

Statement of Policy 2/14

# The use of PRA powers to address serious failings in the culture of firms

June 2014



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## Introduction

1. This statement of policy sets out how the Prudential Regulation Authority (PRA) uses its formal powers to address serious failings in the culture of firms. The culture of a firm has a significant impact on the PRA's objectives of promoting the safety and soundness of firms and, for insurers, an appropriate degree of protection for policyholders. Advancement of the PRA's objectives ultimately relies on firms conducting their business in a safe and sound manner, and support for the PRA's objectives should be embedded in every firm's culture.<sup>(1)</sup> The culture of a firm includes its standards of behaviour.

2. This statement also explains how the PRA's use of its powers meets the recommendations of the Parliamentary Commission on Banking Standards contained in paragraphs 970–973 of *Changing Banking for Good*,<sup>(2)</sup> which were that regulators should have powers to identify and tackle serious failings in standards and culture within banks they supervise, and for the PRA and the Financial Conduct Authority (FCA) to consider cases when such powers should be deployed. Although the recommendations focus on banks, this statement of policy applies to all firms, including insurers.

3. The regulatory practices set out below are consistent with the current approach adopted by the PRA. Therefore, there are no incremental costs and benefits arising from this statement, and it does not impact on the PRA's secondary objective of facilitating effective competition.

## Culture and the PRA's approach to supervision

4. The PRA's approach to supervision, including the use of its powers, is set out in the approach documents. The culture of a firm contributes towards its ability to meet its Threshold Conditions, the minimum requirements that firms must meet in order to be permitted to carry on the regulated activities in which they engage; and the PRA's Fundamental Rules, which set out at a high level the requirements placed on firms. A failure to comply with the Fundamental Rules may be relevant to a firm's ongoing compliance with the Threshold Conditions and may result in enforcement or other actions.<sup>(3)</sup> Furthermore, the PRA expects firms not merely to meet the letter of its requirements, but to maintain sight of the overriding principle of their safety and soundness and act accordingly.<sup>(4)</sup>

5. The PRA expects firms to have a culture that supports their prudent management. The PRA does not have any 'right culture' in mind, rather it focuses on whether boards and management clearly understand the circumstances in which the firm's viability would be under question, whether accepted orthodoxies are challenged, and whether action is taken to address risks on a timely basis. The PRA wants to be satisfied

in particular that designated risk management and control functions carry real weight within firms.<sup>(5)</sup>

6. The PRA also expects that individuals, whatever their position in the firm, should take responsibility for acting in a manner consistent with its safety and soundness; that remuneration and incentive structures should reward careful and prudent management; that firms and individuals should deal with the PRA (and other regulators as appropriate) in an open and co-operative manner as set out in the PRA's Fundamental Rules; and that the board takes responsibility for establishing, embedding and maintaining a firm's culture.<sup>(6)</sup> The PRA seeks to address serious failings in the culture of firms as part of its approach to supervision.

## Identifying serious failings in the culture of firms

7. The PRA identifies serious failings in culture through its normal supervisory activity, which includes (but is not limited to) ongoing frequent contact with firm representatives (including continuous assessment meetings), reviews of the prudence of valuation methods, regular assessment of the independence and professionalism of a firm's risk management, board effectiveness reviews, and consideration of a firm's remuneration policies.

8. Identification of failings in culture is not limited to individual serious occurrences, but may include:

- i. The observation of multiple examples of firms failing to conduct their business in a safe and sound manner, including failings in different business areas, that may not be related or that when examined individually may not be considered serious.
- ii. Evidence of a poorly functioning board that fails to challenge executives or take a lead in consideration of conducting business in a safe and sound manner; which can include setting, articulating and embedding an appropriate culture in the firm, and drawing up clear policies and guidelines that are linked to staff objectives, training, evaluation and incentives.
- iii. Evidence of weak control areas such as risk, compliance and internal audit that may indicate poor management, lack of resource, or insignificant representation at board level.

(1) *The PRAs approach to banking supervision*, June 2014, paragraphs 33 and 37; *The PRAs approach to insurance supervision*, June 2014, paragraphs 37 and 41.

(2) [www.publications.parliament.uk/pa/jt201314/jtselect/jtpebs/27/27ii.pdf](http://www.publications.parliament.uk/pa/jt201314/jtselect/jtpebs/27/27ii.pdf).

