



BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Consultation Paper | CP37/15

The implementation of ring-fencing: prudential requirements, intragroup arrangements and use of financial market infrastructures

October 2015

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Responses are requested by Friday 15 January 2016.

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1 Overview

1.1 The Prudential Regulation Authority (PRA) is required under the Financial Services and Markets Act 2000 (the Act), as amended by the Financial Services (Banking Reform) Act 2013 (the Banking Reform Act) to make policy to implement the ring-fencing of core UK financial services and activities.

1.2 In October 2014, the PRA published CP19/14 ‘The implementation of ring-fencing: consultation on legal structure, governance and the continuity of services and facilities’¹ and subsequently a policy statement (PS10/15)² which set out feedback to CP19/14 and near-final rules on these areas. The PRA also published CP33/15 in September 2015, which described the PRA’s proposed approach to ring-fencing transfer schemes.³

1.3 In this consultation paper (CP) the PRA sets out additional proposed ring-fencing policy, including in the areas of prudential requirements, intragroup arrangements and the use of financial market infrastructures. Alongside the policies set out in PS10/15, these proposals seek to implement the ring-fencing of core UK financial services and activities, as legislated for by the Act.

1.4 The PRA is planning to publish a further CP, by mid-2016, setting out proposals in relation to the data it intends to collect to support its supervision of firms’ compliance with the Act and the PRA’s ring-fencing rules, as well as any residual issues the PRA subsequently identifies on which the PRA needs to consult.

1.5 This CP is relevant to banking groups which will be required by the Act to ring-fence their core activities. This includes both those groups with ‘core’ deposits – broadly those deposits from individuals and small businesses – in excess of £25 billion and those groups with growth plans which expect to exceed this threshold by the Government’s stated implementation date of 1 January 2019. This CP will also be of interest to financial and other institutions, and customers who have dealings with these banking groups.⁴

1.6 This CP is one of two papers published by the PRA on 15 October, which form part of the post-crisis reforms to enhance the resilience and resolvability of firms.⁵ Restructuring efforts, including through ring-fencing of core activities, will support bank resolvability and increase the resilience of ring-fenced bodies (RFBs) to risks originating in other parts of their group or the global financial system and facilitate restructuring of banking groups before and after resolution. The proposals in CP38/15 ‘Ensuring operational continuity in resolution’ also support the resilience and resolvability of banks, building societies and PRA-authorised investment firms by seeking to ensure that critical shared services are arranged in a way that facilitates continuity in the event of a failure.

1.7 The European Commission published a proposal in January 2014 for a regulation on structural measures to improve the resilience of EU credit institutions. In June 2015, the

¹ www.bankofengland.co.uk/pru/Pages/publications/cp/2014/cp1914.aspx.

² www.bankofengland.co.uk/pru/Pages/publications/ps/2015/ps1015.aspx.

³ www.bankofengland.co.uk/pru/Pages/publications/cp/2015/cp3315.aspx.

⁴ The PRA has a dedicated webpage on ring-fencing and structural reform, which includes background, key changes, a table summarising policy development and updates on implementation, see <http://www.bankofengland.co.uk/pru/Pages/supervision/structuralreform/default.aspx>.

⁵ See also PRA Consultation Paper 38/15 ‘Ensuring operational continuity in resolution’ October 2015: www.bankofengland.co.uk/pru/Pages/publications/cp/2014/cp38/15.aspx.

Council of the European Union agreed a draft regulation that would provide for mandatory separation of proprietary trading and related trading activities, and establish a framework for competent authorities to take measures to reduce excessive risk. The Presidency of the Council will start negotiations with the European Parliament as soon as the latter has adopted its position. The PRA will continue to monitor developments in the EU negotiations and consider whether and how the outcome of this legislative process affects elements of the PRA's implementation of ring-fencing, including the proposals set out in this CP.

The PRA's approach to ring-fencing policy

1.8 The Banking Reform Act amended the PRA's general safety and soundness objective in relation to ring-fencing and RFBs on the basis that some retail deposit services are so important that any disruption to their provision would adversely affect financial stability and the wider economy (see Box 1 on page 9). Ring-fencing is intended to help ensure that these core services can be available continuously to individuals and small businesses.

1.9 The PRA's approach to implementing the ring-fencing requirements under the Act is unchanged from its first consultation. The PRA will seek to ensure the continuity of the provision of core services by implementing ring-fencing:

- (a) with regards to the **resilience** of an RFB to certain risks, by seeking to ensure that the business of an RFB is restricted and that the RFB has a degree of protection from shocks that originate in other parts of its group or the global financial system; and
- (b) in a way that 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.

1.10 The PRA's general approach to implementing ring-fencing is to articulate the outcomes to be achieved and to be prescriptive only where necessary. The PRA believes this approach ensures the Act is implemented in a way that recognises the diversity of activities and size of the firms subject to it. The proposals in this CP are intended to supplement the existing prudential regime as it applies to RFBs except where, in specific cases, the proposals are intended to replace existing requirements.

1.11 Ring-fencing recognises that there can be benefits associated with RFBs remaining part of broader banking groups. The PRA's approach to dealings between RFBs and other members of their groups (for example, those in respect of the cross-selling of products and services, correspondent banking and agency arrangements) has sought to preserve these benefits where doing so is not inconsistent with the PRA's amended general safety and soundness objective in relation to ring-fencing or the group ring-fencing purposes.

The Financial Conduct Authority's approach

1.12 The Financial Conduct Authority (FCA) published a CP in July 2015 on the disclosures to consumers who place deposits outside the ring-fence.¹ The FCA stated in its CP that it is not proposing other material changes to its Handbook to implement ring-fencing.

¹ FCA CP15/23: Ring-fencing: Disclosures to consumers by non-ring-fenced bodies
www.fca.org.uk/your-fca/documents/consultation-papers/cp15-23.

Box 1: The PRA's objectives in respect of ring-fencing¹ and the group ring-fencing purposes²

The Banking Reform Act amends the PRA's general safety and soundness objective to the effect that, when discharging its general functions in relation to ring-fencing, RFBs and groups containing RFBs, the PRA should seek to:

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

The legislation also requires the PRA to make rules to ensure the effective provision to an RFB of services and facilities it requires in relation to carrying on a core activity (which is the regulated activity of accepting deposits) and to make provision for group ring-fencing purposes, which are to ensure as far as reasonably practicable that:

- the carrying on of core activities by an RFB is not adversely affected by the acts or omissions of other members of its group;
- in carrying on its business an RFB:
 - is able to take decisions independently of other members of its group; and
 - does not depend on resources which are provided by a member of its group and which would cease to be available to the RFB in the event of the insolvency of the other member; and
- the RFB would be able to continue to carry on core activities in the event of the insolvency of one or more other members of its group.

The PRA's general approach to implementing ring-fencing focuses on the outcomes to be achieved, which are informed by the PRA's amended general safety and soundness objective in relation to ring-fencing and the group ring-fencing purposes. The PRA has made provision for the group ring-fencing purposes in the draft rules. The PRA's amended objective and the group ring-fencing purposes are also reflected in the PRA's group restructuring powers.³

1 See section 2B of the Act, as amended by the Banking Reform Act.

2 See section 142H of the Act, as amended by the Banking Reform Act.

3 See section 142K of the Act, as amended by the Banking Reform Act.

1.13 The PRA has consulted with the FCA on all aspects of the policy proposed in this CP. The PRA and the FCA will continue to work closely as banks implement ring-fencing. On 18 September 2015 the PRA and the FCA published separate co-ordinated consultation papers in relation to Ring-fencing Transfer Schemes to ensure a consistent approach.¹

1 www.bankofengland.co.uk/pru/Pages/publications/cp/2015/cp3315.aspx.

Structure of the CP

1.14 The implementation of ring-fencing will require policy to be made across a number of areas in accordance with the group ring-fencing purposes as set out in Box 1. This CP focuses on the financial resilience of RFBs and the relationship of an RFB with other group entities. This CP also considers an RFB's relationship with other third parties (eg financial market infrastructures). The topics are structured as follows:

- (a) Chapters 2 and 3 set out proposals relating to the prudential regime applicable to RFBs. These include assessment of the adequacy of financial resources as well as the PRA's approach to certain intragroup regulatory permissions, intragroup distributions, investments in the regulatory capital of group members and double leverage. The proposals seek to ensure that RFBs have adequate financial resources. This will help ensure the RFB is resilient to shocks which could disrupt the provision of core services and should reduce the risk that the RFB will depend on resources from other members of its group.
- (b) Chapter 4 covers the interaction of an RFB with other members of its group, including the management of intragroup transactions. The proposals aim to ensure that RFBs manage their relationships with group members to an equivalent standard as with third parties. This seeks to ensure that RFBs should be sufficiently insulated from the acts and omissions of other group members.
- (c) Chapters 5, 6 and 7 set out other ring-fencing proposals relating to: the use of financial market infrastructures; amendments to policies in PS10/15 on governance and the continuity of services and facilities; and monitoring compliance with ring-fencing obligations¹.
- (d) Chapter 8 includes a preliminary discussion on potential reporting requirements, setting out the PRA's initial thinking ahead of future consultation. Chapter 8 therefore does not include specific policy proposals.

1.15 Draft rules, a draft supervisory statement, as well as other proposed consequential changes to existing PRA publications are set out in the appendices to this CP, together with a glossary of terms used in the CP.

1.16 PS10/15 contained near final rules and supervisory statements. These have been incorporated into the draft rules and supervisory statement in Appendix 1 and 2 respectively, with changes to the supervisory statement text in PS10/15 shown as tracked.

Responses and next steps

1.17 This consultation closes on 15 January 2016. The PRA invites feedback on the proposals set out in this CP, including in relation to the preliminary discussion of reporting requirements in Chapter 8. Please address any comments or enquiries to CP37_15@bankofengland.co.uk.

1 ‘Ring-fencing obligation’ is defined in the draft Ring-fenced Bodies Part in Appendix 1 as ‘any obligation, prohibition or other requirement imposed on a ring-fenced body by or under FSMA by virtue of it being a ring-fenced body, including any statutory instrument made under FSMA and any ring-fencing rule, but not including any rule made by the FCA.’

1.18 Respondents are invited to provide further feedback on the material included in PS10/15 if, as a result of the new material included in this consultation, they wish to highlight additional considerations.

1.19 The PRA also invites firms to include in their responses their own assessment of the impact of the proposals.

1.20 The PRA plans to publish a policy statement setting out feedback to the consultation responses, as well as final rules and supervisory statements, by mid-2016.

Firms' preparations for ring-fencing

1.21 The PRA is aware that firms within the scope of the ring-fencing requirements under the Act have already made progress on their plans for implementing ring-fencing in time for 1 January 2019.

1.22 The publication of this CP, as well as 'near-final' rules and supervisory statements included in PS10/15, mean that firms now have good visibility on the proposed ring-fencing regime. As a result, the PRA expects firms in scope to submit near-final plans by 29 January 2016 to their PRA and FCA supervisors, which build on the initial plans that were sent on 6 January 2015 and/or any subsequent updates submitted by firms during 2015. These plans should take into consideration the proposals set out in this CP. PRA supervisors will contact firms directly to specify the level of information the PRA expects to receive in the plans. This applies to all firms that currently meet the core deposits threshold of £25 billion. Firms with growth plans which indicate they are likely to meet this threshold by 2019 should consult with their supervisors to determine whether such a submission would be appropriate.

2 Prudential requirements

2.1 This chapter sets out the PRA's approach to the application of prudential requirements to an RFB and to a sub-group containing an RFB (an RFB sub-group). Proposed amendments to PRA rules to give effect to these proposals are included in Appendix 1 and proposed guidance is included in a draft supervisory statement in Appendix 2. Proposals relating to the treatment of intragroup arrangements and permissions under the capital, large exposures, and liquidity regimes are set out in Chapter 3 of this CP.

2.2 The PRA is not consulting on the application of the leverage ratio or net stable funding ratio (NSFR) to RFBs at this time as policy is still being progressed at the international level. The PRA will review the application of the prudential regime to RFBs and RFB sub-groups and consult on any further changes as these policies develop. The current expectation is that the leverage ratio regime for RFBs will be considered as part of a review by the Financial Policy Committee (FPC) in 2017, which will take into account developments by the Basel Committee and any related amendments to EU banking regulations.¹

Sub-consolidated requirements

2.3 The PRA recognises that many groups intend that their RFBs will conduct business through other legal entities in their group including subsidiaries, and potentially other affiliates. Some of these entities will not be regulated by the PRA. They may nonetheless engage in activities which give rise to risks which may affect the resilience of the RFB and which may pose a risk to the continuity of core services.

2.4 Article 11(5) of the Capital Requirements Regulation (CRR)² allows the PRA to require a firm to comply with specific prudential requirements (see paragraph 2.10 below) on a sub-consolidated basis³ when it is justified for supervisory purposes or where national laws are adopted requiring the structural separation of activities within a banking group.

Proposals

2.5 The PRA proposes to require an RFB to meet prudential requirements on the basis of the sub-group of entities which includes the RFB – the RFB sub-group – by making use of its powers under section 55M of the Act to implement Article 11(5) of the CRR. These sub-consolidated requirements will be in addition to the requirements an RFB must meet under the existing prudential regime on an individual and consolidated basis. The detailed proposals are set out in Chapter 3 of the draft supervisory statement in Appendix 2.

2.6 The PRA expects that an RFB sub-group will contain only related entities that share a common parent and, in line with the PRA's near-final supervisory statement (see PS10/15) on

1 On 10 July 2015 the PRA published a CP on a proposed UK leverage ratio framework and set out that the FPC will review the UK leverage ratio framework in 2017, taking into account developments in Basel and the EU. See CP24/15 Implementing a UK leverage ratio framework at www.bankofengland.co.uk/pradocuments/publications/cp/2015/cp2415.pdf.

2 Regulation (EU) No 575/2013.

3 The CRR defines 'sub-consolidated basis' in Article 4, paragraph 1(49).

the legal structure of groups containing RFBs, should not contain excluded activity entities.¹ The PRA recognises that an RFB sub-group could include a PRA-authorised firm that is not an RFB, although it anticipates that such a scenario would be unlikely to occur.

2.7 In most cases the PRA expects that the RFB sub-group will be headed by an RFB, though the PRA recognises that there may be circumstances where it may be appropriate for an RFB sub-group to be headed by an entity other than an RFB (for example an intermediate holding company). The PRA would consider such proposed structures case-by-case, taking into account the PRA's statutory objectives. The use of section 55M to constitute an RFB sub-group and impose sub-consolidated requirements will enable the PRA to adopt a tailored approach that takes account of the variations in the structure and content of RFB sub-groups between different banking groups.

2.8 The proposal to require an RFB to comply with prudential requirements on the basis of its RFB sub-group will allow the PRA to assess whether an RFB, together with the other entities in its RFB sub-group, has sufficient resources to meet the requirements arising from the risks in its RFB sub-group without relying on other group entities outside the sub-group, in particular excluded activity entities. This approach supports the group ring-fencing purposes, in particular that '*the carrying on of core activities by an RFB is not adversely affected by the acts or omissions of other members of its group*' and that an RFB '*does not depend on resources which are provided by a member of its group and which would cease to be available to the RFB in the event of the insolvency of the other member*'.²

2.9 The PRA recognises that there may be circumstances in which it would be inappropriate to require an RFB to comply with prudential requirements on a sub-consolidated basis. For example, where an RFB does not have subsidiaries, or sister companies under a common parent, or where an RFB's subsidiaries pose immaterial risk to the RFB. In those cases, in addition to the existing requirements placed on the RFB by the CRR and PRA rules, the PRA may require the RFB to comply with other requirements necessary to give effect to the PRA's ring-fencing policy. Further detail is set out in paragraphs 2.24 and 2.27 below.

2.10 Where the PRA requires an RFB to meet prudential requirements on the basis of its RFB sub-group, the RFB must meet the obligations of Parts Two to Four and Six to Eight of the CRR and of Title VII of the Capital Requirements Directive (CRD)³ on a sub-consolidated basis. While the relevant obligations in CRR will apply directly to an RFB on a sub-consolidated basis upon the PRA imposing the requirement under Article 11(5) of the CRR, the PRA will need to provide for the application of the relevant CRD Title VII provisions on a sub-consolidated basis. For this purpose, Chapter 18 of the draft rules in Appendix 1 sets out a list that includes the PRA Rulebook Parts and rules that transpose the relevant Title VII CRD obligations to be complied with on a sub-consolidated basis.⁴ Additionally, in certain specific cases the PRA proposes that an RFB should meet some other existing rules not transposing Title VII CRD obligations on a sub-consolidated basis, where the PRA considers that such rules are integral to the effective application of the rules transposing the CRD. These are also included in the list referred to

¹ In PS10/15, the PRA set out its expectations of the type of entity that an RFB may own. In particular, the PRA set out its expectation in the near-final supervisory statement that an RFB should not have ownership rights in an entity that undertakes activities that, if it were an RFB, would amount to activities that contravene a prohibition or be excluded activities under the Act ('excluded activity entities'). The PRA also stated that consideration of ownership by RFBs of entities other than excluded activity entities would be undertaken case-by-case, in order to assess the risks posed to the RFB's resilience and resolvability and the PRA's objectives.

² The group ring-fencing purposes are set out in section 142H(4) of the Act.

³ Directive 2013/36/EU.

⁴ While the Parts of the Rulebook listed in Chapter 18 in Appendix 1 are correct at the time of the publication of this CP, the PRA will monitor and keep the draft rules under review to take account of any changes that may result from the implementation of MiFID II or any other amendment of PRA rules before the making of these rules.

above. Of relevance to the remainder of this chapter, the list includes the Internal Capital Adequacy Assessment (ICAA), the Pillar 2 Reporting, the Capital Buffers and the Internal Liquidity Adequacy Assessment (ILAA) Parts of the PRA Rulebook.

Application of the ICAA Part of the PRA Rulebook to an RFB sub-group

2.11 As set out above, the PRA proposes to require that an RFB must meet the ICAA Part of the PRA Rulebook on the basis of its RFB sub-group.¹ Included in this Part is the requirement for the RFB to perform and document its Internal Capital Adequacy Assessment Process (ICAAP). As a consequence of the application of this Part on the basis of the RFB sub-group, and as set out in the draft supervisory statement (see Chapter 4 of Appendix 2), the PRA expects that:

- The RFB must manage the risks of the RFB sub-group within its risk appetite under business-as-usual and stress conditions.
- The RFB must ensure the RFB sub-group has sufficient capital to meet capital requirements under business-as-usual and stress conditions, including capital to cover its exposures to entities outside its RFB sub-group.
- Intragroup exposures to entities outside the RFB sub-group should be viewed as equivalent to third party exposures in the context of an RFB's risk and capital assessment.

2.12 The PRA recognises that applying this approach may result in increased capital requirements for some firms. However, permitting an alternative approach which allows an RFB to recognise potential offsetting benefits in the rest of the group outside the RFB sub-group would link the assessment of the capital requirements of an RFB and its sub-group to the risks and financial performance of the rest of the group. The implication of such an alternative approach is that an RFB would not be required to hold capital for all of the risks to which it is exposed. The PRA believes such a 'share-of-group' approach is not compatible with the group ring-fencing purposes.

2.13 Implicit within the requirement that an RFB must meet the ICAA Part of the PRA Rulebook on the basis of its RFB sub-group is the requirement that an RFB must assess the RFB sub-group's exposure to group risk.² The proposed requirement set out above that an RFB must perform an ICAA at the level of the RFB sub-group and treat exposures to entities outside the RFB sub-group as equivalent to third parties does not remove the obligation on the RFB to assess group risk as part of its ICAA. On the contrary, the PRA would expect an RFB to pay particular attention to ensuring it has assessed the risks arising from its arrangements with other group members. These include the risks arising from arrangements where an RFB or entities in its RFB sub-group have joint and several liability with other group members such as those in respect of certain taxes (eg VAT group membership).

Stress testing

2.14 The PRA proposes that an RFB must put in place effective stress testing capability to be able to understand the impact of stresses on it and other entities in its RFB sub-group, and the

¹ Where an RFB is a member of a banking group certain requirements in the ICAA Part of the PRA Rulebook (in particular the ICAA rules and the overall Pillar 2 rule) currently need only be met at the level of the UK consolidated group and, in limited cases, on a sub-consolidated basis. The purpose of the ICAA rules and the overall Pillar 2 rule are to ensure that a firm adequately assesses the risks to which it is exposed and estimates the capital required to support those risks.

² Group risk is defined as the risk that the financial position of a firm may be adversely affected by its relationships (financial or non-financial) with other entities in the same group or by risk which may affect the financial position of the whole group, including reputational contagion.

associated capital implications, and to be able to provide the PRA and the Bank of England (the Bank) with the data required to perform or assess stress tests. Specifically, an RFB must ensure it has appropriate risk resources, relevant financial planning resources, and related systems and control processes in place covering all members of the RFB sub-group. The requirement to put in place appropriate stress testing capability is implicit in the application of the ICAA Part of the Rulebook to an RFB; the PRA believes it is appropriate to reiterate this proposed requirement.

Pension risk

2.15 Ring-fencing secondary legislation restricts the ability of an RFB to be a party to certain types of pension arrangements relating to multi-employer schemes and shared liability arrangements by 1 January 2026.¹ In order to meet these requirements, RFBs may need to make changes to their pension arrangements.

2.16 The PRA proposes that an RFB should conduct an assessment of the capital required to meet its pension obligations as part of its ICAAP. Where this is prior to the full implementation of any changes the RFB plans to make in respect of its pension arrangements, the RFB should base its assessment on relevant factors (eg its expected share of the scheme).

2.17 The PRA proposes to adopt a similar approach when conducting its assessment of the capital required by an RFB in respect of its pension obligations. The PRA may consider transitional arrangements on a case-by-case basis for an RFB to build up required capital levels for pension risk requirements in advance of full implementation of changes the RFB plans to make in respect of its pension arrangements.

Application of the Reporting Pillar 2 Part of the PRA Rulebook to an RFB sub-group

2.18 In line with the proposals set out above that an RFB must meet the requirements of the ICAA Part of the PRA Rulebook on the basis of its RFB sub-group, the PRA proposes to require that an RFB must also meet the Reporting Pillar 2 Part of the PRA Rulebook on the basis of its RFB sub-group (see Chapter 18 of Appendix 1 and Appendix 6). This is because the Reporting Pillar 2 Part is intended to be applied in a manner consistent with the ICAA Part of the PRA Rulebook (in particular, the ICAAP Rules contained in the ICAA Part).

2.19 Intragroup exposures are currently excluded from the calculations of credit concentration risk under the PRA's approach to Pillar 2². In line with the proposal that an RFB should treat intragroup exposures to entities outside the RFB sub-group as equivalent to third party exposures, the PRA proposes that an RFB should include such exposures when performing the calculations for single name, sector and geographic concentration risk. Appendices 4 and 5 set out the proposed amendments to give effect to these proposals.

The Supervisory Review and Evaluation Process (SREP) and Liquidity SREP (L-SREP)

2.20 Consistent with the requirement that an RFB must meet the ICAA Part of the PRA Rulebook on the basis of its RFB sub-group, the PRA proposes to conduct a SREP on the RFB sub-group. In conducting this SREP, the PRA will consider exposures to intragroup counterparties outside the RFB sub-group as if they were to third parties. The PRA will set individual capital guidance (ICG) and conduct a PRA buffer assessment for the RFB sub-group.

1 SI 2015/547 The Financial Services and Markets Act 2000 (Banking Reform) (Pensions) Regulations 2015.

2 www.bankofengland.co.uk/pru/Pages/publications/sop/2015/p2methodologies.aspx.

2.21 Similarly, consistent with the proposal that an RFB must meet the ILAA part of the PRA Rulebook on the basis of its RFB sub-group, the PRA proposes to perform an L-SREP on, and set the individual liquidity guidance (ILG) for, the RFB on the basis of its RFB sub-group.

2.22 These are in addition to the SREPs and L-SREPs that will be performed on an individual basis and, where required by the CRD, on a consolidated basis.

Application of the systemic risk buffer to an RFB

2.23 The PRA is required to set a systemic risk buffer (SRB) rate for an RFB on an individual, sub-consolidated or consolidated basis. The PRA proposes that it will set the SRB rate on a sub-consolidated basis where an RFB sub-group is in place. This proposal is consistent with the requirement that an RFB must meet the requirements of the Capital Buffers Part of the PRA Rulebook on a sub-consolidated basis.¹

2.24 In cases where an RFB is not a member of an RFB sub-group (ie the PRA has determined that it would be inappropriate to require an RFB to meet prudential requirements on a sub-consolidated basis) the PRA will consider case-by-case at which level to apply the FPC's SRB criteria (ie consolidated or individual basis) and set the SRB rate.

2.25 The FPC is responsible for determining the criteria and methodology to set the SRB rate. The FPC will consult on and publish its criteria and methodology for the SRB by 31 May 2016.

Application of requirements to an RFB on an individual basis

2.26 Where an RFB is a member of an RFB sub-group it will still need to meet the requirements placed on it by the CRR and the PRA rules on an individual basis.

2.27 Where an RFB is not a member of an RFB sub-group, in addition to requiring the RFB to comply with the existing prudential regime on an individual basis, the PRA may require the RFB to meet the ICAA and the Reporting Pillar 2 Parts of the PRA Rulebook on an individual basis by making use of its powers under section 55M of the Act. This is because a firm which is a member of a UK group is not required to comply with all rules in the ICAA Part on an individual basis. The PRA intends to set this requirement where it considers it necessary to ensure the continuity of the provision of core services. Furthermore, as noted above, the PRA may set an SRB rate for an RFB on an individual basis, or on a consolidated basis rather than on a sub-consolidated basis, in such cases.

Expectations concerning RFBs' management of liquidity and funding risk

2.28 An RFB will need to meet requirements in respect of liquidity and funding under the CRR, the Liquidity Coverage Ratio (LCR) Delegated Act² and the ILAA Part of the PRA Rulebook on an

1 Specifically, the PRA proposes to apply the criteria specified by the FPC for assessing the extent to which failure or distress of an RFB might pose a long term non-cyclical systemic or macro-prudential risk not covered by the CRR to an RFB on a sub-consolidated basis in respect of its RFB sub-group, in accordance with regulation 34G of the Capital Requirements (Capital Buffers and Macro-prudential Measures) Regulations 2014. Following the requirements laid out in the Regulations, the PRA will then apply the methodology created by the FPC to the RFB to obtain a single index score of systemic importance, which the PRA will use to derive a corresponding buffer rate for the RFB on a sub-consolidated basis.

2 European Commission Delegated Regulation (EU) 2015/61 of 10 October 2014 to supplement Regulation (EU) No 575/2013 of the European Parliament and the Council with regard to liquidity coverage requirement for Credit Institutions.

individual basis.¹ In addition, as set out in paragraph 2.10 and Chapter 4 of Appendix 2, where an RFB is a member of an RFB sub-group, it will need to meet these on a sub-consolidated basis.

