



UNITED KINGDOM

FINANCIAL SECTOR ASSESSMENT PROGRAM

BANKING SUPERVISION AND ISSUES IN FINANCIAL STABILITY

April 2022

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March 18, 2022

TECHNICAL NOTE

BANKING SUPERVISION AND ISSUES IN FINANCIAL
STABILITY

Prepared By
**Monetary and Capital Markets
 Department**

This Note was prepared by IMF staff in the context of an IMF Financial Sector Assessment Program (FSAP) in the United Kingdom. The FSAP was led by Mr. Udaibir Das. The note contains technical analysis and detailed information underpinning the FSAP's findings and recommendations. Further information on the FSAP can be found at <http://www.imf.org/external/np/fsap/fssa.aspx>

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Glossary

ALM	Asset and Liability Management
ARTIS	Authorisations, RegTech and International Supervision
AQR	Asset Quality Review
AST	Annual Stress Test
BoE	Bank of England
BBLs	Bounce Back Loan Scheme
BCP	Basel Core Principles for Effective Banking Supervision
CCB	Capital Conservation Buffer
CCYB	Countercyclical Capital Buffer
CEO	Chief Executive Officer
CET1	Common Equity Tier 1
CIB	Corporate and Investment Banking
CFRF	Climate Financial Risk Forum
CP	Consultative Paper
CRR	Capital Requirements Regulation
CRD	Capital requirements Directive
CRE	Commercial Real Estate
CRMT	Credit Risk Management Team
CVA	Credit Valuation Adjustment
DBST	Desk Based Stress Testing
DP	Discussion Paper
DSIB	Domestic Systemically Important Bank
EBA	European Banking Authority
ECB	European Central Bank
ECL	Expected Credit Losses
EDMC	Enforcement Decision Making Committee
EEA	European Economic Area
EMIR	European Market Infrastructure Regulation
EU	European Union
FBA	U.S. Federal Banking Agency
FCA	Financial Conduct Authority
FGF	Fast Growing Firms
FPC	Financial Policy Committee
FSA	Financial Services Authority
FSB	Financial Stability Board
FSAP	Financial Sector Assessment Program
FSCS	Financial Services Compensation Scheme
FSMA	Financial Services and Markets Act
GFC	Global Financial Crisis
GSIB	Global Systemically Important Bank
GSII	Global Systemically Important Institutions
HMT	HM Treasury
HSS	Home State Supervisor
ICAAP	Internal Capital Adequacy Assessment Process
IEO	Independent Evaluation Office

Glossary (concluded)

ILAAP	Internal Liquidity Adequacy Assessment Process
IRR	Interest Rate Risk
IRRBB	Interest Rate Risk in the Banking Book
ITDR	IT Disaster Recovery
LCR	Liquidity Coverage Ratio
LGD	Loss Given Default
LTV	Loan-To-Value
MI	Management Information
MIFID	Markets in Financial Instruments Directive
MOU	Memorandum of Understanding
MPC	Monetary Policy Committee
MPR	Mid-Point Review
MREL	Minimum Requirement for Own Funds and Eligible Liabilities
MRT	Material Risk-Takers
NBSU	New Bank Start-up Unit
NCA	National Competent Authority
NSFR	Net Stable Funding Ratio
OLAR	Overall Liquidity Adequacy Rule
OSII	Other Systemically Important Institutions
PD	Probability of Default
PFE	Potential Future Exposure
PI	Potential Impact
PIF	Proactive Intervention Framework
PRA	Prudential Regulation Authority
PRC	Prudential Regulatory Committee
PSM	Periodic Summary Meeting
QPR	Quarterly Performance Report
RPS	Remuneration Policy Statement
RWA	Risk Weighted Assets
RWM	Risk and Work Manager
SCO	Secondary Objective
SMCR	Senior Manager and Certification Regime
SMF	Senior Manager Function
SRB	Systemic Risk Buffer
SREP	Supervisory Review and Evaluation Process
SRPC	Supervision, Risk and Policy Committee
SRS	Supervisory Risk Specialists
SSM	Single Supervisory Mechanism
SWD	Resolution and Solvent Wind Down
TCR	Total Capital Requirements
TN	Technical Note
TPR	Temporary Permission Regime
TTP	Temporary Transitional Power
U.K.	United Kingdom
UKDT	U.K. Deposit Takers Supervision
U.S.	United States
VAR	Value-At-Risk

EXECUTIVE SUMMARY AND RECOMMENDATIONS

The Financial Sector Assessment Program (FSAP) carried out a targeted evaluation of issues relating to the effectiveness of banking regulation and supervision in the United Kingdom. It leverages on the 2016 FSAP which concluded that the United Kingdom (U.K.) had a high degree of compliance with the 2012 Basel Core Principles (BCPs) with some shortcomings. The 2021 FSAP reviewed the progress in addressing them and examined the main supervisory and regulatory developments since the last FSAP. The FSAP evaluation also focuses on steps taken to minimize disruptions in the U.K. banking system at the end of the Brexit transition period, and on the regulatory and supervisory measures introduced to contain spillovers from the ongoing COVID-19 pandemic on the U.K. banking system.

The United Kingdom continues to operate a sound regulatory and supervisory framework for the safety and soundness of the banking sector. The United Kingdom has an extremely transparent approach towards bank regulation. There is strong cooperation and information-sharing between the two main agencies viz. Prudential Regulatory Authority (PRA) and Financial Conduct Authority (FCA). The PRA has a broad range of legal powers to enforce prudential standards and uses an array of tools and techniques to implement its risk-based approach. It has taken steps to address key concerns raised during the 2016 FSAP and increased the intensity of supervision on non-systemic smaller firms. It has also kept an active pace in implementing reforms to enhance operational resilience. Detailed supervisory expectations have been laid out for the newly licensed banks including financial technology focused challenger banks. The PRA and FCA are proactively addressing the financial risks associated with climate change into their regulatory programs. The joint PRA and FCA Senior Manager and Certification Regime (SMCR) designed to impose personal accountability on senior managers and improve the conduct of all employees is producing positive results, but the PRA has not yet used full range of powers provided for by the framework. The approach to supervision remains largely principles based and flexible as demonstrated during the COVID-19 pandemic.

The prudential and supervisory response to the COVID-19 pandemic shock was swift and comprehensive. In designing them, the United Kingdom ensured that these exceptional temporary regulatory measures are generally consistent with the core standards implemented after the global financial crisis (GFC). The support measures have thus far yielded positive results, but vigilance is still called for as they are removed, especially with respect to non-performing exposures and any unintended macro financial spillovers, which may increase in certain sectors (hospitality, leisure, housing) and will continue to need enhanced supervisory scrutiny.

Important steps have been taken by the U.K. authorities to minimize banking market disruptions at the end of the Brexit transition period, but challenges remain. The early planning and processes of preserving and amending the EU legislation as well as the introduction of temporary permission regimes (TPR) have resulted in an orderly transition for the banking sector, and disruptions have been minimal thus far. At the end of the transition period, the United Kingdom is nonetheless left with a relatively complex regulatory structure that integrates core aspects of the

EU regulatory framework into a multilayered mix of primary legislation, statutory instruments, onshored regulations and technical standards, and PRA rules and guidance. The post Brexit challenge will therefore include (i) streamlining the prudential framework without lowering the internationally agreed requirements; and (ii) completing the authorization process for former European passporting firms by the end of the TPR.

Brexit also marks a turning point with the United Kingdom assuming autonomy on all matters of regulatory policy. Thus, in the period ahead, the approach to regulating banking services will evolve to meet the specific needs of the United Kingdom. The onshoring of EU legislation was an immediate response after Brexit, but it was not designed to provide the long-term approach to regulating financial services. The authorities have proposed to empower U.K. financial regulators (PRA and FCA) to set out the regulatory rules and supervisory requirements for banks going forward. In doing so, the PRA intends to introduce proportionality measures into the prudential framework for firms that are neither systemically important nor internationally active. The diversity of deposit-taking institutions that comprise the U.K. banking sector is indeed conducive to a proportional approach to regulation, but all segments should remain subjected to rigorous prudential standards, broadly consistent with the Basel framework.

As the United Kingdom faces the new challenges as a rule maker for the U.K. banking market, four issues of an effective oversight regime become highly relevant:

First, preserving the primacy of the PRA's prudential safety and soundness objective will be paramount. Unlike the Financial Services Authority, the former prudential regulator, the PRA does not have a competitiveness mandate. However, the Financial Services Act of 2021 specifies new considerations the PRA must have regard to when implementing Basel III standards. Some in the private and public sectors have interjected into the current debate on the future of the oversight framework the idea that U.K. financial regulators should explicitly consider international competitiveness of the U.K. financial sector in their decision making, along with other factors reflecting public policy priorities (e.g. climate change) and the Financial Services Future Regulatory Review (FRF) Review 2021 Consultation further proposes elevating facilitating the long-term growth and international competitiveness of the U.K. economy as new statutory secondary objectives for the FCA and PRA. It is important to ensure that the PRA continues to maintain a clear focus on adopting and implementing robust prudential standards that are commensurate with the structural and global realities of the U.K. banking market. Safety and soundness of the financial system must remain a sine qua non of the post Brexit regulatory and supervisory regime in the United Kingdom. In the run up to the GFC, several jurisdictions, including in the United Kingdom, encountered a potential conflict between financial stability objectives and competitiveness considerations. Even though competitiveness and other considerations in the Financial Services Act of 2021 do not formally affect the mandate of the PRA—and the Governor of the Bank of England (BOE) has publicly cautioned against any watering down of prudential standards for competitiveness considerations—the need to keep robust prudential standards must remain a high priority as memories of the GFC may fade.

Second, a stronger on the ground focus on individual banks and their activities is highly desirable. The current supervisory approach is a blend of a cross-firm supervision together with firm level oversight. Supervisors rely on strong offsite risk analytical capabilities and have a good understanding of the banks and the risks they face. The PRA adopts a risk based and flexible supervisory approach but should use the full range of existing tools (onsite reviews, credit asset quality reviews, skilled person reviews) on a more frequent basis while conducting in-depth investigations with more testing as well as timely and substantive feedback to firms. This would provide better assurance that risks arising from corporate and investment banking (CIB activities and those that could materialize in the context of COVID-19) are adequately measured and mitigated by firms. The contours of banking and banking products and services are changing thus also heightening the importance of high-quality and in-time bank level supervision. The potential that banks' risk management becomes complacent should not be underestimated as a continued low yield environment is traditionally prone to search for yield strategies within financial systems and excessive risk taking.

Third, a major regulatory and supervisory responsibility the United Kingdom undertakes relates to international banking activities. International banks, including Global Systemically Important Banks (GSIBs) undertaking CIB activities can operate in the United Kingdom as either subsidiaries or branches. The stable functioning of this market segment is vital for global financial stability. While there are no requirements or expectations in the Basel framework or in the BCPs that foreign banks should operate as subsidiaries, the United Kingdom's entity-neutral approach is largely unique among jurisdictions hosting large financial centres. This has implications for supervision as it presents certain limitations and may raise practical challenges in the case of branches (i.e., fewer formal supervisory tools, home and host authorities may share different supervisory views and objectives, etc.), and some of these branches are very large. The U.K. authorities have made clear they have a global responsibility to maintain high prudential standards in the United Kingdom and that openness needs to be accompanied by financial and operational resilience. The PRA has set out its approach to host supervision in a holistic way, providing extensive and detailed expectations for firms. It will be important, however, for the PRA to further enhance cooperation with all third-country home authorities to maximize information sharing and supervisory collaboration and reassess regularly whether the approach to supervising international banking firms delivers the expected supervisory outcome and preserves financial stability.

Fourth, resources are stretched given the range and nature of the tasks the PRA carries out. Budgets and staffing allocations over the past five years have remained relatively flat with only modest increases being made during this period. The PRA has shown flexibility in reallocating resources to new and shifting risks but faces new challenges over the longer term. Going forward, new post Brexit prudential rulemaking responsibilities, an increased number of firms to be supervised after Brexit, new climate change responsibilities, rapid technological change, the need to deliver on major United Kingdom projects and participating in international standard setting body activities while maintaining adequate resources to effectively supervise banks will require the PRA to carefully evaluate and maintain the level of resources required to deliver on its supervisory objectives for banks. Moreover, additional resources are warranted to perform more frequent and

in-depth work on verification and testing of individual banks' CIB activities and business models, conduct more intrusive risk management and asset quality reviews, and proactively review firms' internal models.

