



BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Supervisory Statement | SS[xx]/15

Internal governance of third country branches

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1 Introduction

1.1 This draft supervisory statement is relevant to third country branches ('branches' and where singular a 'branch') with respect to the carrying on of certain activities and the provision of certain services from an establishment in the United Kingdom. It will assist a branch to make judgements which advance the objectives of the PRA by promoting safety and soundness. This statement clarifies the PRA's expectations on:

- general organisational requirements;
- persons who effectively direct the business;
- responsibility of senior personnel;
- skills, knowledge and expertise;
- compliance;
- outsourcing; and
- record keeping.

2 General organisational requirements

General requirements

2.1 The PRA expects that the arrangements, processes and mechanisms implemented by a branch should be comprehensive and proportionate to the nature, scale and complexity of the risks inherent in its business model and of its activities and must take into account the specific technical criteria described in SYSC 19A.

Mechanisms and procedures

2.2 The PRA expects that, taking into account the nature, scale and complexity of the business of the branch, and the nature and range of the financial services and activities undertaken in the course of that business, the branch should establish, implement and maintain:

- decision-making procedures and an organisational structure which clearly and in a documented manner specifies reporting lines and allocates functions and responsibilities; and
- effective internal reporting and communication of information at all relevant levels of the branch.

Business continuity

2.3 The PRA expects a branch to take reasonable steps to ensure continuity and regularity in the performance of its regulated activities.

2.4 A branch should establish, implement and maintain an adequate business continuity policy aimed at ensuring, in the case of an interruption to its systems and procedures, that any losses are limited, the preservation of essential data and functions, and the maintenance of its regulated activities, or,

where that is not possible, the timely recovery of such data and functions and the timely resumption of those activities.

2.5 The matters dealt with in a business continuity policy should include:

- resource requirements such as people, systems and other assets, and arrangements for obtaining these resources;
- the recovery priorities for the branch's operations;
- communication arrangements for internal and external concerned parties (including the PRA, clients and the press);
- escalation and invocation plans that outline the processes for implementing the business continuity plans, together with relevant contact information;
- processes to validate the integrity of information affected by the disruption; and
- regular testing of the business continuity policy in an appropriate and proportionate manner in accordance with 2.6.

Regular monitoring

2.6 A branch should monitor and, on a regular basis, evaluate the adequacy and effectiveness of its systems, internal control mechanisms and arrangements established in accordance with Chapter 2 of the Internal Governance of Third Country Branches Part of the PRA Rulebook, and take appropriate measures to address deficiencies.

3 Persons who effectively direct the business

3.1 The persons referred to in Internal Governance of Third Country Branches 3.1 should either be executive directors or persons granted executive powers by, and reporting immediately to, the governing body.

3.2 The PRA expects at least two independent minds to play parts in the decision-making process in all significant decisions and determine the formulation and implementation of the policies of a branch. Where a branch nominates two individuals to direct its business, the PRA will not regard them as both effectively directing the business where one of them makes some, albeit significant, decisions relating to only a few aspects of the business.

3.2 Where there are more than two individuals directing the business of a branch, the PRA does not regard it as necessary for all of these individuals to be involved in all decisions relating to the determination of strategy and general direction. However, at least two individuals should be

involved in all such decisions. Both individuals' judgement should be engaged so that major errors leading to difficulties for the branch are less likely to occur. Similarly, each individual should have sufficient experience and knowledge of the business and the necessary personal qualities and skills to detect and resist any imprudence, dishonesty or other irregularities by the other individual. Where a single individual, whether a chief executive, managing director or otherwise, is particularly dominant in such a branch this will raise doubts about whether Internal Governance of Third Country Branches 3.2 is met.

4 Responsibility of senior personnel

4.1 The PRA expects a branch to ensure that:

- its senior personnel receive on a frequent basis, and at least annually, written reports on matters covered in sections 5.5, 6 and 7.2, indicating in particular whether the appropriate remedial measures have been taken in the event of any deficiencies; and
- the supervisory function, if any, receives on a regular basis written reports on the same matters.