2.29 Many banking groups structure their operational arrangements in a way which results in individual entities relying on services or resources provided by other group entities. In relation to the application of prudential requirements, this may particularly be the case with respect to the management of liquidity risk. Given the introduction of ring-fencing, the PRA believes it is appropriate to set out its proposed policy in relation to the liquidity management function of an RFB and RFBs' access to the Bank's Sterling Monetary Framework (SMF).

Proposals

Liquidity management function of an RFB

2.30 The LCR Delegated Act requires a firm to ensure that, when structuring its operational arrangements and processes in relation to the management of liquidity and funding, its liquid assets are under the control of a specific liquidity management function 'within the firm'.² The PRA does not propose to set additional requirements in relation to this, but proposes to clarify in a supervisory statement (see Chapter 4 of Appendix 2) that an RFB will need to meet this requirement on an individual basis and on a sub-consolidated basis where an RFB sub-group is in place. An RFB will also need to ensure that the arrangements and processes surrounding the management of liquidity meet other operational requirements set out in a number of Parts of the PRA Rulebook, including the ILAA Part, the Outsourcing Part, the Operational Continuity Part, and the Ring-Fenced Bodies Part.³

Membership of the SMF and collateral placed at the Bank

2.31 The Bank provides liquidity insurance to participants in the SMF through a number of separate but related facilities. Participation in the SMF is open to various types of entity, including banks and PRA-authorised investment firms. It is possible for participants to only access some and not all of the SMF facilities.⁴

2.32 Members of a UK banking group may apply for individual access to the Discount Window Facility (DWF) and, following recent amendments to the SMF, to other facilities where there are regulatory or legal barriers to the movement of liquidity or collateral intragroup, including ring-fencing.

2.33 Given the objectives in the Act in relation to continuity of core services in the United Kingdom and the group ring-fencing purposes, the PRA proposes to set out in a supervisory statement (see Chapter 4 of Appendix 2) that an RFB should be a direct member of SMF facilities (in particular the DWF) or should access these through an entity in its RFB sub-group.

2.34 Similarly, the PRA proposes that where a banking group contains an RFB, group entities which are eligible for the SMF (ie banks or PRA-authorised investment firms) and which are neither RFBs nor members of an RFB sub-group should either be direct members of SMF facilities or be able to demonstrate that they are able to access the Bank's liquidity facilities through a group member which is neither an RFB nor a member of an RFB sub-group.

¹ A firm can apply to the PRA for a permission under Article 8 of the CRR for a derogation from the application of liquidity requirements on an individual basis. Where such applications include an RFB or a member of an RFB sub-group, the PRA will apply the approach set out in Chapter 3 of this CP.

² Article 8(3) of the LCR Delegated Act.

³ Note that the Operational Continuity Part and the Ring-fenced Bodies Part of the PRA Rulebook are under consultation at the time of publication of this CP.

⁴ The Bank of England's Sterling Monetary Framework, paragraph 39
www.bankofengland.co.uk/markets/Documents/money/publications/redbook.pdf.

2.35 Where firms do not meet these expectations, the PRA may use its powers under section 55M of the Act to impose requirements on the RFB or other PRA-authorised members of its group, or its powers under section 192C of the Act to give a direction to a qualifying parent undertaking.

2.36 In addition, as set out in SS24/15 ‘The PRA’s approach to supervising liquidity and funding risks’¹, the PRA would normally expect firms to pre-position collateral assets at the Bank, as part of a complete suite of contingency funding arrangements and may provide explicit guidance as to minimum expected levels. This would also apply to RFBs.

1 PRA Supervisory Statement 24/15 ‘The PRA’s approach to supervising liquidity and funding risks’, June 2015:
www.bankofengland.co.uk/pru/Pages/publications/ss/2015/ss2415.aspx.

3 Intragroup prudential arrangements

3.1 This chapter sets out the PRA's proposals in relation to intragroup prudential arrangements for groups containing RFBs, including proposals on intragroup concessions, intragroup distributions, double leverage and intragroup holdings of capital. The proposals in this chapter seek to ensure that the prudential treatment of an RFB's transactions and arrangements with, and exposures to, group members is consistent with the group ring-fencing purposes. Proposals relating to an RFB's management of exposures to, and arrangements with, group members which are not in the RFB sub-group are set out in Chapter 4 of this CP.

Intragroup concessions

3.2 Intragroup concessions permit a PRA-authorised firm to apply beneficial treatment to certain intragroup transactions or arrangements for the purposes of calculating capital or liquidity requirements under the CRR or in respect of large exposure limits. Were an RFB permitted to make use of intragroup concessions in respect of its transactions or arrangements with all group members, there is an increased risk that: (a) its ability to carry on core activities could be adversely affected by the acts or omissions of other group members, or (b) the RFB would depend on resources which are provided by a group member and which would cease to be available to the RFB in the event of the insolvency of that group member.

3.3 Consistent with the proposals set out in Chapter 2 of this CP that an RFB must meet a number of prudential requirements on a sub-consolidated basis, the PRA believes that an RFB should only be permitted to apply intragroup concessions with respect to its dealings with entities in its RFB sub-group.¹ Where the other entities in an RFB sub-group are PRA-authorised firms, the PRA believes they should similarly only benefit from intragroup concessions in respect of their dealings with members of the RFB sub-group. This will help insulate an RFB from the risks set out above in relation to group members outside its RFB sub-group.

3.4 The PRA has assessed the intragroup concessions available to an RFB under the existing prudential regime and proposes changes to three areas, the proposals for which are explained in detail below: intragroup large exposures permissions; intragroup liquidity concessions; and the calculation of own funds requirements for credit valuation adjustment risk.

3.5 The CRR permits firms meeting specified conditions to offset positions between group entities for the purposes of calculating consolidated market risk requirements.² The PRA is not proposing any policy changes in respect of these requirements, but believes banking groups subject to ring-fencing are unlikely to meet the specified conditions.

3.6 The PRA has also considered intragroup concessions available to an RFB under the EU regulation on derivatives, central counterparties and trade repositories (EMIR)³ with respect to clearing obligations and margining requirements. Firms' compliance with ring-fencing requirements may affect their ability to meet the conditions for those concessions. The FCA is the competent authority with respect to these concessions and firms wishing to discuss the

¹ Subject to meeting the relevant criteria set out in the CRR and PRA rules.

² CRR Article 325.

³ Regulation No 648/2012 of 4 July 2012 on over-the-counter (OTC) derivatives, central counterparties and trade repositories.

potential impacts of ring-fencing on the availability of these concessions to them should contact the FCA.¹

Proposals

Intragroup large exposures permissions

3.7 The CRR requires a firm to hold capital to cover the credit risk associated with its exposures. In addition, as a safeguard against excessive concentration risk, firms must limit their large exposures (LE) to individual entities or groups of connected counterparties to 25% of the firm's eligible capital (the LE limit). However, the CRR permits the PRA to grant permission for intragroup exposures to be subject to 0% risk weight when certain conditions are met.² On application of the 0% risk weight, the exposures are exempt from the LE limit.³ The PRA also has the discretion to grant a permission, which allows a firm's exposures to other group entities to exceed the LE limit.⁴ These permissions are referred to as the PRA's core UK group (CUG) and non-core UK group (NCLEG) regimes respectively.

3.8 The PRA proposes that it would not expect to grant CUG or NCLEG permissions to an RFB, or to PRA-authorised entities in the RFB sub-group, in respect of exposures to group entities not included in the RFB sub-group, including parent entities.⁵ The detailed proposals are set out in the draft supervisory statement in Chapter 5 of Appendix 2. Consequential changes to the published Large Exposures supervisory statement are also set out in Appendix 3.

3.9 The PRA's proposals will ensure that capital is held by the RFB to cover the credit risk arising on exposures to group members outside the RFB sub-group, and that such exposures are subject to the LE limit. This should help insulate the RFB and RFB sub-group from the acts, omissions or insolvency of other group members.

3.10 RFBs and other PRA-authorised firms included in the RFB sub-group can continue to apply for CUG and NCLEG permissions in respect of their exposures to entities included in the RFB sub-group provided that the relevant conditions are met.

Intragroup liquidity concessions

3.11 Provided specified conditions are met, the PRA may waive (in full or in part) the application of CRR liquidity requirements to a firm on an individual basis and instead supervise the firm and other related institutions as a single 'liquidity sub-group'.⁶

3.12 As set out in Chapter 5 of the draft supervisory statement in Appendix 2, and for the reasons set out above in relation to the granting of intragroup concessions, the PRA proposes that it would not expect to grant a permission to form a liquidity sub-group where it proposes to cover institutions which are members of an RFB sub-group and institutions which are not.

3.13 Similarly, the PRA would not expect to grant a permission to apply preferential treatment to certain intragroup outflows and inflows in the LCR calculation for an RFB with respect to transactions with a group entity not in its RFB sub-group.⁷

¹ Via the email address emir@fca.org.uk.

² The relevant conditions for CUG permissions are specified in CRR Article 113(6).

³ CRR Article 400(1)(f) sets out exemptions to the LE limit.

⁴ The relevant conditions for NCLEG permissions are set out in the Large Exposures Part of the PRA Rulebook and SS16/13 Large Exposures.

⁵ Where there is no RFB sub-group (and so prudential requirements are not applied to an RFB on a sub-consolidated basis), and there are no excluded activity entities in the UK group, the PRA will assess whether to grant permissions case-by-case.

⁶ CRR Article 8.

⁷ Under the LCR Delegated Act (Articles 29, 33(2)(a) and 34) the PRA may grant a permission to apply a preferential treatment to certain intragroup outflows and inflow calculations.

3.14 The PRA proposes that entities within an RFB sub-group can continue to apply for intragroup liquidity concessions with respect to other entities in the RFB sub-group provided the necessary conditions are met.

Own funds requirements for credit valuation adjustment (CVA) risk

3.15 As permitted under the CRR, the PRA proposes a rule requiring an RFB and all other PRA-authorised firms in an RFB sub-group which are in scope of CRR to include certain intragroup transactions¹ with counterparties that are not members of the RFB sub-group when calculating the own funds requirements for CVA risk.² See Chapter 10 of Appendix 1 for the draft rule.

3.16 This proposal will support the resilience of an RFB and RFB sub-group by ensuring that capital is held against the risk of mark-to-market losses resulting from deterioration in the creditworthiness of counterparties to derivatives transactions which are not in the RFB sub-group, including those in the wider banking group.

Intragroup distributions

3.17 The Act requires the PRA to make rules restricting the ability of an RFB to make payments (by dividend or otherwise) to other members of its group.³ Payments from an RFB (or an entity in its RFB sub-group) could lead to insufficient financial resources being available to the RFB. Firms are subject to a number of existing prudential, legal and accounting requirements with respect to distributions and other payments, including the Maximum Distributable Amount (MDA) restrictions set out in the Capital Buffers Part of the PRA Rulebook.⁴ The PRA has taken these into account and believes the proposals below are consistent with these existing requirements.

3.18 This section sets out how the PRA proposes to meet the Act's requirement to make rules relating to dividend payments (and similar distributions). See Chapters 2 and 11 of Appendix 1 and Chapter 6 of Appendix 2 respectively for the draft rules and a draft supervisory statement.

Proposals

3.19 The PRA proposes rules requiring an RFB and entities in its RFB sub-group not to make distributions to group entities that are not in the RFB sub-group unless reasonable notice has been given to the PRA of the intention to make the distribution. The PRA proposes that the notice should include information supporting the RFB's ability to maintain sufficient capital resources after the proposed distributions have been made. The PRA also proposes that the notice be signed-off by an appropriate individual approved by the PRA to perform a Senior Management Function.⁵

3.20 The proposed rules would enable the PRA to monitor intended distributions from an RFB or entity in its RFB sub-group, evaluate the impact of these payments on the RFB's ability to continue to meet regulatory capital requirements on an individual and sub-consolidated basis and, as appropriate, prevent such distributions by imposing a requirement under section 55M of the Act or giving a direction to a qualifying parent undertaking under section 192C of the

1 As defined under Article 3 of Regulation (EU) No 648/2012.

2 CRR Article 382(4)(b).

3 See section 142H(5)(b) of the Act

4 Firms are required to calculate a Maximum Distributable Amount (MDA) if they breach their combined buffer. The MDA seeks to restrict a firm's ability to further deplete its capital position through payment of dividends, variable remuneration, or payments on additional tier 1 (AT1) instruments and will apply to an RFB on an individual basis (irrespective of whether it also applies on a consolidated or sub-consolidated basis) under the Capital Buffers Part of the PRA Rulebook.

5 See the PRA's dedicated webpage for more information about the Senior Managers regime at www.bankofengland.co.uk/pru/Pages/supervision/strengtheningacc/default.aspx.

Act, to ensure that adequate capital resources are maintained. However, provided these regulatory requirements are satisfied, the PRA does not intend to require changes to an RFB's dividend policy, or that of its RFB sub-group. This is consistent with the PRA's general approach: that firms should expect to be subject to greater supervisory scrutiny if they are in breach, or expected to be in breach (eg following a distribution), of regulatory capital requirements.

3.21 Other than the proposals set out above in respect of distributions, the PRA does not propose to make additional rules in respect of intragroup payments that arise from an RFB's transactions with members of its group. This is because the PRA considers that such payments would be within the scope of its proposals on arm's length terms in Chapter 4 of this CP.

Double leverage

3.22 A parent may seek to fund regulatory capital invested in an RFB by itself issuing capital or other funding instruments of lower quality. Such a structure is often referred to as 'double leverage' or 'capital upgrading'. The PRA is currently considering its general approach to double leverage but considers it appropriate to set out its policy to address potential risks to the quality of capital in an RFB where a parent uses double leverage.

Proposals

3.23 The PRA proposes that it would expect a UK parent of an RFB not to make use of double leverage to fund its investment in an RFB or other members of an RFB sub-group. The PRA believes that the use of double leverage introduces risks to the quality of capital in the RFB and is therefore likely to pose risks to the group ring-fencing purposes under the Act.

3.24 As set out in the draft supervisory statement in Chapter 4 of Appendix 2, should a UK parent of an RFB seek to make use of double leverage to fund its investment in an RFB or other members of an RFB sub-group, the PRA proposes to assess the extent to which this may pose a risk to the safety and soundness of the RFB and therefore pose a risk to the continuity of the provision of core services. Where this is the case, the PRA may use its powers under section 55M of the Act to impose additional requirements on the RFB or, where appropriate, its powers under section 192C to give a direction to a qualifying parent undertaking of an RFB.

Expectations on intragroup holdings of capital

3.25 In the near-final supervisory statement on legal structures published with PS10/15 the PRA set out its expectation that an RFB should not have an ownership interest in an 'excluded activity entity', and vice versa.¹

3.26 The PRA proposes to extend these expectations to cover all classes of capital instruments, and to include all members of an RFB sub-group within the scope of these expectations. These expectations are set out in the draft supervisory statement in Chapter 2 of Appendix 2.

¹ An 'excluded activity entity' is defined in the draft legal structures supervisory statement in PS10/15 as an entity that undertakes activities that, if it were an RFB, would amount to activities that contravene a prohibition or would be excluded activities under the Act. This definition is included in Chapter 2 of the draft supervisory statement in Appendix 2 to this CP.

Proposals

Holdings of capital instruments in an excluded activity entity in the group

3.27 The PRA proposes that an RFB and other entities in its RFB sub-group should not hold any class of capital instrument in an excluded activity entity in its group. An RFB should also not hold capital instruments in a subsidiary of an excluded activity entity. Capital instruments are intended to absorb losses and are integral to carrying out a successful resolution. Were an RFB or an entity in its RFB sub-group to hold capital instruments in an excluded activity entity in the group, this may expose the RFB to potential losses arising from the types of activity it is not permitted to engage in itself and therefore pose a risk to core services. Such holdings may also further complicate the resolution of the group.

Holdings of capital instruments by an excluded activity entity in the group

3.28 Within a UK group, the PRA similarly proposes that an excluded activity entity should not hold capital instruments in an RFB or entities in its RFB sub-group. This expectation includes both direct and indirect holdings through subsidiaries of an excluded activity entity.

3.29 The PRA believes this will contribute towards achieving the group ring-fencing purposes by reducing the interconnectedness of the RFB sub-group with the rest of the group, thereby supporting the ability of the RFB to take decisions independently and reducing the likelihood that it may be adversely affected by the acts or omissions of other group members. Were an excluded activity entity to own the capital instruments of members of an RFB sub-group in its group, this may further constrain the ability of the members of the RFB sub-group to undertake recovery actions, or ultimately may further complicate the ability to execute successfully resolution actions on the individual entities.

3.30 As set out in PS10/15, this expectation is not intended to prevent a UK holding company with investments in non-EEA subsidiaries from holding capital instruments in entities in its group.

4 Intragroup transactions and exposures

4.1 This chapter sets out proposals which seek to ensure appropriate management of the risks that arise from an RFB's intragroup relationships, including how the PRA proposes to meet its obligations under the Act to make rules relating to arm's length terms.¹ Draft rules in relation to these proposals are included in Appendix 1 and proposed guidance is included in a draft supervisory statement in Appendix 2.

4.2 As set out in the group ring-fencing purposes in the Act², ring-fencing should ensure that an RFB can continue to carry on its core activities regardless of the acts, omissions or insolvency of other group members. An RFB is likely to enter into various transactions with group entities, including cross-selling of products and services and offering products as agent for other group entities. The proposals below seek to ensure intragroup activities are managed appropriately and do not result in significant exposures to, or dependence on, entities outside the RFB sub-group which may threaten an RFB's ability to continue to carry on core activities.

Proposals

Arm's length terms

4.3 Under section 142H(5)(a) of the Act, the PRA is required to make provisions restricting the ability of an RFB to enter into contracts with other members of its group other than on arm's length terms. To meet this requirement, and to ensure that risks associated with non-contractual arrangements are similarly addressed, the PRA proposes a rule that an RFB's contracts, transactions and other arrangements with members of its group (intragroup transactions) must be conducted on arm's length terms. See Chapters 2 and 12 of Appendix 1.

4.4 The proposed arm's length rule supports the delivery of ring-fencing in three ways, as it helps to ensure:

- (i) appropriate pricing of intragroup transactions, to mitigate the risk that resources or value could be inappropriately transferred from an RFB to another group member;
- (ii) that an RFB's intragroup flows and transactions are on terms which could be more readily substituted with a third party, if required; and
- (iii) that the financial position and performance of an RFB is more transparent to its stakeholders.

4.5 The PRA proposes that this arm's length rule also applies to transactions of other entities in an RFB sub-group with group members outside the RFB sub-group. This is to ensure that an RFB's ability to deliver core activities is not undermined as a result of such transactions being conducted otherwise than on arm's length terms.

¹ Section 142H(5)(a) of the Act.

² Section 142H(4) of the Act.

4.6 The PRA proposes further rules requiring an RFB and other entities in its RFB sub-group to establish policies and procedures to support their ability to ensure that intragroup transactions are conducted on arm's length terms. In particular, the PRA proposes that these policies and procedures must at least:

- establish robust processes to identify products, services and all other transactions with group members;
- specify how pricing and non-pricing aspects of intragroup transactions will be determined, including standards for timely recording and settlement (including frequency of settlement);
- specify appropriate change management controls surrounding methodologies and application, including processes for approval and reporting of exceptions to policy;
- include dispute resolution procedures;
- be approved by the board of the RFB and reviewed annually; and
- be subject to regular internal audit assessments.

4.7 The PRA believes that the requirements in respect of policies and procedures are necessary given the broad range of potential intragroup transactions and the degree of judgement involved in determining whether a transaction is on arm's length terms. Proposals with respect to board approval and internal audit assessment should further ensure appropriate governance and assurance of arm's length policies.

4.8 The PRA proposes that where an RFB's arm's length policies and procedures are implemented in a way that cover other entities in the RFB sub-group that are not themselves RFBs, those other entities need not put in place their own arm's length policies and procedures.

Other intragroup transactions and exposures

4.9 The PRA proposes rules that an RFB and entities in its RFB sub-group must apply the same standards to management of exposures to, and arrangements with, group members who are not in the RFB sub-group as they would to third parties, to ensure that the carrying on of core activities is not adversely affected by those group members (see Chapters 2 and 3 of Appendix 1).

4.10 The PRA believes that requiring an RFB and entities in its RFB sub-group to manage arrangements with group members appropriately, and the risks arising from these, is an important component of achieving the outcomes set out in the group ring-fencing purposes in the Act. In particular, the outcome in relation to ensuring an RFB's ability to carry on core activities is not adversely affected by the acts or omissions of other group members.

4.11 As part of meeting this rule, an RFB and entities in its RFB sub-group would need to manage not only individual arrangements with other members of their group but also the overall exposure levels to group members. The PRA has observed that most firms' own internal risk appetite for exposure levels to persons outside the group has historically been well below the large exposure limit specified in CRR Article 395(1).

4.12 The PRA will take action where firms do not manage intragroup exposures appropriately. In addition, the PRA will consider implementing further measures (including lowering large exposures limits requirements) if firms do not manage intragroup exposures appropriately.

4.13 The PRA proposes additional rules and expectations to supplement the proposed rule set out above. These are discussed in detail in the sections below.

Secured intragroup exposures

4.14 An RFB or entities within an RFB sub-group may have collateralised exposures to other group entities outside the RFB sub-group, for example, arising from hedging and derivative transactions, operational and intragroup taxation balances and intragroup funding.

4.15 Collateralisation reduces the level of net intragroup exposures but may expose the RFB to credit, market and liquidity risk through the collateral it holds, especially in the event of the insolvency of other group members. This could undermine the group ring-fencing purposes.

4.16 Where an RFB, or an entity in its RFB sub-group, receives collateral from group members outside the RFB sub-group, the PRA proposes to set out in a supervisory statement its expectation that the RFB must ensure that the collateral is of equivalent quality, both in terms of liquidity and credit, and managed to the same standard as collateral received from persons outside the group (see Chapter 7 of Appendix 2).

Dependence on intragroup and shared customer income

4.17 The PRA recognises that an RFB or entities in its RFB sub-group will maintain commercial relationships with group entities as part of operating as a group. These include arrangements where group members offer products and services, other than as principal, on behalf of other group members. As a result, an RFB or entities in its RFB sub-group may generate income either directly from transactions with other group members or from shared customer relationships which are contingent, or likely to be contingent, on the ability of a number of group entities to provide services to the customer (contingent shared customer income).

4.18 Dependence on such income – to the extent that the business model of the RFB or an entity in its sub-group could not stand alone following a loss or significant reduction in such income – may mean an RFB is unable to continue to carry on core activities.

4.19 The PRA therefore proposes a rule that an RFB and entities in its RFB sub-group must not, as far as reasonably practicable, become dependent on income generated from members of its group outside its RFB sub-group (whether directly or from contingent shared customer income) to an extent that, if such income were to reduce, it would result in the RFB being unable to conduct core activities. See Chapters 2 and 13 of Appendix 1.

4.20 The PRA also proposes to set out in a supervisory statement that an RFB should identify, assess and manage the risks arising from intragroup income and any income generated from customers of the RFB (or customers of an entity in its sub-group) that are also customers of group members outside the RFB's sub-group, including contingent shared customer income. See Chapter 7 of Appendix 2.

4.21 Where there is a risk that the RFB or an entity in its RFB sub-group will become dependent on intragroup or contingent shared customer income, the PRA expects that these entities will either take action to reduce that dependency or to have a credible plan to recover from a loss or significant reduction of such income. In addition, the PRA proposes that an RFB's management should consider the risks arising from intragroup and contingent shared customer income when setting the business strategy of an RFB and entities in its sub-group.

Netting arrangements

4.22 The PRA proposes a rule that an RFB (and other entities in its RFB sub-group) may not enter into netting arrangements which permit a counterparty to offset liabilities to the RFB or other entities in its RFB sub-group with claims that counterparty has on other group members in the event of default of one of the parties (see Chapters 2 and 14 of Appendix 1). This rule is intended to ensure that entities on either side of the ring-fence should manage and settle their exposures with counterparties separately. This rule is intended to cover all such arrangements whether contractual, provided under general customer terms and conditions or under market standardised documents.¹

Availability of collateral

4.23 The PRA proposes a rule that an RFB and other entities in its RFB sub-group must ensure that collateral would not cease to be available to them as a result of the acts, omissions or insolvency of group entities outside the sub-group. See Chapters 2 and 15 of Appendix 1. In the draft supervisory statement in Chapter 7 of Appendix 2, the PRA also sets out its proposed expectation that an RFB and other entities in its RFB sub-group should avoid joint claims on the same collateral (eg property) provided by customers or counterparties to other group entities outside the RFB sub-group. This will help to prevent collateral becoming unavailable in the event of the failure of other group entities outside the RFB sub-group.

4.24 The PRA recognises that there are situations where it is not feasible to separate collateral between entities. In these cases, the RFB and entities in its RFB sub-group should ensure that they have adequate policies and procedures in place to identify their share of any collateral, enable them to exercise their claims on the collateral, and access it when required.

¹ For example the International Swap and Derivatives Association, Cross-Product Master Agreement (Cross-Affiliate Version 2).

5 Use of financial market infrastructures

5.1 This chapter describes the PRA's proposals in relation to RFBs' use of financial market infrastructures (FMIs). FMIs, including inter-bank payment systems, central securities depositories (CSDs) and central counterparties (CCPs), provide key services on which financial markets and their participants rely. Draft rules in relation to these proposals are included in Appendix 1 and proposed guidance is included in a draft supervisory statement in Appendix 2.

5.2 This chapter proposes circumstances where RFBs may participate in payment systems through an intermediary, and the PRA's expectations relating to RFBs' use of CSDs and CCPs. It also provides an update on the PRA's policy on the continuity of services and facilities which support FMI participation.

Participation in inter-bank payment systems

5.3 Secondary legislation (Article 13 of the Excluded Activities and Prohibitions Order (the Order))¹ prohibits an RFB from entering into any transaction that requires the use of services provided through an inter-bank payment system unless it is a direct participant in the system, or where it meets at least one of a number of specified conditions. One of these conditions is that the PRA has, following an application made by an RFB, granted permission for it to access the payment system through an intermediary proposed by the RFB.²

5.4 The legislation specifies that the PRA may grant such permission only when the RFB needs to access the services provided by the payment system in question due to 'exceptional circumstances'. It also requires the PRA to publish a statement containing guidance on what is meant by 'exceptional circumstances' and specifies that the RFB must make its application in a manner and accompanied by such information as may be specified by the PRA.

5.5 This section proposes a definition of 'exceptional circumstances' and how the PRA expects applications referencing this condition to be made.

5.6 The PRA has sought to define 'exceptional circumstances' in a way consistent with its general safety and soundness objective in relation to ring-fencing under the Act. An RFB's method of participation in a payment system can have important implications for the RFB's resilience and resolvability. Where the proposed intermediary is a member of the RFB's group, the method of participation may also affect whether the RFB acts consistently with the group ring-fencing purposes, in particular in order to ensure that, as far as reasonably practicable, the carrying on of core activities by an RFB is not adversely affected by the acts, omissions or insolvency of other members of its group. An RFB must show that the granting of the application would result in it continuing to be able to operate in a way consistent with the group ring-fencing purposes and not so as to adversely affect the ability of the PRA to meet its general safety and soundness objective in relation to ring-fencing. The PRA has sought to

1 SI 2014/2080 The Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014.

2 The other conditions are that: (i) the intermediary through which the RFB accesses the payment system is another RFB within the same group which is a direct participant in that system; (ii) the RFB is not eligible to become a direct participant under the payment system's rules; and (iii) should the intermediary through which the RFB accesses the payment system cease to be able to provide that service, the RFB would be able to make its payments through another intermediary, another payment system or by other means.

define ‘exceptional circumstances’ in a manner which does not impose unnecessary burdens on an RFB.