Table 1. United Kingdom: Main Recommendations		
Recommendation	Priority	Timeline
<u>Powers, resources, and regulatory requirements</u>	High	NT
1. Preserve the primacy of the PRA's prudential safety and soundness objective in principle and in practice; introduce processes and mechanisms to resolve cases where financial stability objectives and other considerations may conflict; and issue a statement confirming the subordinated nature of have regard to considerations		
2. Estimate expected workload in key and emerging areas - such as internal models, complex CIB activities, financial technology, and IT- and align resources and enhance capacity accordingly	High	NT
3. Streamline the post-Brexit prudential rulebook in a manner consistent with core global standards and ensure that applications made by firms in the TPR are processed in due time by the end of the TPR	High	MT
4. Ensure that non-internationally active banks remain required to comply with capital requirements broadly consistent with the principles of the applicable Basel standards	Medium	MT
5. Seek additional statutory powers to review and examine the resilience of all critical services (including, but not limited to cloud services) that third parties provide to regulated firms	High	MT
<u>Supervisory approach</u>	Medium	MT
6. Consider both incorporating reputational risk in the potential impact (PI) methodology as well as providing guidance on how to embed climate-related financial risks when scoring firms' individual risk elements		
7. Actively consider more frequent and in-depth firm-specific onsite reviews of relevant activities and risk management practices to supplement cross firm work and proactively identify issues for timely remediation	High	MT
8. Share supervisory onsite reports at a level of detail appropriate for the seniority of staff at firms to increase transparency and ensure timely feedback to firms between two PSMs; provide more detailed findings and recommendations to be implemented within a given timeframe	High	MT
9. Use S-166 reviews in a proactive manner for a broader range of firms while increasing the PRA's own capabilities and expertise for certain skills (including technological skills) and subject matters	High	MT
10. Ensure better consistency of supervisory approaches across UKDT and ARTIS where appropriate and carefully consider pros and cons before adjusting the supervisory intensity on non-systemic firms	High	NT

Table 1. United Kingdom: Main Recommendations (concluded)		
11. Implement a more active supervisory role in assessing loan classification and provisioning; conduct deep dives of models used for ECL calculation; and phase out progressively the guidance on payment deferrals to require banks to assess and classify loans on a case-by-case basis	High	NT
12. Introduce a clear expectation that firms should set limits on their single name, geographic and sectoral risk concentrations as part of their ICAAP	Medium	MT
13. Implement a more proactive review of internal models; increase resources devoted to the review of firms' internal models used for regulatory purpose and provide guidelines on the calibration of IRB parameters after COVID-19	High	MT
14. Improve cross-firm consistency when setting the PRA buffer; align the frequency of deep dives C-SREP for all Category 1 firms; periodically reassess whether the capital buffer calculation framework is effective for new banks	Medium	MT
15. Monitor over time the effect of the decision to shift the balance of capital requirements from Pillar 2 capital add-on towards buffers	Medium	MT
<u>International bank regulation and supervision</u>	High	MT
16. Further enhance cooperation with third-country authorities, consistent with the materiality of their impact on U.K. financial stability, to maximize data and information sharing, and supervisory collaboration		
17. Continue to assess whether the approach to supervising international firms delivers the expected supervisory outcome	High	MT
18. Introduce appropriate binding requirements on governance and risk management for third country branches if it would further support the supervision of these firms	High	MT
<u>Remediation and enforcement</u>	High	NT
19. Use the whole range of powers provided for by the SMCR and remuneration framework as appropriate to ensure that individuals holding senior manager functions are fully held accountable		
20. Utilize the full panoply of enforcement tools where appropriate and provide more guidance to supervisors on relevant legal principles and risk factors to consider when using these powers	Medium	MT
NT = Near Term (now to one year); MT = Medium Term (within 1 to 3 years)		

INTRODUCTION

1. **This technical note analyzes the key aspects of the regulatory and supervisory framework for banks operating in the United Kingdom (U.K.).** The analysis is part of the 2021 Financial Sector Assessment Program (FSAP) of the United Kingdom. It is based on the regulatory framework in place and the supervisory practices employed as of July 2021.¹ The analysis was based on a review of regulations and supervisory guidance, meetings with the U.K. financial regulators and review of their joint responses to questionnaires. The FSAP team also met with representatives from banks, external auditors, and industry associations. The mission and meetings were all conducted virtually given the travel restrictions due to the COVID-19 pandemic.
2. **The 2016 FSAP performed a full assessment of compliance with the 2012 Basel Core Principles for Effective Banking Supervision (BCP), concluding that the United Kingdom had a high degree of compliance with the BCPs.** This technical note leverages that assessment by reviewing the progress achieved in addressing the main weaknesses previously identified and the main supervisory and regulatory developments since then (see Appendix I). While the BCP served as the basis for the evaluation, no formal assessment has been conducted against BCP principles. The note focuses on the prudential supervision of deposit-takers and designated investment firms that are supervised by the PRA for prudential matters.
3. **The FSAP team appreciated the excellent cooperation, including extensive provision of internal guidelines, supervisory files, and reports.** In particular, the team would like to thank the Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) staff who responded to the extensive and detailed requests promptly and accurately prior to and during the mission at a time when supervisory staff were burdened by many supervisory and regulatory initiatives in the context of Brexit and COVID-19 crisis. The team was impressed by the commitment of the supervisors with whom they met. They are experienced and knowledgeable professionals. In terms of cooperation with the FSAP team, U.K. financial regulators have set a very high bar for future FSAPs in other jurisdictions.

INSTITUTIONAL SETTING

A. Organization, Supervisory Objectives, and Powers

4. **Banks and designated investment firms are dual-regulated firms.** The PRA and the FCA have responsibility for the supervision of a wide range of firms, the PRA for prudential matters and the FCA for conduct matters. The PRA regulates around 1,500 banks and major investment firms, as well as building societies, credit unions, and insurers.² The FCA is the regulator for nearly 60,000

¹ The main authors of this technical note are Luc Riedweg (IMF) and Thomas Curry (IMF expert, former Comptroller of the Currency in the United States).

² Unless specified otherwise, banks, designated investment firms and building societies are referred to in this note as 'firms', 'PRA-regulated firms' or 'dual-regulated firms'.

firms in total, the vast majority of which are solo-regulated firms.³ In the United Kingdom, the Parliament establishes the legislative parameters within which HM Treasury (HMT) sets the regulatory perimeter' through secondary legislation, specifying which financial activities should be regulated. It is also worthwhile noting that HMT has launched a Financial Services Future Regulatory Review (FRF review) (see below).⁴

5. The two authorities have separate and independent mandates, set out in statute, reflecting the United Kingdom's 'Twin Peaks' model. U.K. financial regulators have to coordinate and cooperate in a number of areas, as further explained below (Section B).

- **The PRA has been given a general objective to promote the safety and soundness of PRA-regulated firms and a secondary objective to facilitate effective competition.** Under, the Financial Services and Markets Act 2000 (FSMA), the PRA's general objective is to promote the safety and soundness of PRA-regulated firms, and in advancing that objective the PRA must seek to ensure that firms carry out their business in a way which avoids any adverse impact on the stability of the U.K. financial system, in particular seeking to minimize an impact from a firm's failure. The PRA has a secondary objective (hereafter referred to as SCO) to facilitate, insofar as reasonably possible, effective competition in the markets for services provided by PRA-regulated firms in carrying on regulated activities. When exercising its functions, the PRA is also required to have regard to a number of regulatory principles.⁵ The regulators' statutory objectives set out their fundamental purpose and the ends they must pursue, while the regulatory principles set out the principles that the regulators should apply in pursuit of these objectives. To this end, regulatory principles do not need to be achieved in the same way as objectives, which take precedence and apply broadly to the regulators' activities. The regulators must consider and evaluate specific principles when acting to advance their objectives even though they cannot pursue them as ends in themselves (unlike the general objective) (see Appendix II).
- **The FCA has a strategic objective of ensuring the relevant markets function well.** There are three operational objectives in place to support this strategic objective. These are to secure an appropriate degree of protection for consumers; protect and enhance the integrity of the U.K. financial system; and promote effective competition in the interests of consumers.

³ The FCA regulates the conduct of the United Kingdom's financial services. The FCA is also the prudential regulator for all firms that are not dual-regulated firms (i.e., authorized by the PRA and regulated by both the PRA and the FCA).

⁴ HMT, Financial Services Future Regulatory Framework Review, Phase II Consultation. October 2020 and HMT, Financial Services Future Regulatory Framework Review: Proposals for Reform, November 2021. The implication of the FRF review is covered in a distinct technical note.

⁵ Pursuant to Section 3B of FSMA. Regulatory principles include inter alia: the need to use resources in the most efficient and economic way; the principle that a burden or restriction which is imposed should be proportionate to the benefits which are expected to result from the imposition of that burden or restriction; the desirability of sustainable growth in the economy of the United Kingdom in the medium to long-term; the principle that the regulators should exercise their functions as transparently as possible.

6. The Prudential Regulation Committee (PRC) exercises the BoE’s functions as the Prudential Regulation Authority. The PRC is on the same legal footing as the Monetary Policy Committee (MPC) and the Financial Policy Committee (FPC).⁶ The PRA is structurally independent of the BoE and its other macroprudential and resolution responsibilities under the FSMA and the Bank of England Act of 1998. The PRA takes into account the FPC’s views on financial stability when setting microprudential policy. The FPC has the authority to give binding “directions” to the PRA in relation to certain financial stability matters. Although the FPC is also able to make nonbinding recommendations to the PRA and has done so in the past. In June 2021 it consulted on issuing formal directions to the PRA on the leverage ratio framework to which the PRA concurred.

7. The PRA has established a clear doctrine on how the SCO should be used.⁷ The SCO does not require the PRA to act in a manner that is incompatible with its primary objectives. While in many instances the PRA’s primary and secondary objectives should be fully aligned, cases might exist where, within the range of prudential regulation options available to the PRA, there may be some which would deliver greater benefits to competition and others which would deliver greater benefits to safety and soundness. The existence of the SCO means that the PRA should consider—but is not required to adopt—those options which would deliver greater benefits to competition for a given objective of safety and soundness. Since March 2014, the PRA is required to produce an annual competition report setting out how the PRA is delivering against the SCO. A number of key policy decisions have been taken so far. They include: forming the joint PRA and FCA New Bank Start-up Unit (NBSU); implementing policies to facilitate internal ratings based (IRB) model applications from smaller banks; refining the Pillar 2A capital framework; developing a proportionate approach to operational resilience; assessing the competition implications of policies and check for any unintended distortions to competition; and conducting further analysis on barriers to growth for smaller firms. To date, the SCO has not caused a conflict with the PRA’s general objective. Decisions taken that are further discussed below have largely resulted in more proportionality in the prudential framework (simplified and/or more relevant approaches for smaller banks) and not in lower requirements.

8. The U.K. authorities should continue to preserve the primacy of PRA’s safety and soundness objectives. The PRA’s SCO to facilitate effective competition in financial services, for example by facilitating entry and promoting competition between participants⁸ is distinct from an objective to support the international competitiveness of the United Kingdom’s financial sector when making and enforcing regulations. Such a competitiveness objective was an express mandate

⁶ The members of the PRC are: the Governor of the BoE; Deputy Governors for Financial Stability, Markets and Banking, and Prudential Regulation; the Chief Executive of the FCA; a member appointed by the Governor with the approval of the Chancellor; and five other external members appointed by the Chancellor.

⁷ See the BoE’s Quarterly Bulletin article, “*The Prudential Regulation Authority’s secondary competition objective*”, December 2015 for a discussion on the rationale of the SCO, how the PRA interprets it, and what the SCO means for the PRA’s regulation of banks and insurers.

⁸ Improving competition in financial services, particularly retail banking, was identified as a public policy priority in a number of post-crisis reviews, including the Independent Commission on Banking in 2011 and subsequently the Parliamentary Commission on Banking Standards in 2013.

of the FSA, which was eliminated after the GFC.⁹ There is indeed a strong argument that one of the reasons for regulatory failure leading up to the GFC was excessive concern for competitiveness leading to a generalized acceptance of a 'light-touch' approach to regulation and supervision.¹⁰

- "Competitiveness" has, however, been listed as an aspect of Government economic policy to which the regulators should have regard in Remit Letters issued by the Chancellor since 2015.¹¹ The Financial Services Act of 2021, which grants the PRA rulemaking authority to implement Basel III standards added additional considerations that collectively may cloud the PRA primary objective going forward. It specifies new considerations the PRA must have regard to when making rules implementing the outstanding Basel III standards, including "*the likely effect of the rules on the relative standing of the United Kingdom as a place for internationally active credit institutions and investment firms to be based or to carry on activities*". The FRF Review 2021 further proposes (i) elevating facilitating the long-term growth and international competitiveness of the U.K. economy as new secondary objectives for the FCA and PRA and (ii) introducing more have regards to. While a secondary objective may not formally affect the mandate of the PRA, it could operate—notably where combined with have regard to considerations—to increase the weight assigned by the PRA to non-prudential considerations in the discharge of its functions. This risk has not materialized so far, but the pressure on the U.K. financial regulators is mounting.
- The U.K. authorities assert that primary objectives take precedence over the 'have regard to' considerations set out in the Financial Service Act. These additional policy priorities that have been identified as relevant for the implementation of the Basel standards, and which are not captured within the PRA's statutory obligations are, however, not explicitly subordinate to the safety and soundness general objective. The PRA has published its explanation of how it evaluated specific having regard matters in connection with the proposed Basel III rules and concluded that these proposals do not have a material impact on international competitiveness. It is important to confirm the subordinated nature of 'have regard to' considerations to the PRA's primary objective and clarify the consequences, if any, of the PRA failing to adequately assess these additional policy priorities. Such clarity is particularly relevant going forward as new

⁹ The FSA was obliged to meet its main objectives (encouraging market confidence in the U.K. financial system, public awareness and understanding of the U.K. financial system, securing adequate consumer protections, reducing the incidence and impact of financial crime, enhancing financial stability) in ways consistent with the "principles of good regulation" prescribed by FSMA, which included the desirability of maintaining the competitive position of the United Kingdom when making and enforcing regulations.