(3) *The PRAs approach to banking supervision*, June 2014, paragraphs 14 and 15; *The PRAs approach to insurance supervision*, June 2014, paragraphs 21 and 22.

(4) *Ibid*, 37; *ibid*, 41.

(5) *Ibid*, 73; *ibid*, 82.

(6) *Ibid*, 74–77; *ibid*, 83–86.

iv. Evidence of other weaknesses in board or senior management behaviour and influence on firm culture, including incentives and their adherence to the firm's values.

v. Any other evidence of failings in culture identified by the PRA's supervisory approach.

9. The PRA considers a variety of factors to identify failings in culture, including governance, incentives, risk awareness, and the ability to challenge senior management. The PRA also contributed to development of the Financial Stability Board's *Guidance on Supervisory Interaction with Financial Institutions on Risk Culture*,<sup>(1)</sup> which identified a sound risk culture as one that supports appropriate risk awareness, behaviours and judgements about risk-taking within a strong risk governance framework.

10. A skilled person report may also be used to further help the PRA identify concerns. Further details are given in the next section.

## Tackling serious failings in the culture of firms

11. If serious failings in culture are identified, the PRA acts pre-emptively to tackle the concerns that it identifies and to prevent a firm posing risks to its objectives. The PRA acts to tackle serious failings in culture through its normal supervisory activity, through use of its supervisory powers, and through enforcement action.

12. This statement focuses on the use of the PRA's supervisory powers. The PRA's normal supervisory activity is set out in its approach documents, but at a high level should supervisors identify deficiencies in management and/or governance practices, including cultural deficiencies, the Proactive Intervention Framework (PIF) stage may change. The intensity of supervision will increase, additional reporting requirements may be set, additional information gathering powers may be used, and the PRA will require the firm to act to address deficiencies over a set period.<sup>(2)</sup> The PRA sends an annual letter to each firm's board clearly outlining the key risks that are of greatest concern, and expects to verify itself that action is taken on these key risks, and communicates to the board when and how it expects to do this (with the exception of firms with the lowest potential impact where a standard letter outlines issues relevant to all firms in that group, unless specific issues have been identified with a particular firm). Less significant issues that have arisen are conveyed to the firm, but with the onus on the firm itself to address these and an expectation of self-certification by the most appropriate senior individual that issues have been closed.<sup>(3)</sup>

13. In addition to the powers outlined below, if a firm continues to fail to meet the PRA's regulatory requirements, or if a sanction is an appropriate response, then a range of

enforcement actions remain available to the PRA to promote high standards of behaviour and send a clear signal. The PRA may proceed to an enforcement investigation without having exhausted all other supervisory options. Full details are set out in *The PRA's approach to enforcement: statutory statements of policy and procedure*.<sup>(4)</sup>

## Use of supervisory powers

14. The PRA has a variety of powers available to it under the Financial Services and Markets Act 2000 (as amended) ('the Act'), which it may use if deemed necessary to reduce risks and achieve desired supervisory outcomes, including those related to serious failings in a firm's culture. These include powers by which the PRA can intervene directly in a firm's business, such as varying a firm's permission or imposing a requirement under Part 4A of the Act.<sup>(5)</sup> In addition, to assist with its risk assessment, the PRA may use its power under section 166 of the Act to commission reports by skilled persons on a wide range of areas, including a firm's culture.

15. While the PRA looks to firms to co-operate with it in resolving supervisory issues, it will not hesitate to use formal powers where it considers them to be an appropriate means of achieving desired supervisory outcomes. The PRA may choose to deploy formal powers at an early stage. The PRA is likely to consider a number of factors in connection with the possible deployment of such powers, including the confidence supervisors have that firms will respond appropriately to the PRA's requests without the use of powers, and the PRA's view of a firm's proximity to failure, as reflected in its PIF stage.<sup>(6)</sup>

16. The use of PRA powers and the intensity of the supervisory engagement with firms set out above and in the approach documents are independent of each other and of the PIF stage of a firm. Nonetheless it is likely that if the PRA has cause to use its powers, enhanced supervision will take place as supervisory engagement with the firm intensifies and resources devoted to supervising the firm are strengthened, given the extent of PRA concerns about the risks facing a firm. The PRA will increase its level of monitoring and use specialists as appropriate to individual circumstances, even if a firm is not in an elevated PIF stage.

## Reports by skilled persons<sup>(7)</sup>

17. The PRA has the power to nominate, approve or appoint a skilled person (an independent expert who can provide a view

(1) [www.financialstabilityboard.org/publications/140407.pdf](http://www.financialstabilityboard.org/publications/140407.pdf).