Proposals

5.7 The PRA proposes (see Chapter 9 of Appendix 2) to define as ‘exceptional circumstances’:

- where acting as a direct participant in a particular payment system would result in a level of cost, risk or burden for an RFB, its customers or the payment system that is disproportionate to the degree to which direct participation would contribute to the PRA’s achievement of its general safety and soundness objective in relation to ring-fencing; and
- where an RFB is not already a direct participant in a particular payment system and joining that system during a particular period would result in a level of cost, risk or burden for the RFB, its customers or the payment system significantly greater than establishing direct participation at some later specified date.

5.8 The first type of exceptional circumstance recognises that direct participation in a payment system may – in a limited number of cases – not generate significant benefits in terms of reducing risks to the continuity of core services, but could result in significant cost or burden. An example of this could be where the RFB’s activity in that system is very low. This may be the case for some foreign currency payment systems used by RFBs.

5.9 The second type recognises that the relative size of the costs and benefits of direct participation may change depending on the RFB’s circumstances, and that there may be periods where the costs or risks associated with direct participation are temporarily increased. An example of this could be where an RFB is in the process of undertaking a major firm-specific programme of business, operational or strategic change. Possible scenarios where this may be the case include where the RFB’s ownership is changing or where the RFB is undertaking some action related to a resolution event.

5.10 An RFB’s use of an intermediary to access the services of a payment system may generate a number of risks, for example: those arising from operational dependency; those arising from liquidity dependency should the RFB rely on the intermediary’s provision of credit to facilitate payments; and credit risk where the RFB places funds with an intermediary. These risks and dependencies may threaten an RFB’s resilience. Also, if the RFB’s intermediary is another group entity, this may not be consistent with the group ring-fencing purposes.

5.11 The PRA will grant an RFB permission for indirect access to an inter-bank payment systems only on application and only if it decides, on a case by case basis, that the RFB’s circumstances qualify as ‘exceptional’.

Application process

5.12 The legislation specifies that an application from an RFB must be made in such manner and accompanied by such information as the PRA may direct.¹ The PRA proposes that this application should provide sufficient information to enable the PRA to undertake a thorough examination of the potential costs, risks and other implications of the RFB using the services provided through an inter-bank payment system without being a direct participant in the system and instead accessing the services through the proposed intermediary. In particular, the PRA proposes that an application to the PRA includes:

¹ See Article 13(3) of the Order.

- information on the inter-bank payment system, including the nature of the risk that would arise to the RFB if it participated via an intermediary;
- data on the RFB's activity and likely activity in the system, including data on the average and maximum volumes and values of transactions in the system;
- relevant information on the proposed intermediary, including its creditworthiness and operational capability, and information on the nature of the agreement or proposed agreement between the RFB and its intermediary;
- information on the expected size and type of the risks to the RFB from the use of an intermediary, including information on the potential intraday credit and liquidity exposures that would be generated;
- a contingency plan for material disruption to the services provided by the intermediary; and
- where there is a temporary excessive burden, information on the nature of the additional risk brought about by the particular business, strategic or operational change for the RFB.

5.13 Failure to provide the information necessary to support its application, including that outlined above, may prevent the PRA from considering the application. The PRA may seek additional information depending on the firm's specific circumstances.

5.14 The PRA may grant a time-limited permission where the RFB's circumstances and application warrant this. In other cases, it may grant an open-ended permission, where, in the PRA's view, this is warranted. In accordance with the legislation, the PRA will keep any permission under review, and withdraw the permission if it considers the exceptional circumstances in question no longer apply.¹ An RFB granted permission should provide the PRA with information on a regular basis to enable the PRA to make its assessment, and notify the PRA if the circumstances relating to the permission change.

5.15 Chapter 19 of Appendix 1 provides for the direction to be made by the PRA under Article 13 of the Order, including provision for a form for the purpose of an application.

Participation in other FMIs

5.16 CSDs and CCPs can be important pieces of financial market infrastructure for RFBs. To enable an RFB to manage its own risk or provide services to customers, it will need to access CSDs in order to settle securities such as equities and bonds, and access CCPs to centrally clear OTC and exchange-traded derivatives, as well as other financial instruments. RFBs may need to access a range of CSDs and CCPs, both in the United Kingdom and elsewhere, and which operate in a range of currencies.

5.17 Such access can be through direct participation, or by accessing the FMI indirectly through an intermediary. The use of an intermediary can be cost-effective, in particular where the RFB's use of the FMI is low, and can be associated with lower operational and other risks. However, such indirect participation can generate two main risks for the RFB:

¹ See Article 13(5) of the Order.

- an operational reliance on another party to enable the RFB to access a critical system; and
- the creation of additional credit exposures to the intermediary, and increased dependency on the intermediary's provision of liquidity to make payments when due.

5.18 Where these risks are significant, they could threaten the resilience of the RFB. Where the intermediary is an entity within the same banking group as the RFB, this may also be inconsistent with the group ring-fencing purposes, in particular ensuring that the carrying on of core activities by an RFB is not adversely affected by the acts, omissions or insolvency of other group members.¹

Proposals

Participation in CSDs and CCPs

5.19 The PRA proposes to set out in a supervisory statement that it will expect RFBs to participate in CSDs and CCPs in a manner which is appropriate to the activity and business model of the RFB. This approach is similar to that for all regulated firms.² The PRA expects RFBs to participate directly in those systems in which they have significant activity or which support an important area of business. RFBs should consider the operational benefits of direct participation and consider scenarios where direct participation may be essential to ensure the continuity of access during periods of financial market stress when reliance on intermediaries may not be guaranteed. This is set out in Chapter 9 of the draft supervisory statement in Appendix 2.

5.20 The PRA recognises, however, that the costs and risks associated with direct participation may be prohibitive in certain circumstances in respect of some CSDs or CCPs, and that there may be cases where an RFB does not meet a system's participation requirements. The PRA expects RFBs to demonstrate that, in cases where they are not direct participants but are able to satisfy the relevant participation requirements, they have undertaken a careful examination of the costs and risks of indirect participation, including the risks associated with the intermediaries proposed.

Indirect participation in CSDs and CCPs

5.21 As discussed above, the PRA recognises that there may be cases where RFBs will access a CSD or a CCP through an intermediary. To ensure that the resultant risks are minimised, the PRA proposes a rule to require that RFBs which are not direct participants use accounts which ensure a sufficient degree of separation of the RFB's assets from those of its intermediary and the intermediary's other clients.

5.22 For CSDs based in the EEA, an individually-segregated account would be appropriate. For CCPs based in the EEA, individually-segregated accounts and omnibus accounts where the margin requirement for the account is calculated as the sum of the margin required to cover separately the positions of each client within the omnibus account would be appropriate. For CSDs and CCPs based outside the EEA, RFBs should use accounts that offer a similar level of protection. Chapter 9 of the draft supervisory statement in Appendix 2 sets this out in more detail.

¹ The Bank has initiated a wider programme of work to address the financial stability risks from 'tiering', the arrangement whereby some market participants access an FMI indirectly through a direct member. See The Bank of England's supervision of financial market infrastructures – Annual Report, March 2015.

² In particular, see Chapter 2.1 and 2.2 of the Risk Control provisions of the PRA Rulebook which require that 'a firm must adopt effective arrangements, processes and mechanisms to manage the risk relating to the firm's activities, processes and systems, in light of [its] level of risk tolerance'.

Applying requirements to members of an RFB sub-group

5.23 The Act's requirements in terms of direct participation in inter-bank payment systems apply to RFBs. The PRA expects that, in most cases, entities in an RFB sub-group will access inter-bank payment systems directly, or through an RFB in the RFB sub-group. The PRA proposes to take a similar approach in respect of participation in other FМИs by entities in an RFB sub-group that are not RFBs.

Services and facilities supporting FМИ access

5.24 CP19/14 proposed rules and supervisory statements relating to the continuity of services and facilities that RFBs need to provide core activities. CP19/14 also noted that the provision of services and facilities that an RFB needs to access relevant FМИs was outside the scope of these proposals. The PRA published 'near-final' proposals on the continuity of services and facilities for RFBs in PS10/15.¹

5.25 International standards in this area are currently being considered by the Financial Stability Board, and this work is expected to be ready for consultation by end-2016. As such, the PRA will wait until this work has been completed before proposing policy in this area.

¹ See also the PRA's Consultation Paper38/15 'Ensuring operational continuity in resolution', October 2015: www.bankofengland.co.uk/pru/Pages/publications/cp/2015/cp3815.aspx.

6 Governance and the continuity of services and facilities

6.1 This chapter sets out proposed amendments to the ring-fencing rules in respect of governance and the continuity of services and facilities. These rules were consulted on in CP19/14, with near-final rules set out in PS10/15.

6.2 The PRA has considered the application of the policy on governance and continuity of services and facilities in the light of the proposals set out in Chapter 2 of this CP on RFB sub-groups, in particular whether the near-final rules in PS10/15 should be applied more extensively in respect of a sub-group. The PRA concludes that, with the exception of rule 9.1 of the draft Ring-fenced Bodies Part of the PRA Rulebook, in respect of the continuity of the provision of services to RFBs, it would not be appropriate to do so.

Proposals

Continuity of services and facilities

6.3 The PRA proposes that an RFB must ensure that all members of an RFB sub-group meet rule 9.1 of the draft Ring-fenced Bodies Part of the PRA Rulebook in respect of the continuity of the provision of services to RFBs. This proposal would require all RFB sub-group members to receive services and facilities from other group entities only where such entities are group service entities or are members of the RFB sub-group. See Chapters 2 and 9 of Appendix 1.

6.4 The PRA believes that if these requirements were applied to an RFB only on an individual basis, this would leave a risk that entities within the RFB sub-group could enter into arrangements for the provision of services from group members that an RFB itself could not. Such arrangements would expose those entities in the RFB sub-group to the risk of failure of the group member providing the service and therefore indirectly expose the RFB itself to that risk.

6.5 The other rules in the Ring-fenced Bodies Part of the Rulebook concerning continuity of services and facilities remain unchanged from PS10/15 and apply only to the RFB on an individual basis. This is because these rules apply to service provision and contractual arrangements that may affect the ability of the RFB to conduct core activities. As members of the sub-group that are not RFBs cannot conduct core activities, the PRA does not consider it necessary to extend the application of this rule to such firms.

Governance

6.6 The PRA proposes to make minor amendments to draft Rule 7.3 on human resources policy and draft Rule 5.3(1) on risk management, to ensure that the language of the draft rules more clearly responds to the PRA's statutory rule-making obligations.¹ The PRA also proposes to make minor amendments to some of the definitions previously included in PS10/15. See Chapters 1, 5 and 7 of Appendix 1. The PRA does not consider that these amendments alter the policy outcomes that the proposals included in PS10/15 seek to achieve.

¹ Draft rule 7.3 was previously draft rule 6.3 and draft rule 5.3(1) was previously draft rule 4.3(1) in PS10/15.

6.7 In all other respects the PRA proposes that the ‘near final’ governance requirements be applied as set out in PS10/15 and should apply to an RFB on an individual basis, with provision for specific rules not to apply within an RFB sub-group. The rules not applied within an RFB sub-group include provisions that the board cross membership restrictions will not apply to entities within an RFB sub-group. The governance rules are focused primarily on ensuring that an RFB is able to take decisions independently of other group members. Compliance with this requirement on an individual basis is consistent with firms’ and directors’ existing legal and regulatory obligations with respect to corporate governance and decision making.

7 Compliance with ring-fencing obligations

7.1 In this chapter, the PRA sets out a range of tools that it proposes to use to monitor the operation of the ring-fencing regime. These tools enhance or supplement existing measures supporting the general supervision of firms.

Demonstration of compliance with the ring-fencing obligations

7.2 CP19/14 included a proposal for an RFB to be able to demonstrate to the PRA its compliance with ring-fencing rules. PS10/15 stated that the PRA believed that the scope of the draft rule should be widened to include compliance with all ring-fencing obligations and committed to consult on any such changes as part of a subsequent consultation.¹

Proposals

7.3 The PRA proposes rules in Chapters 2 and 3 of Appendix 1 that an RFB must be able to demonstrate to the PRA:

- its compliance with every ring-fencing obligation; and
- the extent to which it has acted in accordance with any guidance issued by the PRA relating to the operation of the ring-fencing obligations.

7.4 While entities within an RFB sub-group are responsible for meeting their own obligations, the PRA also proposes that a single entity within an RFB sub-group has responsibility for demonstrating to the PRA how all entities within its sub-group comply with their ring-fencing obligations or requirements imposed for the ring-fencing purposes. The responsible entity must also be able to demonstrate to the PRA the extent to which the entities within its sub-group have met relevant PRA guidance.

7.5 The proposed changes to the scope of the rule support the PRA in delivering in the PRA Annual Report its reporting obligations on RFBs' compliance with the ring-fencing regime. The rule also supports the PRA in supervising the ring-fencing regime and thereby contributes to the PRA meeting its general safety and soundness objective in relation to ring-fencing.

7.6 Firms can demonstrate compliance in a number of ways, for example by putting in place policies and procedures and providing evidence to the PRA that these have functioned effectively throughout the period, or by providing evidence to the PRA that individual transactions meet relevant requirements. In order to provide firms with more flexibility in implementing and operating under the ring-fencing regime, the PRA does not intend to specify through further rules or guidance how exactly firms must meet these requirements.

¹ ‘Ring-fencing obligation’ is defined in the draft Ring-fenced Bodies Part in Appendix 1 as ‘any obligation, prohibition or other requirement imposed on a ring-fenced body by or under FSMA by virtue of it being a ring-fenced body, including any statutory instrument made under FSMA and any ring-fencing rule, but not including any rule made by the FCA.’

Policies regarding use of exceptions to Excluded Activities and Prohibitions

7.7 The Act restricts the activities of an RFB through the mechanisms of ‘Excluded Activities’ and ‘Prohibitions’ which are further detailed in the Excluded Activities and Prohibitions Order (the Order).¹ The Order also sets out certain permitted exceptions to the ‘Excluded Activities’ and ‘Prohibitions’, to allow RFBs to carry out certain activities which they would otherwise be prevented from undertaking.

7.8 For some of the exceptions, the legislation sets out the requirements for their use in a way which leaves little room for interpretation, eg the exception which permits any transaction with a central bank or a wholly-owned subsidiary of a central bank. In such cases it is likely that an objective determination is possible on whether the requirements have been met. For other exceptions, the requirements are set out in a way which is likely to involve a greater degree of judgement (eg where an RFB enters into a transaction where the sole or main purpose is to hedge the risks of the RFB or the RFB sub-group).

7.9 The PRA believes that in relation to the use of exceptions where a greater degree of judgement is likely to be involved it is appropriate to set out additional requirements on RFBs in respect of the policies and procedures they are required to put in place.

Proposals

7.10 The PRA has identified three areas where the use of exceptions is subject to a greater degree of interpretation: (i) hedging exceptions; (ii) liquid asset exceptions; and (iii) collateral exceptions.² The PRA therefore proposes rules requiring an RFB to have policies in place which specify in detail in which circumstances it will make use of these exceptions (collectively the ‘exceptions policies’) and how it satisfies itself that the requirements for use of the exceptions have been met. The draft rules are set out in Chapter 17 of Appendix 1 and further guidance is set out in a draft supervisory statement in Chapter 10 of Appendix 2.

7.11 The exceptions policies must deal at a minimum with the matters set out in the draft rule in Chapter 17 of Appendix 1, including:

- the details of the types of transactions that are permitted to be entered into;
- how the RFB determines that the purpose of the relevant transaction meets the requirements for use of the exception;
- a description of how the RFB separately identifies, manages and controls transactions under the exceptions policies from other transactions; and
- how the RFB manages additional or second-order risks introduced by transactions under the exceptions policies.

¹ SI 2014/2080 The Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014.

² For (i) see the exceptions set out in Articles 6(1), 6(2), 14(2) and 14(3) of the Order; for (ii) see the exceptions set out in Articles 6(3)(a) and 18(b) of the Order; and for (iii) see the exceptions set out in Articles 6(3)(b) and 14(5) of the Order.

7.12 In addition to the proposed requirements in respect of the content of exceptions policies, the PRA proposes that an RFB must ensure its exceptions policies are:

- reviewed and updated as often as necessary (but at least annually); and
- approved by the governing body.

7.13 An RFB must also put in place procedures to operationalise these policies including appropriate internal reporting and oversight.

7.14 The requirements proposed in respect of exceptions policies focus on ensuring that RFBs meet a minimum standard in respect of their use of the relevant exceptions under the Order. An RFB should not assume that putting in place exceptions policies would be sufficient to meet the requirements of CRR or PRA rules covering similar topics, such as liquidity and funding risk or collateral management.

8 Discussion of potential reporting requirements

8.1 This chapter sets out the PRA's preliminary views on some potential RFB reporting requirements. It does not contain any proposals for consultation at this stage, but is seeking feedback on these preliminary views.

8.2 The PRA intends to consult on reporting proposals for RFBs by mid-2016. This future consultation may include proposals arising from the preliminary views set out in this section.

8.3 The two main reasons why additional reporting will be required from RFBs are:

- (i) for the prudential supervision of RFB sub-groups; and
- (ii) to enable the PRA to monitor the compliance by RFBs with ring-fencing obligations.

Reporting for the prudential supervision of RFB sub-groups

8.4 The PRA's preliminary view is that reporting requirements that apply on a consolidated basis to banks affected by ring-fencing should also be applied to RFB sub-groups.

8.5 If prudential requirements are applied to an RFB on a sub-consolidated basis, as discussed in Chapter 2 of this CP, then certain CRR reporting and disclosure requirements will automatically be applied to the RFB sub-group.¹

8.6 However, other consolidated reporting requirements would only apply to RFB sub-groups in certain circumstances. These include the submission to the PRA of audited consolidated annual financial statements and financial information pursuant to CRR Article 99 (FINREP).² The PRA's preliminary view is that all RFB sub-groups should be required to submit to the PRA audited consolidated annual financial statements and information required under FINREP.

8.7 The submission to the PRA of audited consolidated financial statements helps to ensure that elements of the RFB sub-groups' own funds calculations derived directly from financial statements are subject to an appropriate level of external audit and audit committee oversight, and that there is effective engagement between external auditors and supervisors under the PRA code of practice.³ FINREP is a key source of supervisory data for groups applying international financial reporting standards (which includes all groups likely to be affected by ring-fencing).

8.8 Also, some or all of the existing PRA reporting requirements may be applied to an RFB on a sub-consolidated basis. Proposals to specify which requirements will be required on a sub-consolidated basis will be made in the 2016 consultation.

1 These would include the CRR common reporting framework (COREP) and Pillar 3 disclosure requirements.

2 Existing requirements apply on a consolidated basis to all banks affected by ring-fencing, but whether or not they will apply to an RFB sub-group will depend on whether the parent of the RFB sub-group has issued listed securities. From January 2016, the requirement to submit to the PRA annual report and accounts will be set out in the Regulatory Reporting Part of the PRA Rulebook. The Companies Act sets out circumstances in which UK companies are required to prepare consolidated annual financial statements. The scope of FINREP reporting is set out in CRR Article 99.

3 www.bankofengland.co.uk/publications/Documents/other/prapolicy/2013/codeofpracticess7-13.pdf.

Reporting to enable the PRA to monitor compliance by RFBs with ring-fencing obligations

8.9 The PRA will require data to monitor an RFB's compliance with the ring-fencing obligations, and risks to the PRA's general safety and soundness objective in relation to ring-fencing. The 2016 consultation will propose reporting requirements for this purpose. The PRA will also consider which data are needed to support the report that the PRA is required to make about ring-fencing within the PRA annual report¹.

8.10 Section 142H(5)(c) of the Act requires the PRA to make rules requiring the disclosure to the PRA of information relating to transactions between an RFB and other members of its group ('intragroup transactions'). Two areas where reporting requirements could be introduced to satisfy the Act's requirement are discussed below.

- (i) Intragroup exposures and funding transactions. To assess the direct impact on an RFB of the insolvency of another group entity and the dependency of the RFB on intra-group funding, the PRA will need a sufficiently comprehensive set of information on RFBs' exposures to other group entities and on funding provided to the RFB by other group entities. The PRA is therefore considering requiring RFBs to report data on their exposures to, and funding transactions from, intragroup entities, where these fall below the current COREP reporting thresholds for inclusion in the Large Exposures and Additional Liquidity Monitoring Metrics (ALMM) templates.² The same definitions and breakdowns as those used in COREP would apply to these new reporting requirements.³ On proportionality grounds, the PRA may consider a lower threshold than used in COREP for the new data items to exclude reporting of small individual transactions.
- (ii) Intragroup financial reporting. The PRA will need to monitor the extent to which RFBs and members of their RFB sub-groups are reliant on intragroup and shared customer income (as considered in Chapter 4 of this CP), and the extent to which it might be possible for RFBs to mitigate against excessive reliance on group entities outside the sub-group. The PRA is therefore considering requiring reporting of aggregate financial data related to intragroup assets, liabilities, income and expenses, including granular information on derivatives. Box 2 provides further details.

8.11 The potential reporting requirements discussed in paragraph 8.10 above are likely to be based on existing CRR reporting requirements (COREP and FINREP), including the reporting frequency, the institutions required to report and the basis of reporting (individual, consolidated or both) required from each institution. In each case, the PRA would produce new data items, including reporting instructions, definitions and validations tailored to suit reporting of intragroup transactions. The data items would be designed to avoid duplication with other existing reporting requirements.

8.12 Proposals to specify new requirements relating to reporting of intragroup transactions will be made in the 2016 consultation.

¹ The requirement for the PRA to report on ring-fencing matters is set out in paragraph 19(1A) to Schedule 1ZB of the Act.

² Banks are not yet required to report ALMM templates, but the current intention of the European Commission is that the relevant templates will apply from January 2016 onwards, subject to final adoption by the Commission. See the PRA's dedicated webpage 'CRD IV updates' for more information: www.bankofengland.co.uk/prad/Pages/crdiv/updates.aspx.

³ Specifically in C28.00, C29.00 and C67.00 templates.

Box 2: Intragroup financial reporting – relevant FINREP templates

A proposed scope of the intragroup financial reporting (discussed in paragraph 8.10(ii)) is set out in the table below, including references to corresponding FINREP templates.

Data topic	Corresponding FINREP template
Financial balance sheet data (assets and liabilities)	F01.01, F01.02
Financial profit and loss data	F02.00, F16.01
Off-balance sheet exposures (loan commitments, financial guarantees and other commitments)	F09.01, F09.02
Derivatives (trading and hedge accounting)	F10.00, F11.01
Breakdowns of gains or losses on financial assets and liabilities	F16.02, F16.04, F16.05, F16.06, F16.07, F45.01
Performing, non-performing and forbear exposures	F18.00, F19.00
Fee and commission income and expenses	F22.01, F22.02
Use of fair value	F41.01, F41.02, F41.03

Any proposed reporting that the PRA may develop based on the templates above will:

- Be tailored specifically to cover transactions and balances between the RFB sub-group and group entities outside the sub-group.
- Take into account the need for additional information relevant to an understanding of the context of the intragroup transaction. For example, where an RFB enters into derivatives with another group entity in order to hedge risk relating to transactions with a third party, information on third party transactions may provide relevant context.
- Take into account the need for additional information relevant to an understanding of the RFB sub-group's relationship with the rest of the group eg data on shared customer income.
- Consider the potential for future changes to the FINREP templates proposed by the European Banking Authority (EBA). For example, to ensure compatibility with IFRS 9.

Feedback requested

8.13 The PRA is interested in views on all aspects of RFB reporting, and in particular invites comments on the preliminary views set out in this chapter regarding:

- the submission to the PRA of audited annual financial statements for the RFB sub-group;
- FINREP reporting by an RFB on a sub-consolidated basis;

- reporting of RFBs' intragroup exposures and funding transactions that fall below existing COREP reporting thresholds, using new data items and definitions to be based on COREP;
- the potential use of a lower threshold than used in COREP for reporting of intra-group exposures and funding transactions; and
- reporting of intragroup financial data, including data on shared customer income, using new data items and definitions to be based on FINREP.

8.14 In particular, the PRA is interested in the impact of creating such reporting requirements for those banking groups potentially affected by ring-fencing and any specific challenges in reporting intragroup transactions using newly-created data items based on existing COREP and FINREP templates.

8.15 Feedback received will be used to ensure that any proposals that the PRA may consult on in the future will be as effective as possible.

9 The PRA's statutory obligations

9.1 In making its rules and establishing its practices and procedures, the PRA must meet a number of legal obligations. The PRA must assess the costs and benefits of proposals and have regard to the regulatory principles as set out in the Act, including proportionality. In addition, when consulting on draft rules, the PRA is required to consider the impact on mutuals. The PRA has a duty to facilitate competition as a secondary objective subordinate to its general safety and soundness objective. Finally, the PRA must consider the equality and diversity impact of its proposals.

Cost benefit analysis

9.2 The proposals discussed in this CP are designed to implement the ring-fencing of core activities as set out in the Act. The proposals apply to banking groups with at least £25 billion of core deposits as defined in the legislation.

Scope of the analysis

9.3 An analysis of the overall costs and benefits of the implementation of ring-fencing was published by the Government in 2013.¹ The analysis presented in this chapter is limited to the key areas of incremental impact of the proposals that the PRA is consulting on in this CP. This analysis does not reflect the impact of the ring-fencing requirements placed on firms by legislation, such as the application of the SRB, or the costs associated with the near-final rules within PS 10/15.

9.4 The cost benefit analysis in this CP is based on a cost of compliance exercise that the PRA undertook to ascertain firms' expected costs associated with structural reform. The PRA asked six banks, which currently have estimated core deposits over £25 billion, to provide their relevant assessment for 2014 and best assessment of their 2019 financial position on a fully phased CRD IV² basis. This is used as the baseline for the cost benefit assessment. We also asked the banks to provide the expected costs and balance sheet changes associated with implementing ring-fencing. Therefore, this analysis presents the PRA's assessment on how compliance with the proposals set out in this CP could impact these six banks.

9.5 Although the PRA has used the data provided by firms as part of the cost of compliance exercise as the basis for the estimates presented in this cost benefit analysis, the PRA considers that in some cases the incremental costs and benefits of the proposals in this consultation paper cannot be reasonably estimated. This is because of the lack of reliable information at a sufficient level of detail.