¹⁰ See "A new approach to financial regulation judgment, focus and stability", HMT, July 2010, and "Financial Services Future Regulatory Review: Phase II consultation", HMT, October 2020. A competitiveness objective was not retained when the PRA was established.

¹¹ The BoE Act 1998 requires HMT, at least once in each Parliament, to make recommendations to the PRC about aspects of the economic policy of the government to which the PRC should have regard when considering how to advance the objectives of the PRA and when considering the application of the regulatory principles set out in the FSMA.

legislation may include more specific policy priorities relevant to each particular regulatory regime, as proposed by HMT during the FRF review.

- In the run up to the GFC, several jurisdictions, including in the United Kingdom, encountered a potential conflict between financial stability objectives and competitiveness considerations. Although the Governor of the BoE has cautioned against watering down prudential standards to preserve competitiveness, there is continued need to be vigilant and preserve the primacy of the PRA's prudential safety and soundness objective in principle and in practice, by ensuring that concerns of prudential nature never get subordinated to others.¹² As argued by the CEO of the FCA, maintaining high regulatory standards rather than having a "competitiveness" mandate is indeed the best way to preserve the City of London's status as a dynamic financial centre.¹³

9. The U.K. financial regulators have a broad range of legal powers to enforce prudential standards. The PRA is empowered to authorize firms, conduct ongoing supervision, approve the appointment of banks' senior managers, address compliance with laws and regulations, and undertake timely corrective actions to address safety and soundness concerns. Banks and designated investment firms are required to meet the Threshold Conditions set by FSMA and comply with rules made by the PRA and FCA, in order to be authorized and to continue operating. The Threshold Conditions include, in particular, the obligation to have adequate financial resources and the requirement to conduct business in a prudent manner. In cases where a bank is failing or likely to fail to satisfy Threshold Conditions, U.K. financial regulators may take action.

10. U.K. financial regulators are extremely transparent in their approach to regulating firms. Under the FSMA, the PRA is required to review and publish annually its strategy in relation to how it will deliver its statutory objectives.¹⁴ Key processes to promote transparency include:

- ***Regular communications on the supervisory approach and the main supervisory expectations.*** Both the PRA's Approach to Banking Supervision and the FCA Mission: Approach to Supervision set out how U.K. financial regulators are advancing their objectives by following key supervisory principles (judgement-based, forward looking and risk focused for the PRA). These approach documents are supplemented by other supervisory policy statements and guidance that provide more detailed information on the PRA's and FCA's approach for specific segments of the banking sector (e.g., approach to new and growing firms, approach to supervising international firms) or certain aspects (e.g., approach to enforcement). Supervisory expectations are communicated through speeches by BoE, PRA and FCA Executives, Dear CEO letters and various other publications. PRA's supervisory Directorates send annual letters to firms to outline the highest priorities for the coming year across the industry as a whole. These letters tend to be more thematic and higher level than individual firm letters. Similarly, on a risk-based

¹² Speech by Andrew Bailey, Mansion House, February 2021.

¹³ Hearing in parliament's Treasury Select Committee, July 2020.

¹⁴ The PRA's strategy for 2020/21 was published with the PRA Business Plan in April 2020 and the strategy for 2021/22 was set out in the Prudential Regulation Business Plan 2021/22 in May 2021.

cycle, the FCA sends periodic portfolio strategy letters to the banks. During meetings with the FSAP team, firms have emphasized the high level of transparency exhibited by the PRA and FCA.

- **A structured consultation process.** New or revised regulations and supervisory expectations are introduced in a transparent manner, following public consultations. A new mechanism to ensure effective coordination and management of new regulatory initiatives (the Regulatory Initiatives Grid) has also been introduced by the Financial Services Regulatory Initiatives Forum.¹⁵ The Grid, which is expected to be published at least twice a year, sets out the “regulatory pipeline”. It lays out information about the timing of major regulatory initiatives over a 24-month horizon and their estimated operational impact (the first Grid was published in May 2020 and an updated version was released in September 2020 and May 2021). Firms are appreciative of their ability to provide inputs, notably through the PRA Practitioner Panel. Overall, the U.K. authorities are actively deploying new initiatives. As in other jurisdictions, the timing of a limited number of initiatives has been delayed in the context of COVID-19 (e.g., implementation of Basel 3.1).
- **Evaluations and reviews carried out in a transparent manner.** Evaluations conducted by the Independent Evaluation Office (IEO) of the BoE and by the PRA have helped assess progress and determine whether further action is necessary (e.g., IEO evaluation of the PRA’s approach to its secondary objective in March 2018, PRA’s evaluation of the senior managers and certification regime (SMCR) in December 2020). Evaluation findings have been published.

11. The internal allocation of tasks within the PRA is clearly established. While certain matters are reserved to PRC (including certain firm-specific and policy-related issues), the day-to-day management of the PRA and implementation of the prudential regulation strategy (including the exercise of the PRA’s statutory powers) is delegated to the CEO.¹⁶ The Supervision, Risk and Policy Committee (SRPC), acting as the most senior committee below the PRC, provides advice to the CEO in the exercise of its powers. It is worthwhile noting that:

- Current processes ensure that decisions of great importance are taken at the appropriate level so that all areas of the PRA have a chance to discuss them together at the PRC or SRPC level (e.g., decision to add a firm to the Watchlist) as well as during Periodic Summary Meetings (PSM) held for each firm, as further detailed below). The FSAP team saw evidence of this process working effectively in practice.

¹⁵ This Forum is comprised of the BoE, PRA, FCA, Payment Systems Regulator and Competition and Markets Authority, with HMT attending as an observer member.

¹⁶ As specified in its terms of reference, the PRC has non-delegable responsibility for annually reporting to the Chancellor on the adequacy of resources allocated to the PRA, making rules under FSMA, determining the PRA’s strategy, and reviewing the PRA’s statutory guidance about how it intends to advance its objectives in discharging its general functions. The delegation to the CEO excludes for example the approval of a supervisory strategy in relation to Category 1 firms and the approval of the appointment of the Chairman and CEO for several firms (including Barclays, HSBC, NatWest, Lloyds Banking Group, Standard Chartered and Santander U.K.).

- Several tools and internal reports are used to monitor supervisory activities. The Quarterly Performance Report (QPR) is used by the PRC and PRA senior management to steer and monitor the performance of the PRA against its business plan as well as progress against planned supervisory activities. Articulated around key questions (*Are we doing what we said we would? What are we achieving? What is our capacity and how are we making use of it? What are our biggest risks and how are these set against our tolerance?*) and synthetic dashboards, it includes extremely detailed information on a range of topics (progress and achievement, COVID-19 impact on supervisory activities, key risks, watch list, resources, etc.). The Risk and Work Manager (R&WM) system records the supervisory activities agreed by the PSM for each firm and their delivery. Firms' progress against supervisory actions are reviewed by the SRPC. The FSAP team was provided sample of such reports that are extremely detailed.
- To fulfil its objectives, the PRA is organized internally into three supervision directorates along particular business types (U.K. Deposit Takers Supervision (UKDT), Authorisations, Reg Tech, and International Supervision (ARTIS) and Insurance Supervision) that are supported by three other directorates (Prudential Policy, PRA Risk and Operations and Supervisory Risk Specialists), organized along risk areas where relevant (credit risk, traded risk, operational risk, capital, and liquidity). The Supervisory Risk Specialists (SRS) provide technical expertise in specific risk disciplines to support a range of functions including policy development and implementation (see Appendix III).

12. The PRA undertook in 2021 a strategic review of its operations. The key conclusion is that the PRA has performed well over the past eight years, and a fundamental overhaul of the supervisory model is not required. The review has identified a number of areas where the PRA's existing operating model could be strengthened to become more risk-based, deploy more consistent approaches and make governance more effective. The review also suggests improving how the PRA explains and justifies rule making, increasing preparedness for firms' orderly exit, and improving the way data analytics and technology are used to supervise firms. These are sensible initiatives. Adjustments to the supervisory approach that would reduce the intensity of supervision on non-systemic firms or shift the balance between cross-firm supervision and firm-specific supervision at the expense of the latter should, however, be carefully considered. Early detection, which is an essential element for the success of any "ease of exit" strategy requires devoting the necessary resources for a robust supervision program.

B. Interagency Cooperation Mechanisms

13. Interagency cooperation mechanisms between the PRA and FCA are in place and interactions are sound and mature. The PRA and FCA operate under a statutory framework that clearly defines each agency's remit. The framework is supplemented by a Memorandum of Understanding (MoU) entered by the two organizations.¹⁷ A high level of cooperation was observed where responsibilities are shared. Cooperative relationships exist at all levels of shared responsibilities (e.g., authorizations, enforcement and SMCR). The FCA's focus on firm conduct and AML compliance is relevant to the PRA's risk management oversight responsibilities.

14. The PRA and FCA has entered cooperative information sharing agreements with international counterparts. The PRA is an active home and host participant in global and regional supervisory colleges. Brexit and London's role as an international banking center requires extensive global coordination and collaboration, especially with the ECB Single Supervisory Mechanism (SSM) and European Economic Area (EEA) National Competent Authorities (NCAs) where the U.K is a host supervisor of a firm with a significant U.K. presence. The FCA has also signed MoUs with both EEA and non-EEA supervisory authorities, setting out how authorities work together and exchange information. The level of trilateral information sharing and collaboration between the PRA, the United States (U.S.) Federal Banking Agencies (FBAs) and the ECB/SSM is well established at the highest levels and among line supervisors. Joint examination with U.S. FBAs and other supervisory thematic and other reviews of international bank subsidiaries and branches should continue and be expanded. Every effort should be made to preserve this positive culture as generational changes occur within each of the supervisory authorities. The PRA also should build on the highly collaborative trilateral approach to further improve its bilateral relationships with other G-SIB supervisors and EU national competent authorities supervising firms with a U.K. presence. Even greater collaboration would help address challenges posed by international banking firms and affiliates, as further detailed below (see developments on the supervision of international firms).

C. Adequacy of Resources

15. While the PRA has an independent funding source under the levy, its annual budget allocations may be constrained by its internal fiscal discipline policies. The PRA is funded by levies upon regulated firms.¹⁸ Statutory principles in FSMA require the PRA to use its resources in the most efficient and economical way. Given the challenges faced by the PRA, this mandate may favor underfunding important but less than high risk supervisory objectives going forward. The annual budget is developed by the PRA and reviewed and adopted by the PRC, but it is subject to the approval of the BoE's Court which acts as a unitary board, setting the Bank's strategy and budget and taking key decisions on resourcing. There is a risk that the PRA's budgetary priorities may not always align with the BoE's overall objectives. Importantly, the PRC is required to report to the Chancellor of the Exchequer on the adequacy of its resources and its independence from the

¹⁷ MoU between the FCA and the BoE (exercising its prudential regulation functions), July 2019.

¹⁸ CP8/21 Regulated fees and levies: Rates proposals 202/22, April 2021.

rest of the Bank. This means the PRC must explain its budget priorities and how they are suitable for the PRA without regard of their wider appropriateness for the Bank. The PRA allocates its budgets, including staffing, based on the outcome of an annual planning process. It is a bottom-up process where functional divisions propose supervisory activities and the necessary resources needed to do so. These budget requests are then reviewed and adjusted against the proposed PRA budget and the levy, which may constrain overall funding and the ultimate size of resource allocations to specific supervisory priorities. This process prioritizes budget requests against strategic priorities identified by the PRA. This means that some important but less than high risks may not be addressed. The budget is reviewed and adjusted periodically during the budget year. Reprioritizations may reduce or delay the deployment of resources to other identified priority risks. Recent examples of reprioritization relate to EU withdrawal structural changes and responding to COVID-19. Reprioritizations are reviewed by the PRC and agreed to by BoE senior leadership.

