



BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

The PRA and Bank's response to the Independent Review of the Co-operative Bank

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1 Introduction

1.1 On 6 March 2018, the Economic Secretary to the Treasury, John Glen MP, announced an independent review into the prudential supervision of the Co-operative Bank ('the Co-op') between 2008 and 2013 ('the review period'); and approved the appointment of Mr Mark Zelmer to carry out the Independent Review ('the Report'). The Report has now been published.¹

1.2 The Report addresses the eight topics set out in the Treasury's Direction and provides a detailed assessment of the actions, policies, and approach of the Financial Services Authority (FSA) and the PRA as the institution with statutory responsibility for the prudential supervision of the Co-op for the review period.

1.3 The PRA and the Bank welcome the Report, which acknowledges the significant changes to prudential regulation that have taken place since the financial crisis, and notes the very challenging environment in which the FSA operated during this time. The Report focusses on how the PRA and the Bank of England (referred to as 'the Bank' or 'BoE') could further enhance their approaches.

1.4 The Report includes eight recommendations addressed to both the PRA and the Bank. This document sets out the PRA's initial response to all recommendations in Chapter 3, which also sets out a number of areas in which the PRA will undertake further work. The Bank's response to the recommendations addressed to the Bank is in the Annex. The PRA has started working on the recommendations, and will provide published updates.

1.5 The PRA and the Bank would like to thank Mr Mark Zelmer and his Review Team, as well as past and present staff.

¹ 'Independent review of the prudential supervision of The Co-operative Bank Plc', available at: <https://www.gov.uk/government/publications/independent-review-of-the-prudential-supervision-of-the-co-operative-bank-plc>.

2 Background

2.1 The PRA was established in April 2013 as part of reforms to the regulation of financial services after the financial crisis. The PRA has two primary objectives: a general objective to promote the safety and soundness of the firms it regulates; and an objective specific to insurance firms, to contribute to ensuring that policyholders are appropriately protected. In addition, the PRA has a secondary objective to act in a way (so far as is reasonably possible) to facilitate effective competition in the markets for services provided by PRA-authorized firms.

2.2 The PRA contributes to the Bank's mission to achieve financial stability through its responsibility for the prudential regulation and supervision of banks, building societies, credit unions, insurers, and major investment firms. The Prudential Regulation Committee (PRC) is the body within the Bank responsible for exercising the Bank's functions as the PRA. The PRC makes the PRA's most important supervisory and policy decisions.

2.3 The establishment of the PRA provided the opportunity to adopt a new supervisory approach which was set out in 'The PRA's approach to banking supervision'. This was first published prior to the PRA's establishment in April 2013, and has had subsequent revisions, allowing it to take account of new developments.² In revising its supervisory approach, the PRA sought to apply the lessons learnt during the financial crisis, many of which were clearly set out in the FSA's report on the failure of Northern Rock,³ the FSA's reports on the Royal Bank of Scotland (RBS),⁴ and the PRA and Financial Conduct Authority (FCA) review into the failure of Halifax Bank of Scotland (HBOS).⁵

2.4 The three principles underpinning the PRA's core approach have remained constant over the past years: supervisors rely on judgement in taking decisions; supervisors assess firms against current risks, and also those that could plausibly arise further ahead; and the PRA focuses on those issues and firms that are likely to pose the greatest risk to the PRA's objectives. Across these principles, the PRA continues to ensure interventions do not go beyond what is necessary in order to achieve these objectives.

2.5 The Bank and PRA remain committed to learning the lessons of past events and the Report provides another opportunity to ensure practices remain effective and appropriate.

² Past and current versions of the PRA's approach to supervision documents for banking and insurance are available on the Bank's website at: <https://www.bankofengland.co.uk/prudential-regulation/publication/2018/pr-a-approach-documents-2018>.

³ 'The supervision of Northern Rock: a lessons learned review', March 2008: <https://www.fca.org.uk/publication/corporate/fsa-nr-report.pdf>.