9.6 There are areas where the resolution regime and operational continuity considerations will require banks to alter their existing legal structure and operational arrangements regardless of the requirements under structural reform. These changes contribute to banks' expenditure on new systems. Ring-fencing also imposes additional one-off and ongoing

1 HM Treasury and Department for Business, Innovation and Skills, 'Banking reform: draft secondary legislation', July 2013; https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/223566/PU1488_Banking_reform_consultation_-_online-1.pdf. This impact assessment estimated significant benefits to the UK economy from ring-fencing and related reforms corresponding to an annualised net present value of approximately £7.1 billion (in 2011/12 terms). The net benefit figure estimated by the Government included the private costs to banks, which were estimated to be between £1.7 billion and £4.4 billion per annum.

2 Directive 2013/36/EU and Regulation (EU) No 575/2013, jointly CRD IV.

operational costs, for example, changing customer sort-codes and further system enhancements.

9.7 The combined estimated costs associated with the operational continuity and structural reform proposals for the banks subject to ring-fencing are considerable, as set out in the Government's cost benefit analysis.

Summary findings

9.8 The benefits associated with implementing the ring-fencing policies set out in this CP are significant and result mainly from the ability to protect core services and promote financial stability by reducing the contagion of potential shocks within banking groups and through the UK banking system. The proposed policies also facilitate the restructuring of a group in recovery or following a resolution event, further reducing the potential costs of a banking crisis.

9.9 In its approach, the PRA has sought to preserve, to the extent possible, the benefits arising from RFBs being part of a wider group. For example, the cross-selling of products and services, correspondent banking and agency arrangements between an RFB and other entities in its group are not restricted provided they are carried out in a way that is not inconsistent with the PRA's amended general safety and soundness objective in relation to ring-fencing or the group ring-fencing purposes.

9.10 Some of the policies set out in this CP, however, could increase firms' capital requirements. The impact in terms of costs to firms will depend on, among other factors, the amount of capital that firms would need to raise in order to comply with the PRA's ring-fencing proposals. The PRA has estimated that the application of Pillar 2A to an RFB on a sub-consolidated basis and the effect of not granting large exposures permissions between RFBs and entities outside an RFB sub-group, in particular, could increase total capital requirements by £2.2-3.3 billion in aggregate.

9.11 The PRA is also proposing that a parent of an RFB cannot make use of double leverage to fund its investment in the RFB. The proposal could increase the capital required by banking groups captured by ring-fencing; however it is not possible to quantify the amount at this stage.

9.12 The ongoing operational costs associated with PRA rules relating to structural reform relate mainly to additional reporting requirements, required infrastructure and additional oversight costs at the sub-group level. The costs associated with reporting requirements will be assessed as part of the reporting requirements consultation paper, expected by mid-2016.

Prudential requirements

9.13 One of the key objectives of ring-fencing is to minimise the risk that the failure of an RFB or of a member of an RFB's group could affect the continuity of the provision of core services. The application of a Pillar 2 assessment at the level of the RFB sub-group supports this objective and helps ensure the RFB is adequately capitalised.

9.14 The PRA's approach to set Pillar 2 capital is described in PS 17/15.¹ One of the key aspects of this approach is that banking groups can be subject to lower capital charges if they hold a

¹ PRA Policy Statement 17/15, 'Assessing capital adequacy under Pillar 2', August 2015; www.bankofengland.co.uk/pru/Pages/publications/ps/2015/ps1715update.aspx.

well-diversified loan portfolio at group level, in terms of geographical and sector concentrations, as well as limited large single name exposures.

9.15 Applying Pillar 2A to an RFB on an individual or sub-consolidated basis, depending on the proposed firm structure and in addition to the current application of Pillar 2A on a group consolidated basis, will reduce group-wide diversification benefits. RFBs are also likely to have a smaller balance sheet and more concentrated business mix. In particular, levels of geographical and sector concentration could increase. If the PRA applied the Pillar 2A methodology at the RFB or sub-group level to account for these potential changes, this would result in an increase in Pillar 2A capital of £2.1 billion in aggregate across the firms currently expected to be within scope.

9.16 Single name credit concentration might also increase at the RFB level. This may be due to its exposures to intragroup entities and a reduced number of customers or counterparties relative to the wider group. At this stage, the PRA is unable to quantify the impact, which will be driven by exposure allocations and distributions of the RFB's loan portfolio.

9.17 The application of Pillar 2B at the level of the RFB or its sub-group, depending on the firm's proposed structure, could change the distribution within the group of the capital associated with Pillar 2B, however the impact on the size of the buffer depends on the final business model of the RFB and wider group.

Intragroup prudential arrangements

9.18 Currently firms are able to apply for permission for intragroup exposures to be subject to zero percent risk weights and to be exempt from the large exposure limit where certain conditions are met. The PRA's proposals would result in these no longer being available at the level of the RFB or its sub-group and require the RFB or its sub-group to treat their intragroup exposures as equivalent to third party exposures.

9.19 Based on regulatory data for large exposures covering the main CRR firms within the banking groups affected by ring-fencing, the average exposure is 3% of firms' eligible capital base, with more than 95% of exposures (post credit risk mitigation allowable under CRD) being below 10% of firms' eligible capital. The PRA has therefore calibrated the potential capital increase estimate in this analysis based on exposures being below 10%. If RFBs were to have higher levels of exposure, the additional capital requirements could be higher.

9.20 If the RFB or RFB sub-group and entities outside the RFB sub-group were to have unsecured exposures of between 1-10% of their respective eligible capital bases to one another, this would generate additional capital requirements of £120million to £1.2billion for the group.¹

9.21 Treating the RFB or its sub-group's exposures to other members of the group as third parties also limits the ability of businesses placed within the RFB or its sub-group to cross-fund, on an unsecured basis, other business activities within the group. This could lead to funding inefficiencies both within the RFB, or its sub-group, as well as entities that are not part of the RFB. This could potentially lead to higher funding costs. The proposal not to grant intragroup liquidity concessions that cover institutions which are members of an RFB sub-group and institutions which are not, would improve the RFB sub-group's resilience to liquidity shocks but may also lead to a less efficient allocation of liquidity, relative to structures currently in place.

¹ Assumes a 50% risk weight and a 14% tier one capital requirement.

9.22 Intragroup CVA capital requirements based on the RFB or its sub-group's OTC derivative transactions are not expected to be material, based on current firm plans. While the PRA recognises that firms may experience higher capital requirements, the amount of additional capital is not expected to be significant.

9.23 The expectation that the UK parent of an RFB will not use double leverage to fund its investment in the RFB, where this could pose a risk to the safety and soundness of the RFB, helps ensure that the RFB is funded with higher quality capital, but can impose costs on the banking groups that were planning to make use of double leverage. At this stage the PRA is not able to assess whether the proposals will increase the amount of Common Equity Tier 1 capital at the group level.

Intragroup transactions and exposures

9.24 Companies within groups are already required to apply arm's length requirements to intragroup transactions for transfer pricing purposes. Therefore, the PRA envisages that there will be limited, if any, implications arising from requesting groups to apply arm's length rules to intragroup transactions conducted by an RFB, including transactions between the RFB and other members of the RFB sub-group.

9.25 The proposals set out in this CP reduce the extent of collateral sharing that banks will be able to undertake between entities in the RFB sub-group and those not in the RFB sub-group. While this benefits the RFB and its sub-group, as it limits their exposures to the rest of the group, it could potentially increase the amount of collateral required and the number of hedging transactions if a customer deals with entities on both sides of the ring-fence. The exact increase in collateral would depend on a firm's business model.

Use of financial market infrastructures

9.26 Being a direct member of the payment systems limits the participant's liquidity and credit risk, but entails one-off set up costs and ongoing intraday liquidity requirements coupled with day-to-day operational costs. In light of the current arrangements to access financial market infrastructure and the proportionate approach adopted in the definition of exceptional circumstances, the PRA does not envisage significant costs. Similarly, due to firms' current access arrangements, the PRA does not believe that the requirements for access to CCPs or CSDs will generate significant costs.

Cost to the PRA

9.27 Costs will result from changes to the PRA's systems to accommodate an additional level of reporting, and increased oversight staffing to assess the financial resources and operations of the RFB in addition to carrying out group-wide assessments.

The regulatory principles

9.28 In developing the proposals in this CP, the PRA has had regard to the eight regulatory principles set out in section 3B of the Act. Of these, four principles are of particular relevance:

- *The principle that a burden or restriction which is imposed on a person, or on the carrying on of an activity, should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction.* The PRA has followed this principle when developing the proposals outlined in this CP, and has indicated in the CP the key areas of its judgements. The PRA's approach of articulating the outcomes to be achieved in relation to ring-fencing

and only to be prescriptive where necessary is consistent with taking a proportionate approach.

- *The principle that the PRA should exercise its functions as transparently as possible.* In this CP, the PRA sets out the key information relevant to its proposals, and gives respondents the opportunity to comment.
- *The desirability in appropriate cases of the PRA exercising its functions in a way that recognises differences in the nature of, and objectives of, business carried on by different persons subject to requirements imposed by or under the Act.* Although the proposals in this CP will affect only a relatively small number of firms, the PRA recognises that even within this population there will be a range of business models. The PRA has taken this into consideration when developing its proposals, for example in relation to the application of requirements which recognise that certain banking groups may intend that their RFBs will conduct business through other legal entities in their group, including subsidiaries and potentially other affiliates.
- *The need to use the resources of each regulator in the most efficient and economic way.* The proposals in this CP are intended to supplement the existing prudential regime as it applies to RFBs except where, in specific cases, the proposals are intended to replace existing requirements.

Impact on mutuals

9.29 The Act requires that the PRA assesses whether, in its opinion, the impact of the proposed rules on mutuals will be significantly different from the impact on other firms.¹ Building societies, credit unions and industrial and provident societies are exempt from ring-fencing requirements, and from the definition of financial institutions to which RFBs may not have exposures.² The PRA does not therefore expect mutuals to be materially affected by the proposals in this CP.

Impact on competition

9.30 This section considers the potential impact on competition of the rules proposed in this CP. The assessment is based on the cost benefit analysis and focuses on prudential requirements and intragroup arrangements. It covers the implications for barriers to entry and expansion, and for competition in retail and wholesale banking.

Prudential requirements and intragroup arrangements

9.31 The proposals relating to prudential requirements and intragroup prudential arrangements set out in this CP (eg application of the Pillar 2 regime at the RFB sub-group level and restricting the use of double leverage) could increase costs for firms that cross the threshold of £25 billion of core deposits. These proposals should not, however, significantly affect firms crossing the threshold as long as all activities in such groups can be carried out by RFBs. Smaller UK retail banks currently below the threshold typically do not engage in activities that cannot be carried out by RFBs. Moreover, competition among firms that are still far below the threshold would limit the impact on market outcomes of higher costs for firms that are above or close to the threshold.

¹ Mutuals are defined as building societies, friendly societies, industrial provident societies and EEA mutual societies.

² Section 142A(2) of the Act, as amended by the Banking Reform Act .

9.32 The proposals could also increase costs for firms which undertake excluded activities (eg dealing in investments as principal) if they plan to enter the UK retail market at a scale above the threshold of £25 billion of core deposits. There would be no direct impact for entry below the ring-fencing threshold.

9.33 All firms above the threshold will face similar ring-fencing requirements for activities that RFBs are not permitted to undertake (eg certain investment banking activities). The PRA does not expect that the proposals in this CP will amount to a competitive disadvantage for new entrants (compared to incumbents) in the relevant markets.

Retail activities

9.34 Firms may look to pass on the higher costs associated with ring-fencing to customers. This could have implications for the price of banking services and products provided by groups subject to ring-fencing. Their ability to pass on higher costs will depend on factors that affect the intensity of competition in the relevant markets, such as the ease of switching for customers and barriers to entry and expansion.

9.35 Ring-fencing only applies to a subset of banking groups, and intense competition from other firms can constrain their pricing behaviour. In areas where competition is not intense, RFBs might be able to pass additional costs on to customers. It is difficult to compare the intensity of competition in different markets and to estimate the relative scale of cost pass-through. Market investigations by competition authorities have highlighted a number of factors that weaken competition in retail banking markets, and could facilitate pass-through:

- (a) Switching rates are low in personal current accounts and business current accounts for small and medium-sized enterprises (SMEs), which are often gateways to cross-sell other products.¹
- (b) Behavioural biases can lead to failure by customers to take into account the cost of non-prominent fees (eg overdraft charges) and add-on products (eg payment protection insurance).²
- (c) Some customers may fail to switch once introductory rates have expired (eg for credit cards and cash savings products).³ As a result, firms may be able to pass higher costs on to such customers.
- (d) High levels of concentration in some key markets, in particular personal and business current accounts and SME lending.⁴

9.36 Given that banks typically offer a range of retail products, and each product market may be subject to different competitive dynamics, it is not possible to measure with accuracy how firms may pass ring-fencing costs to customers. Within this context, the PRA notes that retail banking (including SME banking) and credit cards are subject to ongoing investigation by the

¹ Switching rates for personal and business current accounts for SMEs were 3% and 4% in 2014, respectively. Over 80% of banks' sales of general purpose business loans to SMEs are originated from business current account customers. CMA (2015), 'Retail banking market investigation: Updated issues statement'.

² OFT (2013), 'Review of the personal current account market'; Competition Commission (2009), 'Market investigation into payment protection insurance'.

³ FCA (2015), 'Cash savings market study report'.

⁴ CMA (2014), 'Personal current accounts: Market study update', CMA and FCA (2014), 'Banking services to small and medium-sized enterprises: A CMA and FCA market study'.

Competition and Markets Authority and the FCA, respectively.¹ The FCA is considering launching a market study on mortgage lending in 2016 Q1.²

Wholesale activities

9.37 There is substantial uncertainty about firms' ring-fencing plans with regards to wholesale activities. However, RFBs are not permitted to undertake certain investment banking activities such as dealing in commodities, dealing in investments as principal and securities underwriting. Such activities may face higher costs as a result of intragroup limits on unsecured exposures between the RFB or the RFB sub-group and other members of the group, which could lead to funding inefficiencies and therefore potentially higher levels of wholesale funding from external sources (see paragraph 9.21).

9.38 Mid-market corporates (turnover between £25 million and £500 million) may be particularly vulnerable to an increase in the price of investment banking services. Mid-market corporates often require investment banking services but they may have a more limited choice of suppliers and less negotiating power than larger corporates.³

9.39 Groups subject to ring-fencing account for a small share, around 4%, of equity underwriting for mid-market corporates, and any effect from ring-fencing on competition in this area is unlikely to be significant. They account for a larger share, around 42%, of bond underwriting for mid-market corporates.⁴ The level of market concentration however does not appear unduly high, and ring-fenced groups usually operate as part of broader syndicates, suggesting that issuers could switch volumes to other underwriters.⁵ The ability of corporate clients to switch providers is being investigated by the FCA as part of its market study on investment and corporate banking.⁶

Equality and diversity

9.40 In making its rules and establishing its practices and procedures, the PRA must have regard to the regulatory principles as set out in the Act. The PRA may not act in an unlawfully discriminatory manner. It is required, under the Equalities Act 2010, to have due regard to the need to eliminate discrimination and to promote equality of opportunity in carrying out its policies, services and functions. To meet this requirement, the PRA has performed an assessment of the policy proposals and does not consider that the proposals give rise to equality and diversity implications.

¹ CMA (2015), 'Retail banking investigation: Updated issues statement'; FCA (2014), 'Credit card market study: terms of reference'. The CMA has indicated that the use of internal risk-based models to calculate risk-weights might favour incumbents, in particular in SME lending, compared to new entrants that have to rely on the standardised approach. The policies proposed in this Consultation Paper however are unrelated to how risk-weighted assets are calculated.

² FCA (2015), 'Call for inputs on competition in the mortgage sector'.

³ FCA (2015), 'Investment and corporate banking market study—Terms of reference'; FCA (2015), 'Wholesale sector competition review'.

⁴ Sources: Dealogic, Bloomberg and Bank calculations based on data for 2010-2014. To estimate market shares for equity and bond underwriting the PRA has divided the value of each bond issuance equally between the participating bookrunners.

⁵ The Herfindahl-Hirschman concentration index for bond underwriting for mid-market corporates is below 700. In merger investigations markets with HHI exceeding 1,000 may be regarded as concentrated (see Competition Commission and Office of Fair Trading (2010), 'Merger Assessment Guidelines'). Sources: Dealogic, Bloomberg and Bank calculations based on data for 2010-2014.

⁶ FCA (2015), 'Investment and corporate banking market study-Terms of reference'.

Appendices

-
- 1 Draft Ring-fenced Bodies rules instrument**

 - 2 Draft supervisory statement - Ring-fenced bodies (RFBs)**

 - 3 Draft amendments to Supervisory Statement 16/13 – Large Exposures**

 - 4 Draft amendments to FSA078 – Pillar 2 Concentration risk minimum data requirements**

 - 5 Draft amendments to Statement of Policy - The PRA's methodologies for setting Pillar 2 capital**

 - 6 Draft amendments to Appendix to Supervisory Statement 32/15 – Pillar 2 Reporting Schedule**

 - 7 Glossary**

PRA RULEBOOK: CRR FIRMS AND NON-AUTHORISED PERSONS: RING-FENCED BODIES INSTRUMENT [YEAR]

Powers exercised

- A. The Prudential Regulation Authority ("PRA") makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 ("the Act"):
 - (1) section 137G (The PRA's general rules);
 - (2) section 137T (General supplementary powers);
 - (3) section 142H (Ring-fencing rules) and
 - (4) section 192JA (Rules applying to parent undertakings of ring-fenced bodies).
- B. The PRA also makes this instrument in exercise of the power under Article 13(3) of The Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014.
- C. The rule-making powers referred to above are specified for the purpose of section 138G(2) (Rule-making instrument) of the Act.
- D. The PRA exercises the following powers in the Act to make those terms in the Glossary that are used in this instrument in rules applicable to parent undertakings of ring-fenced bodies:
 - (1) section 192JA (Rules applying to parent undertakings of ring-fenced bodies); and
 - (2) section 137T (General supplementary powers).

Pre-conditions to making

- E. In accordance with section 138J of the Act (Consultation by the PRA), the PRA consulted the Financial Conduct Authority. After consulting, the PRA published a draft of proposed rules and had regard to representations made.

PRA Rulebook: Ring-fenced Bodies Instrument [YEAR]

- F. The PRA makes the rules in Annexes A to G to this instrument.

Commencement

- G. This instrument comes into force on [DATE].

Citation

- H. This instrument may be cited as the PRA Rulebook: CRR Firms and Non-Authorised Persons: Ring-fenced Bodies Instrument [YEAR].

By order of the Board of the Prudential Regulation Authority

[DATE]

Annex A

In this Annex, the text is all new and is not underlined.

Part

Ring-fenced Bodies

Chapter content

- 1. APPLICATION AND DEFINITIONS**
- 2. APPLICATION OF RULES WITHIN A SUB-CONSOLIDATION GROUP**
- 3. GENERAL RULES**
- 4. BOARD COMPOSITION AND MEMBERSHIP**
- 5. RISK MANAGEMENT**
- 6. INTERNAL AUDIT POLICY**
- 7. HUMAN RESOURCES POLICY**
- 8. REMUNERATION POLICY**
- 9. CONTINUITY OF PROVISION OF SERVICES**
- 10. INTRAGROUP CREDIT VALUATION ADJUSTMENT RISK**
- 11. DISTRIBUTIONS**
- 12. ARM'S LENGTH TRANSACTIONS**
- 13. INCOME DEPENDENCE**
- 14. NETTING ARRANGEMENTS**
- 15. AVAILABILITY OF COLLATERAL**
- 16. ACCESS TO CENTRAL COUNTERPARTIES AND CENTRAL SECURITIES
DEPOSITORIES**
- 17. POLICIES REGARDING USE OF EXCEPTIONS TO EXCLUDED ACTIVITIES AND
PROHIBITIONS**
- 18. APPLICATION OF CERTAIN PRA RULES TO RING-FENCED BODIES ON A SUB-
CONSOLIDATED BASIS**
- 19. APPLICATION FOR PERMISSION FOR INDIRECT ACCESS TO INTER-BANK
PAYMENT SYSTEMS**

1 APPLICATION AND DEFINITIONS

1.1 Unless otherwise stated, this Part applies to a *ring-fenced body*.

1.2 In this Part, the following definitions shall apply:

arm's length policy

means the policy established in accordance with 12.3.

arm's length procedures

means the procedures established in accordance with 12.3.

close family tie

means a relationship:

- (1) of marriage or *civil partnership*; or
- (2) which has the characteristics of a relationship of marriage or of *civil partnership*;
or
- (3) between a *person* referred to in 1.3(2)(d) and his or her parent, sibling, child, grandparent or grandchild, including a step-relationship in each case.

common equity tier 1 capital ratio

has the meaning in Article 92(2)(a) of the CRR.

collateral exception

means:

- (1) in relation to an *excluded activity*, the exception provided for in Article 6(3)(b) of the *Excluded Activities and Prohibitions Order*; or
- (2) in relation to a *prohibition*, the exception provided for in Article 14(5) of the *Excluded Activities and Prohibitions Order*.

collateral exceptions policy

means a policy document setting out in detail how a *ring-fenced body* makes use of the *collateral exceptions* and which meets the requirements of Chapter 17.

collateral exception transaction

means a transaction entered into by making use of a *collateral exception*.

conduit vehicle

has the meaning in Article 1 of the *Excluded Activities and Prohibitions Order*.

distribution

has the meaning in section 829 of the Companies Act 2006.

exception

means:

- (1) the *hedging exception*;
- (2) the *liquid asset exception*; and
- (3) the *collateral exception*.

exceptions policy

means:

- (1) the *hedging exceptions policy*;
- (2) the *liquid asset exceptions policy*; and
- (3) the *collateral exceptions policy*.

exception transaction

means a transaction entered into in accordance with any of the following:

- (1) *hedging exception*;
- (2) *liquid asset exception*; and
- (3) *collateral exception*.

Excluded Activities and Prohibitions Order

means the Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014 (SI 2014/2080).

extraordinary vacancy

means a vacancy on the *governing body* of a *ring-fenced body* arising from the resignation, dismissal or death of an independent *non-executive director* before the expiry of his or her term of appointment as a *director*.

group services entity

in relation to a *ring-fenced body*, means an entity within the same *group* as the *ring-fenced body*, whose only business is to provide services or facilities to any other *person*.

hedging exception

means:

- (1) in relation to an *excluded activity*, the exception provided for in Article 6(1) of the *Excluded Activities and Prohibitions Order*; or
- (2) in relation to a *prohibition*, the exception provided for in Article 14(2) of the *Excluded Activities and Prohibitions Order*.

hedging exceptions policy

means a policy document setting out in detail how a *ring-fenced body* makes use of the *hedging exceptions* and which meets the requirements of Chapter 17.

hedging exception transaction

means a transaction entered into in accordance with a *hedging exception*.

income-dependent

means a state in which the *ring-fenced body* would be unable to continue to carry on *core activities* if income to the *ring-fenced body* or any member of the *sub-consolidation group* were to reduce as a result of the acts, omissions or insolvency of a member of the *ring-fenced body's group* that is not a *ring-fenced affiliate*.

intragroup transaction

has the meaning in Article 3 of Regulation (EU) No 648/2012.

liquid asset exception

means:

- (1) in relation to an *excluded activity*, the exception provided for in Article 6(3)(a) of the *Excluded Activities and Prohibitions Order*; or
- (2) in relation to a *prohibition*, the exception provided for in Article 18(b) of the *Excluded Activities and Prohibitions Order*.

liquid asset exceptions policy

means a policy document setting out in detail how a *ring-fenced body* makes use of the *liquid asset exceptions* and which meets the requirements of Chapter 17.

liquid asset exception transaction

means a transaction entered into by in accordance with a *liquid asset exception*.

permitted supplier

means a *person* that provides services or facilities to any other *person* and that is:

- (1) a *group services entity*; or
- (2) a *ring-fenced affiliate*.

prohibition

means a prohibition imposed under the *Excluded Activities and Prohibitions Order*.

relevant person

means:

- (1) a *ring-fenced body*;

- (2) any other *firm* that is a member of a *sub-consolidation group*; or
- (3) a *ring-fenced holding company*.

ring-fenced affiliate

means:

- (1) in relation to a *ring-fenced body*, any member of the *sub-consolidation group* of which the *ring-fenced body* is a member, other than the *ring-fenced body* itself; and
- (2) in relation to a *relevant person*, any member of the *sub-consolidation group* of which the *relevant person* is a member, other than the *relevant person* itself.

ring-fenced holding company

means a body corporate falling within section 192JA(2) of *FSMA* that is the ultimate *parent undertaking* of a *sub-consolidation group*;

ring-fencing obligation

means any obligation, prohibition or other requirement imposed on a *ring-fenced body* by or under *FSMA* by virtue of it being a *ring-fenced body*, including any statutory instrument made under *FSMA* and any *ring-fencing rule*, but not including any *rule* made by the *FCA*.

specified factor

means:

- (1) in relation to an *excluded activity*, any of the factors set out in Article 6(2) of the *Excluded Activities and Prohibitions Order*; or
- (2) in relation to a *prohibition*, any of the factors set out in Article 14(3) of the *Excluded Activities and Prohibitions Order*.

sponsored structured finance vehicle

has the meaning in Article 1 of the *Excluded Activities and Prohibitions Order*.

sub-consolidation group

means the *undertakings* included in the scope of consolidation as a result of a requirement imposed on a *ring-fenced body* under Article 11(5) of the *CRR*.

tier 1 capital ratio

has the meaning in Article 92(2)(b) of the *CRR*.

total capital ratio

has the meaning in Article 92(2)(c) of the *CRR*.

transaction

includes any contract, transaction, or arrangement, which may or may not contain contractual terms.

1.3 For the purposes of this Part:

- (1) a *director* is regarded as independent if he or she is not disqualified by virtue of falling within any of 1.3(2)(a) to (h).
- (2) a *director* is not regarded as independent if he or she:
 - (a) has been an *employee* of the *ring-fenced body* or of any other member of its *group* within the period of five years before his or her appointment as a *director* (but a non-executive *director* is not to be regarded as an *employee* for this purpose);
 - (b) has, or has had, within the period of three years before appointment, a material business relationship with the *ring-fenced body* or any other member of its *group* either directly, or as a partner, shareholder, *director* or as a member of *senior management* or equivalent of an *undertaking* that has such a relationship with the *ring-fenced body* or other member of its *group*, as the case may be;
 - (c) has received or receives fixed or variable *remuneration* from the *ring-fenced body* or any other member of its *group*, other than a *director's* fee or *remuneration* attributable to a period of service that concluded five years before his or her appointment as a *director*;
 - (d) has a *close family tie* with any of the following:
 - (i) an individual who provides or has provided professional or business advice (whether in his or her individual capacity or otherwise) to the *ring-fenced body* or any other member of its *group*;
 - (ii) a *director* of the *ring-fenced body* or of any other member of its *group*; or
 - (iii) a member of *senior management* or equivalent of the *ring-fenced body* or of any other member of its *group*;
 - (e) holds a directorship in any other *undertaking* that is not a member of the *ring-fenced body's group* of which any other *director* of the *ring-fenced body* is also a *director*;
 - (f) has a link, of a nature that might reasonably be expected to give rise to a conflict that is to be identified under 3.2, with any other *director* of the *ring-fenced body* through involvement in any other *undertaking* that is not a member of the *ring-fenced body's group*;
 - (g) can reasonably be identified as representing or otherwise associated with the interests of a particular shareholder or shareholders of a *parent undertaking* of the *ring-fenced body* where that shareholder is or those shareholders are able to exercise significant influence over the management of the *parent undertaking*; or
 - (h) has served on the *governing body* of the *ring-fenced body* or of any other member of its *group* for more than nine years from the date of first election.