4.2 In the PRA's view, the supervisory function does not include a general meeting of the shareholders of the firm, or equivalent bodies, but could involve, for example, a separate supervisory board within a two-tier board structure or the establishment of a non-executive committee of a single-tier board structure.

5 Employees, agents and other relevant persons

Skills, knowledge and expertise

5.1 In the PRA's view, a branch's systems and controls should enable it to satisfy itself of the suitability of anyone who acts for it. This includes assessing an individual's honesty and competence. This assessment should normally be made at the point of recruitment. An individual's honesty need not normally be revisited unless something happens to make a fresh look appropriate.

5.2 Any assessment of an individual's suitability should take into account the level of responsibility that the individual will assume within the branch. The nature of this assessment will generally differ depending upon whether it takes place at the start of the individual's recruitment, at the end of the probationary period (if there is one) or subsequently.

Segregation of functions

5.3 In the PRA's view a branch should ensure that the performance of multiple functions by its relevant persons does

not and is not likely to prevent those persons from discharging any particular functions soundly, honestly and professionally. The senior personnel within the branch should define arrangements concerning the segregation of duties within the branch and the prevention of conflicts.

5.4 The effective segregation of duties is an important element in the internal controls of a branch in the prudential context. In particular, it helps to ensure that no one individual is completely free to commit assets or incur liabilities. Segregation can also help to ensure that the firm's governing body receives objective and accurate information on financial performance, the risks faced by the branch and the adequacy of its systems.

5.5 A branch should normally ensure that no single individual has unrestricted authority to do all of the following:

- initiate a transaction;
- bind the branch or the firm;
- make payments; and
- account for it.

5.6 Where a branch is unable to ensure the complete segregation of duties (for example, because it has a limited number of staff), it should ensure that there are adequate compensating controls in place (for example, frequent review of an area by relevant senior managers).

5.7 Where a branch outsources its internal audit function, it should take reasonable steps to ensure that every individual involved in the performance of this service is independent from the individuals who perform its external audit. This should not prevent services from being undertaken by a firm's external auditors provided that:

- the work is carried out under supervision and management of the branch's own internal staff; and
- potential conflicts of interest between the provision of external audit services and the provision of internal audit are properly managed.

Awareness of procedures

5.8 A branch should ensure that its relevant persons are aware of the procedures which must be followed for the proper discharge of their responsibilities.

5.9 A branch should monitor and, on a regular basis, evaluate the adequacy and effectiveness of its systems, internal control mechanisms and arrangements established in accordance with Internal Governance of Third Country Branches 5.1 and section 5 of this supervisory statement and take appropriate measures to address any deficiencies.

6 Compliance and internal audit

Compliance

6.1 A branch should, taking into account the nature, scale and complexity of its business, and the nature and range of financial services and activities undertaken in the course of that business, establish, implement and maintain adequate policies and procedures designed to detect any risk of failure by the branch to comply with its obligations under the regulatory system, as well as associated risks, and put in place adequate measures and procedures designed to minimise such risks and to enable the PRA to exercise its powers effectively under the regulatory system.

6.2 Depending on the nature, scale and complexity of its business, it may be appropriate for a branch to have a separate compliance function. Where a branch has a separate compliance function, it should be permanent, effective, operate independently and should have the following responsibilities:

- to monitor and, on a regular basis, to assess the adequacy and effectiveness of the measures and procedures put in place in accordance with section 6.1 above, and the actions taken to address any deficiencies in the branch's compliance with its obligations; and
- to advise and assist the relevant persons responsible for carrying out regulated activities to comply with the branches obligations under the regulatory system.

6.3 In order to enable the compliance function of a branch to discharge its responsibilities properly and independently, the branch should ensure that the following conditions are met:

- the compliance function should have the necessary authority, resources, expertise and access to all relevant information;
- the relevant persons involved in the compliance functions should not be involved in the performance of services or activities they monitor; and
- the method of determining the remuneration of the relevant persons involved in the compliance function should not compromise their objectivity.

A branch need not comply with the second and third bullet points if it is able to demonstrate that in view of the nature, scale and complexity of its business, and the nature and range of its financial services and activities, those provisions are not proportionate and that the branch's compliance function continues to be effective.