⁴ 'The failure of the Royal Bank of Scotland', December 2011: <https://www.fca.org.uk/publication/corporate/fsa-rbs.pdf>.

⁵ 'The failure of HBOS plc (HBOS)', November 2015: <https://www.bankofengland.co.uk/prudential-regulation/publication/2015/pr-fca-review-into-the-failure-of-hbos>.

3 Report recommendations and the PRA's response

Recommendation: The PRA and the BoE should continue to evolve their stress test exercises so that they encompass a broad range of risks to which banks are exposed, and consider how best to incorporate the inherent uncertainty that would prevail as a stress scenario unfolds in real life.

3.1 The Bank and the PRA agree with this recommendation. Stress testing of firms is one of the key tools to support the Bank's microprudential and macroprudential objectives, and while the Bank's approach to stress testing has significantly evolved since the review period, the Bank and PRA are committed to evolving stress test exercises further.

3.2 Banking stress tests examine the potential impact of a hypothetical adverse scenario on the individual institutions that make up the banking system, and on the system as a whole. This allows the PRA and Bank to assess banks' resilience, and make sure they have enough capital to withstand shocks, and to support the economy if a stress does materialise.

3.3 The Bank and PRA work jointly on stress testing, and the Annex includes a fuller joint Bank and PRA response to this recommendation.

Recommendation: The PRA and the BoE should continue to study how best to use the new resolution tools in systemic situations.

3.4 The Bank and PRA agree with this recommendation. The Bank has made significant progress in improving the resolvability of firms as part of the broader 'too big to fail' agenda. The Bank acknowledges that more progress needs to be made where failures occur in systemic situations. See the Annex for the Bank's response to this recommendation.

3.5 While the Bank is solely responsible as resolution authority for exercising the statutory resolution tools, the PRA will continue to apply its rule-making powers where appropriate to improve the resolvability of firms.

Recommendation: The PRA should consider how best to balance its objective of promoting the safety and soundness of PRA-authorized firms, with its particular focus on the harm that firms can cause to financial stability, against the interests of individual classes of depositors or creditors that may end up being adversely affected or exposed to more risk in response to the actions of the authorities.

3.6 While the PRA agrees it is important to balance and consider how it advances its objectives, it is important to recognise that the PRA's objectives are set by Parliament. Pursuant to Section 2B of the Financial Services and Markets Act 2000, the PRA's primary objective is to promote the safety and soundness of the firms it regulates, and it is required by statute to advance this objective by focusing on the stability of the UK financial system. The PRA sets out how it will advance its objectives in the PRA's approach to banking supervision.⁶

3.7 The PRA does, however, have a duty to co-ordinate with the FCA in the exercise of its statutory functions, including policy-making and supervision. The FCA, as the conduct regulator

⁶ October 2018: <https://www.bankofengland.co.uk/prudential-regulation/publication/2018/pr-a-approach-documents-2018>.

for firms prudentially regulated by the PRA, has a clear mandate to protect consumers, which includes depositors and creditors.

3.8 A Memorandum of Understanding (MoU) between the PRA and the FCA describes how the two regulators fulfil this duty to co-ordinate in a way that supports each regulator's ability to advance its objectives.⁷ A key principle of this co-operation, given the regulators' separate mandates for prudential and conduct regulation of PRA-authorized firms, is that each authority should focus on the key risks to its own objectives, while being aware of the potential concerns of the other, thus balancing the PRA objectives of safety and soundness with the FCA's focus on the interests of consumers.

Recommendation: The PRA and BoE are encouraged to take advantage of the new information on asset encumbrances and consider whether there should be some formal or informal constraints on the extent to which banks and other deposit-taking institutions can encumber their assets in normal circumstances and how best to factor encumbrances into the recovery and resolution plans for these institutions.

3.9 The PRA and the Bank agree that excessive asset encumbrance in going-concern can significantly reduce optionality for recovery and resolution strategies. PRA supervisors consider the level of asset encumbrance as part of their ongoing assessment of risk. In light of this recommendation the PRA will re-examine the question of whether to set asset encumbrance limits (formal or informal).