1.4 Unless otherwise defined, any italicised expression used in this Part and in the *CRR* has the same meaning as in the *CRR*.

2 APPLICATION OF RULES WITHIN A SUB-CONSOLIDATION GROUP

- 2.1 In this Chapter, “*relevant rule*” means each of the rules in:
- (1) 3.5;
 - (2) 9.1;
 - (3) Chapter 12 other than 12.1; and
 - (4) Chapters 11, 13, 14, 15 and 16.
- 2.2 Subject to 2.3 and 2.4:
- (1) a *relevant person* that is not a *ring-fenced body* must comply with each *relevant rule* as if it were a *ring-fenced body*; and
 - (2) a *relevant person* must ensure each of its *ring-fenced affiliates* that is not a *relevant person* complies with each *relevant rule* as if it were a *ring-fenced body*.
- 2.3 In applying this Chapter to Chapter 11, the notice required under 11.1 must be provided only by a *relevant person*.
- 2.4 In applying this Chapter to Chapter 12:
- (1) the reference to 12.1 in 12.3 does not apply; and
 - (2) compliance by a *ring-fenced body*(RB) with 12.3 to 12.5 in relation to a *ring-fenced affiliate*(RA) that is not a *ring-fenced body* is sufficient to establish compliance by any *relevant person* that is a *ring-fenced affiliate* of RB with those rules in relation to RA.
- 2.5 Without prejudice to 2.2, a *ring-fenced body* that is required under Article 11(5) of the CRR to comply with obligations on a *sub-consolidated basis* must ensure that:
- (1) responsibility for the matters in 2.6 is allocated to:
 - (a) a single *ring-fenced body* in its *sub-consolidation group*; or
 - (b) the *ring-fenced holding company* but only if a *person* employed by it or an *officer* of it performs a *PRA senior management function* in relation to a *ring-fenced body* in the *sub-consolidation group*; and
 - (2) the allocation is documented and notified to the *PRA*.
- 2.6 The matters referred to in 2.5(1) are:
- (1) ensuring the performance by each *ring-fenced body* of its *ring-fencing obligations*; and
 - (2) ensuring the performance by each *relevant person* in the *sub-consolidation group* of its obligations under 2.2.
- 2.7 Without prejudice to 2.2, the *person* allocated with responsibility under 2.5(1) must:
- (1) discharge the responsibility; and

- (2) document and keep updated the arrangements and processes that enable it to discharge the responsibility.
- 2.8 Without prejudice to 3.4, the *person* allocated with responsibility under 2.5(1) must be able to demonstrate to the *PRA*:
- (1) compliance with *ring-fencing obligations* by any *ring-fenced body* within the *sub-consolidation group*;
 - (2) compliance with *relevant rules* by any *ring-fenced affiliate*, other than a *ring-fenced body*, as if it were a *ring-fenced body*, subject to 2.3 and 2.4;
 - (3) compliance with 10.1 by any *ring-fenced affiliate* that is not a *ring-fenced body* but is a *CRR firm*; and
 - (4) the extent to which any *ring-fenced body* within the *sub-consolidation group* and its *ring-fenced affiliates* have acted in accordance with any guidance given by the *PRA* relating to *ring-fenced bodies* or *ring-fenced affiliates*.

3 GENERAL RULES

- 3.1 A *ring-fenced body* must, in carrying on its business, ensure that it is able to take decisions independently of other members of its *group*.
- 3.2 A *ring-fenced body* must establish and maintain arrangements to identify and manage any conflict between:
- (1) any duty a *director* or a member of *senior management* owes to the *ring-fenced body*; and
 - (2) any interest of the *director* or member of *senior management*.
- 3.3 A *ring-fenced body* must take all reasonable steps to identify and manage any conflict between its interests and those of one or more members of its *group*.
- 3.4 A *ring-fenced body* must be able to demonstrate to the *PRA*:
- (1) its compliance with every *ring-fencing obligation*; and
 - (2) the extent to which it has acted, if it has chosen to do so, in accordance with any guidance given by the *PRA* to *ring-fenced bodies* and which relates to the operation of the *ring-fencing obligations*.
- 3.5 A *ring-fenced body* must ensure, as far as reasonably practicable, it applies the same standards to the management of its:
- (1) exposures to any member of its *group* that is not a *ring-fenced affiliate* as it would to the management of its exposures to any *person* that is not a member of its *group*; and
 - (2) *transactions* with any member of its *group* that is not a *ring-fenced affiliate* as it would to the management of its *transactions* with any *person* that is not a member of its *group*,

to ensure that the carrying on of *core activities* is not adversely affected by the acts, omissions or insolvency of that other *group member*.

4 BOARD COMPOSITION AND MEMBERSHIP

- 4.1 A *ring-fenced body* must ensure that at least half of the members for the time being of its *governing body* are independent *non-executive directors*.
- 4.2 For the purposes of 4.1:
 - (1) the chairperson of a *ring-fenced body's governing body* is not to be counted as one of the number of independent *non-executive directors* or as one of the total number of members for the time being of the *governing body*; and
 - (2) where an *extraordinary vacancy* arises which, if not filled, would cause the *ring-fenced body* to fail to comply with 4.1, the *ring-fenced body* must fill the vacancy as soon as reasonably possible after the vacancy has arisen, and will not be in breach of 4.1 while it is in the course of so doing.
- 4.3 A *ring-fenced body* must ensure that the *person performing the Chairman function*:
 - (1) is an independent *non-executive director*; and
 - (2) does not chair the *governing body* of any other member of the *ring-fenced body's group*, other than a *ring-fenced affiliate*.
- 4.4 A *ring-fenced body* must ensure that no more than one-third of the members of its *governing body* are *employees* of or *directors* of any other member of the *ring-fenced body's group*, other than of a *ring-fenced affiliate*.
- 4.5 A *ring-fenced body* must ensure that it publicly advertises every vacancy for an independent *non-executive director* so as to bring the existence of the vacancy to the notice of those members of the public who might reasonably be expected to seek nomination.
- 4.6 4.5 does not apply if an *extraordinary vacancy* arises in the office held by the *person performing the Chairman function* of a *ring-fenced body*.
- 4.7 A *ring-fenced body* must ensure that none of its *senior management* who is a member of its *governing body* is an executive member of the *governing body* of any other member of the *ring-fenced body's group*, other than a member that is:
 - (1) a body corporate falling within section 192JA(2) of *FSMA*; or
 - (2) a *ring-fenced affiliate*.
- 4.8 For the purpose of 4.7, 'executive member' means a *person* who performs any executive function in relation to the relevant member of the *ring-fenced body's group*.

5 RISK MANAGEMENT

- 5.1 A *ring-fenced body* must ensure that its risk committee includes a *person* performing the *Chairman of Risk Committee function*.
- 5.2 A *ring-fenced body* must ensure that the *person* performing the *Chairman of Risk Committee function* does not chair any committee whose functions include oversight of the risk function of any other member of the *ring-fenced body's group*, other than a *ring-fenced affiliate*.
- 5.3 A *ring-fenced body* must ensure that:
 - (1) its risk management function has sufficient resources to perform its role, including the identification, monitoring and management of risk;
 - (2) those resources are at all times identifiable as performing the risk management function for the *ring-fenced body*; and
 - (3) its risk management function supports the ability of the *ring-fenced body* to comply with 3.1.
- 5.4 A *ring-fenced body* must ensure that a *person* performing the *Chief Risk function* for the *ring-fenced body* is not also a *person* performing the *Chief Risk function* or function equivalent to the *Chief Risk function* (howsoever designated) for any other member of the *ring-fenced body's group* or for the *group*, other than for a *ring-fenced affiliate* or for the *sub-consolidation group*.

6 INTERNAL AUDIT POLICY

- 6.1 A *ring-fenced body* must ensure that its *audit committee* includes a *person* performing the *Chairman of Audit Committee function*.
- 6.2 A *ring-fenced body* must ensure that the *person* performing the *Chairman of Audit Committee function* does not chair any committee whose functions include oversight of the audit function of any other member of the *ring-fenced body's group*, other than a *ring-fenced affiliate*.
- 6.3 A *ring-fenced body* must ensure that:
 - (1) its internal audit function has sufficient resources to perform its role;
 - (2) those resources are at all times identifiable as performing the internal audit function for the *ring-fenced body*; and
 - (3) its internal audit function supports the ability of the *ring-fenced body* to comply with 3.1.
- 6.4 A *ring-fenced body* must ensure that a *person* performing the *Head of Internal Audit function* for the *ring-fenced body*:
 - (1) is not also a *person* performing the *Head of Internal Audit function* or function equivalent to the *Head of Internal Audit function* (howsoever designated) for any other member of the *ring-fenced body's group* or for the *group*, other than for a *ring-fenced affiliate* or for the *sub-consolidation group*; and

- (2) is able to have direct access to the *management body* of the *ring-fenced body* where he or she considers it necessary.

7 HUMAN RESOURCES POLICY

- 7.1 A *ring-fenced body* must ensure that its nomination committee includes a chairperson.
- 7.2 A *ring-fenced body* must ensure that the chairperson of its nomination committee does not chair any committee whose functions include nomination for any other member of the *ring-fenced body's group*, other than a *ring-fenced affiliate*.
- 7.3 A *ring-fenced body* must ensure as far as reasonably practicable that, in carrying on its business, it does not depend on any *employee* who may cease to be available to undertake work for the *ring-fenced body* in the event of the insolvency of any other member of its *group* and that this is reflected in its human resources policy.

8 REMUNERATION POLICY

- 8.1 A *ring-fenced body* must establish a *remuneration committee* that comprises only members of its *management body* who do not perform any executive function in relation to the *ring-fenced body*.
- 8.2 A *ring-fenced body* must ensure that its *remuneration committee* includes a *person* performing the *Chairman of Remuneration Committee function*.
- 8.3 A *ring-fenced body* must ensure that the *person* performing the *Chairman of Remuneration Committee function* does not chair any committee whose functions include *remuneration* for any other member of the *ring-fenced body's group*, other than for a *ring-fenced affiliate*.
- 8.4 When establishing, implementing and maintaining *remuneration* policies, practices and procedures for its *employees*, a *ring-fenced body* must ensure that these *remuneration* policies, practices and procedures:
- (1) are consistent with and promote the sound and effective risk management of the *ring-fenced body*;
 - (2) do not encourage risk-taking that exceeds the level of tolerated risk of the *ring-fenced body*;
 - (3) are in line with the business strategy, objectives, values and long-term interests of the *ring-fenced body*; and
 - (4) do not encourage a *ring-fenced body* to bear any risk that would undermine its ability to comply with any *ring-fencing obligation*.
- 8.5 Nothing in 8.4 restricts a *ring-fenced body* from enabling the receipt by its *employees* of *remuneration* in the form of shares or other instruments of another member of the *ring-fenced body's group*, provided that the receipt of such *remuneration* is in accordance with 8.4.

9 CONTINUITY OF PROVISION OF SERVICES

- 9.1 Where a *ring-fenced body* receives services and accesses facilities that it requires on a regular basis from an entity in its *group*, it may do so, whether directly or indirectly, only where that entity is a *permitted supplier*.
- 9.2 A *ring-fenced body* must ensure the agreement and any related arrangement under which it receives services or accesses facilities it requires in relation to the carrying on of *core activities* does not permit any other party to terminate, suspend or materially alter the services or facilities or the agreement or arrangement as a result of an act, omission or deterioration in the financial circumstances of another entity within the same *group* as the *ring-fenced body*.
- 9.3
 - (1) 9.3(2) applies if the ability of a *permitted supplier* (PS1) that provides services or facilities referred to in 9.2 to a *ring-fenced body* is dependent upon the provision of services or facilities to PS1 by another *permitted supplier* (PS2), whether the provision of services or facilities to PS1 by PS2 is direct or indirect.
 - (2) 9.2 does not prevent the *ring-fenced body* agreeing PS1 may suspend or alter the provision of those services or facilities to the extent it is prevented from providing those services or facilities as a result of a deterioration in the financial circumstances of PS2, provided:
 - (a) the *ring-fenced body* takes all reasonable steps before and after entering into that agreement to reduce the probability and likely impact of such an alteration to the provision of those services or facilities; and
 - (b) the agreement requires PS1 to use its best efforts to eliminate or reduce the effect of any such suspension or alteration.

10 INTRAGROUP CREDIT VALUATION ADJUSTMENT RISK

- 10.1 A *ring-fenced body* and a *ring-fenced affiliate* that is a *CRR firm* must include an *intragroup transaction* in its calculation of its *own funds* requirements for credit valuation adjustment risk in accordance with Part 3, Title VI of the *CRR* where the *intragroup transaction* is entered into with a member of its *group* that is not a *ring-fenced affiliate*.
- 10.2 A *ring-fenced body* that is required under Article 11(5) of the *CRR* to comply with obligations on a *sub-consolidated basis* must comply with rule 10.1 on that *sub-consolidated basis*.

[Note: Art. 382(4)(b) of the CRR]

11 DISTRIBUTIONS

- 11.1 A *ring-fenced body* must not make a *distribution* to any entity in its *group* that is not a *ring-fenced affiliate* unless it has given reasonable notice to the *PRA* of its intention to make the payment.
- 11.2 When a *ring-fenced body* gives notice under 11.1 it must include the following:
 - (1) the amount of the intended *distribution*;
 - (2) the date on which the *distribution* is intended to be paid;
 - (3) the current *common equity tier 1 capital ratio*, *tier 1 capital ratio* and *total capital ratio* held by each *ring-fenced body* in its *group*; and
 - (4) any relevant supporting information, including an assessment of any impact of the intended *distribution* on the current and forecast capital position of each *ring-fenced body* in its *group*.
- 11.3 The information in 11.2(3) and (4) must also be provided on a *sub-consolidated basis* in respect of any *ring-fenced body* that is required under Article 11(5) of the *CRR* to comply with obligations on a *sub-consolidated basis*.
- 11.4 The information in 11.2 must be approved by an appropriate *PRA approved person* who performs a *controlled function* in relation to a *firm* in the *sub-consolidation group* and that *PRA approved person* must be named in the notice.

12 ARM'S LENGTH TRANSACTIONS

- 12.1 A *ring-fenced body* must enter into a *transaction* with a *ring-fenced affiliate* only on arm's length terms.
- 12.2 A *ring-fenced body* must enter into a *transaction* with a member of its *group* which is not a *ring-fenced affiliate* only on arm's length terms.
- 12.3 A *ring-fenced body* must establish, implement and maintain an effective policy and procedures to identify and evaluate *transactions* entered into with other members of its *group* to enable compliance with the obligations in 12.1 and 12.2.
- 12.4 A *ring-fenced body's arm's length policy* must at least:
 - (1) establish robust means for identification, timely recording and monitoring of all *transactions* entered into with other *group* members;
 - (2) specify how the terms of a *transaction* will be determined, including pricing and settlement;
 - (3) specify appropriate governance arrangements for amendments to the policy and procedures;
 - (4) specify processes for approval and reporting of exceptions to the policy and procedures; and

- (5) include procedures for dispute resolution between the *ring-fenced body* and members of its *group* with which it transacts.
- 12.5 A *ring-fenced body's arm's length procedures* must include at least:
- (1) approval of the *arm's length policy* by its *governing body*;
 - (2) review by the *governing body* of the *arm's length policy* at least annually taking into account the report of the internal audit function under 12.5(5) and the reports under 12.5(3);
 - (3) the provision of internal reports to its *governing body* on the operation of the *arm's length policy* including the extent to which the *ring-fenced body's transactions* comply with its *arm's length policy*;
 - (4) periodic assessment of the following matters by its internal audit function:
 - (a) the extent to which the *arm's length policy* complies with the requirements of this Chapter;
 - (b) the effectiveness of the *arm's length policy*; and
 - (c) the effectiveness of the procedures established in compliance with this Chapter.
 - (5) provision of a report from the internal audit function to the *governing body* on its assessment of the matters in 12.5(4).

13 INCOME DEPENDENCE

- 13.1 A *ring-fenced body* must not, as far as reasonably practicable, become *income-dependent* due to income generated from:
- (1) transactions entered into with members of its *group* that are not *ring-fenced affiliates*; or
 - (2) transactions entered into with a customer, or customers, where that income is contingent, or likely to be contingent, on services continuing to be provided to that customer, or customers, by members of the *ring-fenced body's group* that are not *ring-fenced affiliates*.

14 NETTING ARRANGEMENTS

- 14.1 A *ring-fenced body* must not enter into a netting arrangement if the effect of the netting arrangement is to permit a *person*, other than a member of the *ring-fenced body's group*, to offset its liabilities to the *ring-fenced body* against its claims on any member of the *ring-fenced body's group* that is not a *ring-fenced affiliate* in the event of default of any party to the netting arrangement.

15 AVAILABILITY OF COLLATERAL

- 15.1 A *ring-fenced body* must ensure that any collateral provided by its counterparties would not cease to be available to the *ring-fenced body* as a result of the acts, omissions or insolvency of, or actions taken in relation to, a member of the *ring-fenced body's group* that is not a *ring-fenced affiliate*.

16 ACCESS TO CENTRAL COUNTERPARTIES AND CENTRAL SECURITIES DEPOSITORIES

- 16.1 This Chapter applies if a *ring-fenced body* accesses the services of:
- (1) a *central counterparty* whether as a *clearing member* or otherwise; or
 - (2) a central securities depository whether as a participant or otherwise.
- 16.2 In this Chapter:
- (1) central securities depository has the meaning set out in Article 2.1(1) of Regulation (EU) No 909/2014, and includes a 'securities settlement system' as defined in that regulation;
 - (2) participant has the meaning set out in Article 2.1(19) of Regulation (EU) No 909/2014; and
 - (3) for the avoidance of doubt:
 - (a) the definitions of *central counterparty* and *clearing member* apply for the purposes of this Chapter whether or not the *central counterparty* or *clearing member* is regulated by Regulation (EU) No. 648/2012, or is established in an *EEA state* or elsewhere; and
 - (b) the definitions of central securities depository and participant apply for the purposes of this Chapter whether or not the central securities depository or participant is regulated by Regulation (EU) No. 909/2014, or is established in an *EEA state* or elsewhere.
- 16.3 For the purposes of this Chapter, if a *ring-fenced body* accesses the services of a *central counterparty* or a central securities depository not established in an *EEA state* or any part of whose operations are not subject to the law of an *EEA state*, the *ring-fenced body* will be considered to comply with the *rules* in this Chapter if it has taken necessary steps to ensure that its positions, if applicable, and assets are identifiable separately from the positions, if applicable, and assets of any other *person* by measures equivalent to those set out in the *rules* in this Chapter in affording the same level of protection.
- 16.4 If a *ring-fenced body* accesses the services of a *central counterparty* as a *clearing member*, it must ensure the positions and assets held for its account are distinguished in accounts at the *central counterparty* from the positions and assets held for the account of any other *clearing member* and of the *central counterparty*.

- 16.5 If a *ring-fenced body* accesses the services of a *central counterparty* through a *clearing member*, it must ensure the positions and assets held for its account are distinguished:
- (1) in accounts at the *central counterparty* from the positions and assets held for the account of the *clearing member* and either:
 - (a) the positions and assets held for the account of the *ring-fenced body* are distinguished in accounts at the *central counterparty* from the positions and assets held for the account of all other clients of that *clearing member*, or
 - (b) the value of assets required by the *central counterparty* as margin to cover the positions held for the account of all clients of that *clearing member* including the *ring-fenced body* within the account at the *central counterparty* is calculated on a gross basis, such that the value is at least equal to the sum of the margin amounts that would be required by the *central counterparty* for each individual client within that account if each individual client were a *clearing member*; and
 - (2) in accounts at the *clearing member* from the positions and assets held for the account of the *clearing member's* other clients and of the *clearing member*.
- 16.6 If a *ring-fenced body* accesses the services of a central securities depository as a participant, it must ensure any assets held for its account at the central securities depository are distinguished in accounts at the central securities depository from the assets held for the account of any other participant and of the central securities depository.
- 16.7 If a *ring-fenced body* accesses the services of a central securities depository through a participant, it must ensure any assets held for its account are distinguished:
- (1) in accounts at the central securities depository from the assets held for the account of the participant and of all other clients of that participant; and
 - (2) in accounts at the participant from the assets held for the account of the participant's other clients and of the participant.

17 POLICIES REGARDING USE OF EXCEPTIONS TO EXCLUDED ACTIVITIES AND PROHIBITIONS

- 17.1 For each *exception* separately, a *ring-fenced body* must establish, implement and maintain an effective policy that sets out at least the following:
- (1) the types of *exception transactions* that are permitted to be entered into under the relevant *exceptions policy* including details on at least the following aspects:
 - (a) the specific types of instrument or contract which are permitted;
 - (b) the features of instruments or contracts which are permitted, including permitted underlying collateral where the instrument or contract references underlying collateral;
 - (c) permitted counterparties or types of counterparties; and
 - (d) the permitted terms or maturities of instruments or contracts;

- (2) how the types of *exception transactions* that are permitted to be entered into and any related limit frameworks are integrated into the risk management framework of the *ring-fenced body* including its risk appetite;
- (3) how the *ring-fenced body* determines that the sole or main purpose of an *exception transaction* is and continues to be:
 - (a) for a *hedging exception transaction*, to limit the extent to which:
 - (i) the *ring-fenced body*,
 - (ii) any *subsidiary undertaking* of the *ring-fenced body*,
 - (iii) any *sponsored structured finance vehicle* of the *ring-fenced body*,
 - (iv) any *conduit vehicle* of the *ring-fenced body*, or
 - (v) any combination of the *undertakings* referred to in (i) to (iv)

will be adversely affected by the *specified factor*;
 - (b) for a *liquidity asset exception transaction*, to manage the liquidity of the *ring-fenced body*; and
 - (c) for a *collateral exception transaction*, to provide collateral in relation to *hedging exception transactions*;
- (4) which individual or committee within the *ring-fenced body* has day to day responsibility for approval and oversight for *exception transactions* including:
 - (a) how, or in which circumstances, any responsibility is shared or delegated; and
 - (b) which *exception transactions* are escalated for approval, and the approval route including any *exception transactions* that are required to be subject to direct approval by the *governing body*, or a subcommittee of the *governing body* or other senior executive committees;
- (5) any differences in use of the *exception transactions* between the *trading book* and the non-trading book;
- (6) third party documentation that the *ring-fenced body* requires to be in place prior to execution of an *exception transaction*;
- (7) how the *ring-fenced body* separately identifies, manages and controls *exception transactions* from other transactions;
- (8) how the *ring-fenced body* identifies and manages any additional or second-order risks introduced by *exception transactions*;
- (9) how the *ring-fenced body* considers the likely performance of *exception transactions* in stress scenarios (both market wide and idiosyncratic) and how it uses reverse stress testing techniques to identify any potential areas of over-reliance; and
- (10) a description of the internal reporting process, including significant internal reporting outputs, that the entity has put in place to monitor adherence to the *exception policies*.

- 17.2 A *ring-fenced body* must set out the policies in 17.1 in relation to the *hedging exceptions* separately for each *specified factor*.
- 17.3 In addition to 17.1, a *ring-fenced body* must set out in its *hedging exceptions policy* separately for each *specified factor*.
- (1) how the business of:
 - (a) the *ring-fenced body*;
 - (b) any *subsidiary undertaking* of the *ring-fenced body*;
 - (c) any *sponsored structured finance vehicle* of the *ring-fenced body*;
 - (d) any *conduit vehicle* of the *ring-fenced body*; or
 - (e) any combination of the *undertakings* referred to in (a) to (d) results in exposures to the *specified factor*;
 - (2) how the *ring-fenced body* separately identifies, monitors and controls those *hedging exception transactions* it enters into which relate to customer derivative transactions for the purpose of monitoring the position risk requirement as required by Article 12(1)(a) of the *Excluded Activities and Prohibitions Order*;
 - (3) how the *ring-fenced body* assesses the effectiveness of *hedging exception transactions* including what quantitative assessments are performed; and
 - (4) the policies of the *ring-fenced body* in relation to hedging of anticipated transactions or exposures, including the limits it places on *hedging exception transactions* which relate to anticipated transactions or exposures and the process it follows to identify, monitor, control, report and assess *hedging exception transactions* which relate to anticipated transactions or exposures separately from other *hedging exception transactions*.
- 17.4 A *ring-fenced body* must ensure its *exceptions policies* are lawful and act in accordance with its *exceptions policies* as long as these policies are lawful.
- 17.5 A *ring-fenced body* must ensure its *exceptions policies* are:
- (1) approved by the *governing body*; and
 - (2) reviewed by the *governing body* at least annually taking into account the reports under 17.7 and 17.8.
- 17.6 A *ring-fenced body* must put in place and implement procedures to operationalise its *exceptions policies* including internal reporting and oversight.
- 17.7 A *ring-fenced body* must ensure that its *governing body* periodically receives internal reports on the operation of the *exceptions policies*, including:
- (1) transactions entered into under each of the *exceptions policies*; and
 - (2) the extent to which these transactions comply with the *exceptions policies*.

- 17.8 A *ring-fenced body* must ensure that its internal audit function assesses the following matters periodically and reports its findings to its *governing body*:
- (1) the extent to which the *exceptions policies* comply with the requirements of this Chapter and with the *ring-fenced body's* statutory obligations;
 - (2) the effectiveness of the *exceptions policies*; and
 - (3) the effectiveness of the procedures established in compliance with this Chapter.

18 APPLICATION OF CERTAIN PRA RULES TO RING-FENCED BODIES ON A SUB-CONSOLIDATED BASIS

- 18.1 A *ring-fenced body* that is required under Article 11(5) of the *CRR* to comply with obligations on a *sub-consolidated basis* must comply with the following provisions of the *PRA Rulebook* on that *sub-consolidated basis*:
- (1) the *ICAAP rules* in the Internal Capital Adequacy Assessment Part;
 - (2) the *risk control rules* in the Internal Capital Adequacy Assessment Part;
 - (3) the overall financial adequacy rule in Internal Capital Adequacy Assessment Part 2.1;
 - (4) Chapter 15 of the Internal Capital Adequacy Assessment Part;
 - (5) the Capital Buffers Part;
 - (6) the Internal Liquidity Adequacy Assessment Part;
 - (7) 2.1 (read with 2.2), 2.6, 2A.2, Chapter 5 and Chapter 6 of the General Organisational Requirements Part;
 - (8) 3.2 of the Skills, Knowledge and Expertise Part;
 - (9) 2.3, 2.7 and Chapter 3 of the Risk Control Part;
 - (10) 2.1(2) (read with 2.2) and 2.4 of the Group Risk Systems Part¹;
 - (11) the Remuneration Part;
 - (12) the Public Disclosure Part;
 - (13) the Benchmarking of Internal Approaches Part; and
 - (14) the Reporting Pillar 2 Part.
- 18.2 A *ring-fenced body* that is required under Article 11(5) of the *CRR* to comply with obligations on a *sub-consolidated basis* must comply with the obligations under the Capital Requirements (Country-by-Country Reporting) Regulations 2013 (SI 2013/3118) on that *sub-consolidated*

¹ This proposed new Part of the PRA Rulebook is being consulted upon as part of CP 28/15.

basis. For the avoidance of doubt, the treatment provided for in Regulations 4 and 5 of those regulations is available (with the necessary changes) to the *ring-fenced body* in its seeking to comply with this *rule* on a *sub-consolidated basis*.