(2) *The PRAs approach to banking supervision*, June 2014, Table A; *The PRAs approach to insurance supervision*, June 2014, Table A.

(3) *Ibid*, 194 and 196; *ibid*, 196 and 198.

(4) [www.bankofengland.co.uk/publications/Documents/other/pral/approachenforcement.pdf](http://www.bankofengland.co.uk/publications/Documents/other/pral/approachenforcement.pdf).

(5) *The PRAs approach to banking supervision*, June 2014, paragraph 197; *The PRAs approach to insurance supervision*, June 2014, paragraph 219.

(6) *Ibid*, 198–199; *ibid*, 220–221.

(7) For full details, please refer to *PRA Supervisory Statement SS7/14*, 'Reports by skilled persons', June 2014; [www.bankofengland.co.uk/pral/Pages/publications/ss/2014/ss714.aspx](http://www.bankofengland.co.uk/pral/Pages/publications/ss/2014/ss714.aspx).



of aspects of a firm's activities) to produce a report under section 166 of the Act to gain a deeper understanding of identified concerns, to determine whether they result from serious failings in culture, and to propose recommendations for management to address them; if the PRA feels that further information would be desirable and the PRA does not already have adequate information from other supervisory sources. The PRA may either require a firm to appoint a skilled person, or may appoint one directly itself.

18. The PRA requires skilled persons to submit an independence statement, and one of the factors that the PRA will consider is whether the skilled person appears to have any professional difficulty, potential conflict of interest, or insufficient detachment. The PRA may contract directly with the skilled person if necessary to ensure independence in instances where there may be undue management influence. There may be situations where it is appropriate to use a skilled person who has prior experience of working with a firm or may potentially do so, due to the level of existing knowledge of a firm's systems or controls. However, in such situations any conflict of interest will continue to be an important consideration in the PRA's assessment of independence.

19. The PRA expects reports to be delivered in a timely manner, and the PRA will normally specify a time limit for the skilled person to complete a report or update the relevant information. However the length of time must be balanced against the desire for an appropriate quality of information in the report. Firms will usually receive draft and final copies of the report at the same time as the PRA, and will typically be allowed the opportunity to respond.

#### 20. Examples of skilled person reports commissioned in relation to culture.

- i. An investigation into the effectiveness and embeddedness of the risk management of a firm, including the adequacy of its risk culture and the adequacy and effectiveness of management structures.
- ii. An investigation into board and executive-level governance arrangements at a firm, including whether the culture of the board and supporting decision-making bodies are conducive to monitoring risks and controls.

21. The PRA may also require a firm to provide it with specified information or information of a specified description under section 165 of the Act. Further details are provided in the *Statement of policy on the financial stability information power*.<sup>(1)</sup>

## Requirements

22. The PRA has the power to impose a requirement under Part 4A, section 55M of the Act on a firm to undertake or cease

a particular action. One of the grounds for exercising this power is if it appears to the PRA that it is desirable to exercise the power in order to advance any of the PRA's objectives. It therefore enables the PRA to take early intervention action should failings in the culture of a firm pose a risk to the PRA's objectives. The power is no longer linked to varying a firm's permissions as it was under the Act's original form, but instead may be used on a stand-alone basis.

23. There is substantial flexibility for the PRA to tailor requirements specific to the circumstances of a firm and the nature of the PRA's concerns, including serious cultural failings. Requirements may include (but are not limited to) requiring the firm to address concerns identified by the PRA, requiring the nomination of an individual within a firm to have responsibility for recommendations specified by the PRA, or requiring the retention of an independent individual to ensure compliance with PRA recommendations, as judged necessary by the PRA (the latter can also be achieved under section 166 of the Act).

#### 24. Examples of powers of requirement used in relation to culture (voluntarily agreed to by firms or that the PRA has formally imposed).

- i. A requirement for a firm to put in place appropriate governance structures and committees to oversee regulatory concerns about meeting regulatory requirements.
- ii. A requirement that an external party be appointed to monitor and oversee the board's compliance with the PRA's requirements, with a reporting line direct to the PRA.
- iii. A voluntary requirement entered into by a firm to limit its balance sheet growth to a set percentage per annum, in response to PRA concerns over the safety and soundness of the firm. This lasted until the PRA was satisfied that more robust governance structures were in place.