16. Resources are stretched in the PRA. Budgets and staffing allocations over the past five years have remained relatively flat with only modest increases being made during this period. Although the PRA has a well-articulated risk based “bottom up” budgeting process, meaningful risks may not get the necessary resources because of the statutory efficiency mandate and self-imposed and BoE structural limits on the size and growth rate of its overall budget noted above. Fixed and newly identified supervisory objectives also may be delayed due to changed circumstances and budget constraints. Brexit-related work and the response to the COVID-19 crisis required a reallocation of resources to the most pressing and immediate risks to financial stability. While there is flexibility in managing priorities and resources, the PRA practice of reallocating resources in response to new and shifting risks may not be sustainable over the longer term. Going forward, new post Brexit prudential rulemaking responsibilities, new climate change responsibilities, the need to deliver on major projects and participating in international standard setting bodies while maintaining adequate resources to supervise banks are likely to further exacerbate budgetary pressures on the PRA. Also, as discussed below, the FSAP team is of the view that additional resources are warranted in specific areas to perform more frequent and in-depth work on verification and testing of individual banks’ corporate and investment banking (CIB) activities and business models, conduct more intrusive risk management and asset quality reviews, and proactively review firms’ internal models. In light of future challenges, it will be important to reevaluate the adequacy of resources. The PRA may also wish to incorporate more flexible or unallocated hours into its budget for new projects and unanticipated or newly emergent risks so as not to significantly deviate from fixed annual supervisory plans.

D. Recommendations

17. The U.K. authorities are strongly encouraged to implement the following recommendations:

- Overweighting competition and competitiveness considerations, as the FSA did in the runup to the GFC, could negatively impact the PRA’s safety and soundness objective and adversely affect financial stability going forward, the U.K. authorities should (i) preserve the primacy of the PRA’s

prudential safety and soundness objective both in principle and in practice, (ii) introduce processes and mechanisms to address cases where financial stability objectives and other considerations may conflict, and (iii) and issue a policy statement confirming the subordinated nature of 'have regard to' considerations.

- New rulemaking responsibilities, the deferral of planned supervisory activities due to COVID-19 and the need for more intrusive supervisory practices warrant reevaluating budget and staffing levels. The PRA should revise its estimate of future workload and align resources to it.
- Given the importance of home host arrangements for effective supervision of internationally active banks with a U.K. presence, the PRA should further enhance cooperation with third-country authorities, consistent with the materiality of their impact on U.K. financial stability, to maximize data and information sharing, and supervisory collaboration.

PRUDENTIAL REGULATIONS AND REQUIREMENTS

A. Regulatory Framework for Banking Supervision

18. The legal framework for banking supervision is well established in laws, regulations, and supervisory guidance. The Statutory Requirements and the PRA Rulebook contain binding rules for PRA-regulated firms. While the PRA is empowered to set regulatory requirements through broad rule-making powers conferred by FSMA ("PRA rules"), most prudential requirements for banks and investments firms were included in European Union (EU) legislation before the United Kingdom's departure from the EU and the expiry of the Brexit transition period on December 31, 2020. The policy framework also includes policies and guidance in the form of Supervisory Statements setting out supervisory expectations as to how regulated firms should behave. They are supplemented by Statements of Policy that detail the PRA policy on a particular matter.

19. Post Brexit, the approach to regulating banking services is expected to change. In the EU, most regulatory provisions are set out in law and the requirements apply equally to all banks and investment firms regardless of size. Substantial modifications to the EU approach are highly likely to be introduced. As a result of the onshoring of EU legislation in the United Kingdom and the exercise of the Temporary Transitional Powers (TTP), banks are currently subject to substantially the same rules and regulations as before Brexit (see section B). Going forward, now that the United Kingdom is no longer in the EU, changes are being considered, which are likely to impact the allocation of responsibilities (who will be the rule-maker?) as well as the content of the banking prudential regime.

20. While the onshoring of EU legislation was an immediate response after EU exit, it was not designed to provide the long-term approach to regulating financial services. The European Union (Withdrawal) Act 2018 converted applicable EU legislation, including EU banking rules into U.K. law, as explained below. The PRA Rulebook has also been updated to reflect the United Kingdom's withdrawal from the EU and the end of the transition period. This is however transitional

as the U.K. authorities do not intend to keep detailed regulatory provisions in law. They have proposed to “move back to a more British style of regulation, with the rules made by regulators rather than set out in law”.¹⁹ To this end, HMT has launched the FRF review. One of the proposals is to empower U.K. financial regulators to set out the regulatory and supervisory requirements that apply to firms. The vast majority of the prudential requirements regime would be implemented in PRA rules. The Financial Services Act of 2021 is consistent with the proposed FRF approach in that rule making powers to implement Basel 3 standards are delegated to the PRA within a policy framework set out in the law.

21. The PRA has proposed to move to a graduated regime and introduce proportionality measures into the prudential framework. The current U.K. legal framework is still based on the approach adopted in EU and broadly applies the same requirements to all banks and building societies. The PRA, in its new role as a rule-maker, is considering introducing greater proportionality and differentiation to the regulatory framework for less significant firms. Given that applying the same prudential requirements to all firms can give rise to a “complexity problem”, the PRA has proposed in a recent Discussion Paper (DP) “several options for developing a simpler but no less resilient prudential framework for banks and building societies that are neither systemically important nor internationally active”. The intention is to develop a strong and simple framework that is fully consistent with the Basel Core Principles (BCPs), but simpler than the Basel standards that apply to large and internationally active banks. As explained in the DP, this would be a major change in prudential policy applying to banks and building societies in the U.K. design and implementation will likely take a number of years to complete.

22. Efforts to introduce proportionality in the regulatory framework should be consistent with established safety and soundness best practices and principles. The diversity of deposit-taking institutions that comprise the U.K. banking sector is conducive to a proportional approach to regulation, but all segments should be subject to rigorous prudential standards. While the principle of proportionality is key for effective regulation, the focus should be on reducing excessive compliance costs without reducing the rigor of the regulation. As the PRA advances its proposals, any associated efforts to reduce regulatory burden will need to be appropriately balanced against the primary objective of maintaining a strong and resilient financial system. While there is no expectation that Basel III should be fully applied to non-international active banks, the BCP specify that the capital requirements applied to non-internationally active banks should be broadly consistent with the principles of the applicable Basel standards relevant to internationally active banks.

B. Measures Introduced in the Context of Brexit

23. The U.K. authorities have taken a wide range of actions to minimize disruptions at the end of the transition period. The United Kingdom left the EU on January 31, 2020, and the transition period ended on December 31, 2020. Several measures have been introduced to (i) ensure

¹⁹ “Strong and simple”, speech delivered by Sam Wood, deputy-governor, Mansion House, November 2020.

that the U.K. regulatory framework remains fully functional and operable once EU law ceases to apply and (ii) maintain the continuity of financial services.²⁰ More specifically:

- The onshoring process of amending EU legislation and regulatory requirements so that they work in a U.K.-only context has been completed. Additionally, U.K. regulators have been given the power to make transitional provisions to financial services legislation for a temporary period (known as the Temporary Transitional Power (TTP)), with the aim of helping firms adapt to their new regulatory obligations post-Brexit. It is worthwhile noting that the withdrawal from the EU does not affect the implementation of the Basel standards in the United Kingdom as the authorities remain committed to international standards (see Box 1).
- Transitional regimes for EEA firms have been introduced, including the temporary permissions regime (TPR) to minimize disruption to cross-border financial services due to the loss of passporting rights. The TPR allows EEA firms which had previously used the EEA financial sector passport to continue operating temporarily in the United Kingdom (for up to three years) within the scope of their previous passport permission after the end of the transition period while they are seeking permanent authorization from their U.K. financial regulators. Firms under the TPR are treated as if they have U.K. authorization and are subject to the same regulatory and supervisory framework as any U.K. regulated firm. Firms that did not submit an application for authorization or fail to obtain one within the TPR period, have their temporary permissions cancelled. The Financial Services Contracts Regime enables such firms, or firms that did not enter the TPR and still have regulated business in the United Kingdom to run off, to wind down their U.K. business in an orderly fashion.

24. Steps the U.K. authorities have taken resulted in an orderly transition for the banking sector at the end of the transition period. The processes of preserving and amending the EU legislation as well as the introduction of temporary regimes have been supported by a mobilization of all stakeholders, including extensive communication efforts. U.K. financial regulators have established a central coordination unit to monitor, respond, and communicate on Brexit-related matters. The PRA and the FCA have engaged with firms in a variety of topics and have undertaken extensive firm specific and industry communications to encourage operational readiness for the end of the transition period (e.g., monthly roundtables, webinars, speeches, and Dear CEO letters). Resulting from extensive preparation efforts made by the authorities and the banking industry, no significant disruptions linked to the United Kingdom's withdrawal from the EU have been reported so far. During the meetings with the FSAP team, both U.K. GSIBs and non-U.K. GSIBs indicated that they were anticipating and preparing for a no-deal scenario for financial services coupled with no equivalence decisions from the EU. Therefore, U.K.-based firms took decisive steps to establish legal entities in the EU to be able to serve EU-based clients, migrate EU clients from the United Kingdom

²⁰ This technical note covers measures introduced to ensure that U.K.-based banks continue to be regulated and supervised in the United Kingdom. However, it does not discuss how U.K.-based firms may continue to access the EU market (i.e., the issue of equivalences between the EU and the United Kingdom) and the MoU on regulatory cooperation in financial services (these aspects are covered in the main FSAP discussion). Supervisory cooperation with EU supervisors has, however, been reviewed.

to these EU-regulated entities, and transfer businesses that are now conducted through these entities. Those actions were completed before January 1, 2020, which ultimately played a key role in minimizing disruptions.

25. At the end of the transition period, the United Kingdom is nonetheless left with a relatively complex regulatory framework. The prudential regime is governed by piecemeal legal provisions and combines primary legislation, a range of statutory instruments, onshored binding technical standards, and PRA rules and guidance, which makes it difficult for firms to navigate. The PRA and FCA also expect firms to make every effort to comply with EBA's guidelines to the extent they remain relevant. Given renewed industry pressure to consider wider policy goals as discussed above, one of the main future challenges for financial regulators will be to consolidate banking services legislation and regulation and streamline the regulatory rulebook where necessary without reducing the stringency of financial regulation.

26. The TPR is firmly on track, but work remains to be done. Around 66 former EEA passporting firms have entered the TPR with a view to becoming authorized as third country branches:

- Those firms (that are deemed authorized) need to comply with the same rules that apply to third country branches, subject to transitional relief (the branch income statement is subject to a 15-month transitional relief but firms in the TPR have to submit whole-firm liquidity information). Recognizing that firms operating with deemed authorizations under the TPR may need additional time to adjust to the new expectations introduced in SS 5/21 (see below), the PRA has proposed that firms will not need to meet the expectations immediately but will need to do so as soon as practicable and in any event by the time they exit the TPR.
- A decision making and governance process has been established and the PRA is working on an indicative timeline for making decisions based on preparedness and complexity of TPR firms' applications. Detailed information is being collected to process the applications²¹ and (at the time of the IMF mission in June 2021) two decisions had been undertaken on such applications. Since the time of the review more decisions have been processed. The PRA will also need to approve the general manager and any of the senior decision-makers who undertake a Senior Management Function (SMF). Three firms outside the PRA risk appetite have been authorized as subsidiaries.
- The PRA is in the process of implementing its supervisory procedures, notably its *Continuous Assurance* supervisory approach. The intensity of supervision is calibrated to the systemic

²¹ Core information requested from all applicants include: explanation as to how local governance/committees fit into group frameworks; group strategy, challenges, and significant future changes; key performance and asset quality metrics; 5 years of financial projections (P&L and balance sheet); most recent presentation to rating agencies; and most recent capital and liquidity reports submitted to HSS. Additional information may be requested such as remediation plans and internal stress testing. The FSAP team did not review any decision processed after the June 2021 mission.

importance of the branch. As progress is made with the applications, the balance of work is expected to shift from authorization to ongoing supervision.