[**Note: Art. 71, 73-76, 78-96, 98, 123, 129, 130, 140-142 of the CRD.**]

19 APPLICATION FOR PERMISSION FOR INDIRECT ACCESS TO INTER-BANK PAYMENT SYSTEMS

- 19.1 The *PRA* directs that any *ring-fenced body* wishing to apply for permission under Article 13 of the *Excluded Activities and Prohibition Order* must:
 - (1) complete the relevant form on the *PRA*'s website;
 - (2) ensure the application is accompanied by information specified in the relevant form; and
 - (3) submit it in the manner set out in the relevant form.

Externally defined glossary terms²

Term	Definition source
central counterparty	Article 4(1)(34) CRR
civil partnership	Interpretation Act 1978 Schedule 1
clearing member	Article 300(3) CRR
core activity	S417 FSMA
EEA state	Interpretation Act 1978 Schedule 1
excluded activity	S417 FSMA
the FCA	S417 FSMA
group	S421 FSMA
parent undertaking	S420 FSMA
person	Interpretation Act 1978 Schedule 1
ring-fenced body	S417 FSMA
ring-fencing rules	S417 FSMA
rule	S417 FSMA
sub-consolidated basis	Article 4(1)(49) CRR
subsidiary undertaking	s420 FSMA
trading book	Article 4(1)(86) CRR

² Please note that this list of externally defined terms is not part of the draft rules and is published together with the rules only to facilitate the understanding of certain defined terms used in the draft rules as part of the consultation.

Annex B

Amendments to the Glossary

In the Glossary Part of the PRA Rulebook, insert the following new definitions:

audit committee

means a committee established in accordance with Audit Committee 2.1.³

Chairman function

has the meaning given in Senior Management Functions 4.2.

Chairman of Audit Committee function

has the meaning given in Senior Management Functions 4.4.

Chairman of Remuneration Committee function

has the meaning given in Senior Management Functions 4.5.

Chairman of Risk Committee function

has the meaning given in Senior Management Functions 4.3.

Chief Risk function

has the meaning given in Senior Management Functions 3.4.

Head of Internal Audit function

has the meaning given in Senior Management Functions 3.5.

ICAAP rules

means the *rules* in Chapter 3 (Strategies, processes and systems), Chapter 12 (Stress test and scenario analysis) and Chapter 13 (Documentation or risk assessments) of the Internal Capital Adequacy Assessment Part.

risk control rules

means the *rules* in Chapter 4 to Chapter 11 of the Internal Capital Adequacy Assessment Part.

³ See draft rules consulted upon as part of CP 34/15 for the proposed definition of “audit committee”.

Annex C

Amendments to the Audit Committee Part

In this Annex, deleted text is struck through.

...

1.2 In this Part, the following definitions shall apply:

audit committee

~~means a committee established in accordance with 2.1.~~

...

Annex D

Amendments to the Senior Management Functions Part

In this Annex, deleted text is struck through.

...

- 1.2 In this Part, the following definitions shall apply:

Chairman function

~~has the meaning given in 4.2.~~

Chairman of Audit Committee function

~~has the meaning given in 4.4.~~

Chairman of Remuneration Committee function

~~has the meaning given in 4.5.~~

Chairman of Risk Committee function

~~has the meaning given in 4.3.~~

...

Head of Internal Audit function

~~has the meaning given in Senior Management Functions 3.5.~~

Chief Risk function

~~has the meaning given in Senior Management Functions 3.4.~~

...

Annex E

Amendments to the Allocation of Responsibilities Part

In this Annex, deleted text is struck through.

...

1.2 In this Part, the following definitions shall apply:

...

Chairman function

has the meaning given in 4.2.

Chief Risk function

has the meaning given in Senior Management Functions 3.4.

...

Annex F

Amendments to the Internal Capital Adequacy Assessment Part

In this Annex, deleted text is struck through.

...

1.2 In this Part, the following definitions shall apply:

...

ICAAP rules

~~means the rules in Chapter 3 (Strategies, processes and systems), Chapter 12 (Stress test and scenario analysis) and Chapter 13 (Documentation or risk assessments).~~

...

risk control rules

~~means the rules in Chapter 4 to Chapter 11 of this Part.~~

...

Annex G

Amendments to the Interpretation Part

In this Annex, new text is underlined and deleted text is struck through.

1 APPLICATION

- 1.1 Unless otherwise stated, this Part applies to ~~a firm and a qualifying parent undertaking~~:
- (1) a firm;
 - (2) a qualifying parent undertaking as defined in section 192B of FSMA; and
 - (3) a body corporate falling within section 192JA(2) of FSMA.
- ...

Appendix 2: Draft supervisory statement: Ring-fenced bodies (RFBs)**Contents**

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1 Introduction

[In this chapter, the text is all new and is not underlined.]

1.1 This supervisory statement is aimed at ring-fenced bodies (RFBs), as defined in Section 142(A) of the Financial Services and Markets Act 2000 (the Act) and parent undertakings of RFBs, as defined in Section 192JA of the Act. The purpose of this supervisory statement is to set out the PRA's expectations of an RFB and members of its group in relation to the ring-fencing of core activities and services.

1.2 This statement should be read alongside the PRA Rulebook, the Capital Requirements Regulation (CRR)¹ and ring-fencing legislation set out in the Act and statutory instruments.² The Ring-fenced Bodies (RFB) Part of the PRA Rulebook in particular sets out PRA rules applicable to RFBs.

1.3 The Financial Services (Banking Reform) Act 2013 amended the PRA's general safety and soundness objective to the effect that, when discharging its general functions in relation to ring-fencing, RFBs and groups containing RFBs, the PRA should seek to:

- ensure that the business of RFBs is carried on in a way that avoids any adverse effect on the continuity of the provision in the United Kingdom of core services;
- ensure that the business of RFBs is protected from risks (arising in the United Kingdom or elsewhere) that could adversely affect the continuity of the provision in the United Kingdom of core services; and
- minimise the risk that the failure of an RFB or of a member of an RFB's group could affect the continuity of the provision in the United Kingdom of core services.³

1.4 The legislation also requires the PRA to make rules to ensure the effective provision to an RFB of services and facilities it requires in relation to carrying on a core activity (which is the regulated activity of accepting deposits) and to make provision for group ring-fencing purposes⁴, which are to ensure as far as reasonably practicable that:

- the carrying on of core activities by an RFB is not adversely affected by the acts or omissions of other members of its group;
- in carrying on its business an RFB:
 - is able to take decisions independently of other members of its group; and
 - does not depend on resources which are provided by a member of its group and which would cease to be available to the RFB in the event of the insolvency of the other member; and
- the RFB would be able to continue to carry on core activities in the event of the insolvency of one or more other members of its group.

1.5 The PRA's general approach to implementing ring-fencing focuses on the outcomes to be achieved, which are informed by the PRA's amended general safety and soundness objective in

¹ Regulation (EU) No 575/2013.

² SI 2014/1960 The Financial Services and Markets Act 2000 (Ring-fenced Bodies and Core Activities) Order 2014; SI 2014/2080 The Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014; and SI 2015/547 The Financial Services and Markets Act 2000 (Banking Reform) (Pensions) Regulations 2015.

³ See section 2B of the Act.

⁴ See section 142H of the Act.

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relation to ring-fencing and the group ring-fencing purposes. The PRA has made provision for the group ring-fencing purposes in the RFB Part of the PRA Rulebook. The PRA's amended objective and the group ring-fencing purposes are also reflected in the PRA's group restructuring powers.¹

1.6 This statement is structured as follows:

- Chapter 2 sets out the PRA's expectations in relation to the legal structure of banking groups containing one or more RFBs.
- Chapter 3 sets out the PRA's expectations relating to the application of requirements to an RFB on a sub-consolidated basis, including the circumstances in which it requires the establishment of an RFB sub-group, the composition of an RFB sub-group, and how prudential requirements are applied on a sub-consolidated basis.
- Chapter 4 sets out the PRA's expectations in relation to the application of capital and liquidity requirements to RFB sub-groups, in particular the Internal Capital Adequacy Assessment (ICAA) and the Internal Liquidity Adequacy Assessment (ILAA) Parts of the PRA Rulebook.
- Chapter 5 sets out the PRA's expectations regarding applications by an RFB and other entities in an RFB sub-group for permissions in relation to intragroup large exposures exemptions and intragroup liquidity permissions (intragroup concessions).
- Chapter 6 sets out the PRA's expectations in relation to the Distributions Chapter of the RFB Part of the PRA Rulebook on the notification that must be made in relation to distributions to group entities outside an RFB sub-group.
- Chapter 7 sets out the PRA's expectations with respect to intragroup commercial relationships, and the management of intragroup exposures.
- Chapter 8 sets out the PRA's expectations on the arrangements that an RFB and other entities in an RFB sub-group may make where they receive services and facilities from other group entities or third parties outside of their group.
- Chapter 9 sets out the PRA's expectations in relation to an RFB's participation in other financial market infrastructures (FMIs), in particular central securities depositories (CSDs) and central counterparties (CCPs).
- Chapter 10 sets out the PRA's expectations with respect to an RFB's exceptions policies.

¹ See section 142K of the Act.

2 Legal structure and holdings of capital

[In this chapter, changes are tracked against the near-final supervisory statement on ring-fenced bodies: legal structure set out in PS10/15 ‘The implementation of ring-fencing: legal structure, governance and the continuity of services and facilities’ available at: www.bankofengland.co.uk/pru/Pages/publications/ps/2015/ps1015.aspx. Underlining indicates new text and striking through indicates deleted text.]

Near final supervisory statement on ring-fenced bodies: legal structure

Introduction

This supervisory statement is aimed at ring-fenced bodies (RFBs) as defined in the Financial Services and Markets Act 2000, section 142A.

2.1 The PRA sets out below its purpose of this supervisory statements is to set out the expectations that the PRA has in relation to the ownership structure of banking groups containing one or more RFBs, in particular in relation to ownership structure and holdings of capital instruments within the group. This The section also content of this supervisory statement sets out some of the factors that the PRA will take into consideration when deciding whether or not to impose requirements in relation to the group ownership structure of such banking groups.

Expectations of banking group structures containing an RFB

2.2 The PRA will seeks to ensure the continuity of the provision of core services by an RFB. Where an RFB’s group structure or holdings of capital instruments in group entities could adversely affect the safety and soundness of the RFB and therefore pose risks to the continuity of provision of core services, the PRA may use its powers under section 55M or section 192C of the Act to impose requirements on such an RFB or give a direction to a qualifying parent undertaking respectively.

Expectations of the types of entity that an RFB may own or hold capital instruments in

2.3 The PRA’s expectation is that expects an RFB must not to have ownership rights or hold capital instruments in an entity that undertakes activities that, if it were an RFB, would amount to activities that would contravene a prohibition or be excluded activities under the Act (for the purpose of this statement: an ‘excluded activity entity’). An RFB should also not hold capital instruments in a subsidiary of an excluded activity entity. Ownership rights may include voting rights and other rights to participate in the capital or profits of the relevant entity. Capital instruments include those which qualify as Common Equity Tier 1, Additional Tier 1 or Tier 2 instruments under the CRR.

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2.4 The PRA similarly expects that where an RFB sub-group is formed, all entities in the RFB sub-group must meet these expectations, ie the PRA expects that no such entity should have ownership rights or hold capital instruments in an excluded activity entity or a subsidiary of an excluded activity entity. These expectations This reduces the risk of losses associated with, for example, international or investment banking activity weakening the RFB directly or through entities in its RFB sub-group. As a result, this approach helps to ensure the continuity of the provision of core services by implementing ring-fencing with regard to improving the resilience of the RFBs. It may also reduce the complications associated with the possible resolution and/or failure of a subsidiary if it undertook activities that would be prohibited or excluded activities if it were an RFB.

2.5 The PRA will adopt this approach proportionately to achieve the outcomes set out by the group ring-fencing purposes of the Act.

2.6 In principle, the PRA does not necessarily object to an RFB or entities in an RFB sub-group owning entities which are not excluded activity entities or holding the capital instruments of such entities. Such ownership holdings would be considered on a case-by-case basis, based on the risks that it they might pose to the RFB's resilience and resolvability and the PRA's objectives. In particular, such an assessment would consider whether the entity — if it were owned by the RFB or a member of its sub-group — would represent a material threat to:

- ensuring that the RFB does not depend on resources provided by other members of its group that would cease to be available in the event of the insolvency of the other member;
- ensuring, as far as reasonably practicable, that the RFB would be able to continue to carry on core activities in the event of the insolvency of other group members; or
- ensuring that the business of RFBs is protected from risks (arising in the United Kingdom or elsewhere) that could adversely affect the continuity of the provision in the United Kingdom of core services.

Expectations of the types of entity that may own an RFB or hold an RFB's capital instruments

2.7 Within a UK group (that is, the group headed by the ultimate UK parent), the PRA does not expect an excluded activity entity, or a subsidiary of an excluded activity entity, to have ownership rights or hold capital instruments in an RFB or any other member of an RFB sub-group. This policy supports the group ring-fencing purposes outlined in the Act, in particular: the RFB's ability to make independent decisions in accordance with the group ring fencing purposes; insulating the RFB from the acts or omissions of its group; and limiting the reliance of the RFB on resources provided by other members of its group. It may also reduce the complications of successfully resolving an RFB or its group. The PRA would will adopt this approach proportionately to achieve the outcomes set out in the group ring-fencing purposes. The PRA expects that the owner of an RFB may maintain or establish a non-EEA branch, have a participating interest in a non-EEA undertaking or have ownership stakes in an excluded activity entity.

2.8 In assessing whether an entity that is not an excluded activity entity should be restricted from owning an RFB (or a member of its sub-group) within the UK group, the PRA will consider, as part of the assessment required under the Act, the resilience and resolvability of the RFB

and risks posed to the continuity of provision of core activities. This assessment will include the extent to which:

- the RFB is able to make decisions independently of group entities where required by the Act;
- the RFB is not reliant on resources in group entities (for example capital resources) which may cease to be available in the event of insolvency of that group entity; and
- the RFB is sufficiently insulated from risks in the rest of the group, so as to ensure it is not adversely affected by the acts or omissions of group entities.

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3 Application of requirements on a sub-consolidated basis

[In this chapter, the text is all new and is not underlined.]

Introduction

3.1 This chapter sets out the PRA's approach to requiring an RFB to meet prudential requirements on a sub-consolidated basis, including the circumstances in which it will constitute an RFB sub-group and how it decides the composition of an RFB sub-group. An RFB sub-group is a sub-set of related group entities within a consolidated group, consisting of one or more RFBs and other legal entities, which is established when the PRA gives effect to Article 11(5) of the CRR.

3.2 The section also sets out the process by which the PRA will give effect to the application of prudential requirements on a sub-consolidated basis.

Establishment of an RFB sub-group

3.3 Article 11(5) of the CRR permits competent authorities to require firms to comply with prudential requirements on a sub-consolidated basis¹ in certain circumstances, in addition to the application of requirements to firms on an individual and consolidated basis. These circumstances include where the Member State has adopted national laws requiring structural separation of activities within a banking group.

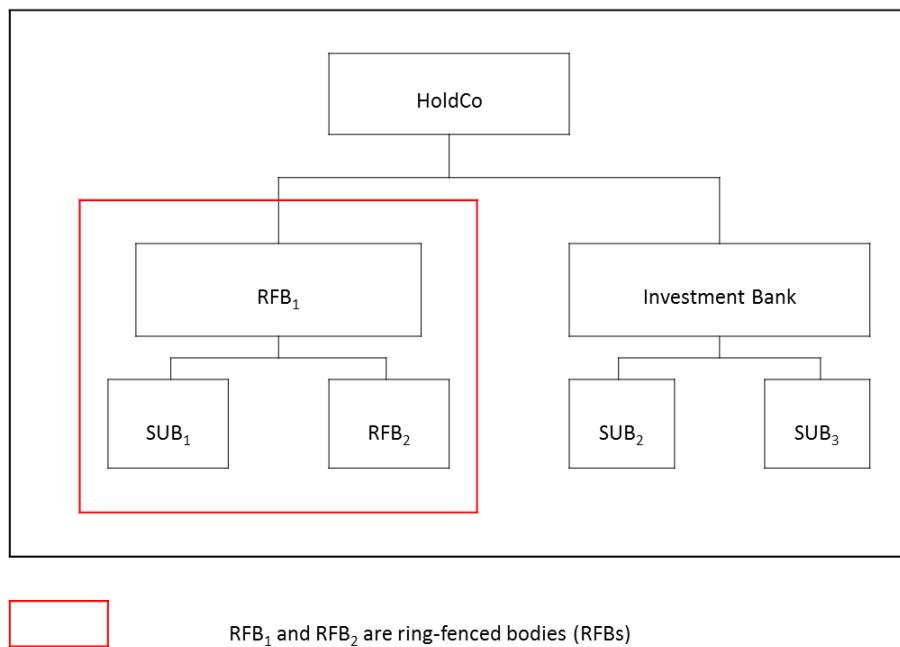
3.4 The PRA expects that, in general, an RFB should meet prudential requirements on a sub-consolidated basis, in respect of its RFB sub-group, ie the sub-group of entities headed by the RFB. Further detail on the membership of an RFB sub-group and the boundary for sub-consolidation is set out in paragraphs 3.12 to 3.20.

3.5 This ensures that prudential requirements are also applied to an RFB in respect of business undertaken by entities that are closely linked to it, including, but not limited to, its subsidiaries. Financial weakness in these entities may harm the RFB, and by extension its ability to continue to provide core services.

3.6 Application of requirements to an RFB on a sub-consolidated basis ensures that an RFB is able to meet those requirements relating to its sub-group without relying on resources in entities outside the RFB sub-group, including excluded activity entities.

3.7 Figure 1 overleaf illustrates a simplified banking group structure including an RFB sub-group.

¹ The CRR defines 'sub-consolidated basis' in Article 4, paragraph 1(49).

Figure 1

RFB sub-group

RFB₁ and RFB₂ are ring-fenced bodies (RFBs)

SUBs₁₋₃ are entities that are not authorised or regulated by the PRA

HoldCo is the parent holding company of the Group in the UK

3.8 There may be circumstances in which it would be inappropriate to apply prudential requirements on a sub-consolidated basis, in which case the PRA would not use Article 11(5) to constitute an RFB sub-group. For example, if an RFB has one or more very small subsidiaries, whose activities are judged to present immaterial risk to the RFB, then it may be disproportionate to apply prudential requirements on a sub-consolidated basis. Or if an RFB were not to have any subsidiaries, there may not be a need to apply requirements on a sub-consolidated basis.

3.9 The PRA will consider the following factors when deciding whether it would be appropriate to constitute an RFB sub-group, for the purposes of applying prudential requirements to an RFB on a sub-consolidated basis:

- the size of the subsidiaries and/or sister entities both in absolute terms and relative to the RFB;
- the size of the sub-group relative to the UK consolidated group; and
- the nature of the activities of the subsidiaries and/or sister entities and the risks they pose to the RFB.

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Application of prudential requirements and other PRA policy to an RFB sub-group

3.10 Where the PRA has determined that prudential requirements should apply to an RFB on the basis of its RFB sub-group, the RFB must meet the requirements of Parts Two to Four and Parts Six to Eight of the CRR on a sub-consolidated basis. An RFB will also need to meet PRA rules transposing Title VII of the Capital Requirements Directive (CRD)¹ on a sub-consolidated basis, as well as some related PRA rules where the PRA has decided that such rules are integral to the effective application of the prudential framework. The rules that an RFB must meet on a sub-consolidated basis are set out in the RFB Part of the PRA Rulebook.

3.11 Where it has been established, an RFB sub-group is also relevant in the context of the application of other elements of the PRA's ring-fencing rules and related policy, as set out in the RFB Part of the PRA Rulebook and in this supervisory statement.

Defining the composition of an RFB sub-group and the boundary for sub-consolidation

3.12 In determining the composition of a prospective RFB sub-group, the PRA will assess the appropriateness of the inclusion of each legal entity that could be included in the sub-group. This assessment will be undertaken in advance of the establishment of an RFB sub-group. The PRA expects to assess the appropriateness of the composition of the RFB sub-group on an ongoing basis as part of its supervision of the RFB.

3.13 The PRA expects that the composition of an RFB sub-group aligns to the legal entity structure around the RFB. This means that an RFB sub-group must be coherent and contain related entities that share a common parent.

3.14 Typically, the PRA expects that an RFB sub-group is headed by an RFB. In some circumstances, it may be appropriate for an RFB sub-group to be headed by an entity other than an RFB. For example, the RFB sub-group might be headed by an intermediate parent holding company if this were to own more than one RFB. The PRA recognises that an RFB sub-group could include a PRA-authorised firm that is not an RFB, although it anticipates that such a scenario would be unlikely to occur. The PRA expects the legal entity structure of the RFB sub-group to be aligned with the governance and management arrangements that apply to that RFB sub-group.

3.15 There may be circumstances in which it would be inappropriate for an entity to be located in an RFB sub-group. The PRA expects to apply the same principles to its assessment of the appropriateness of the membership and composition of an RFB sub-group as that set out in Chapter 2 with respect to ownership and holdings of capital. Therefore, the PRA expects an RFB sub-group not to contain an excluded activity entity².

3.16 The PRA presumes the following when assessing whether the inclusion of an entity in the RFB sub-group is acceptable:

¹ Directive 2013/36/EU.

² See paragraph 2.3 for the definition of an 'excluded activity entity'.

- an entity in which an RFB may not have ownership rights or holdings of capital instruments should not be included in the sub-group, including excluded activity entities ;
- entities that may not have ownership rights or holdings of capital instruments in an RFB should not be included in the sub-group; and
- where the inclusion of an entity could affect adversely the continuity of provision of core services by the RFB, it should not be included in the sub-group.

3.17 The PRA will also consider the impact of the inclusion of an entity on the management and governance arrangements that are applied to the sub-group and any other relevant factors.

3.18 In general, the greater the level of complexity of the legal entity structure of a potential RFB sub-group, and/or the greater the level of risk arising from the business undertaken by an RFB's subsidiaries or other affiliates, the greater the level of scrutiny the PRA expects to undertake in order to assess the appropriateness of the composition of an RFB sub-group.

3.19 If the PRA were to determine that it is inappropriate for an entity to be included in an RFB sub-group, the PRA would expect to require that such an entity be removed from the sub-group legal structure. In deciding whether to require an RFB to comply with obligations on a sub-consolidated basis, the PRA expects that any decisions that require the removal of entities from the sub-group will be taken before prudential requirements are applied to the RFB on a sub-consolidated basis.

3.20 In other circumstances, where the PRA judges that the activities of an entity pose a risk to the RFB, but not to the extent that the entity needs to be removed from the sub-group, the PRA may use its powers under section 55M of the Act or to give direction to a qualifying parent undertaking under section 192C of the Act, in order to address the risk. The PRA may take account of the activities of the entity in considering any application for intragroup concessions made by an RFB or any other PRA-authorised entity which is a member of its RFB sub-group.

Mechanics for applying prudential requirements to an RFB on a sub-consolidated basis

3.21 Provision for the application of prudential requirements on a sub-consolidated basis is set out in Article 11(5) of the CRR. In order to give effect to Article 11(5) of the CRR, the PRA constitutes an RFB sub-group, and mandates sub-consolidation, by use of a requirement under section 55M of the Act. The PRA anticipates that the structure and content of RFB sub-groups are likely to vary between different groups and the approach to implementation enables the PRA to adopt a tailored approach to each group based on its circumstances.

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4 Application of capital and liquidity standards to RFB sub-groups

[In this chapter, the text is all new and is not underlined.]

Introduction

4.1 This chapter sets out the PRA's expectations in relation to the application of capital and liquidity requirements to RFB sub-groups, in particular the ICAA and ILAA Parts of the PRA Rulebook. It also sets out the PRA's expectations regarding the use of 'double leverage' (also known as 'capital upgrading') by a UK parent of an RFB.

Application of the ICAA Part of the PRA Rulebook

4.2 RFBs are required to meet the capital requirements set out in the CRR and related PRA rules, including those set out in the Definition of Capital Part, the Capital Buffers Part and the ICAA Parts and related reporting obligations. Where an RFB sub-group is formed, the RFB will also need to ensure that the requirements of the CRR and PRA rules are met by the RFB on the basis of its sub-group. The RFB should have regard to the contents of relevant PRA supervisory statements and statements of policy in relation to the capital requirements of the RFB sub-group, including:

- SS7/13 CRD IV and capital;¹
- SS6/14 Implementing CRD IV: Capital buffers;²
- SS31/15 The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP);³
- SS32/15 – Pillar 2 reporting, including instructions for completing data items FSA071 to FSA082;⁴ and
- Statement of Policy: The PRA's methodologies for setting Pillar 2 capital;⁵

4.3 Where an RFB is not a member of an RFB sub-group, the PRA may require an RFB to meet the ICAA Part of the PRA Rulebook on an individual basis by making use of its powers under section 55M. The PRA will set this requirement where it considers it necessary to ensure continuity of the provision of core services.

4.4 An RFB required to comply with obligations on the basis of its RFB sub-group must similarly meet the ICAA Part of the PRA Rulebook on the basis of that RFB sub-group. The RFB will therefore need to ensure the overall financial adequacy rule, the overall Pillar 2 rule, the

¹ www.bankofengland.co.uk/pru/Pages/publications/crdcapital.aspx.

² www.bankofengland.co.uk/pru/Pages/publications/capitalbuffersss614.aspx.

³ www.bankofengland.co.uk/pru/Pages/publications/ss/2015/ss3115.aspx.

⁴ www.bankofengland.co.uk/pru/Pages/publications/ss/2015/ss3215.aspx.

⁵ www.bankofengland.co.uk/pru/Pages/publications/sop/2015/p2methodologies.aspx.

ICAAP rules and the risk control rules set out in that Part are met on the basis of its RFB sub-group. In relation to the ICAAP an RFB will therefore need to:

- perform an ICAAP at the level of the RFB sub-group; and
- perform ICAAP stress testing on the RFB sub-group and include relevant stress test results in its ICAAP.

4.5 The PRA expects an RFB to assess the risk and capital requirements of the RFB sub-group, treating any exposures to (or positions in, or arrangements with) group entities outside the sub-group in the same way it would if these were to a third party. The RFB should not, for example, simply assess its capital requirements for a particular risk based on a share of the group's requirement.