25. The PRA can also exercise its power under section 55M of the Act so that a firm can be prohibited from dealing with its assets or customer assets held by the firm, the consequences of which are set out in section 55P of the Act.

26. The PRA does not have to publicise the imposition of requirements if publication would be unfair to the person concerned, prejudicial to the safety and soundness of a firm, or (for insurers) prejudicial to securing the appropriate degree of protection for policyholders.

(1) [www.bankofengland.co.uk/pr/Pages/publications/fsinfopower.aspx](http://www.bankofengland.co.uk/pr/Pages/publications/fsinfopower.aspx).

### Own initiative variation of permission

27. It may be appropriate to use the PRA's own-initiative variation of permission (OIVOP) power under section 55J of the Act to change the firm's permissions in certain circumstances, or to agree a voluntary variation of permission with the firm. This can extend as far as withdrawal of authorisation.

### 28. Stylised example of OIVOP power in relation to culture (including skilled person report).

The PRA could have concerns over the non-financial resources of a firm following changes to personnel and a lack of board expertise to safely conduct deposit taking activities, which could lead to the firm voluntarily varying its permission so not as to accept regulated deposits for a six-month period. During this period a skilled person report would be commissioned under section 166 of the Act to identify the changes that would be required in order for the firm to recommence deposit-taking activities in a safe and sound manner.

### Other powers

29. The PRA has the power to take action against individuals through the Approved Persons Regime, which will be reformed in relation to senior managers and a new 'Certification Regime', the implementation of which will be consulted on in 2014. While these powers are used on individuals, their use on senior management, including in response to failings in culture, is a potential tool for the supervision of firms.

30. The powers of direction under section 192C of the Act enable the PRA to take steps to direct the parent holding company of PRA-authorized firms to take or not to take specified action if required. Further details are provided in the statement of policy on *The power of direction over qualifying parent undertakings*.<sup>(1)</sup>

### Working with the FCA

31. The PRA has a statutory duty to co-ordinate with the FCA in the exercise of its public functions, including policymaking and supervision. As required by sections 3D and 3E of the Act,

a Memorandum of Understanding (MoU) between the FCA and the PRA describes how the two regulators fulfil this duty to co-ordinate in a way that supports each regulator's ability to advance its own objectives,<sup>(2)</sup> and the FCA and the PRA will share their respective views on key conduct and prudential issues facing a firm. Co-ordination between the PRA and the FCA is also assisted by the membership of their CEOs on each other's board and on the Financial Policy Committee.<sup>(3)</sup>

32. The PRA works closely with the FCA as part of its supervisory approach, and supervisors of dual-regulated firms co-operate routinely and meet regularly at least once a year (twice a year for the largest banks) to discuss issues of common interest as required by the MoU. Furthermore, either regulator is able to call a meeting as needed, and there is a broad range of day-to-day informal supervisory contact between the regulators beyond the meetings required by the MoU.

33. Where the PRA identifies concerns they are discussed with the FCA as appropriate and, wherever possible, the regulators come to a common view on the underlying issues and the proposed course of action.

34. Where the regulators agree that use of powers is necessary to tackle failings in standards and culture, they will seek to take joint action if appropriate. When a skilled person report is commissioned by both regulators it is commissioned in a co-ordinated manner, including using the same skilled person where practicable and appropriate. The PRA may also share skilled persons reports with the FCA. The Act and the MoU also require the PRA to consult with the FCA (and vice versa) before imposing requirements on firms, as well as requiring consultation when a firm wishes to vary its permission voluntarily. However, it may be appropriate for the PRA to take action where the FCA does not wish to, or to take different action to the FCA, depending on the circumstances of the firm and the perceived failings in culture.

35. Should enforcement action be necessary, the PRA and the FCA consult each other throughout the process, and the PRA and FCA run joint enforcement investigations where appropriate.

(1) [www.bankofengland.co.uk/publications/Documents/other/pral/powerdirection.pdf](http://www.bankofengland.co.uk/publications/Documents/other/pral/powerdirection.pdf).

(2) [www.bankofengland.co.uk/about/Documents/mous/moufcapra.pdf](http://www.bankofengland.co.uk/about/Documents/mous/moufcapra.pdf).

(3) *The PRAs approach to banking supervision*, June 2014, Box 4 — Working with other authorities and *The PRAs approach to insurance supervision*, June 2014, Box 4 — Working with other authorities.