Box 1. Brexit and Banking Services

Preserving and amending EU law (onshoring process)

- As EU legislation was a very significant component of U.K. financial services regulation before Brexit, the U.K. authorities needed to ensure that there would be no gaps in the United Kingdom's regulatory regime following EU withdrawal, and that regulation would continue to operate effectively.
- To ensure that the United Kingdom has a functioning regulatory framework once EU law no longer applies, all relevant EU and EU-derived legislation as they stood at the end of the Brexit transition period, including binding technical standards that applied directly to U.K. firms, have been retained as U.K. law by the EU (Withdrawal) Act 2018, as amended by the European Union (Withdrawal Agreement) Act 2020 (process also referred to as nationalizing the Acquis of the EU law).
- Amendments to rules and requirements have been made where necessary by HMT or the U.K. financial regulators using powers under the Withdrawal Act to ensure these rules and requirements work in a U.K. context (those amendments were made by way of secondary legislation in Statutory Instruments (SI)).^{1/} The scope of this power is strictly limited to preventing, remedying, or mitigating any failure of retained EU law to operate effectively or any other "deficiency" in retained EU law. In many cases, the changes made by these instruments to retained EU law can be considered as simply conforming the text to the new situation where (i) the text applies only in the United Kingdom rather than in the wider EU context as part of EU law; and (ii) functions that were formerly exercised by EU bodies, such as the EU Commission are to be exercised by U.K. bodies. For example, under this onshoring process the EU Commission's role in making equivalence determinations for overseas jurisdictions has been replicated and transferred to HMT. However, as a result of the onshoring process, there are some areas where the requirements on regulated firms have changed.^{2/}

Temporary Transitional Power (TTP)

- To help firms in adjusting to the U.K.'s post-transition regulatory regime, U.K. financial regulators have been given the power to make transitional provisions to financial services legislation for a temporary period until March 31, 2022. (pursuant to the Financial Services and Markets Act 2000 (Amendment) (EU Exit) Regulations 2019 (the FSMA SI). This is known as the Temporary Transitional Power (TTP), which allows the PRA and the FCA to delay the application or modify firms' regulatory obligations where they have changed as a result of the onshoring process.

^{1/} E.g., the Capital Requirements (Amendment) (EU Exit) Regulations 2018 (CRR EU Exit SI). Statutory Instruments (SIs) are a form of legislation which allow the provisions of an Act of Parliament to be subsequently brought into force or altered without Parliament having to pass a new Act. They are also referred to as secondary, delegated, or subordinate legislation. The Regulators' Powers SI requires that any EU Exit Instrument that the Bank or PRA proposes to make must be approved by HMT before it is made.

^{2/} This includes: onshoring changes that the PRA is making to rules and Binding Technical Standards; changes that HMT and U.K. financial regulators are making to onshored EU regulations; and changes that HMT is making to existing domestic legislation that relates to EU membership (for example U.K. legislation that implemented an EU Directive). For example, while the level of application of CRR requirements for U.K. headquartered groups is unaffected, onshoring changes require U.K. groups that sit below an EU parent institution to establish a new level of consolidation at the U.K. level.

Box 1. Brexit and Banking Services (concluded)

- The U.K. financial regulators have exercised their temporary transitional powers. The PRA has updated its Rulebook to reflect the United Kingdom's withdrawal from the EU and the end of the transition period and published the transitional directions. The general effect of the transitional direction is to delay the application to firms of many (but not all) changes to regulatory requirements resulting from onshoring for 15 months after the end of the transition period. Firms will continue to be subject to pre-exit requirements unless otherwise stated in the direction. For example, for the duration of the TTP period, (i) banks continue to treat EU27 exposures and assets preferentially, under the applicable capital frameworks, and under the Capital Requirements Regulation (CRR) liquidity and large exposure regimes, (ii) firms continue to report and disclose regulatory data on the same basis as before the end of the transition period, and (iii) U.K. groups that are part of EEA headquartered banking groups do not need to comply with consolidated liquidity requirements at the U.K. level. At the end of the TTP period, regulated firms will have to comply with all onshored regulatory obligations.
- The PRA and FCA have identified certain key exceptions where the TTP will not be used to delay onshoring changes to firms' obligations. The PRA directions contain a list of areas that are excepted from the general transitional provision (e.g., contractual recognition of bail-in rules, stay in resolution rules and Financial Services Compensation Scheme (FSCS) rules, obligations relating to the securitization regulation), as well as several specific transitional provisions. Similarly, certain FCA obligations which have changed took effect from January 1, 2021. They include for example reporting obligations under various EU financial services directives and regulations (EMIR, MIFID), certain requirements under the Market Abuse Regulation, and mortgage lending.

Implementation of the Basel standards in the post-Brexit environment

The withdrawal from the EU does not affect the implementation of the Basel standards in the United Kingdom. The majority of the Basel standards were already implemented into EU law when the U.K. left the EU. In December 2020, the CRR as amended by CRR II was converted into retained U.K. law and the CRD V was transposed into domestic law in the United Kingdom with a phased implementation. As some of the Basel III standards contained in the EU CRR II do not enter into force until June 2021, these were not converted into domestic law on December 31, 2020 and therefore will be implemented separately in the United Kingdom. To this end, using its new rulemaking authority given by the Financial Services Act of 2021, the PRA issued in February 2021 a consultation paper (CP5/21) on the remaining elements of Basel III (exclusive of the changes relating to the leverage ratio) and in July 2021 a policy statement (PS 17/21) containing its final policy on these elements. The requirements will apply from January 1, 2022.

- The FPC has consulted on proposed changes to the U.K. leverage framework. In parallel, the PRA has consulted on its proposed approach to implementing these changes with an implementation date in line with the other key elements of CRR II (January 1, 2022). The PRA has also stated that it intends to implement the Fundamental Review of the Trading Book (FRTB) at a future time, in accordance with internationally agreed timelines for implementation (an approach that was already included in CRR II).
- The PRA has not yet started the consultation process on how to implement the remaining elements of the Basel III Reforms (Basel 3.1) that have been delayed by the BCBS by one year. Announcements that have been made so far by the PRA are consistent with the implementation timeline of the Basel standards.

C. Regulatory Response to the COVID-19 Crisis

27. In response to the COVID-19 shock, the U.K. authorities introduced a wide range of timely regulatory measures to alleviate the impact on financial stability. Exceptional regulatory measures were adopted along with broader governmental measures (fiscal, monetary), in order to maintain the safety and soundness of PRA-regulated firms, ensure that banks are able to continue to lend to households and corporates, and mitigate excessive procyclicality:

- Following the PRC's decision in March 2020 to set the countercyclical capital buffer (CCyB) at zero percent, the PRA and FPC encouraged banks to use their capital and liquidity buffers to absorb losses and help maintain the provision of key financial services to the real economy in periods of systemic stress by reducing incentives for banks to deleverage abruptly and excessively. Using the flexibility embedded in the prudential and accounting frameworks, the PRA provided guidance on how to treat payment holidays for accounting and regulatory purposes with a view to improving consistency of approaches among firms and avoiding a significant overstatement of ECLs.²² To ensure that banks maintain adequate capital positions to support the wider economy, the PRA took precautionary steps and exerted "friendly pressure" on the large U.K. banks through Dear CEO letters to suspend dividends and share buybacks until the end of 2020 and cancel payments of any outstanding 2019 dividends. Those important measures were quickly introduced in March 2020, shortly after the outbreak of the pandemic.
- They were supplemented by a range of additional measures introduced in 2020 and 2021 as the crisis unfolded, including decisions to introduce transitional arrangements to smooth the impact of ECL accounting on regulatory capital, delay the implementation of the Basel 3.1 standard by one year, exclude loans under the Bounce Back Loan Scheme (BBLs) from the leverage ratio exposure measure²³, and address excessive procyclicality in market capital requirements²⁴ (see Table 2 for additional details on key microprudential measures introduced by the PRA).
- Regulatory measures have been accompanied by a wide variety of changes to supervisory practices to reprioritize, downsize or postpone less imperative planned supervisory work (as discussed below).

28. Exceptional regulatory measures are generally consistent with the core standards implemented after the GFC and the interpretations offered by the standard setting bodies.

Rather than relaxing accounting and prudential standards which would have raised concerns, the PRA has largely used the flexibility embedded in the frameworks to introduce exceptional measures

²² Standard-setting bodies and many supervisors including the PRA have indicated that payment holidays granted to borrowers in response to COVID-19 (1) should not be considered distressed restructuring and should not automatically trigger a prudential default; (2) should not automatically result in exposures moving from a 12-month ECL to a lifetime ECL measurement.

²³ A significant number of SMEs and mid-corporates have borrowed under the U.K. government BBLs or Coronavirus Business Interruption Loan Scheme which are respectively guaranteed 100% and 80% by the U.K. government.

²⁴ For a discussion on controls made by the PRA, see developments below on the supervision of market risks.

that are similar to actions taken by other jurisdictions with large financial centers (e.g., the U.S., the E.U, and Switzerland notably). For example, most regulators have provided guidance on how (1) extraordinary support measures should be treated (for example, capital treatment of loans subject to government guarantees), (2) payment moratoria need to be taken into account for asset classification and provisioning, and (3) ECLs should be measured in accordance with existing standards. The only exception to adhering to core standards is the treatment of loans made under the BBLS that are exempted from the leverage ratio total exposure measure, which is not allowed under the Basel framework (although again was similar to actions taken by other jurisdictions).²⁵ This measure was supported by the FPC given that, in the extraordinary economic circumstances, the benefits to financial stability of better macroeconomic outcomes outweighed the estimates of the direct cost to lender resilience of a reduction in leverage ratio requirements.

29. Wide-ranging measures to mitigate the economic disruption caused by the pandemic have yielded positive results in the United Kingdom. The FPC concluded that although there are material downside risks, U.K. banks remain resilient to a wide range of possible economic outcomes. Lending to non-financial corporates and households has slightly increased (+4 percent between March 2020 and March 2021).²⁶ Payment deferrals provided immediate relief to borrowers facing short-term payment challenges and avoided pushing them into insolvencies.²⁷ While regulatory measures only constitute one component of a much broader package of government relief measures, they have undoubtedly contributed to the public policy response. For example, guidance on payment deferrals have helped banks manage many COVID-19-related payment deferrals at a time when support had to be implemented swiftly and broadly rather than on a case-by-case basis. As emphasized in the December 2020 BoE Financial Stability Report, the capital retained by not paying out dividends had contributed to 50 basis points of common equity Tier 1 ratio of the large U.K. banks. No major disruptions have been reported and previous supervisory work on operational risk and business continuity has proved helpful.

30. The U.K. financial regulators have not formalized a detailed exit strategy, but the unwinding of exceptional regulatory measures has already started. Since the exceptional measures were introduced, policy documents and statements have been clear on the duration of temporary measures, and when and how they will be reviewed (see Table 2). Also, certain changes automatically fall away or will continue to be relevant after the COVID-19 pandemic ends (e.g., the decision to delay Basel 3.1 by one year and the decision to neutralize the impact of ECL provisioning on CET1 capital will naturally be time-limited, and the statement on the usability of buffers will remain relevant in other episodes of stress). Several aspects will continue to warrant scrutiny:

²⁵ The Basel framework includes a national discretion that allows jurisdictions to temporarily exempt central bank reserves from the leverage ratio exposure measure in exceptional macroeconomic circumstances, subject to adequate offsetting. However, government bonds and exposures guaranteed by the sovereign are not allowed to be excluded.

²⁶ Source: Bank of England, [LPMB6NO | Bank of England | Database](#)

²⁷ Percentage of borrowers who have resumed payments.

- *Buffer usability.* Despite adequate communication efforts by the PRA and FPC, the conversations the PRA had with banks, investors and rating agencies suggest that U.K. banks would have been reluctant to use their capital buffers, had they been put in a position to make that choice. Most U.K. banks did not have to use their capital buffers as they had strong capital positions when entering the COVID-19 crisis. Furthermore, most banks have actually improved their capital adequacy ratio and have maintained large headroom above their buffer requirements while being able to lend. However, should banks get closer to breaching their CCB, they may take defensive action to avoid using their capital buffers for a number of reasons (fear of market stigma, willingness to keep precautionary buffers given the uncertainty in outlook, avoid automatic restrictions on the payment of AT1 coupons). This will require further analysis as the support measures are unwound.²⁸ The range of policy options is however limited for the U.K. authorities as this issue should be addressed internationally in appropriate fora rather than domestically.²⁹
- *ECL provisioning.* As transitional arrangements to smooth the impact of ECL accounting on regulatory CET1 capital are gradually phased out (100 percent of the provisions attributable to the application of ECL provisioning are added back to CET1 capital in 2020 and 2021, this percentage being then reduced over the subsequent three years), the impact of ECL provisioning will materialize again and progressively. Considering that banks have used a wide range of provisioning approaches during the COVID-19 crisis, more work is needed on ECL provisioning, as further discussed below.
- *Capital distribution.* The largest U.K. banks were authorized in December 2020 to recommence dividend distribution within certain constraints and restrictions were lifted completely in July 2021. The PRA has been prudent, as the results of stress tests of banks' capital positions (highlighting that banks are resilient to a wide range of economic outcomes and able to support the economy) have been used to support the decision that an extension of the exceptional and precautionary action taken in March 2020 was no longer necessary. Also, the transition to the standard approach has been gradual through 2021. Going forward, it will be important for the PRA to continue to routinely challenge all banks' capital projections in a forward-looking manner as part of the Supervisory Review and Evaluation Process (SREP) and annual stress tests and assess the credibility of the mid-term capital plans including dividends distributions.
- *Guidance on payment deferrals.* The guidance remains in effect since June 2020. Recognizing that firms are likely to have limited-borrower specific information to assess on an individual

²⁸ Banks maintained strong capital positions due to the range of support measures. Also, RWAs have not increased materially, and substantial losses have not materialized so far. But this may change going forward as support measures are unwound and IRB parameters are recalibrated. If there were impediments to buffer usability, banks with capital levels closer to breaching the CCB might reduce lending to avoid using their buffers. Preliminary results of the analysis conducted by the PRA shows lower lending growth for low headroom firms on average. It would be interesting to continue gathering tangible evidence as the crisis unfolds and analyzing whether banks' lending pattern differs depending on firms' headroom above buffer requirements

²⁹ See also "Early lessons from the COVID-19 pandemic on the Basel reforms". BCBS, June 2021.

borrower basis whether exposures subject to payment deferrals have suffered a significant increase in credit risk (SICR), are credit-impaired or have defaulted, the PRA issued guidance authorizing firms to make holistic assessment where sufficient information individual information is not available. Also, such assessments can be based on information that can be made available after the payment deferral is taken up. This guidance is still considered relevant (as confirmed by the PRA in August 2020). As the availability of information has significantly improved since mid-2020 and clearer economic prospects has reduced the uncertainty associated with individual assessment of borrowers' creditworthiness and unlikelihood to pay, it will be important for the PRA to require banks to review all exposures on a case-by-case basis and assess the borrowers' unlikelihood to pay and whether the loans have suffered SICR (including, but not only, upon restructuring) in accordance with applicable prudential and accounting rules.