4.6 Implicit within the requirement that an RFB must meet the ICAA Part of the PRA Rulebook on the basis of its RFB sub-group is the requirement that an RFB must assess group risk¹. The requirement set out above that an RFB must perform an ICAAP at the level of the RFB sub-group and treat exposures to entities outside the sub-group as equivalent to third parties does not remove the obligation on the RFB to assess group risk as part of its ICAAP. On the contrary, the PRA expects an RFB to pay particular attention to ensuring it has assessed the risks arising from its arrangements with other group members. These include the risks arising from arrangements where an RFB has joint and several liability with other group members such as those in respect of certain taxes (eg VAT group membership).

4.7 As a consequence of meeting the ICAA Part of the PRA Rulebook at the level of the RFB sub-group, the PRA expects an RFB to:

- manage the risks of the RFB sub-group within its risk appetite under business-as-usual and stress conditions;
- ensure the RFB sub-group has sufficient capital to meet capital requirements under business-as-usual and stress conditions, including capital to cover exposures to entities outside its RFB sub-group; and
- view intragroup exposures to entities outside the RFB sub-group as equivalent to any third party exposures in the context of its risk and capital assessment.

Application of the PRA's Supervisory Review and Evaluation Process (SREP) to an RFB sub-group

4.8 Consistent with the requirement that an RFB must meet the ICAA Part of the PRA Rulebook on the basis of its RFB sub-group, where an RFB sub-group is formed the PRA conducts a SREP on the RFB sub-group. In conducting this SREP, and in particular in the context of setting Pillar 2A capital for concentration risk, the PRA considers exposures to intragroup counterparties not included in the RFB sub-group in the same way as if they were to third parties. The PRA believes this approach furthers the PRA's general safety and soundness objective in relation to ring-fencing and the group ring-fencing purposes.

¹ Group risk is defined in the ICAA Part as the risk that the financial position of a firm may be adversely affected by its relationships (financial or non-financial) with other entities in the same group or by risk which may affect the financial position of the whole group, including reputational contagion.

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4.9 The PRA will therefore:

- assess Pillar 2A capital requirements and set individual capital guidance (ICG) for the RFB on the basis of its RFB sub-group;
- conduct a PRA buffer assessment for the RFB on the basis of its RFB sub-group and may set a PRA buffer at that level; and
- assess the Risk Management and Governance (RM&G) arrangements for the RFB on the basis of its RFB sub-group and may set an RM&G add-on at that level.

4.10 The PRA believes this approach is appropriate to enable it to assess whether the RFB has sufficient capital on the basis of its RFB sub-group to cover its risks on a business-as-usual basis and under stress. This approach will also reinforce other requirements placed on an RFB in relation to the adequacy and independence of its governance arrangements.

4.11 This is in addition to the SREP^s that are performed on a consolidated and individual basis.

Stress testing

4.12 The PRA expects an RFB to develop its stress testing capability in order to be able to understand the impact of stresses on its business and where applicable that of its RFB sub-group, and the associated capital implications, and to be able to provide the PRA and the Bank of England (the Bank) with the data required to perform or assess stress tests.

4.13 The requirement to put in place appropriate stress testing capability is implicit in the application of the ICAAP rules to the RFB, but the PRA believes it is appropriate to reiterate this explicitly.

4.14 The PRA expects RFBs to ensure they have in place not only appropriate risk resources but also relevant financial planning resources and related systems and control processes to meet these requirements.

Pension Risk

4.15 Ring-fencing secondary legislation restricts the ability of an RFB to be a party to certain types of pension arrangements relating to multi-employer schemes and shared liability arrangements by 1 January 2026.¹ In order to meet these requirements, RFBs may need to make changes to their pension arrangements.

4.16 The PRA proposes that an RFB should conduct an assessment of the capital required to meet its pension obligations as part of its ICAAP. Where this is prior to the full implementation of changes the RFB plans to make in respect of its pension arrangements, the RFB should base its assessment on relevant factors (eg its expected share of the scheme).

4.17 The PRA proposes to adopt a similar approach when conducting its assessment of the capital required by an RFB in respect of its pension obligations. The PRA may consider transitional arrangements on a case-by-case basis for an RFB to build up required capital levels for pension risk requirements in advance of full implementation of changes the RFB plans to make in respect of its pension arrangements.

¹ SI 2015/547 The Financial Services and Markets Act 2000 (Banking Reform) (Pensions) Regulations 2015.

Application of the ILAA Part of the PRA Rulebook

4.18 RFBs are required to meet the liquidity requirements set out in the CRR, the Liquidity Coverage Ratio (LCR) set out in the LCR Delegated Act¹ and the rules contained in the ILAA Part of the PRA Rulebook. These requirements apply to a firm on an individual basis, and also on a consolidated basis where firms are required to comply with Part Six of the CRR on a consolidated basis.

4.19 Where an RFB sub-group is formed, the RFB also needs to ensure that the requirements of the CRR, the LCR Delegated Act and the PRA rules, including the ILAA rules, are met by the RFB sub-group. The RFB should also have regard to the contents of SS24/15 *The PRA's approach to supervising liquidity and funding risks*² in relation to the RFB sub-group, as the PRA also applies this approach to the RFB sub-group.

Liquidity Management Function of an RFB

4.20 The LCR Delegated Act requires a firm to ensure that, as part of structuring its operational arrangements and processes in relation to the management of liquidity and funding, its liquid assets are under the control of a specific liquidity management function within the firm.³ An RFB will need to meet this requirement on an individual basis and on a sub-consolidated basis where an RFB sub-group is in place. An RFB will also need to ensure that the arrangements and processes surrounding the management of liquidity meet other operational requirements set out in a number of parts of the PRA Rulebook, including the ILAA Part, the Outsourcing Part, the Operational Continuity Part, and the RFB Part.⁴

Application of the PRA's Liquidity Supervisory Review and Evaluation Process (L-SREP) to an RFB sub-group

4.21 Where an RFB sub-group is formed, the PRA will perform an L-SREP and determine the individual liquidity guidance (ILG) for the RFB sub-group. This is in addition to the L-SREP that will be performed on the RFB on an individual basis and any L-SREP performed on a consolidated basis.

Membership of the Sterling Monetary Framework (SMF)

4.22 The Bank provides liquidity insurance to participants in the SMF⁵ through a number of separate but related facilities. Participation in the SMF is open to various types of entity, including banks and PRA-regulated investment firms. It is also possible for participants to only access some and not all of the SMF facilities.

4.23 The PRA expects that an RFB should be a direct member of SMF facilities (in particular the Discount Window Facility (DWF)) or should access these through a member of its RFB sub-group.

4.24 Similarly, the PRA expects that where a banking group contains an RFB, group entities which are eligible for the SMF (ie banks or PRA-regulated investment firms) and which are neither RFBs nor entities in an RFB sub-group should either be direct members of the Bank's

¹ European Commission Delegated Regulation (EU) 2015/61 of 10 October 2014 to supplement Regulation (EU) No 575/2013 of the European Parliament and the Council with regard to liquidity coverage requirement for Credit Institutions.

² www.bankofengland.co.uk/pru/Pages/publications/ss/2015/ss2415.aspx.

³ Article 8(3) of the LCR Delegated Act.

⁴ Note that the Operational Continuity Part and the RFB Part of the PRA Rulebook are currently under consultation in CP38/15 and CP37/15 respectively.

⁵ The Bank of England's Sterling Monetary Framework paragraph 39 www.bankofengland.co.uk/markets/Documents/money/publications/redbook.pdf.

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SMF facilities or be able to demonstrate that they are able to access the Bank's liquidity facilities through a group member which is neither an RFB nor an entity in an RFB sub-group.

4.25 Where firms do not meet these expectations, the PRA may use its powers under section 55M of the Act to impose requirements on an RFB or other PRA-authorised members of its group, or its powers under section 192C of the Act to give a direction to a qualifying parent undertaking.

4.26 In addition, as set out in SS24/15, the PRA will normally expect firms to pre-position collateral assets at the Bank, as part of a complete suite of contingency funding arrangements and may provide explicit guidance as to minimum expected levels. This would also apply to RFBs.

Double Leverage

4.27 In a UK group it is possible that a parent may wish to fund its regulatory capital invested in an RFB or RFB sub-group by itself issuing capital or other funding instruments of lower quality. Such a structure is often referred to as 'double leverage' or 'capital upgrading'.

4.28 The PRA expects a UK parent of an RFB not to make use of double leverage to fund its investment in an RFB or other entities in an RFB sub-group. The PRA believes that such a structure is likely to pose risks to the group ring-fencing purposes under the Act.

4.29 Should a parent of an RFB seek to make use of double leverage to fund its investment in an RFB or other entities in an RFB sub-group, the PRA will assess the extent to which this may pose a risk to the safety and soundness of the RFB and therefore pose a risk to the continuity of the provision of core services. Where this is the case, the PRA may use its powers under section 55M of the Act to impose requirements on the RFB or, where appropriate, its powers under section 192C of the Act to give a direction to a qualifying parent undertaking of an RFB.

5 Intragroup concessions

[In this chapter, the text is all new and is not underlined.]

Introduction

5.1 The PRA sets out below its expectations regarding applications by RFBs and entities within an RFB sub-group for permissions in relation to intragroup large exposures exemptions and intragroup liquidity permissions available under Article 8 of the CRR and the LCR Delegated Act.

Large Exposures

5.2 This section sets out the PRA's approach to applications by an RFB or a PRA-authorised entity within an RFB sub-group to include undertakings within a core UK group (CRR Article 113(6)) or a non-core large exposure group (CRR Article 400(2)(c)). This section should be read in conjunction with the specified CRR articles, the requirements in the Large Exposures and RFB Parts of the PRA Rulebook, the supervisory statement SS16/13 *Large Exposures*¹, and the high-level expectations outlined in the PRA's approach to banking supervision².

CRR Article 113(6): core UK group applications

5.3 CRR Article 113(6) permits a firm, subject to conditions, to apply a 0% risk weight to exposures to certain entities within its consolidation group. CRR Article 400(1)(f) requires that exposures that would be assigned a 0% risk weight under CRR Article 113(6) are fully exempted from the large exposures limit stipulated in CRR Article 395(1).^{3,4}

5.4 Where a firm making the application is a member of a banking group which includes an RFB, the PRA will consider the application in light of the ring-fencing obligations placed on the RFB and any other members of its group, and also the obligations placed on the PRA by the Act in relation to ring-fencing. In particular, where the PRA considers that the granting of the approval would be inconsistent with the PRA's general safety and soundness objective in relation to ring-fencing or the group ring-fencing purposes, the PRA does not expect to grant the approval.

5.5 The PRA does not therefore expect to approve an application made by an RFB, or an entity within an RFB sub-group, to apply a 0% risk weight to exposures to other entities within its consolidation group which are not also members of that RFB sub-group, even if the RFB or the PRA-authorised entity within the RFB sub-group is able to demonstrate that conditions in CRR Article 113(6) are met⁵. Such intragroup exposures are to be treated as exposures to a third party and will be subject to the large exposures limit.

¹ www.bankofengland.co.uk/pru/Pages/publications/largeexpos.aspx.

² www.bankofengland.co.uk/pru/Pages/supervision/approach/default.aspx.

³ Group exposures that are not assigned a 0% risk weighting shall be treated as exposures to a third party.

⁴ CRR Article 395(1) sets the large exposure limit, after applying the effect of the credit risk mitigation in accordance with CRR Articles 399 to 403, to a counterparty or group of connected clients at 25% of eligible capital.

⁵ This is in line with the PRA's supervisory statement on large exposures (SS16/13), where it states that 'the PRA will still make a wider judgement whether it is appropriate to grant this treatment even where the conditions in CRR Article 113(6) are met' (para. 2.4). An exception to this approach might be justified in cases where the PRA judges that applying prudential requirements to an RFB on a sub-consolidated basis is inappropriate, and no entity within the consolidated group undertakes excluded or prohibited activities.

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5.6 If an RFB sub-group exists, the RFB or a PRA-authorised entity within the RFB sub-group wishing to apply a 0% risk weight for exposures to entities included in the RFB sub-group may make a formal application to the PRA, through which they should seek to demonstrate how the conditions in CRR Article 113(6) are met.

CRR Article 400(2)(c) – non-core large exposures group exemptions (trading book and non-trading book)

5.7 Where a firm making an application for permission to use the non-core large exposures group exemptions is a member of a banking group which includes an RFB, the PRA will consider the application in light of the ring-fencing obligations placed on the RFB and any other members of its group, and also the obligations placed on the PRA by the Act in relation to ring-fencing. In particular, where the PRA considers that the granting of the approval would be inconsistent with the PRA's general safety and soundness objective in relation to ring-fencing or the group ring-fencing purposes, the PRA does not expect to grant the approval.

5.8 The PRA does not therefore expect to exercise the discretion provided by CRR Article 400(2)(c)¹ to exempt trading book or non-trading book exposures incurred by an RFB or a PRA-authorised entity within an RFB sub-group, to other entities not in the RFB's subgroup but covered by the same supervision on a consolidated basis, from the large exposures limit stipulated in CRR Article 395(1).² Such intra-group exposures are to be treated as exposures to a third party and will be subject to the large exposures limit.

5.9 If an RFB sub-group exists, the RFB and the PRA-authorised entities within the RFB sub-group may apply to the PRA for a non-core large exposures group exemption covering undertakings in the RFB's subgroup. To have an application approved, the RFB and the entities within the RFB sub-group must demonstrate how the conditions set out in CRR Article 113(6) are met, except for the condition to be established in the United Kingdom – CRR Article 113(6)(d). An RFB's application (or the application by a PRA-authorised entity within the RFB subgroup) for a non-core large exposures exemption should also demonstrate how they comply with the conditions set out in the large exposures rules in the PRA Rulebook.

Intragroup liquidity concessions

5.10 This section sets out the PRA's approach to the assessment of intragroup liquidity concessions in the CRR and the LCR Delegated Act where such an application is made by a member of a banking group which includes an RFB.

5.11 This section should be read in conjunction with the specified CRR articles, the specified articles in the LCR Delegated Act, the requirements in the ILAA and the RFB Parts of the PRA Rulebook and related supervisory statements.

CRR Article 8: Derogation from the application of liquidity requirements on an individual basis

5.12 A firm may apply to the PRA for a permission under CRR Article 8 for the PRA to waive (in full or in part) the application of the liquidity requirements in the CRR to it and instead to supervise the firm together with other institutions in its group as a single liquidity sub-group. Where the relevant conditions in CRR Article 8 are met, including that the institutions have

1 Competent authorities may partially or fully exempt exposures by an institution to its parent undertaking, subsidiaries of that parent undertaking or to its own subsidiaries.

2 In cases where the PRA judges that applying prudential requirements to an RFB on a sub-consolidated basis is inappropriate, and no entity within the consolidated group undertakes excluded or prohibited activities, the PRA may consider exempting the RFB from the proposed approach.

entered into contracts that provide for the free movement of funds between them and that there are no material practical or legal impediments to the fulfilment of these contracts, the PRA is able to grant the permission. The PRA is not required to grant the permission where the conditions specified are met, and may take into account a wider set of considerations.

5.13 Where an application by a firm under CRR Article 8 includes an institution which is an RFB or a member of an RFB sub-group the PRA will consider whether the CRR conditions are met in light of the ring-fencing obligations placed on the RFB and entities in the RFB sub-group. The PRA will also consider the obligations placed on it by the Act in relation to ring-fencing. In particular, where the PRA considers that the granting of the approval would not be consistent with the PRA's general safety and soundness objective in relation to ring-fencing or the group ring-fencing purposes, the PRA does not expect to grant the approval.

5.14 Although the PRA will assess each application in light of the specific facts applicable in that situation, the PRA expects that:

- Where an RFB sub-group is in place and a firm proposes to form a liquidity subgroup consisting solely of institutions which are members of that RFB sub-group the PRA expects that, subject to meeting the conditions of CRR Article 8, it is likely to grant the permission.
- Where the firm proposes to form a liquidity sub-group consisting of institutions which are members of an RFB sub-group and institutions which are not, the PRA expects that it will not approve the application. This is because the PRA does not expect that the firm will be able to meet the conditions set out in CRR Article 8 and, in addition, that the granting of such a permission would not be consistent with the PRA's general safety and soundness objective in relation to ring-fencing.
- Where the firm proposes to include an RFB which is not a member of an RFB sub-group in a liquidity sub-group the PRA will assess the application in light of the specific obligations placed on that firm.

LCR Delegated Act Articles 29, 33(2) and 34: Intragroup concessions in respect of liquidity outflows, liquidity inflows and the cap on inflows.

5.15 Subject to the approval of the PRA, a firm may apply a preferential treatment to certain intragroup transactions for the purposes of calculating liquidity outflows, liquidity inflows and the cap on liquidity inflows under Articles 29, 33(2) and 34 of the LCR Delegated Act, respectively.

5.16 Where a firm seeking the approval is a member of a banking group which includes an RFB, the PRA will consider the application in light of the ring-fencing obligations placed on the RFB and any other members of its group, and also the obligations placed on the PRA by the Act in relation to ring-fencing. In particular, where the PRA considers that the granting of the approval would be inconsistent with the PRA's general safety and soundness objective in relation to ring-fencing or the group ring-fencing purposes, the PRA does not expect to grant the approval.

5.17 Although the PRA will assess each application in light of the specific facts applicable in that situation, the PRA expects the following:

- Where an RFB sub-group is in place and a firm seeks approval for a preferential treatment in respect of transactions between members of that RFB sub-group, subject

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to meeting the requirements of the LCR Delegated Act, the PRA is likely to grant the approval.

- Where an RFB sub-group is in place and the firm seeks approval for a preferential treatment in respect of transactions between members of that RFB sub-group and entities which are not members of that RFB sub-group, the PRA will not grant the approval.
- Where the approval is in respect of transactions by or with an RFB which is not a member of an RFB sub-group the PRA will assess the application in light of the specific obligations placed on that firm.

6 Distributions

[In this chapter, the text is all new and is not underlined.]

Introduction

6.1 The PRA sets out below its expectations in relation to Chapters 2 and 11 of the RFB Part of the PRA Rulebook on the notice that an RFB or an entity in its sub-group must give to the PRA in relation to proposed distributions to group entities outside the RFB sub-group.

6.2 Where such proposed distributions have a significant adverse effect on the capital position of an RFB that could adversely affect the continuity of the provision of core services in the United Kingdom, the PRA may use its powers under section 55M of the Act or to give direction to a qualifying parent undertaking under section 192C of the Act to prevent the making of such distributions.

Notification period

6.3 Chapters 2 and 11 of the RFB Part of the PRA Rulebook require an RFB, or an entity in its RFB sub-group, to provide reasonable notice to the PRA of its intention to make any distributions to allow supervisors to assess the impact of the proposed distributions, and to discuss any concerns the PRA may have in advance of such distributions.

6.4 In determining a reasonable notice period, the PRA expects firms to take into account the type (eg dividends), the frequency and the amount of the distributions.

6.5 Where the proposed distribution poses a significant risk to the capital position of the RFB, the PRA expects the notice to be at least 30 days in advance of the intended payment.

Distributions to person(s) external to the group

6.6 A distribution to any person external to the consolidated group to which the RFB belongs is not in the scope of this rule. However, the PRA may still request information on these external distributions, when needed, in pursuing its objectives under the Act.

Relevant information to be submitted with the notification

6.7 Chapter 11 requires the notice to include, amongst others, any relevant supporting information to support the proposed distribution, including any impact of the proposed distribution on each RFB's current and forecast capital position.

6.8 The relevant information to support the analysis should include the following where applicable:

- impact on current key regulatory ratios (eg Common Equity Tier 1 ratio and leverage ratio), taking into consideration other discretionary payments (eg Additional Tier 1 payments, variable remuneration payouts) up to the expected payment date;
- impact on PRA buffer and/or ICG requirements; and

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- other relevant information (eg forecast dividends, and capital levels over a three year time horizon and glide path to future requirements).

6.9 In line with the PRA's Fundamental Rule 2.7, the PRA expects to be informed of any material change to the information submitted along with the notification as soon as possible.

Interaction with the notification requirement under the Capital Buffer rules by the PRA

6.10 Rule 4.3(9) of the Capital Buffers Part of the PRA Rulebook requires a firm, including an RFB, that does not meet the combined buffer to notify the PRA, and provide a set of information, at least one month in advance of its intended date of payment or action referred to in Rule 4.3(2)(a), (b) and (c) of the Capital Buffers Part.

6.11 The PRA considers that Rule 4.3(9) of the Capital Buffers Part and Chapter 11 of the RFB Part serve different objectives, although there are some overlaps in the required information to be submitted to the PRA. If Rule 4.3(9) applies in respect of a proposed distribution, firms may submit all the required information under both rules in a single notification and clearly identify that the notification is given for both purposes.

7 Intragroup transactions and exposures

[In this chapter, the text is all new and is not underlined.]

Introduction

7.1 Rules in Chapters 2, 3 and 13 to 15 of the RFB Part of the PRA Rulebook require RFBs and entities in an RFB sub-groups to apply the same standards to management of their exposures to, and arrangements with, members of their group that are not in their sub-consolidation group as they would to third parties, to ensure that their core activities are not adversely affected by the acts, omissions or insolvency of those other group members.

7.2 This chapter sets out the PRA's expectations of an RFB and other entities in an RFB sub-group with regards to Rule 3.5 and Chapters 2 and 13 to 15 of the RFB Part. The expectations supplement other requirements, including CRR and the Risk Control Part of the PRA Rulebook, and RFBs are reminded of the need to appropriately apply such requirements in the context of an RFB's intragroup relationships.

Management of intragroup exposures

7.3 Rule 3.5 and Chapter 2 of the RFB Part of the PRA Rulebook require an RFB and entities in its RFB sub-group to apply the same standards to the management of their exposures to and arrangements with group entities outside the RFB sub-group as they apply to third parties. As part of meeting these requirements, an RFB and entities in its RFB sub-group must manage not only individual arrangements with other members of their group but also the overall exposure levels to group members.

7.4 The PRA will take action where firms do not manage intragroup exposures appropriately. In addition, the PRA will consider implementing further measures (including lowering the large exposure limits specified in CRR Article 395(i)) if it observes that RFBs do not appropriately manage their intragroup exposures.

Secured intragroup exposures

7.5 All PRA-authorised firms are required to have sound collateral management systems and processes to meet their obligations under existing prudential requirements (including the CRR and the Risk Control Part of the PRA Rulebook). Consistent with Rule 3.5 and Chapter 2 of the RFB Part of the PRA Rulebook and existing prudential requirements, the PRA sets out below its expectations in relation to collateral received from other group members:

- (a) Where an RFB or an entity in its RFB sub-group receives collateral from group entities outside the RFB sub-group, the PRA expects the RFB or entity in its RFB sub-group to assess and manage the collateral it receives as if it had received it from persons outside its group. This includes putting in place policies and procedures with respect to the types of collateral accepted as well as volume, pricing, valuation and margining requirements.
- (b) In order to be recognised in the calculation of the effect of credit risk mitigation, CRR Article 194(3)(b) requires that the assets received be 'sufficiently liquid and their value over time sufficiently stable to provide appropriate certainty as to the credit protection

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achieved'. The PRA expects an RFB and entities in an RFB sub-group to demonstrate the liquidity and the values of the collateral received from other group members outside the RFB sub-group through sale or repurchase agreements in both normal and stressed scenarios.

- (c) CRR Article 207 sets out the requirements for financial collateral to qualify as eligible collateral. The PRA expects an RFB and entities in the RFB sub-group to be able to demonstrate that the value of collateral received does not have a material positive correlation with the credit quality of the obligor.
- (d) It is possible that intragroup funding may have a contractually short-dated profile. Short-dated collateral may, therefore, be taken against these intragroup exposures. In order to qualify as eligible collateral, an RFB and entities in its RFB sub-group must ensure that it satisfies the requirements of CRR Article 207(5) which requires that the residual maturity of the financial collateral received shall be at least as long as the underlying intragroup exposure. In its assessment of the effectiveness of the collateral taken, firms should assess the behavioural characteristics of the underlying maturity profile of the funding provided.
- (e) Where an RFB or entity in an RFB sub-group outsources all or part of its credit risk mitigation management to a party outside the RFB sub-group, the RFB would still be expected to manage those risks effectively in compliance with the requirements in the Operational Continuity Part of the PRA Rulebook.¹
- (f) Where collateral is held in custody by third parties, the PRA expects an RFB and entities in its RFB sub-group to be able to clearly demonstrate that these assets are appropriately segregated, in accordance with CRR Article 207(4)(3).

Dependence on intragroup and shared customer income

7.6 An RFB and other entities in its RFB sub-group are required, as far as reasonably practicable, not to become dependent on intragroup income or the income generated from a customer that is likely to be contingent on services continuing to be provided to that customer by group members outside of the RFB's sub-group, in a manner which would undermine the ability of the RFB to conduct core activities. See Chapters 2 and 13 of the RFB Part of the PRA Rulebook.

7.7 In order to effectively achieve this intended outcome, the PRA expects an RFB and entities in its RFB sub-group to:

- identify intragroup and shared customer income;
- assess the extent to which there may be a risk to the continuity of the provision of core services if such income were to cease or reduce significantly; and
- manage this risk in advance of such dependence occurring.

7.8 For the purposes of this supervisory statement, shared customer income refers to any income generated from a customer of the RFB or a member of its sub-group that is also a customer of a group member outside of the RFB's sub-group. Chapter 13 focuses on the element of this income that is contingent, or likely to be contingent on services continuing to

¹ Note that the Operational Continuity Part of the PRA Rulebook is currently under consultation in CP38/15.

be provided to that customer by group members outside of the RFB's sub-group (contingent shared customer income).

7.9 The PRA expects that an RFB and entities in its RFB sub-group should either reduce dependence, or have a credible plan to recover from the loss of or significant reduction in, intragroup and contingent shared customer income streams where there is a risk that they will become dependent on such income. As part of meeting this expectation, an RFB need not assess individual customer relationships that are likely to be immaterial but should group together customers that share relevant characteristics and are likely to behave in a similar way in the event of discontinuation of services by group members outside of the RFB's sub-group.

7.10 The PRA expects that, when setting the business strategy of an RFB or its sub-group, an RFB's management should have regard to the risk of becoming dependent on intragroup and contingent shared customer income. The PRA also expects an RFB's management to set a risk tolerance with respect to the reliance of the RFB and entities in its RFB sub-group on intragroup and contingent shared customer income associated with the RFB sub-group's business strategy and to determine key ratios and figures to enable internal monitoring of the associated risks.

Availability of collateral

7.11 In relation to Rule 15.1 and Chapter 2 of the RFB Part of the PRA Rulebook, the PRA expects an RFB and other entities in an RFB sub-group to avoid, where practicable, joint claims on the same collateral (eg property) provided by customers or counterparties to other group entities outside the RFB sub-group. This would help to prevent the collateral becoming unavailable to the RFB in the event of the failure of other group entities outside the RFB sub-group.