3.10 Since 2012, new liquidity policies have been introduced that effectively constrain the extent to which high-quality assets can be encumbered and require firms to maintain a buffer of unencumbered high-quality assets. Liquidity policies currently include the Liquidity Coverage Ratio (LCR) and the PRA's Pillar 2 framework. In addition, the Net Stable Funding Ratio (NSFR) policy is currently in development.

3.11 In 2017, the PRA undertook a review of whether risks posed by asset encumbrance were sufficiently captured by existing prudential policies, or whether it needed to go further. The review found that risks relating to encumbrance were well addressed by the existing going-concern liquidity framework, and did not establish a clear link between going-concern encumbrance limits, and firms' liquidity needs and resources in resolution. It was therefore concluded that explicit encumbrance limits would be redundant.

3.12 Improved regulatory data and public disclosures have also significantly enhanced transparency of levels of asset encumbrance and the quality of unencumbered assets, both across the system and for individual firms.

3.13 The PRA will also take part in the Bank's review on the extent to which encumbrance should be considered in recovery and resolution planning. See the Annex for the Bank's response to this recommendation.

⁷ MoU between the PRA and FCA: <https://www.bankofengland.co.uk/-/media/boe/files/memoranda-of-understanding/fca-and-pra>.

Recommendation: PRA supervisors would benefit from more detailed internal guidance on how to assess the risks to which regulated financial institutions are exposed and the associated mitigants, as well as on how to assess significant transactions of those institutions.

3.14 The PRA agrees with this recommendation with respect to guidance on how to assess significant transactions, given these occur relatively rarely in a supervisor's career. Supervisors are informed of techniques and methods, through a combination of devices such as training courses, written materials and, of course, from the direct experience of colleagues. Given that most significant transactions pose a unique set of challenges and risks, the PRA will develop further material to convey key principles which supervisors can apply given their specific circumstances.

3.15 The assessment of risks to which regulated financial institutions are exposed is at the heart of the PRA's supervisory approach. There are annual, internal stocktake meetings for all firms to discuss the major risks they face, the supervisory strategy, and proposed remedial actions, including guidance about the adequacy of a firm's capital and liquidity.

Recommendation: The Prudential Regulation Committee and the executive management of the PRA should continue to play a leading role in ensuring that supervisory strategies for individual firms proactively take account of emerging regulatory developments.

3.16 The PRA agrees with this recommendation, and believes a good practice exists in relation to emerging regulatory developments. The PRA will document and standardise existing good practice to ensure that supervisors have ready access to this information.

3.17 One of the key points of the PRA's supervisory approach is to be forward-looking – not just in relation to how a firm's safety and soundness might develop, but also how the regulatory regime may evolve and impact the firm. Consistent with that approach, regulatory change that will or may materially affect a firm is a matter that supervisors consider during routine supervision, and if relevant at the internal annual stocktakes which discuss the major risks firms face.

3.18 This is in the context of the PRA's commitment to transparency: the PRA's rules and expectations at any point in time must be clear to firms and firms should not be required to comply with rules that are under development and therefore not yet in force.

3.19 A variety of good practices exist across the organisation, as the Report notes. Information of forthcoming policy changes is disseminated to supervisors by a variety of means, such as written summaries, presentations, and meetings.

Recommendation: The PRA should continue to pay close attention to any attempts by banks to circumvent regulatory and supervisory requirements and focus on the economic substance of transactions, not their accounting treatment or how they are funded.

3.20 The PRA agrees with this recommendation. As set out in the PRA's 2018/19 Business Plan,⁸ one of the PRA's current strategic goals is to adapt to changes in the external market.

⁸ 'Prudential Regulation Authority Business Plan 2018/19', April 2018: <https://www.bankofengland.co.uk/prudential-regulation/publication/2018/pru-business-plan-2018-19>.

