BANK OF ENGLAND

# Speech

## The supervisory approach of the Prudential Regulation Authority


Speech given by

Andrew Bailey, Executive Director


At The Queen Elizabeth II Conference Centre, London

19 May 2011

**Principles of PRA regulation**

Can I first of all add my welcome to you all. Regulators are not meant to be popular, even if their events are well-attended. As Hector has explained, today is the next step towards setting out the future model of regulation for the PRA. The document you have is the result of a lot of thinking and discussion in the Bank of England and the FSA over the last nearly twelve months. It is not very long – intentionally so. We would like it to be read rather than weighed. It is a consultation document, but not in a rigid legal sense. We want to foster open debate and thereby improve the design of the PRA. Consistent with this objective, we are issuing the document in advance of the Bill entering Parliament in order to inform debate and scrutiny once that happens.

My aim today is to provide you with some more detail about our proposed approach to the supervision of deposit-takers and a small number of larger investment firms. The key feature of the PRA will be its statutory objective for prudential supervision, which will put a clear emphasis on the promotion of the stability of the UK financial system, thereby supporting the objectives of the Bank of England generally and its new Financial Policy Committee in particular. The PRA will support the Bank's work to build a public consensus around the need for financial stability as a key objective of public policy, because financial stability is a precondition for improving public welfare. Our conference today is I hope a step in that process of building consensus. Later this summer we will spell out our future approach to the prudential regulation of insurers.

Under the so-called twin peaks model of future financial regulation in the UK, and in contrast to the FSA, the PRA will have a single objective, allowing it to focus fully on promoting the safety and soundness of the firms it regulates. Key elements in the PRA's regulatory approach will be to ensure that financial firms do business in such a way that adverse effects on the UK financial system are avoided and to minimise damage to the system in the event that a firm does fail. But crucially, as Hector explained, the PRA will not endeavour to avoid failure of firms within its regulatory remit at all cost.

In a similar vein, the PRA's regulatory philosophy will be based on the premise that financial firms should be subject to the disciplines of the market, with regulation and supervision addressing residual market failures. Through a combination of prudential policy, supervision and work to improve the UK's resolution infrastructure, we will seek to ensure that all firms it regulates can fail or be closed in an orderly manner with minimal impact on the financial system, consistent with the PRA's objective of promoting financial stability in the UK.

Maintaining financial stability is an objective in public policy which we should all value highly. We have seen what happens when we lose it. But achieving and maintaining financial stability does not mean that we have an industry in which no-one can fail. The costs of attempting to achieve 'a no-failure' policy are easy to identify, not least that we would have an industry in which competition is severely reduced. And a financial services industry in which failure is not possible is unlikely to be able to serve the needs of the economy effectively.

**Risk assessment framework**

In order to deliver its objective of stability of the financial system, the PRA will use a new framework to assess risks to financial stability. Key elements in that risk assessment framework will be: the potential impact on the financial system of a firm coming under stress or failing; the impact on the viability of a firm's business model of the macroeconomic and business risk context; and a firm's overall safety and soundness, which may act to mitigate the potential risk a firm poses to financial stability. Key mitigants to be assessed by the PRA will be: the degree of resolvability of a firm (working closely with the Bank's Special Resolution Unit); its financial strength (including its ability to generate capital through earnings, its capital held against future risks, the quality of its liquid assets and its liquidity management); and the quality of a firm's risk management and governance (including the competence of its senior management).

This new risk assessment framework will replace the FSA's ARROW approach and seek to integrate the entire range of the PRA's supervisory activities. Risks to a firm will be identified using: baseline monitoring; investigation and assurance; and the macroeconomic and business context. Drawing on PRA and Bank expertise, that will result in a risk assessment for the firm, which can then form the basis for a supervisory strategy (with appropriate mitigating actions) for the firm.

Our approach to risk assessment will be proportionate. This is a very important point in the new approach. Business model and resolvability analysis as well as stress tests for small firms (such as credit unions) will be largely based on simple macroeconomic and sectoral risk profiling. But the PRA will have to undertake a more intensive and idiosyncratic analysis of the business models of and potential stresses for large institutions.

Overall, the PRA's risk assessment framework will make increased use of forward-looking analysis to, on the basis of a balance of risks, assess the likelihood of firm failure, drawing on the Bank's and FPC's analysis of systemic risk.

**Judgement-based supervision**

The PRA will take a forward-looking and judgment-based approach to supervision. As Hector outlined earlier, baseline monitoring will be undertaken for all firms, including those that can be resolved with minimal disruption to the financial system (e.g. credit unions and small deposit-takers). This monitoring will include a review of a firm's resolvability (at least) once a year, analysis of a firm's financial position, discussions with senior management and ensuring compliance with minimum prudential standards for capital, liquidity and large exposures, as well as early interventions (where necessary) driven by a new Proactive Intervention Framework (PIF). I will come back to this framework later.

Beyond such baseline monitoring, PRA resources will be focused on those firms and prudential issues that have the greatest impact on the stability of the UK financial system. Importantly, forward-looking supervision will involve aiming to ensure not only that firms are compliant with prudential rules today, but also assessing whether firms are likely to be financially sound in various future states of the world.