6.4 In setting the method of determining the remuneration of persons involved in the compliance function, branches will need to comply with SYSC 19A (the Remuneration Code).

Internal audit

6.5 The PRA expects that a branch should, where appropriate and proportionate in view of the nature, scale and complexity of its business and the nature and range of its financial services and activities, undertaken in the course of that business, establish and maintain an internal audit function. This should be separate and independent from the other functions and activities of the branch. The internal audit function should have the following responsibilities:

- to establish, implement and maintain an audit plan to examine and evaluate the adequacy and effectiveness of the branch's systems, internal control mechanisms and arrangements;
- to issue recommendations based on the result of work carried out in accordance with the audit plan;
- to verify compliance with those recommendations; and
- to report in relation to internal audit matters in accordance with 4.1.

6.6 The term 'internal audit function' in section 6.5 refers to the generally understood concept of internal audit within a branch, that is, the function of assessing adherence to and the effectiveness of internal systems and controls, procedures and policies. The internal audit function is not a controlled function itself, but it is part of the systems and controls function (CF28).

7 Risk control

7.1 Internal Governance of Third Country Branches 2.1 requires a branch to have effective processes to identify, manage, monitor and report the risks it is or might be exposed to.

7.2 A branch should establish, implement and maintain adequate risk management policies and procedures, including effective procedures for risk assessment, which identify the risks relating to the branch's activities, processes and systems, and where appropriate, set the level of risk tolerated by the branch.

7.3 A branch should adopt effective arrangements, processes and mechanisms to manage the risk relating to the branch's activities, processes and systems, in light of that level of risk tolerance.

7.4 The management body of a branch should approve and periodically review the strategies and policies for taking up, managing, monitoring and mitigating the risks the branch is or might be exposed to, including those posed by the macroeconomic environment in which it operates in relation to the status of the business cycle.

7.5 For a branch included within the scope of Internal Capital Adequacy Assessment 15 (Reverse stress testing), the strategies, policies and procedures for identifying, taking up, managing, monitoring and mitigating the risks to which the firm is or might be exposed include conducting reverse stress testing in accordance with that chapter. A branch which falls outside the scope of that Part should consider conducting reverse stress tests on its business plan as well. This would further senior personnel's understanding of the firm's vulnerabilities and would help them design measures to prevent or mitigate the risk of business failure.

7.6 A branch should monitor the following:

- the adequacy and effectiveness of its risk management policies and procedures;
- the level of compliance by the branch and its relevant persons with the arrangements, processes and mechanisms adopted in accordance with 7.3; and
- the adequacy and effectiveness of measures taken to address any deficiencies in those policies, procedures, arrangements, processes and mechanisms, including failures by the relevant persons to comply with such arrangements, processes and mechanisms or follow such policies and procedures.

7.7 A branch should, where appropriate and proportionate in view of the nature, scale and complexity of its business and the nature and range of the investment services and activities undertaken in the course of that business, establish and maintain a risk management function that operates independently and carries out the following tasks:

- implementation of the policies and procedures referred to in 7.2 to 7.6; and
- provision of reports and advice to senior personnel in accordance with 4.1.

7.8 Where a branch does not maintain a risk management function that functions independently, it should nevertheless be able to demonstrate that the policies and procedures which it has adopted in accordance with 7.2 to 7.6 satisfy those provisions and are consistently effective.

7.9 In setting the method of determining the remuneration of employees involved in the risk management function, branches will need to comply with SYSC 19A (the Remuneration Code).

7.10 The term 'risk management function' in 7.6 and 7.8 refers to the generally understood concept of risk assessment within a branch, that is, the function of setting and controlling risk exposure. The risk management function is not a controlled function itself, but is part of the systems and controls function (CF28).

8 Outsourcing

8.1 A branch should, when relying on a third party for the performance of operational functions which are critical for the performance of regulated activities, listed activities or ancillary services on a continuous and satisfactory basis, ensure that it take reasonable steps to avoid undue additional operational risk.

8.2 A branch should not undertake the outsourcing of important operational functions in such a way as to impair materially:

- the quality of its internal control; and
- the ability of the appropriate regulator to monitor the branch's compliance with all obligations under the regulatory system.