Contributing to that priority, the PRA scans the horizon regularly for emerging risks to its objectives arising from changes in the economy, financial system and markets, and product innovation, as well as from firms' responses to regulation. The PRA will re-examine the processes and procedures it currently has in place to deal with firms' attempts to circumvent regulatory and supervisory requirements.

3.21 The PRA has been clear publicly that firms should expect supervisors to query, and where appropriate act upon, such activities. Firms should be able to demonstrate their compliance, not only with the letter of the regulation, but also with its spirit.

3.22 The prudential regulatory framework needs to remain responsive to changes in the behaviour of market participants and to the structure of the financial system that might reduce the safety and soundness of firms, or cause financial instability. Changes we should be concerned about include attempts to arbitrage prudential regulations, and unintended effects of regulation on financial markets.

3.23 As part of its horizon scanning activity, the PRA looks for instances of potential regulatory arbitrage. A cross-Directorate group within the PRA periodically draws together intelligence from supervisors, as well as from the wider Bank (Financial Stability, Markets, Financial Market Infrastructure, Resolution and Prudential Policy), to identify thematic developments. The PRA then considers whether such developments warrant adjustments to prudential regulations and/or the PRA's supervisory strategy or approaches. Furthermore, the PRA and Bank have also been active in international forums, such as the Basel Committee on Banking Supervision, in promoting an international response to attempts to circumvent regulatory and supervisory requirements. This thematic work is complemented by the PRA's supervisory teams assessing and taking action in cases where transactions planned or executed by one firm may circumvent regulation.

3.24 In light of this recommendation, the PRA will introduce a specific focus in its horizon-scanning on how IT expenditure is being accounted for by banks.

3.25 The PRA does not review every transaction. In the first instance, it is the responsibility of Senior Managers and the boards of regulated firms to identify and mitigate the risk that their firms are engaged in regulatory arbitrage. In this respect, the PRA also holds firms to account for their compliance with the Senior Managers Regime, which requires a clear identification and allocation of responsibilities to individuals responsible for running firms.

Recommendation: The PRA should consider introducing more formal third-party reviews of key prudential information supplied by banking groups through their regulatory data returns.

3.26 The PRA agrees with this recommendation, and will consider how to ensure that regulatory data is accurate, including whether to introduce more formal third-party reviews. Accurate regulatory returns are an essential part of the PRA's supervisory approach. Third-party reviews were a feature of previous banking supervision in the UK when banks would typically be subject to a review under s39 of the 1987 Banking Act (the equivalent of 'Reports by skilled persons' under s166 of FSMA). This approach was halted as a routine part of supervision because it was felt to be disproportionate. Such reviews of returns do take place where supervisors have grounds to believe that the poor quality of returns pose a material risk to the PRA's objectives.

3.27 The PRA will consider whether to require more formal third-party reviews of key prudential information supplied by banks through their regulatory returns. The PRA will assess:

- whether the benefits of any such reviews would outweigh the costs;
- to which types or sizes of firms they might apply;
- which data might be within scope;
- whether reviews would be targeted or regular; and
- whether the results of the review would be private or public.

3.28 One consideration relevant to this is the significant amount of work some regulated firms must carry out in the coming years in response to the UK's withdrawal from the EU.

3.29 The PRA last considered the audit of regulatory data in 2013, and decided at the time that the benefits did not match the costs. However, all policies are reconsidered as circumstances change. Work has begun and recommendations will be brought to the PRA's senior committees.

3.30 The PRA will consider whether to require third-party review alongside the current suite of supervisory tools that are available, and used. Regarding the accuracy of regulatory returns:

- (a) Firms have responsibility for complying with relevant regulations and rules, and need to take reasonable steps to ensure that information submitted is accurate, fairly and properly based, and complete. In addition, under the Senior Managers Regime firms are required to assign a Prescribed Responsibility for the production and integrity of regulatory reporting.
- (b) The PRA carries out validation and plausibility checks on prudential information for all firms. In addition, line supervisors review prudential information as part of day-to-day supervision.
- (c) Where the PRA has particular concerns about the accuracy of regulatory information, it may require individual firms to carry out work, for example internal audit reviews or remedial procedures, or it may commission an external view, potentially under s166.