Peer analysis will play an important role in the assessment of a firm's business risk, both to detect whether a firm is an outlier relative to its peers and to understand sectoral risks that may threaten financial stability and thus require action by the FPC. We will use forward-looking stress tests to assess the balance of risks surrounding a firm's financial strength (including quantity and quality of capital and liquidity, risk concentrations, and firms' recovery plans). The focus will be on bottom-up stress tests of individual banks, but the PRA will also assist in sector-wide exercises, working with the Bank to support the FPC or supra-national authorities such as the EBA or IMF. The PRA and Bank will be active in this field, as we are today, but not in the over-simplified world of pass and fail. We use stress tests, and will develop our use of them, as diagnostic tools to examine the potential impact of different developments, acknowledging that looking into the future is inherently uncertain.

To support the PRA's objective of creating a regime in which firms can be resolved in an orderly way (i.e. a non-zero failure regime), analysis of a firm's resolvability and the development of credible and effective resolution plans are key parts of the PRA's supervisory assessment. Among other factors, the PRA will, in conjunction with the Bank's Special Resolution Unit, analyse the impact of the resolution plan on the financial system, in particular whether critical economic functions such as the payments system are adequately protected. At a minimum, firms will need to demonstrate that they can produce a single view of depositors' funds to enable the FSCS to pay out insured depositors quickly, to reduce the impact on financial stability. And by quickly, I mean the seven day payout target that we have set. I firmly believe that rapid payout, and the promise of it on a credible basis, is important to maintain the public's confidence in their banks.

**Supervisory interventions and actions expected of firms**

We will be introducing a new framework for proactive intervention in the PRA with a set of stages, or triggers, that represent points at which regulatory intervention would be required. This is in part in order to formalise resolution arrangements but also to mitigate against the risk of regulatory forbearance. This is not intended to detract from the judgement-based supervisory approach that will be at the core of the PRA philosophy: supervisors will of course need to use their judgement within the formal Intervention Framework.

Guided by the Intervention Framework, the PRA's supervisory interventions will be aimed at reducing the major risks to the stability of the financial system. The framework will set out both actions expected to be taken by a firm as its financial position deteriorates as well as the authorities' actions to prepare for orderly failure or resolution of a firm. In line with our forward-looking approach to supervision, the assessment of a firm's position in the PIF will be based on the firm's viability in both current and future states of the world, and be undertaken as part of the ongoing supervisory process. That position will be communicated to the firm and reviewed in response to specific concerns arising in a firm's external operating environment, such as the build-up of sectoral risks identified by the FPC. As a firm moves from stage 1 (involving a normal level of supervisory monitoring) to later stages of the five stage PIF, supervisory monitoring and actions will become more intrusive, and contingency planning with the Bank's SRU and the FSCS will take on greater importance.

The PRA will adopt a high threshold of materiality when mitigating actions are raised with firms. Such actions will be closely linked to the PRA's assessment of risks and focused on the stability of the UK financial system. Actions will be communicated clearly and at senior level to the firm, with an expectation that the firm will respond appropriately. Hector and I will be closely involved in giving these messages, with our supervisory teams.

In cases where a firm's viability is under threat, the PRA will take supervisory action at an early stage to reduce the probability of disorderly failure. So the focus will be on ensuring that a firm's resolution plan is credible, which will require the PRA to work closely with the firm in question and the SRU at the Bank and the FSCS. And in order to reduce the likelihood of firm failure the PRA may require a firm to change its business model or hold greater capital buffers, especially for systemically important firms. Because the PRA will in general aim to pre-empt risks before they materialise, enforcement actions are likely to be rare. And to make failure capable of being resolved, the organisation of firms might need to change.

**Delivery of supervision**

In order to deliver its new approach to supervision, the PRA will be staffed by highly qualified teams with strong analytical skills and experience in supervision. Naturally, the scale and depth of the resources required for effective supervision will vary according to a firm's business model and complexity.

Major supervisory judgements will be subject to rigorous review, involving the PRA's most senior management. For the systemically most important firms there will be regular contact with PRA senior management. Constructive engagement and corrective action undertaken by regulated firms may, in some states of the world, act as a substitute for additional capital requirements imposed by supervisors.

To support the objective of preserving financial stability, we will enhance the role of third parties. Auditors will play an important role in this respect, because they can identify and alert the regulator to potential weaknesses in a firm's controls and the quality of financial data, which underpin the information used to supervise firms. The PRA will maintain regular dialogue with a firm's auditors about current and future risks to the firm, to improve both audit effectiveness and prudential supervision. There will also be active engagement with a firm's audit committee and non-executive directors to monitor mitigation of key risks to a firm.

To allow the PRA to form an independent judgement of the key risks to financial stability, it will need to have access to accurate information from firms. Regulatory data submitted to the PRA should be of high quality, as they will form the basis of the PRA's supervisory approach and will be a key input to analysis for the FPC. We will maintain an effective data quality assurance process, and at times involve third parties to verify a firm's regulatory returns and resolution plans. These are changes from the past. The PRA will review its regulatory data collection periodically, so that the data collected are used in support of supervisory judgements, while at the same time ensuring compliance with regulatory reporting standards set by the European Supervisory Authorities. The PRA does not want to collect unnecessary information.