Table 2. United Kingdom: Key Microprudential Measures Introduced in Response to the COVID-19 Crisis		
Date of implementation	Measure	Exit strategies
March 2020	Statement on the usability of capital buffers	<ul style="list-style-type: none"> • N/A
March 2020	Payment holiday guidance – accounting treatment and definition of default	<ul style="list-style-type: none"> • The guidance is not time-limited but will naturally fall away as payment holidays exit
March 2020	Temporary permission to offset capital increases due to higher VaR multipliers with reductions in risks-not-in-VaR requirements	<ul style="list-style-type: none"> • The temporary approach was withdrawn in September 2020; firms are required to formally apply for exceptions to be discounted under the new CRR Article 500c
March 2020	Restrictions on capital distributions	<ul style="list-style-type: none"> • The PRA decided in December 2020 that banks can return to paying dividends but within restrictions • Restrictions were lifted in July 2021.
April 2020	Delay implementation of Basel 3.1 standards	<ul style="list-style-type: none"> • N/A
April 2020	Decision to maintain firms' Systemic Risk Buffer (SRB) rates at the rate set in December 2019 until December 2021	<ul style="list-style-type: none"> • The PRC agreed in November 2020 to freeze the SRB rates for another year until December 2022
April 2020	Delayed submission of certain regulatory returns where the original remittance deadlines fall on or before May 31, 2020	<ul style="list-style-type: none"> • The PRA indicated in June 2020 that it would expect on time submission for future regulatory reporting as firms had time to adjust to new ways of working
May 2020	Leverage ratio exemption for BBLS	<ul style="list-style-type: none"> • The exemption will remain in place until the loan made under the BBLS mature
May 2020	Decision to set Pillar 2A requirements as a nominal amount, instead of a percentage of total RWAs	<ul style="list-style-type: none"> • The PRA will set Pillar 2A as a nominal amount in the 2020 and 2021 SREP. Nominal Pillar 2A will roll off over time after end-2021 in firms' subsequent SREPs
June 2020	Transitional arrangements for capital impact of IFRS 9 ECL provisioning	<ul style="list-style-type: none"> • Transitional arrangements apply until 2024 • This measure introduced by the EU in the CRR "Quick fix" became directly applicable and was retained as U.K. law as the end of the transition period
February 2021	Delayed submission of annual reports by up to two months	<ul style="list-style-type: none"> • Delay accepted where the remittance deadlines fall on or before July 31, 2021
Source: Prudential Regulation Authority.		

D. Recommendations

31. Authorities are strongly encouraged to further enhance the prudential framework by:

- Streamlining the post-Brexit regulatory framework in a manner consistent with core standards and ensure that applications made by firms in the TPR are processed in due time.
- Continuing to ensure that banks maintain capital requirements broadly consistent with the Basel standards.
- Phasing out progressively the guidance on treatment of loans with payment deferrals by reintroducing a case-by-case assessment in accordance with pre-crisis requirements.

SUPERVISORY APPROACH AND PRACTICES

A. General Approach to Supervision

All Banks and Designated Investment Firms

32. **The main principles underpinning the core elements of the PRA's supervisory approach have not materially changed over the past years.** To advance its objectives (promote the safety and soundness of regulated firms as well as, as a secondary objective, effective competition in relevant market), the PRA observes several key principles:

- *Judgement-based:* supervisors reach judgements on the risks that a firm is running, the risks that it poses to the PRA's objectives, whether the firm is likely to continue to meet the Threshold Conditions, and how to address any problems or shortcomings. During the meeting with the FSAP team, firms emphasized the credibility, strong judgement, experience, and professionalism of PRA supervisors.
- *Forward-looking:* firms are assessed under current risks and also against those that could plausibly arise in the future.
- *Risk-based:* the PRA focuses on firms and issues that pose the greatest risk to the stability of the U.K. financial system and the statutory objectives; the frequency and intensity of supervision may increase in line with the risk a firm poses to the PRA objectives.
- *Proportionate:* the intensity of the PRA analysis and its supervisory expectations are proportionate to the nature, scale, and complexity of regulated firms. The PRA has adopted and issued several policy statements and consultations outlining its proportional approach to a variety of supervisory matters including temporary prudential measures relating to COVID-19, the supervision of new and growing firms, the supervision of international banks, outsourcing and third-party risk management, operational resiliency, and climate-related financial risks.

33. The PRA tailors its supervisory approach according to a firm’s potential impact on the stability of the financial system, its proximity to failure and its resolvability. Other factors include the nature, scale, and complexity of a firm’s operations. Each firm has a different potential impact, risk profile and proximity to failure. Supervisors capture these dimensions by applying a Potential Impact category to the firm, scoring individual risk elements³⁰, and assigning a Proactive Intervention Framework (PIF) rating:

- *A key feature of the approach is the potential impact assessment.* The PRA’s Potential Impact Score (PI score) measures the significance of individual PRA-regulated firms to the financial system and the wider U.K. Economy. Based on the PI assessment, firms are divided into five categories (i.e., 1 to 5). Category 1 represents the most significant firms with a capacity to cause major disruption to the U.K. financial system; Category 5 represents firms with almost no individual capacity to cause disruption to the U.K. financial system. The categorization of firms serves a variety of purposes including: the determination of the level of supervisory resources devoted to the firm; the identification of systemic firms; the level of policy application; and the determination of the minimum level of seniority of decision-makers. PI scores are calculated on an annual basis. The PRA has been successful at increasing the intensity of the supervision where the activities of the firms are of greater significance to U.K. financial stability.
- *The Proactive Intervention Framework (PIF) which is derived from individual risk elements score indicates how close a firm is to failure.* Supervisors consider a firm’s proximity to failure when drawing up its supervisory plan. There are five PIF stages, each denoting a different proximity to failure.³¹ Stage 1 represents low risk to viability of firm; Stage 5 represents firms in resolution or being actively wound up. If a firm’s Proactive Intervention Framework (PIF) stage is deemed to be at PIF 3 or above, supervisors consider whether or not the firm should be added to the Watchlist. Once a firm is placed on the Watchlist, there is a more intense focus on risks which the firm needs to remediate (meetings with the firm on these topics will be more frequent and there will be a greater focus on deadlines by which results should be achieved).

34. Two aspects deserve further work. The approach could be improved in certain areas:

- Climate-related financial risks are not included as a distinct category with a specific scoring methodology. This omission is understandable as climate-financial risks are expected to have an impact on the main banking risks while being reduced by mitigating factors (risk management, etc.) that are already included in the individual risk element scores. However, it would be helpful

³⁰ External context, business risk, management and governance, risk management and controls, capital, liquidity, and resolvability.

³¹ The PIF has two key objectives: (i) to support early identification of risks to a firm’s viability and ensure the firm and the PRA take appropriate actions to reduce the probability of firm failing; (ii) to ensure the PRA, in conjunction with other authorities (FCA, FSCS), takes appropriate actions to prepare for the failure of the firm and to reduce the impact of a disorderly failure. There is no prescribed method of converting individual risk element scores into an overall PIF stage. This is done using supervisory judgement. The PIF is not sensitive to a firm’s potential impact or resolvability.

if the PRA considered how to reflect and take into consideration climate-related financial risks when individual risk elements are scored.

- Another area for improvement relates to the Potential Impact methodology which is based on several metrics (size, activity within critical functions, etc.). It could be improved by explicitly taking into consideration potential reputational damage for the PRA.

35. Decisions about individual firms are structured around the Periodic Summary Meeting (PSM) process.

The PSM is the annual oversight process through which PRA senior management monitors supervisory teams' progress against, and proposals for, the supervisory strategy for a firm (or group of firms) to mitigate identified key risks to the PRA statutory objectives. The process ensures all firms are subject to a degree of challenge from outside the direct supervisory line. PSMs are held for all categories of firms on an annual basis.³² The PSM also approves the supervisory team's view of the key risks posed by the firm to the PRA's primary objectives, the work plan for the coming year and the longer term, the PI and PIF scores, the risk matrix, and the Threshold Conditions review. For the largest firms, PSM's decisions (including the supervisory workplan) and follow-up letters are approved at the level of the PRC, chaired by the governor of the BoE. The PRA presents the findings of the PSM to the board of directors of Category 1 UKDT firms on an annual basis (presented by the deputy governor). The FCA also attends PSMs for relevant firms and provides detailed inputs.

36. The supervisory strategy, key messages for the firm and main risks are clearly articulated and regularly discussed at PSMs, but further enhancements are necessary.

The key messages for firms, including the results of individual reviews performed by supervisory teams and risk specialists are included in the PSM letter which summarizes the PRA overall view. Requested corrective actions emphasized at the PSM level and mitigating activities are subsequently formally communicated to firms in PSM letters which include timelines for remediation (unlike some firm-specific reports, as explained below). The FSAP team saw evidence of this process working effectively in practice. Areas for improvement include:

- Although PSMs are intended to be strategic meetings, PSM packs for banks undertaking significant CIB activities do not always include (i) an analysis of the P&L, (ii) an analysis of the main contributors (which business line, which desk), (iii) an identification of fast-growing desk/activities, and (iv) an indication as to whether these activities are already well understood by the PRA or require further in-depth work (e.g. where the combination of risks is new to the firms or weaknesses with trading controls are persistent).
- For Category 2-5 firms, the result of reviews conducted outside the annual visit cycle (e.g., a credit Asset Quality Review (AQR)) are communicated to the board of directors of the firm through the annual PSM letter following the annual visit, which does not necessarily ensure

³² Supervisors may choose to hold a Mid-Point Review (MPR); providing management with a stock take of progress against supervisory deliverables agreed at the PSM and assurance that the supervisory strategy and work-plan remain appropriate and effective in light of any material changes in the firm's risk profile.

timely feedback as reviews might have been conducted several months prior to the PSM meeting. For credit AQR, the detailed report is not shared with the firm, only the main findings are included in the PSM letter.

- For branches, while it is certainly important to assess the activities, the risk profile and the risk management framework from a group-wide perspective, the fact remains that in certain instances the PSM focus almost exclusively on the group and lacks necessary detail on the branch itself.
- In one instance, important weaknesses flagged in the PSM pack were omitted in the key risks and key messages discussed with the Board and included in the PSM letter.

37. The scope and intensity of the supervisory program is determined on a risk-based, proportionate basis. The PRA has an array of tools and techniques to carry out its supervisory responsibilities. Supervisory work includes both firm-specific and cross-firm activities, such as desk-based assessments, short onsite visits, and thematic reviews.