4 Conclusion

4.1 The PRA and Bank are grateful to Mr Mark Zelmer for the care and detailed consideration he has taken in his independent review of the prudential supervision of the Co-op.

4.2 There have been substantial changes to the UK regulatory regime and to the prudential approach to supervising banks in the last decade. The PRA has developed a rigorous approach to supervision, which is risk-based and judgement-led, and is committed to ensuring that the approach to supervising banks achieves the PRA's statutory objectives.

4.3 The PRA is committed to delivering the actions as set out in this document, and will provide published updates.

Annex

1 The Bank's response to relevant recommendations

Recommendation: The PRA and the BoE should continue to evolve their stress test exercises so that they encompass a broad range of risks to which banks are exposed, and consider how best to incorporate the inherent uncertainty that would prevail as a stress scenario unfolds in real life.

1.1 The Bank and PRA agree with this recommendation. Building on previous exercises, since 2016 the Bank and PRA have run concurrent stress tests¹ in conjunction with the Financial Policy Committee (FPC) including: an annual cyclical scenario (ACS) and a biennial exploratory scenario (BES).² The Bank and PRA are committed to evolving the stress tests further.

1.2 The Report notes the inherent uncertainty involved in calibrating appropriate stress scenarios. For this reason, the Bank's ACS is very severe across a number of dimensions. The ACS is designed to make sure banks are adequately capitalised to survive a range of plausible but unlikely severe shocks. The calibration of the macroeconomic stress in the ACS is based on a cross-country dataset of past crises, from 1970 to the present. The scenario will therefore reflect a broad range of 'real life' experiences. This approach endeavours to ensure the scenario captures second order effects. The 2017 and 2018 tests were judged to be more severe overall than the global financial crisis.

1.3 The Report also asks that the PRA and BoE considers how best to incorporate the inherent uncertainty that would prevail as a stress scenario unfolds in real life. By basing the calibration of asset price stresses on historical crisis experience, the shocks in the ACS reflect real world uncertainty and panic selling, as observed during the financial crisis. For example, in the ACS, market measures of uncertainty such as the VIX index rise substantially, and banks' wholesale funding spreads also rise materially.

1.4 As the Report notes, it is important that stress tests continue to reflect the broad range of risks that banks might face, and further work is being planned on this. In the June 2018 Financial Stability Report,³ the FPC announced that the Bank and PRA would start running cyber stress tests, with a pilot in 2019. And in September 2018, the Bank advised it would assess the system-wide financial risks from climate change and explore whether climate-related factors should be included in a future BES.⁴

Recommendation: The PRA and the BoE should continue to study how best to use the new resolution tools in systemic situations.

1.5 The Bank agrees with this recommendation. The Bank has made significant progress establishing a credible resolution regime in line with international standards on which it has reported publicly and to Parliament. The Bank will continue, in line with its published

¹ For the seven major UK banks – Barclays, HSBC Holding Group, Lloyds Banking Group, Nationwide, The Royal Bank of Scotland Group, Santander UK, and Standard Chartered.

² The ACS' severity evolves in line with the financial cycle, while the BES is used to explore new and emerging threats to financial stability that may not be linked to the financial cycle.

³ 'Financial Stability Report', June 2018: <https://www.bankofengland.co.uk/financial-stability-report/2018/june-2018>.

⁴ 'Transition in thinking: The impact of climate change on the UK banking sector', September 2018, available on the Bank's dedicated climate change webpage at: <https://www.bankofengland.co.uk/climate-change>.

programme, to enhance its ability to meet its statutory resolution objectives in the event of both idiosyncratic and systemic stress.

1.6 Under Article 4 of the Bank Recovery and Resolution (No.2) Order 2014, the Bank is designated as the authority empowered to apply the resolution tools and exercise resolution powers in the UK.