We recognise that management, shareholders, creditors and auditors all play an important role in managing prudential risk and will therefore look to the market as a source of discipline to promote prudent behaviour. One of the PRA's goals will be to ensure the market is able to assess safety and soundness of a firm, through greater comparability of disclosures across firms and through time, including a comprehensive disclosure of risks. As part of this commitment to encourage more market discipline, the PRA will seek to publish some regulatory returns, though it will not go so far as to disclose its own supervisory judgements about firms.

**PRA policy making**

The PRA's approach to prudential regulation will be to set out a high-level framework containing minimum standards expected of firms. The prudential policy framework will aim to protect against a range of possible outcomes and support judgement-based supervision, with policies covering areas such as capital and liquidity adequacy, large exposures, risk management, resolvability and remuneration. PRA policies will incorporate FPC recommendations, to ensure consistency between micro and macro-prudential policy. The PRA's policies and rules will, as much as possible, be clear and contain explanations of their purpose. In turn, the PRA will expect firms to consider the purpose and spirit of PRA rules when managing their business and to avoid creative compliance and regulatory arbitrage designed to mask the riskiness of their activities or financial exposures.

The PRA will adopt a proactive and constructive approach to influencing the international debate about regulatory standards. It will seek to ensure that its judgement-based approach is not undermined by international developments, working closely with HMT, the rest of the Bank of England and the FCA to develop a consistent UK negotiating position on financial regulation. The PRA will focus on active and early engagement with European authorities such as the EBA and EIOPA, as well as the Financial Stability Board and the Basel Committee on Banking Supervision, at senior level. Increasingly, the rules of financial regulation are set on an international basis, but that should not be taken to mean that the necessary judgements we have to make when applying those rules on a forward-looking basis are constrained.

**Coordination with other authorities**

Domestic

Effective coordination with the FCA will be critical to the successful delivery of the PRA's new supervisory framework. The PRA and FCA will need to establish supervisory colleges and MoUs to ensure information relevant to both organisations will be shared. We and the formative FCA recognise the importance of effective co-ordination in practice – both to achieve our objectives and in recognition of the importance of operating efficiently and not burdening the regulated community. I expect that we and the FCA will publish details of our proposals on how we propose to handle this co-ordination in practice.

But micro-prudential supervision and coordination between the twin peaks regulators is not sufficient to deliver financial stability and must be complemented by effective macro-prudential oversight. As a subsidiary of the Bank of England, there will also be close cooperation and information exchange between the PRA and rest of the Bank including the FPC. Firm-specific information provided by the PRA will feed into the FPC's macro-prudential assessment; and FPC analysis of potential systemic risks will help inform the PRA's judgements on specific types of institutions and sectors. The FPC will also give recommendations and directions to the PRA and FCA on regulatory tools to be used to support macro-prudential policy, and the PRA will be responsible for implementing those, just as it will be for authorisation of firms it regulates and the judgements that key individuals are fit and proper.

The PRA's functions will differ markedly from those of the FCA and the FSCS. It will not be responsible for consumer protection, for ensuring market integrity or for preventing financial crime or money laundering – those distinctions must be clear. It will seek to mitigate the disruption to the functioning of the economy from the failure of a firm it regulates, but that will not extend to preventing direct losses to depositors: the FSCS exists to provide protection as a last resort.

International

As noted in the document we published this morning, the PRA will aim to apply the same prudential requirements to all banks, including those from overseas. And given the PRA's statutory objective to contribute to financial stability, supervisory efforts will focus on large international banks. In the case of UK subsidiaries of overseas banks, links of the UK entity with the group as a whole as well as the group's viability need to be an integral part of the PRA's supervisory assessment. And to ensure orderly resolvability of such subsidiaries, the PRA will engage closely with overseas supervisors, via colleges and cross-border coordination of recovery and resolution plans.

The PRA will have only limited powers (and limited access to group-wide information) over branches of EEA banks. Given the importance of these branches in the UK, the PRA will seek to influence the group-level supervisory approach of the home state regulator in cases where the bank group poses a risk to UK financial stability. A key priority will be to ensure that home regulators have realistic plans to resolve such groups without adversely affecting the stability of the UK financial system. This is a key missing element of the so-called European Passporting System. Moreover, it is essential that international co-operation among regulators is real and effective. The PRA as a home regulator will need to give as much information as it will want to receive as a host regulator.

The PRA will also use the establishment of the European Supervisory Authorities as an opportunity to influence the supervision of EEA branches, through active participation in supervisory colleges and in the European Banking Authority, as well as peer reviews of other countries' supervisory approaches.

In conclusion, you may well ask why we think we can produce an approach that "gets it right" this time. I think the key element of the new approach is the clarity that should come from the single objective of maintaining financial stability. The Twin Peaks model helps in this respect because it provides greater focus for the regulator on each peak. Of course, now we have to put the new approach into effect, so our job is far from done.

Thank you.