this document, as well as addition of new content on how we tailor our supervisory approach for 'Non systemic UK banks and building societies' and 'ring-fenced bodies' (pages 36-39).
- Update to 'International banks' section (pages 38-39).
- Removal of 'Making policy to support the PRA's general approach' chapter as now the PRA is an established regulator with policy published on the Bank of England's website. A link has been added in the Introduction to information regarding the way we make policy.
- Removal of box 'Underlying economic justification for prudential regulation' as now the PRA is an established regulator and detailed justification is not necessary. Useful content from this previous section has been added to the 'Our secondary objective' and 'Firm failure' sections (pages 4-6).