8.3 Internal Governance for Third Country Branches 2.1 requires a branch to have effective processes to identify, manage, monitor and report risks and internal control mechanisms. Except in relation to those functions described in 8.5, where a firm relies on a third party for the performance of operational functions which are not critical or important for the performance of relevant services and activities (see 8.1) on a continuous and satisfactory basis, it should take into account, in a manner that is proportionate given the nature, scale and complexity of the outsourcing, the provisions in this section in complying with that rule.

8.4 An operational function is regarded as critical or important if a defect or failure in its performance would materially impair the continuing compliance of a branch with the conditions and obligations of its authorisation or its other obligations under the regulatory system, its financial performance, or the soundness or the continuity of its relevant services and activities.

8.5 Without prejudice to the status of any other function, the following functions should not be considered as critical or important for the purposes of this section:

- the provision to the branch of advisory services, and other services which do not form part of the relevant services and activities of the branch, including the provision of legal advice to the branch, the training of personnel of the branch, billing services and the security of the branch's premises and personnel; and
- the purchase of standardised services, including market information services and the provision of price feeds.

8.6 A branch should exercise due skill, care and diligence when entering into, managing or terminating any arrangement for the outsourcing to a service provider of critical or important operational functions or of any relevant services and activities.

8.7 A branch should in particular take the necessary steps to ensure that the following conditions are satisfied:

- the service provider should have the ability, capacity, and any authorisation required by law to perform the outsourced functions, services or activities reliably and professionally;
- the service provider should carry out the outsourced services effectively, and to this end the branch should establish methods for assessing the standard of performance of the service provider;
- the service provider should properly supervise the carrying out of the outsourced functions, and adequately manage the risks associated with the outsourcing;
- appropriate action should be taken if it appears that the service provider may not be carrying out the functions effectively and in compliance with applicable laws and regulatory requirements;
- the branch should retain the necessary expertise to supervise the outsourced functions effectively and to manage the risks associated with the outsourcing, and should supervise those functions and manage those risks;
- the service provider should disclose to the branch any development that may have a material impact on its ability to carry out the outsourced functions effectively and in compliance with applicable laws and regulatory requirements;
- the branch should be able to terminate the arrangement for the outsourcing where necessary without detriment to the continuity and quality of its provision of services to clients;

- the service provider should co-operate with the PRA and any other relevant competent authority in connection with the outsourced activities;
- the branch, its auditors, the PRA and any other relevant competent authority should have effective access to data related to the outsourced activities, as well as to the business premises of the service provider; and the appropriate regulator and any other relevant competent authority should be able to exercise those rights of access;
- the service provider should protect any confidential information relating to the branch and its clients; and
- the branch and the service provider should establish, implement and maintain a contingency plan for disaster recovery and periodic testing of backup facilities where that is necessary having regard to the function, service or activity that has been outsourced.

8.8 A branch should ensure that the respective rights and obligations of the branch and the service provider are clearly allocated and set out in a written agreement.

8.9 If a branch and the service provider are members of the same group, the branch may, for the purposes of 8.6 to 8.8 and 8.10 and 8.11, take into account the extent to which the branch controls the service provider or has the ability to influence its actions.

8.10 A branch should make available on request to the PRA and any other relevant competent authority all information necessary to enable the PRA and any other relevant competent authority to supervise the compliance of the performance of the outsourced activities with the requirements of the regulatory system.

8.11 A branch should notify the PRA when it intends to rely on a third party for the performance of operational functions which are critical or important for the performance of relevant services and activities on a continuous and satisfactory basis.

9 Record keeping

9.1 Subject to any other record-keeping rule, the PRA expects records to be capable of being reproduced in the English language on paper. Where a branch is required to retain a record of a communication that was not made in the English language, it may retain it in that language. However, it should be able to provide a translation on request. If a branch's records relate to business carried on from an establishment in a country or territory outside the United Kingdom, an official language of that country or territory may be used instead of English.

9.2 A branch should have appropriate systems and controls in place with respect to the adequacy of, access to, and the security of its records so that the branch may fulfil its regulatory and statutory obligations. With respect to retention periods, the PRA expects that records should be retained for as long as is relevant for the purposes for which they are made.