- Over the course of the supervisory cycle, supervisory teams undertake a mandatory set of assessments (referred to as “Continuous Assessment Activities”): annual assessment of the firm’s business plan, regular reviews of the firm’s capitalization and liquidity, review of regulatory returns, annual supervisory assessment visit for Category 2-4 firms, etc.
- Those minimum requirements are deliberately high level.³³ They provide a large degree of flexibility reflected in the supervisory program, as agreed by the PSM. The intensity of ongoing monitoring and supervisory work is higher for the Category 1 firms and Watchlist firms. For example, for Category 1 firms, minimum requirements are supplemented by more detailed work targeted to each firm (business line reviews, Board Effectiveness Reviews, assessment of risk management of particular products, etc.). Relevant firms are also part of thematic reviews. There is generally no mandated minimum scope or frequency for any particular reviews as they are performed depending on the risk profile of the firm concerned in any one year. Overall, the depth and frequency of contact with firms varies according to the Potential Impact score of a firm. Detailed guidance for PRA supervisors is included in PRActice documents.
- The PRA emphasizes the need and desirability of frequent meetings between supervisors and a firm’s senior managers to better understand the firm’s business model and risks. While communication with firm senior management is useful and should obviously be maintained, more meetings with lower level or front-line staff may reveal weaknesses or issues not otherwise visible to senior managers and supervisors.
- The PRA adopts a risk-based approach to supervision. Where issues are identified, supervisors have several tools at their disposal to correct deficiencies. They include written communications

³³ For example, there is no mandated frequency of onsite inspections even for large firms.

to the firm setting out necessary actions that need to be addressed. The PRA may also require a Section 166 Skilled Persons Review (S-166 Reviews) or launch an enforcement investigation.

38. The PRA and FCA are proactively addressing the financial risks associated with climate change into their regulatory programs. The PRA and FCA are working cooperatively with each other and the BoE to share information and best practices on climate strategy and to ensure that the financial system and the economy are resilient to the risks from climate change and supportive of the transition to a net-zero economy. They have been leaders in the development of climate change prudential policy.

- The PRA and FCA are the sponsors or members of several domestic and international climate change related fora. The PRA and FCA co-convened the Climate Financial Risk Forum (CFRF) in March 2019 to build intellectual capacity and share best practices. The CFRF has published a guide for the financial sector containing practical tools, information, and case studies on climate risk management, scenario analysis, disclosure, and innovation.
- The U.K. joint Government-Regulator TCFD Taskforce published an interim report and roadmap setting mandatory climate-related disclosures across the U.K. economy by no later than 2025. The PRA will perform a review of firms' published climate-related disclosures in 2022. Based upon the review the PRA will decide whether to publish for consultation measures to require PRA firms to improve the quantity, quality, or consistency of climate related disclosures.
- From a risk management supervision standpoint, the PRA will assess whether firms effectively manage the risks that climate change presents to the safety and soundness of their operations and to broader financial stability. The PRA has published supervisory expectations on how firms should develop their approach to the financial risks from climate change and embed it into their governance and risk management frameworks, scenario analysis, and disclosure.³⁴ In a July 2020 Dear CEO letter, the PRA set a deadline of year-end 2021 for firms to have fully embedded the PRA's supervisory expectations on climate. The letter also noted that firms must demonstrate to the PRA how they have gained comfort that they are holding sufficient capital to withstand material climate-related losses. SRS conducted in H1 2021 a review of firms' embedding of climate risk within strategy, governance, remuneration, and risk management framework, which shows progress (climate risk governance frameworks are largely in place, climate strategies are being defined) and challenges (tools and metrics are being developed, only one firm had a clear statement of climate risk appetite, and no firm has established a risk limit framework, capital modelling for climate risk is in its infancy).
- One of the challenges for the PRA will be to embed climate-related financial risks in its supervisory approach and assess firms' effectiveness in adopting and implementing regulatory expectations on climate risk governance, risk management framework, scenario analysis and disclosure risk. Work is under way. A Supervisory Guidance Pack has been prepared to support

³⁴ SS3/19 Enhancing banks' and insurers' approaches to managing the financial risks from climate change, April 2019.

supervisors in engaging with firms on climate-related financial risk and their efforts to embed the supervisory expectations detailed in SS3/19 by end-2021. The guide covers a range of topics, describes in pragmatic way what is expected from firms and supervisors and includes a list of priority question. These are commendable efforts. Further guidance, more training and an update of PRACTICE are expected.

39. Over recent years, the PRA has made broad and increased use of cross firm thematic reviews. They undoubtedly allow the PRA to better understand the risk to the safety and soundness of the U.K. financial sector as a whole and to benchmark individual firms against the spectrum of best to worst practice.

- Thematic review examples include the review of credit cards, unsecured personal loans, and car finance (2017) and Fast Growing Firms (FGF) which focused on a cohort of 20 banks which were growing at greater than 10 percent on an annual basis and held between £1bn and £45bn of assets (2019). COVID-19 related thematic reviews were conducted in 2020 (Buy-to-Let mortgage thematic review, review of potential fraud and credit risk in firms' BBLs portfolios, treatment of retail payment holidays). The assessment of the second line of defense is an integral part of most thematic reviews. The outcome of the reviews are communicated to firms through letters highlighting the main (generic) findings observed for the group of firms under review. The letters are not tailored to individual firms in the cohort that might benefit from written feedback on firm specific findings. Thematic reviews have also resulted in supervisory statements and/or additional work (e.g., the buy to let mortgage thematic review focused on a few firms subject to the FGF review).
- Overall, cross-firm thematic reviews have largely focused on retail activities and somewhat less so on wholesale CIB business lines. This may be something that the PRA should reconsider. Going forward, it will also be important to ensure that supervisory expectations are not excessively set against the best practice within a peer-group (in relative term) and remain anchored in rules or guidance (in absolute term).

40. Another key aspect of the PRA approach has been increased reliance on offsite work to identify key risks, trends, and firm outliers. Significant data processing is undertaken by the PRA to produce on a routine basis a range of data analysis reports to monitor firms' risks and performance over time and identify outliers.³⁵ Overall, strong offsite risk analytical capabilities support efforts to benchmark firms and detect outliers:

- Building on detailed briefings and dashboards that consider market developments, sector performance and cross firm peer analysis, as well as on inputs provided by several Working Groups focusing on the main risks, ARTIS and UKDT Risk Committees analyze a range of key risks and emerging risks across both financial and operational resilience concerns. For non-

³⁵ UKDT Risk Pack, ARTIS Quarterly Risk Pack, ARTIS dashboard, Magic sheet (summary metrics) documents, etc.

systemic Category 2-4 firms, the use of peer analysis data and trend analysis to compare firms' performance across various metrics plays an important role in the supervisory approach.

- The PRA has also developed since 2017 a Horizon Scanning process to identify emerging micro-prudential threats and evolving risks across banks and insurers. The process is led by a small central team (PRA Horizon Scanning Hub) and uses Bank-wide expertise to develop material for discussion with PRA senior management with a view to informing next steps and deciding whether additional or new work should be prioritized. For example, investigation into the drivers of the declining trends in U.K. banks' modelled mortgage risk weights resulted in further analysis and proposals, leading eventually to a Supervisory Statement setting out PRA expectations for mortgage IRB models.

41. The supervisory approach offers a combination of horizontal and vertical work, but the vertical component could be reinforced. Unlike other supervisory authorities, the PRA does not rely on a dedicated team of examiners who may stay onsite for several weeks or months. Neither does the PRA maintain a permanent presence at the firms it supervises. PRA staff go into the firm for specific meetings relating to a review and perform data analysis and drafting within the PRA. Depending on the type of review, supervisory teams in charge of a group of firms may be joined by risk specialists. Visits to firms' premises for meetings or reviews take place on a regular basis, but the duration is typically shorter and less intense than onsite examinations. This approach has an impact on the depth and breadth of some reviews, on the ability to engage in testing and the on granularity of certain supervisory findings and recommendations. While recognizing that there is not one-size-fits-all way of doing supervision, the FSAP team is of the view that using the full range of existing tools (onsite reviews, credit asset quality reviews, skilled person reviews) on a more frequent basis while conducting more in-depth investigations with more testing and independent verification would provide more assurance that risks arising from CIB activities and those that are expected to materialize in the context of COVID-19 are adequately mitigated by firms. Current limitations include (see also section B for more details):

- Certain firm-specific reviews do not include very detailed findings and they usually do not contain recommendations to be implemented within a given timeframe.³⁶ Conclusions are not always shared in a timely fashion, and whilst communication with executive staff at firms is deliberately concise and strategic, it does usually not include detailed reports (credit AQRs and detailed reports from SRS are not communicated to firms). Communication does not include references to the applicable regulation and/or guidance, which would help make the PRA's expectations clearer to a firm. Explaining where the supervisors are coming from, what is precisely at stake, providing more details surrounding the findings, explaining which rule and expectation the team had in mind when formulating the observations would enhance

³⁶ Arguably, the most important findings are expected to be discussed at the PSM level, reflected in the PSM letter (which summarizes the overall view of the firm and have as input many of the individual reviews performed by supervision teams and risk specialists) and subject to remediation plans (as explained above in para 36). That said, all supervisory findings should lead to recommendations and remedial actions.

transparency, maximize the work done by supervisors and facilitate ongoing discussions with banks at a more technical level while being fully consistent with the PRA's objective to be transparent.

- The PRA reacted very quickly after specific events (e.g., Archegos), but more in-depth investigations with more transaction testing would help to be more proactive to identify new or rising risks and ensure that mitigants and controls are in place. For example, only 19 of 445 credit reviews have included a review of loan files since 2018, which is questionable given the importance of transaction testing to assess the effectiveness of credit risk management processes.³⁷ Given the complexity of CIB activities (exotic derivatives, correlation portfolios, prime brokerage, etc.), having an in-depth understanding of the products, of the risks arising from these activities and of internal controls and risk management procedures to ensure that risks are adequately managed is critical. The PRA has a number of tools to achieve that objective, such as for example front-to-back reviews of trading activities. However, evidence of effective use of onsite firm-specific reviews such as front to back reviews is rather limited. More in-depth investigations would also be useful to further challenge firms and ensure that corrective actions were introduced as requested by the PRA.³⁸
- Firm-specific findings, detailed recommendations and requested actions plans could be communicated more often to firms through individual letters, as part of or in the wake of these thematic reviews. While it has been done in a number of instances, this is not a widely observed practice. Highlighting best practices or collective findings observed in a group of firms certainly provides added value for the firms and the PRA but ensuring through monitoring that firms take remedial actions in a timely fashion necessarily require in the first place to issue firm-specific recommendations to be implemented within a given timeframe.

42. The Section 166 Skilled Persons Review authority should be used more frequently in a proactive manner. The PRA and FCA can outsource certain supervisory activities to third parties using the power of section 166 of the FSMA. Both the PRA and FCA have published frameworks setting out the selection process, permissible uses and reporting governing the S-166 Reviews authority. S-166 Reviews are reactive in nature as the decision to launch them is taken when the PRA has specific concerns with a firm. For example, the PRA has used section 166 powers where supervisors observed chronically poor reporting. PRA and FCA public reports show a limited use of such reviews to date. While this tool provides some flexibility, it also highlights that the PRA has

³⁷ Credit file reviews would certainly allow reaching more clear-cut conclusions. In one report following a credit review, it was mentioned that *"it is unclear that provisions have been taken at a time that a credit first become impaired and that the level of provision was sufficient"*.

³⁸ In relation to secured financing activities, a letter was sent in September 2018 to a number of firms included in a cross-firm review of trading controls in the front and back office. The letter also included the results of the prime brokerage quantitative fund thematic review and corporate equity derivatives thematic review. With hindsight, that letter contains very relevant findings. However, for one non-U.K. GSI, these activities (securities financing, prime brokerage) were not subsequently subject to onsite visits and the PSM pack for 2021 emphasized that "weaknesses in trading controls remain similar to those identified in 2017/18".

limited resources to conduct in-depth investigations on certain topics (IT risks, cloud, risk data aggregation and reporting). Going forward, increased use of the S-166 Reviews may be a valuable supplement to the PRA's workplan given its strained resources. The S-166 Review process may also permit greater review of loan files and verification of regulatory reports and firm management information systems that are relied upon by the PRA in its offsite reviews and analysis. The PRA could therefore explore the possibility to use Skilled Persons Review in a more proactive manner and for a broader range of firms while internalizing more competencies. The S-166 Review requires effective oversight, and it is not a substitute for the supervisors' independent judgment. The S-166 Review must be free of conflicts of interest and should not be a long-term solution to inadequate skill sets within the professional staff of the PRA.