1.7 The Report is right to highlight the importance of ensuring that these tools can be used as intended, in a systemic situation and in a one-off failure. It would naturally be more difficult to achieve all the statutory objectives of resolution in a systemic crisis, where several major banks failed at once. The Bank has sought to manage these challenges by building a robust resolution regime designed to reduce contagion by recapitalising systemic institutions and maintaining operational continuity through a resolution, limiting the impact of a systemic event. Heightened transparency around what the Bank expects for firms to be resolvable, as set out in the Bank's Resolvability Assessment Framework (RAF),⁵ together with the Bank's publication of its approach to resolution, should also help to deliver time-consistency in its actions. Substantial progress has already been made in recent years towards improving the resolvability of firms. Any UK bank that would require the use of resolution tools to manage its failure must build up substantial resources of capital and debt instruments capable of absorbing losses and recapitalising them in resolution.

1.8 The Bank has taken steps when developing the requirements for these loss absorbing resources to mitigate the risks from having to use them in systemic situations. For example, these loss absorbing resources must take the form of either equity or subordinated debt of at least one year residual maturity so as to reduce the risk of runs or the need to impose losses on senior creditors or depositors.⁶

1.9 UK banks are well on the way to meeting their loss absorbency requirements in full by 2022 and the biggest UK banks already have loss absorbency in excess of a quarter of their risk-weighted assets.

1.10 In addition to building up these resources, a number of other measures have been taken that can help in systemic situations, including:

- (a) statutory safeguards within the resolution regime designed to protect netting, maintain payment obligations to financial infrastructure and ensure that creditors' losses are capped at no more than what they would lose if the bank had gone into insolvency; and
- (b) the introduction by the Bank of a resolution liquidity framework to supplement its existing published facilities for banks, thereby offering a liquidity backstop in circumstances where market funding may be unavailable.⁷

1.11 Work continues on identifying further ways in which to maintain the effectiveness of resolution tools in a systemic scenario. For example, these could include imposing requirements to restrict cross-holdings of minimum requirement for own funds and eligible

⁵ 'Introduction to the Resolvability Assessment Framework', December 2018:

<https://www.bankofengland.co.uk/paper/2018/introduction-to-the-resolvability-assessment-framework>.

⁶ 'The Bank of England's approach to setting a minimum requirement for own funds and eligible liabilities (MREL)', June 2018: <https://www.bankofengland.co.uk/paper/2018/boes-approach-to-setting-mrel-2018>.

⁷ 'The Bank of England's approach to resolution', October 2017: <https://www.bankofengland.co.uk/paper/2017/the-bank-of-england-approach-to-resolution>.

liabilities (MREL) between globally systemic banks so as to reduce contagion within the banking system (as currently proposed in the Capital Requirements Regulation II).

1.12 In addition, as set out in the December 2015 Financial Stability Report,⁸ the FPC's calibration of the capital framework considers the overall amount of capital in the banking system to absorb losses on both a 'going concern' basis and in resolution, taking into consideration the impact and probability of crises.

Recommendation: The PRA and BoE are encouraged to take advantage of the new information on asset encumbrances and consider whether there should be some formal or informal constraints on the extent to which banks and other deposit-taking institutions can encumber their assets in normal circumstances and how best to factor encumbrances into the recovery and resolution plans for these institutions

1.13 The PRA and Bank agree that excessive asset encumbrance in going-concern can significantly reduce optionality for recovery and resolution strategies.

1.14 A key part of the Bank's RAF will be to place greater responsibility on firms to demonstrate how they will meet their liquidity needs in resolution. This will involve having the capability to estimate, anticipate, and monitor their potential liquidity resources and needs, and to mobilise liquidity resources in the approach to and throughout resolution. Banks will therefore need to take into account encumbrance levels as part of that analysis, and this information will be available to the Bank during recovery and planning for resolution. Alongside the RAF, the Bank is also working on how liquidity should bear on a decision to trigger resolution. The Bank will continue to collaborate with the PRA on the impacts of this work on recovery and resolution.

⁸ 'Financial Stability Report', December 2015: <https://www.bankofengland.co.uk/financial-stability-report/2015/december-2015>.