10 Risk control on governance arrangements

Governance arrangements

10.1 The PRA expects that branches should, taking account of their size, nature and complexity, consider whether in order to fulfil Internal Governance for Third Country Branches 2.1 and the general organisational requirements in this supervisory statement, their risk control arrangements should include:

- appointing a Chief Risk Officer; and
- establishing a governing body risk committee.

Chief risk officer

10.2 The PRA expects that a chief risk officer should:

- be accountable to the firm's governing body for oversight of branch-wide risk management;
- be fully independent of a branch's individual business units;
- have sufficient authority, stature and resources for the effective execution of his responsibilities;
- have unfettered access to any parts of the branch's business capable of having an impact on the branch's risk profile;
- ensure that the data used by the branch's to assess its risks are fit for purpose in terms of quality, quantity and breadth;
- provide oversight and challenge of the branch's systems and controls in respect of risk management;
- provide oversight and validation of the branch's external reporting of risk;
- ensure the adequacy of risk information, risk analysis and risk training provided to members of the firm's governing body;
- report to the firm's governing body on the branch's risk exposures relative to its risk appetite and tolerance, and the extent to which the risks inherent in any proposed business strategy and plans are consistent with the governing body's risk appetite and tolerance. The Chief Risk Officer should also alert the firm's governing body to and provide challenge on, any business strategy or plans that exceed the branch's risk appetite and tolerance; and

- provide risk-focused advice and information into the setting and individual application of the branch's remuneration policy (see SYSC 19A.3.15E).

10.3 The PRA expects branches to seek the PRA's approval for a Chief Risk Officer to perform the systems and controls function, and that where a branch is part of a group it will structure its arrangements so that a Chief Risk Officer at an appropriate level within the group will exercise functions in 10.3 taking into account group-wide risks.

Reporting lines of chief risk officer

10.4 The Chief Risk Officer should be accountable to a branch's governing body. The PRA recognises that in addition to the Chief Risk Officer's primary accountability to the governing body, an executive reporting line will be necessary for operational purposes. Accordingly, to the extent necessary for effective operational management, the Chief Risk Officer should report into a very senior executive level in the branch. In practice, the PRA expects this will be to the chief executive, the chief finance officer or another executive director.

Appointment of chief risk officer

10.5 Branches should ensure that a Chief Risk Officer's remuneration is subject to approval by the firm's governing body, or an appropriate sub-committee. Branches should also ensure that the Chief Risk Officer may not be removed from that role without the approval of the firm's governing body.

Governing body risk committee

10.6 The PRA expects that, while the branch's governing body is ultimately responsible for risk governance throughout the business, branches should consider establishing a governing body risk committee to provide focused support and advice on risk governance. Where a branch has established a governing body risk committee, its responsibilities should typically include:

- providing advice to the branch's governing body on risk strategy, including the oversight of current risk exposures of the branch, with particular, but not exclusive, emphasis on prudential risks;
- development of proposals for consideration by the governing body in respect of overall risk appetite and tolerance, as well as the metrics to be used to monitor the branch's risk management performance;
- oversight and challenge of the design and execution of stress and scenario testing;
- oversight and challenge of the day-to-day risk management and oversight arrangements of the executive;

- oversight and challenge of due diligence on risk issues relating to material transactions and strategic proposals that are subject to approval by the governing body;
- provide advice to the branch's remuneration committee on risk weightings to be applied to performance objectives incorporated in the incentive structure for the executive; and
- providing advice, oversight and challenge necessary to embed and maintain a supportive risk culture throughout the branch.

10.7 Where a governing body risk committee is established, its chairman should be a non-executive director, and while its membership should predominantly be non-executive it may be appropriate to include senior executives such as the chief finance officer.

10.8 In carrying out their risk governance responsibilities, the branch's governing body and governing body risk committee should have regard to any relevant advice from the firm's Audit Committee or the branch's internal audit function concerning the effectiveness of its current control framework. In addition, they should remain alert to the possible need for expert advice and support on any risk issue, taking action to ensure that they receive such advice and support as may be necessary to meet their responsibilities effectively.