7.12 The PRA recognises that there are situations where it is not feasible to separate the collateral between entities. In these cases, the RFB and other entities in its RFB sub-group should ensure that they have adequate policies and procedures in place to identify their share of any collateral, enable them to exercise their claims on the collateral, and access it when required.

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8 Continuity of services and facilities of RFBs

[In this chapter, changes are tracked against the near-final supervisory statement on ring-fenced bodies: continuity of services and facilities set out in PS10/15 ‘The implementation of ring-fencing: legal structure, governance and the continuity of services and facilities’ available at www.bankofengland.co.uk/pru/Pages/publications/ps/2015/ps1015.aspx. Underlining indicates new text and striking through indicates deleted text.]

~~Near final supervisory statement on ring-fenced bodies: continuity of services and facilities~~

Introduction

This supervisory statement is based at ~~ring-fenced bodies (RFBs)~~ as defined in the Financial Services and Markets Act 2000, Section 142A.

8.1 The purpose of this chapter supervisory statement is to set out the PRA’s expectations on the arrangements that an RFBs and, where an RFB sub-group has been established, other entities in the RFB sub-group (ring-fenced affiliates¹) may make where they receive services and facilities from other group entities or third parties outside of their group.

Group service arrangements

8.2 An RFB and its ring-fenced affiliates may receive services and facilities only from other group entities where such entities are group services entities² or are ring-fenced affiliates.⁽¹⁾⁽²⁾

8.3 ‘Services and facilities’ includes the following types of services and facilities that support the business of the RFB: data-processing services; property management services; information technology; data centres; and back office functions. Note that this is not an exhaustive list.

8.4 RFBs should be aware that the rules and guidance on outsourcing requirements in the Senior Management Arrangements, Systems and Control sourcebook Outsourcing Part of the PRA’s Rulebook (SMS&C-8) and SS [XX/XX] Operational Continuity in Resolution apply to RFBs.³

8.5 The PRA expects RFBs and ring-fenced affiliates to demonstrate that they are appropriately managing the operational risk associated with any services and facilities they outsource. Factors supporting this could include:

¹ A ‘ring-fenced affiliate’ is defined in the RFB Part of the PRA Rulebook.

² A ‘group services entity’ is defined in the RFB Part of the PRA Rulebook.

³ Note that SS XX/XX Operational Continuity in Resolution is under consultation. See Appendix 1 of CP38/15 ‘Ensuring operational continuity in resolution’: www.bankofengland.co.uk/pru/Pages/publications/cp/2015/cp3815.aspx.

(1) A ‘group services entity’ means an entity within the same group as the ring-fenced body whose only business is to provide services or facilities.

(2) The PRA has introduced the term ‘ring-fenced affiliate’ into the near final rules to identify any member of the RFB’s sub-consolidation group. The definition of sub consolidated group will be finalised after consideration of responses to a subsequent consultation paper. While the policy intent conveyed by this draft rule is accurate with regard to its application within a sub consolidated group, the way it is expressed in the final version of the rules is subject to change.

- group services entities are financially and operationally resilient to an insolvency or resolution event involving the group entities they provide services to;
- there are appropriate contingency arrangements in the event of there being disruption to the RFB's outsourcing arrangement; and/or
- the services and facilities being provided to the RFB are substitutable.

Group and third-party service arrangements

8.6 The provision of services and facilities from other group entities and third parties to an RFB that is required for the RFB to carry on its core activities should not be capable of being disrupted through the acts, omissions, or insolvency of other group members.

8.7 It is expected that this could be achieved through RFBs ensuring:

- that their contractual arrangements do not contain clauses such as set off rights, security interest, netting arrangements, and material adverse event provisions which could be triggered as a result of the acts or omissions of other group members. Note that this is not an exhaustive list of relevant contractual provisions; and
- that a material deterioration in the financial circumstances of another group entity, or an insolvency or resolution event, does not disrupt any arrangements the RFB has with relevant parties which are necessary for the RFB to conduct its core activities.

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9 Use of financial market infrastructures

[In this chapter, the text is all new and is not underlined.]

Introduction

9.1 The Act requires RFBs to participate directly in inter-bank payment systems, subject to a number of exceptions.¹ This section sets out the PRA's expectations in relation to RFBs' participation in inter-bank payment systems, including applications by RFBs to access payment systems through an intermediary. It also sets out expectations in relation to RFBs' participation in other financial market infrastructures (FMIs), in particular central securities depositories (CSDs) and central counterparties (CCPs).

Participation in inter-bank payment systems

9.2 Article 13 of SI 2014/2080 The Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014 (the Order) prohibits an RFB from entering into any transactions enabling it to use services provided through an inter-bank payment system unless:

- it is a direct participant in the system; or
- where it is not a direct participant in the system, at least one of the conditions set out in Article 13(2) of the Order is satisfied.

9.3 One of the conditions specified in Article 13(2) refers to where the PRA has, following an application from an RFB, granted permission for it to access the services provided by an inter-bank payment system through an intermediary proposed by the RFB. The Order specifies that an application for permission must be made in such a manner and accompanied by such information as the PRA may direct. It also specifies that the PRA may only grant permission where it considers that the RFB needs to access the services provided by the inter-bank payment system in question due to exceptional circumstances and after the PRA has published a statement containing guidance on what is meant by 'exceptional circumstances'.

9.4 This chapter is intended to meet the statutory requirement in Article 13(9) of the Order on the PRA to provide guidance on what is meant by 'exceptional circumstances'. It also sets out what the PRA seeks to achieve in respect of RFBs' access to inter-bank payment systems and what will be required of RFBs.

9.5 Article 13 of the Order also sets out that if the PRA decides to refuse or withdraw permission, an RFB may refer the matter to the Tribunal, in accordance with Part 9 of the Act.

¹ See Article 13 of SI 2014/2080 The Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014.

Exceptional circumstances

9.6 The PRA considers that, for the purposes of granting permission for an RFB needing to access the services of an inter-bank payment system through a proposed intermediary, relevant 'exceptional circumstances' may include:

- Disproportionate burden: where being a direct participant in the system would result in a disproportionate level of cost, risk or other burden for the RFB, its customers or the system, having regard to the PRA's general safety and soundness objective in relation to ring-fencing under the Act.

For example, where an RFB needs to access a particular inter-bank payment system in order to provide services to its customers, or to manage its own risks, but the use of that system typically only generates low or infrequent payments activity (such as in respect of some foreign currency inter-bank payment systems for some RFBs).

- Temporary excessive burden: where an RFB is not a direct participant in the system and joining the system during a particular period would result in a level of cost, risk or other burden for the RFB, its customers or the inter-bank payment system significantly greater than would be the case if it becomes a direct participant at a later planned specified date and the PRA considers that granting permission is consistent with its general safety and soundness objective in relation to ring-fencing.

For example, where an RFB is undergoing significant firm-specific business, strategic or operational change, and becoming a direct participant in the system would generate significant additional cost, risk or burden compared to becoming a direct participant at a later, specified date. Significant business, strategic or operational changes might be the result of, for example, recent changes in the RFB's ownership or action the RFB is taking under the direction of a resolution authority.

9.7 The examples provided above are illustrative and non-exhaustive. The PRA may assess that a particular circumstance for a firm is not exceptional, even where it appears to have similarities to the examples described. In addition, the PRA may consider circumstances other than those described above to be exceptional.

9.8 The PRA will assess any application from an RFB on its individual merits, and based on the information provided by the applicant in a relevant application form, as provided for in Chapter 19 of the RFB Part of the PRA Rulebook. The PRA will assess the application against the group ring-fencing purposes, and the likely impact on the ability of the PRA to meet its general safety and soundness objective in relation to ring-fencing under the Act.

9.9 In particular, the PRA will examine the alternative arrangements the RFB proposes to direct participation. This will include an assessment of the risks to the resilience and resolvability of the RFB, including any additional credit, liquidity, operational or other risks that use of an intermediary may give rise to, and the potential impact on the continuity of core services arising from the use of the intermediary the RFB has proposed. The PRA may choose to grant permission subject to conditions. If so, it will impose requirements under section 55M of the Act in support of its decision.

Expectations for CSD and CCP participation

9.10 CSDs and CCPs can be important pieces of financial market infrastructure for RFBs. Access to such systems can be through direct participation, or by accessing the CSD or CCP indirectly

Appendix 2

through an intermediary. The use of an intermediary can be cost effective, in particular where the RFB's use of the system is low, and can be associated with lower operational and other risks. However, such indirect participation can generate two main risks for the RFB; i) an operational and liquidity dependence on another party; and ii) additional credit exposures.

9.11 Where these risks are significant, they could threaten the resilience of the RFB. Where the intermediary is an entity within the same banking group as the RFB, they may also be inconsistent with the group ring-fencing purposes.

9.12 The PRA expects RFBs to participate in CSDs and CCPs in a manner which is appropriate given the activity and business model of the RFB. The PRA expects RFBs to participate in CSDs and CCPs directly where they have significant activity or where use of the system supports an important area of the RFB's business. RFBs should consider the operational and other benefits of direct participation and consider scenarios where direct participation may be essential to ensure continuity of access during periods of financial market stress where reliance on intermediaries may not be guaranteed. This approach supports the PRA's general safety and soundness objective in relation to ring-fencing to ensure that the business of RFBs is protected from risks that could adversely affect the continuity of the provision in the United Kingdom of core services and is consistent with the approach which applies to all regulated firms.¹

9.13 The PRA recognises, however, that the costs and risks associated with direct participation may be prohibitive in certain circumstances in respect of some CSDs and CCPs, and that there may be cases where an RFB does not meet the relevant participation requirements. The PRA expects RFBs to demonstrate that, in cases where they are not direct participants but are able to satisfy the relevant participation requirements, they have undertaken a careful examination of the costs and risks of indirect participation, including the risks associated with the intermediary proposed.

9.14 Chapter 16 of the RFB Part of the PRA Rulebook imposes a requirement on the manner by which an RFB should access CCPs and CSDs. For CCPs based in the EEA, RFBs which are not direct participants may meet this requirement by using individually segregated accounts and omnibus accounts where the margin requirement for the account is calculated as the sum of the margin required to cover separately the positions of each client within the omnibus account. For CSDs based in the EEA, RFBs which are not direct participants may meet this requirement by using individually segregated accounts.

9.15 Article 14 of the Order prohibits RFBs from incurring a financial institution exposure unless it meets one of the specified exemptions. One of these is that an RFB may incur a financial institution exposure where the exposure concerned is a payment exposure and the RFB has complied with any rules or requirements imposed by the FCA or the PRA under the Act in relation to payment exposures. The PRA considers that the rules made in Chapter 16 of the RFB Part of the PRA Rulebook include rules in relation to payment exposures.

Application of requirements to entities in an RFB sub-group

9.16 The PRA expects that entities in an RFB sub-group will access inter-bank payment systems directly, or through an RFB in the sub-group. Where this is not possible, or would result in a disproportionate level of cost, risk or other burden, then the PRA accepts that

¹ In particular, the Risk Control Part of the PRA Rulebook requires that 'a firm must adopt effective arrangements, processes and mechanisms to manage the risk relating to the firm's activities, processes and systems, in light of [its] level of risk tolerance' (see Chapter 2.1 and 2.2 of the Risk Control Part of the PRA Rulebook).

entities in an RFB sub-group would participate in an inter-bank payment system through an intermediary other than an RFB in the same group. The PRA expects members of an RFB sub-group to take a similar approach in respect of membership of other FMIs.

Appendix 2

10 Exceptions to excluded activities and prohibitions

[In this chapter, the text is all new and is not underlined.]

Introduction

10.1 An RFB has a duty under section 142G of the Act not to perform excluded activities and not to contravene prohibitions. The Order sets out the details of excluded activities and prohibitions, and also permitted exceptions. RFBs will need to put in place policies and procedures in relation to their use of exceptions under the Order in order to meet the requirements of the Compliance and Internal Audit Part of the PRA Rulebook and the Demonstration of Compliance rule.¹

10.2 These requirements are supplemented by PRA rules in Chapter 17 of the RFB Part of the PRA Rulebook which require an RFB to develop and implement exceptions policies which set out in detail when it will make use of the hedging exceptions, the liquid asset exceptions and the collateral exceptions in the Order (these terms are defined in the RFB Part of the PRA Rulebook).

Expectations in relation to exceptions policies

10.3 The PRA expects an RFB's exceptions policies to specify all matters relating to its use of the relevant exceptions under the Order in detail, and not to be written in general terms. In particular, the exceptions policies should be sufficiently detailed to enable the RFB to determine easily whether a transaction meets the requirements for use under the relevant exception in the Order.

10.4 The exceptions policies must cover at least those matters set out in the RFB Part of the PRA Rulebook but an RFB may include additional details or descriptions of related policies or procedures where appropriate.

10.5 The PRA rules in relation to exceptions policies require an RFB to set out how it determines the purpose of the transaction.² The PRA expects that an RFB will make this determination at the time it enters into the transaction and regularly throughout the life of the transaction. It is possible that the purpose of a transaction may change over time or in light of changing circumstances. The PRA expects an RFB to be alert to such potential changes and to implement its policies and procedures so as to identify exceptions transactions where this may be the case and to take appropriate action immediately.

10.6 Where an RFB undertakes transactions within the scope of its exceptions policies those transactions are likely to introduce other risks that need to be managed.³ For example, where an RFB enters into a transaction with a counterparty in order to hedge interest rate risk, that transaction would itself introduce counterparty risk; similarly transactions undertaken for the

1 Rule 3.4 of the RFB Part of the PRA Rulebook.

2 Rule 17.1(3) of the RFB Part of the PRA Rulebook.

3 Rule 17.1(8) of the RFB Part of the PRA Rulebook.

purpose of managing liquidity risk might introduce interest rate risk or currency risk. The PRA rules in relation to exceptions transactions require the RFB to identify and manage such additional or second-order risks introduced by such transactions. The PRA expects that in meeting this requirement firms will be alert to the range of risks that are introduced by exceptions transactions and will ensure that these are subject to the RFB's risk management processes. The PRA expects that an RFB would be particularly alert to transactions which are unnecessarily complex or which introduce excessive risk.

10.7 The PRA expects an RFB to ensure that its exceptions policies and procedures are kept up to date, implemented effectively and subject to appropriate oversight.

Application of requirements to entities in an RFB sub-group

10.8 The rules to develop exceptions policies in Chapter 17 of the RFB Part of the PRA Rulebook only apply to RFBs as the Order only applies to RFBs. The PRA expects that where an RFB is a member of an RFB sub-group, the RFB will apply the relevant parts of its exceptions policies to the other entities in its RFB sub-group or assess their activities against its exceptions policies. The PRA expects an RFB to do this as part of assessing whether it is meeting the PRA's expectations in relation to legal structure, in particular whether it owns entities which are performing activities that would be excluded activities or contravene prohibitions if those entities were RFBs (see Chapter 2 'Legal structure and holdings of capital').

Appendix 3: Draft amendments to Supervisory Statement 16/13 – Large Exposures

This appendix outlines proposed amendments to SS16/13 ‘Large Exposures’. The current version of the supervisory statement is available at:

www.bankofengland.co.uk/prad/Pages/publications/largeexpos.aspx

Underlining indicates new text and striking through indicates deleted text. Note that SS [xx/xx] *Ring-fenced Bodies (RFBs)* is currently under consultation (see Appendix 1) and cross-references to this statement will be updated once this is finalised.

1 Introduction

...

1.3 This statement should be read in conjunction with the specified CRR articles, the requirements in the Large Exposures Part of the PRA Rulebook and the high-level expectations outlined in *The PRA’s approach to banking supervision*.⁽¹⁾ For ring-fenced bodies (RFBs), as defined in the Financial Services and Markets Act 2000 (FSMA), section 142A, this statement should be read alongside the PRA’s Supervisory Statement SS [xx/xx] Ring-fenced Bodies (RFBs).

...

2 CRR Article 113(6): core UK group applications

...

Application process

...

2.4 Firms should note that the PRA will still make a wider judgement whether it is appropriate to grant this treatment even where the conditions in CRR Article 113(6) are met. Where an application is made by an RFB, this judgment will include an assessment of the impact of the proposed treatment on the PRA’s general safety and soundness objective in relation to ring-fencing.⁽²⁾

...

¹ www.bankofengland.co.uk/prad/Pages/supervision/approach/default.aspx.

² See section 2B of FSMA.

...

3 CRR Article 400(2)(c) – non-core large exposures group exemptions (trading book and non-trading book)

...

Application process

...

3.10 An RFB should note that the PRA will assess whether it remains appropriate to permit the treatment where the conditions as listed in paragraph 3.8 are met, including an assessment of the impact of the proposed treatment on the PRA's general safety and soundness objective in relation to ring-fencing.⁽¹⁾

¹ See section 2B of FSMA

Appendix 4: FSA078 Pillar 2 Concentration risk minimum data requirements

This appendix outlines proposed changes to the Instructions for FSA078.

Underlining indicates new text and striking through indicates deleted text.

All firms should complete this data item as set out in Sections 1 and 2 below as well as Section 1(6) of the statement of policy on Pillar 2.

Reference date

The reference date should coincide with the ICAAP reference date.

Currency

Firms should report in the currency of their ICAAP ie either Sterling, Euro, US dollars, Canadian dollars, Swedish kroner, Swiss francs or Yen. Firms should specify the currency used.

Units

RWAs amounts should be reported in millions.

Definitions

All definitions are in line with ITS on Supervisory Reporting, and CRD IV¹, unless otherwise specified.

¹ Capital Requirements Directive (2013/36/EU and Capital Requirements Regulation (575/2013), collectively 'CRD IV'.

Section 1: Firm minimum data requirements

1. For the assessment of single name, sector and geographic (international) concentration risk , firms should provide:
 - i) the total RWAs; and
 - ii) calculate the Herfindahl-Hirschman Index (HHI) of the portfolios within scope (see section 2) for each of the concentration risk types. RWAs should be calculated based on the approach used to calculate the credit risk Requirements (CRR), ie the standardised approach, the foundation IRB approach or the advanced IRB approach . For counterparty credit Risk (CCR) exposures the CVA component of the capital requirements should be excluded from the RWAs estimate. For central counterparty (CCP) exposures the default fund contribution (DFC) should be included in both the EAD and RWAs estimates.

2. The HHI is calculated as:

$$HHI = \frac{\sum w(i)^2}{(\sum w(i))^2}$$

Where $w(i)$ represents:

- *single name concentration risk*: the total credit risk RWAs of a single counterparty aggregated to ultimate group parent level;
- *sector concentration risk* : the total credit risk RWAs per defined sector (see Table 1); and
- *geographic (international) concentration risk*: the total credit risk RWAs per defined economic region (see Table 2).

Section 2 Portfolios in scope

3. **Single name concentration risk**: wholesale credit (non-retail) portfolio exposures across the banking and trading book excluding intragroup exposures¹, securitisations and defaulted assets. The HHI should be calculated by looking at the individual exposures for the entire portfolio, not just the 20 largest exposures. Sectors and portfolios are not relevant. RWAs should be aggregated to ultimate group parent level. Investment trusts should be included as single exposure; any diversification within the trust would be reflected in a lower risk weight.
4. **Sector concentration risk**: wholesale credit (non-retail) portfolio exposures across banking and trading book excluding intragroup exposures², sovereigns, housing associations and defaulted assets. There is no requirement to allocate countries by sector; sovereign exposures are excluded from this calculation. Where firms have exposures to counterparties in multiple sectors, they can either report these as exposures in the primary sector or split the exposures proportionally across the sectors. RWAs should be aggregated according to the following sector breakdown:

¹ Where this data item is reported by a ring-fenced body on a sub-consolidated basis, intragroup exposures to group entities that are not included in the sub-consolidation should be included in both the HHI calculation and in the total RWAs.

² Where this data item is reported by a ring-fenced body on a sub-consolidated basis, intragroup exposures to group entities that are not included in the sub-consolidation should be included in both the HHI calculation and in the total RWAs.

Table 1: Sector breakdown

Agriculture, Forestry and Fishing
Construction
Finance Industry
Real Estate
Manufacturing
Mining and Quarrying
Retail/Wholesale Trade
Business Services & Other
Transport, Utility & Storage

5. Geographic (international) concentration risk: wholesale and retail credit portfolio exposures across banking and trading book excluding intragroup exposures¹, residential mortgages on the standardised approach and defaulted assets. RWAs should be aggregated according to the regional breakdown in Table 2, based on the country of origination of the exposure. However, a firm may report based on country of risk rather than country of origin where it judges that this better captures geographical concentration risk.

Table 2: Geographic regional breakdown

United Kingdom
North America
South American, Latin America & Caribbean
Euro Area
Eastern Europe & Central Asia
East Asia & Pacific
South Asia
Middle East & North Africa
Sub-Saharan Africa

¹ Where this data item is reported by a ring-fenced body on a sub-consolidated basis, intragroup exposures to group entities that are not included in the sub-consolidation should be included in both the HHI calculation and in the total RWAs.

Appendix 5: Statement of Policy – The PRA’s methodologies for setting Pillar 2 capital

This appendix outlines proposed changes to the Statement of Policy ‘The PRA’s methodologies for setting Pillar 2 capital’ available at:

www.bankofengland.co.uk/pru/Pages/publications/sop/2015/p2methodologies.aspx.

Underlining indicates new text and striking through indicates deleted text.

...

6.3 For the purposes of the methodology specified below, only wholesale credit portfolios are considered for single name and sector concentration risk (excluding securitisation, intra-group exposures⁽¹⁾ and non-performing loans). All credit portfolios other than residential mortgage portfolios on the standardised approach are considered for geographic concentration risk.

...

6.6 The Gordy-Lütkebohmert (GL) methodology⁽⁴⁾⁽²⁾ is an extension of the Basel risk-weight function and aims to quantify the undiversified idiosyncratic risk in a credit portfolio not considered to be sufficiently granular. The GL methodology uses credit risk parameters to quantify the single name risk in a portfolio and suggests the necessary capital add-on range to account for single name concentration risk.

Sector and geographic credit concentration risk

6.7 When assessing the degree to which a firm might be subject to industry sector or geographical credit concentration risk, the PRA adopts a methodology based on published multi-factor capital methodologies (eg Düllmann and Masschelein).⁽²⁾⁽³⁾

...

(1) Where the calculation is in respect of a ring-fenced body on a sub-consolidated basis, intra-group exposures to group entities not included in the sub-consolidation are treated as if they were exposures to third parties.

(1)(2) Gordy, M and Lütkebohmert, E (2007), ‘Granularity adjustment for Basel II’, *Discussion Paper 01/2007*, Deutsche Bundesbank.

(2)(3) Düllmann, K and Masschelein, N (2007), ‘A tractable model to measure sector concentration risk in credit portfolios’, *Journal of Financial Services Research*, Vol. 32, pages 55–79.

The proposed changes below should be made to the 'Pillar 2 Reporting Schedule'. Underlining indicates new text and striking through indicates deleted text.

Templates	Scope of population(*)	Group/individual entities	Reporting period/submission deadlines	Reporting frequency
Summary of P2 data Template FSA071 - Firm information and P2 summary	All firms	On an individual, <u>sub-consolidated</u> or consolidated basis in accordance with Pillar 2 Reporting 1.1-1.4 <u>and Ring-fenced Bodies Part 18.1(14)</u> ; individual entities within a group on a case-by-case basis	in conjunction with ICAAP submission dates	Significant firms annually; others on a regular and proportionate basis
Operational Risk Templates FSA072 - Pillar 2 OpR Historical losses FSA073 - Pillar 2 OpR Historical Loss Details FSA074 - Pillar 2 OpR Forecast Losses FSA075 - Pillar 2 OpR Scenario Data	Significant firms and firms with an AMA permission	On an individual, <u>sub-consolidated</u> or consolidated basis in accordance with Pillar 2 Reporting 1.1-1.4 <u>and Ring-fenced Bodies Part 18.1(14)</u> ; individual entities within a group on a case-by-case basis	in conjunction with ICAAP submission dates	Significant firms and firms with an AMA permission annually; others on a regular and proportionate basis
Credit Risk Standardised Approach Templates FSA076 - Pillar 2 Credit Risk Standardised Approach Wholesale FSA077 - Pillar 2 Credit Risk Standardised Approach Retail	Firms using the Standardised approach on all or part of their books, on request	On an individual, <u>sub-consolidated</u> or consolidated basis as requested; individual entities within a group on a case-by-case basis	in conjunction with ICAAP submission dates	On request
Concentration Risk Templates FSA078 - Pillar 2 Concentration Risk Minimum Data Requirements FSA079 - Pillar 2 Concentration Risk Additional Data Requirements	All firms	On an individual, <u>sub-consolidated</u> or consolidated basis in accordance with Pillar 2 Reporting 1.1-1.4 <u>and Ring-fenced Bodies Part 18.1(14)</u> ; individual entities within a group on a case-by-case basis	in conjunction with ICAAP submission dates	Significant firms annually; others on a regular and proportionate basis
Market Risk Template FSA080 - Pillar 2 Market Risk	Firms with significant illiquidity risk in their trading or available for sale books	On an individual, <u>sub-consolidated</u> or consolidated basis in accordance with Pillar 2 Reporting 1.1-1.4 <u>and Ring-fenced Bodies Part 18.1(14)</u> ; individual entities within a group on a case-by-case basis	on a case-by-case basis	Significant firms annually; others on a regular and proportionate basis
Pension Risk Template FSA081 - Pillar 2 Pension Risk	All firms with defined benefit pension schemes	On an individual, <u>sub-consolidated</u> or consolidated basis in accordance with Pillar 2 Reporting 1.1-1.4 <u>and Ring-fenced Bodies Part 18.1(14)</u> ; individual entities within a group on a case-by-case basis	in conjunction with ICAAP submission dates	Significant firms annually; others on a regular and proportionate basis
Credit Risk Internal Ratings Based Approach Templates FSA082 - Pillar 2 Credit Risk IRB retail	Firms with an IRB permission for retail exposures	On an individual, <u>sub-consolidated</u> or consolidated basis in accordance with Pillar 2 Reporting 1.1-1.4 <u>and Ring-fenced Bodies Part 18.1(14)</u>	on a case-by-case basis - data as of 31/12	Significant firms annually; others on a regular and proportionate basis

(*) The PRA may ask other firms to submit the data on a case by case basis

Appendix 7: Glossary of terms for the consultation paper

Excluded activity entity	an entity that undertakes activities that, if it were an RFB, would amount to activities that contravene a prohibition or would be excluded activities under the Act.
Group services entity	in relation to a ring-fenced body, means an entity within the same group as the ring-fenced body, whose only business is to provide services or facilities to any other person.
Individual basis	where requirements are applied to a specific firm on its own, rather than as part of a wider group. ‘Individual basis’ also includes the basis of individual consolidation where this is permitted.
RFB sub-group	the definition of this term is the same as “Sub-consolidation group”.
Ring-fenced body (RFB)	a UK institution which carries on one or more core activities in relation to which it has a Part 4A permission.
Sub-consolidated basis	this is defined in CRR Article 4, paragraph 1 (49).
Sub-consolidation group	the undertakings included in the scope of consolidation as a result of a requirement imposed on a ring-fenced body under Article 11(5) of the CRR.
The Order	means the Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014 (SI 2014/2080)