43. The PRA approach to supervision proved to be flexible and adaptable during the COVID-19 pandemic. Two internal groups were established to foster the sharing of supervisory intelligence on the impact of the crisis on firms, markets and FMs and coordinate the supervisory response. Overall, the PRA has been able to maintain effective and prudent supervision despite a challenging environment:

- The PRA adjusted its supervisory priorities and focused on the most meaningful risks such as credit risk, liquidity risk and operational risk. In order to free operational capacity in firms and allow them to tackle the immediate challenges posed by the pandemic, several supervisory work programme areas were deprioritized alongside a reduction in the regulatory demands on firms (e.g., the annual stress test (AST) exercise was cancelled, and governance reviews and business model reviews were postponed). PSM were refocused on the most important risks.
- Relying on a mix of information already represented in periodic regulatory reports as well as on ad hoc information (e.g., on moratoria), the PRA strengthened supervisory monitoring and analysis: the frequency of meetings and interactions with firms increased significantly; thematic reviews and desktop stress test exercises were conducted; and a specific IFRS 9 data collection was undertaken to help understand the consistency of firms' approaches (see Box 2 for further details). The August 2020 "reverse stress test" suggested that banks would need to incur around £120 billion of credit losses (that is, a further £100 billion of losses beyond those already provisioned for) in order to deplete aggregate end-2019 capital by 5.2 percentage points to a level usually seen in the AST, such as the 2019 stress test (in which banks demonstrated they could continue to lend).

44. Several enhancements could be considered as the COVID-19 crisis unfolds. The full effect of COVID-19 on banks remains to be seen. Going forward, it will be important to: (i) ensure adequate loan classification and provisioning through more frequent credit file reviews (see below), (ii) have a better understanding of ECL models through deep dives (see below), (iii) issue guidelines on the recalibration of IRB models (see below) and (iv), as already discussed, revise the guidance on payment deferrals.

Box 2. Supervision in the Context of COVID-19

Organizationally, the PRA focused more on horizontal risk themes in relation to the COVID-19 shock.

To determine the most appropriate actions to take in response to COVID-19, the PRA created two key internal groups at the onset of the crisis: the COVID-19 Supervisory Taskforce (Supervisory TF) and the COVID-19 Policy Taskforce. Six key horizontal workstreams were initiated in the PRA at the onset of the crisis: Operational Resilience; Funding and Liquidity; Credit; Traded and Counterparty Credit Risk; Capital; and Troubled Firms.

The PRA prioritized its focus on the key risks to firms and the financial sector from the COVID-19 crisis. As a result, to optimize strained capacity given the pressures of the pandemic and allow banks to focus on key operations, support financial markets and the wider economy as much as possible, the PRA reprioritized, downsized, or postponed some planned supervisory work during 2020. Examples include delaying changes to the application of Senior Managers regime rules; postponing the Climate stress tests; and cancelling the 2020 AST. Some aspects of supervisory work such as governance reviews and business model reviews have been postponed.

Although onsite activities were interrupted after the outbreak of the pandemic in March 2020, the frequency of (virtual) meetings with firms increased significantly. Calls were supplemented by internal management information (MI) provided by firms. For example:

- Using a centralized agenda to collect firm specific and thematic information, two meetings on retail and wholesale credit conditions and credit risk were held on a weekly basis between March and June 2020 with large firms to identify risks in a rapidly changing environment and discuss mitigation (the frequency changed to fortnightly in June and monthly in September). The wholesale credit risk calls were used to focus on vulnerable sectors that were likely to be more impacted due to the lockdowns (e.g., aviation, leisure, and hospitality) or higher volatility in certain markets (e.g., the oil and gas sector).
- Daily liquidity and funding calls were held with the treasury functions of Category 1 banks to identify areas requiring further analysis, with additional work on how the major banks' liquidity resilience could evolve if either the stress continued (e.g., continued outflows on revolving credit facilities) or if the lockdowns ended (e.g., unwinding of corporate and retail deposit growth).

Several COVID-19-related data requests have been initiated to monitor asset quality and lending volume on a timelier and more frequent basis than normal. Temporary data requests were set up early in the pandemic to provide key information on (i) the operational impact on firms (branches closed, staff off sick etc.); (ii) payment moratoria, forbearance, and new lending; (iii) government backed lending; and (iv) for cat 2-4 firms core capital and liquidity data (Category 1 firms already report liquidity data on a more frequent basis). Conversely, some standard reporting deadlines were extended to give firms space to cope with extra reporting demands placed on them.

Detailed analysis was carried out and enhanced supervisory monitoring introduced. Two thematic reviews on exposures to SMEs and one thematic review to investigate the asset quality of the payment holiday portfolios were carried out across UKDT Category 1 firms and a selection of non-systemic firms). Both ARTIS and UKDT maintain a troubled firm dashboard focusing on firms impacted by COVID-19 and highlighting their latest capital, liquidity, encumbrance, and Central Bank borrowing data. UKDT introduced a heat maps with 4 key inputs. 55 firms were identified as potentially more vulnerable to a COVID19 stress and some of them were subject to enhanced monitoring.

Box 2. Supervision in the Context of COVID-19 (concluded)

Desktop stress test exercises were conducted. Relying on already available information extracted from the regular supervisory reporting without having to request additional data and projections from banks, the BoE conducted in lieu of the AST two desktop stress test exercises in May and August of 2020) of the major U.K. firms to understand the potential impact of COVID-19 on the economy, based on a set of stylized assumptions. In addition, the PRA undertook in 2020 Desk Based Stress Testing (DBST) for nearly 100 non-systemic banks and building societies, based on regulatory data only. Results were used to rank order firms for riskiness, and to identify outliers for further review (and not to set individual capital buffer requirements). A further DBST is planned in 2021 to assess firms' forward-looking resilience and sensitivities to the COVID environment.^{1/}

A specific IFRS 9 data collection was undertaken to help understand the consistency of firms' approaches. This has been conducted on a quarterly basis through 2020 and will continue through 2021. The data collection which covers UKDT Category 1 firms and around 15 selected smaller firms include firms' economic scenarios as well as firms' Expected Credit Loss (ECL) estimates. The analysis of firms' ECL is supported by calls with firms each quarter to understand material changes in forward looking scenarios, material changes in modelled outputs and key judgements regarding post model adjustments (also known as Management Overlays). A particular focus through 2020 has been the extent to which government schemes have delayed or suppressed defaults, and the extent to which models can be relied on to estimate ECL. Work remains to be done to more formally assess provision, as explained below. For retail assets, the work that has been launched has not been yet completed. The approach will seek to assess (i) the overall provisions in aggregate and (ii) comparative provision levels across banks to highlight outliers. Once the retail asset approach is finalized, the PRA plans to follow with an approach for assessing corporate assets.

^{1/} The primary purpose of the Supervisory TF is to share supervisory intelligence on the impact of COVID-19 to firms, markets and FMIs, as well as to consider and coordinate the supervisory response to COVID-19 developments. The primary purpose of the Policy TF is co-ordination of cross-Bank policy work being undertaken in response to the disruption from COVID-19.

International Firms

45. The U.K. financial regulators are the host of a very large financial centre. All non-U.K. GSIBs are active in the London market; around one-fifth of global banking activity is undertaken in the United Kingdom, and firms supervised by ARTIS (hereafter referred to as ARTIS firms) account for over half of U.K. banking assets.³⁹ Subsidiaries of foreign banks hold a combined £4,017 bn of assets while branches have £8,350 bn of assets. Those firms are highly interconnected with the rest of the financial system including U.K. banks and FMIs, as well with their parent companies through an array of intragroup transactions. This means that disorderly failures would represent significant risks to U.K. financial stability and more broadly to global financial stability. The PRA is certainly one of the largest host supervisory authorities in the world as it is responsible for the supervision of 170 international firms which operate in the United Kingdom, from 49 countries.⁴⁰ The PRA has the same

³⁹ Firms have a range of business models. The largest firms tend to focus on CIB activities banking, while smaller firms may focus on businesses like trade finance or retail activity. Some subsidiaries are almost wholly separate from the wider group, but branches and investment banking subsidiaries tend to be more integrated.

⁴⁰ These firms can operate solely as subsidiaries (50 firms), branches (91 firms) or through a mixed model of branches and subsidiaries (29 firms). 19 international firms are supervised as systemic firms (covering 16 branches and 3 subsidiaries).

enforcement powers over firms operating in the United Kingdom as branches as it does over subsidiaries and is legally empowered to take an appropriate range of remedial actions to address problems such as the firm's failure to satisfy the Threshold Conditions.

46. International headquartered banks undertaking CIB activities can operate in the United Kingdom as either subsidiaries or branches.⁴¹ The U.K. authorities are cognizant of the advantages of hosting a large financial centre (for growth and trade) as well as of the risks it carries (the domestic economy is more vulnerable to international shocks that can be "imported") and the responsibilities it implies. They have made clear they have a global responsibility to maintain high prudential standards in the United Kingdom and that openness needs to be accompanied by financial and operational resilience. Drawing on the lessons from the GFC, the U.K. financial regulators consider that it is largely impossible to supervise a subsidiary or a branch without looking at the U.K. entity in the context of the wider group, as investment banking and capital markets activities undertaken by a range of international firms are highly interconnected with the rest of the group. Therefore, the supervisory strategy does not seek to treat ARTIS firms as completely "stand alone" entities and permits them to be highly integrated with the rest of their (non-U.K.) groups provided that they continue to meet PRA rules and expectations. The PRA also gives weight to the positive assessment of home state equivalence which is a pre-requisite for international firms to operate in the United Kingdom. Overall, the PRA is "*equally tolerant of wholesale CIB firms operating as interdependent subsidiaries or branches*". In practice, several firms have closed their subsidiary in the United Kingdom and now operate solely as a systemic branch and the number of large branches has increased (with branches from EU banks that become authorized rather than operating under an EEA passport). The PRA has distinct expectations for entities that engage in retail banking activities (see Box 3 for additional details).

47. The PRA has set out its approach to host supervision in a holistic way, providing lots of details about its expectations. The supervisory process for supervising international banks reflects the fact that the firms the PRA supervises are branches or subsidiaries of international groups based abroad. The PRA aims to achieve the same outcome (in terms of financial stability) for the ARTIS firms as for domestic firms, but using different tools:

- A recently published Supervisory statement on the PRA's approach to branch and subsidiary supervision (SS 5/21) makes clear that the PRA remains open, after the United Kingdom's withdrawal from the EU to highly integrated firms operating as branches and subsidiaries, if they are resilient, appropriately controlled, and governed, meet the PRA's Threshold Conditions and are capable of being effectively supervised (see Box 3). For international banks, this will depend in part on the risks in the wider group being visible to the PRA, and the level of cooperation and information it is receiving from the firm and relevant foreign supervisory and resolution authorities, including an assessment of home state equivalence.

⁴¹ A branch is an operating entity which does not have a separate legal status and forms a legally dependent part of a parent bank. As a separate legal entity, a subsidiary is authorized by the PRA.

- As set out in in SS1/18 and SS5/21), the PRA may place a degree of reliance on the home state supervisor (HSS) for certain aspects of supervision (for supervising branches and more broadly to get more information on the wide group) to be able to deliver the same supervisory outcome. In addition to classical MoUs signed with many regulators (including with the European authorities (ECB, EBA) and national competent authorities in the EU), as well as with U.S., Swiss and Japanese authorities), the PRA has agreed more detailed “splits of responsibilities” with a number of authorities. The aim is to improve clarity over who is doing what and on how supervision is coordinated, particularly where a branch provides key intermediary services in the United Kingdom. Lastly, the PRA has developed a trigger framework to identify if the collaboration with an HSS is not delivering the required supervisory outcomes.

48. The entity-neutral approach, which is largely unique among jurisdictions hosting large financial centres has implications for supervision. International standards do not specify the legal form in which foreign banks should operate. In several other jurisdictions, it is largely impossible for internationally headquartered banks with significant cross border CIB activities to operate as branches.⁴² As the United Kingdom approach may result in significant risk to financial stability as well as reputational risk for the PRA, several lines of defense have been introduced. Considering that a group can be a threat as well as a source of support to the U.K. based entity, the PRA may adjust its approach to supervision and require a branch or a subsidiary to operate on a more standalone basis if it does not have sufficient information or is not satisfied with the degree of cooperation it has, or if the controls over risks to the U.K. activities appear to be inadequate. In this regard, the relationship with the HSS (and other key host supervisors) is critical to delivering effective supervision.

49. The PRA has reached a steady state level of enhanced cooperation with the vast majority of HSS (more than 50). The degree of cooperation with the HSS that the PRA expects should be commensurate with the size of the firm, the degree of cross-border integration of its business, and the systemic nature of branches with CIB activities operating in the United Kingdom. In practice, supervisory files shared with the FSAP team reveal that the intensity of the PRA’s supervisory effort is indeed increased for firms of greater significance for U.K. financial stability. The PRA expects an open and transparent exchange of supervisory information and views (in a college format, and/or bilaterally as appropriate), which includes having an open dialogue at an appropriate frequency with the HSS on the relative importance of the U.K. firm (subsidiary or branch) to the overall strength of the whole banking group and on material risks facing the firm. Subsidiaries and branches are subject to the PSM process and are included in thematic reviews. Thanks to regular engagement with most but not all HSS, the PRA has been able to gather granular information on the risk profile of international banks (e.g., relevant information on safety and soundness of the parent, information on groupwide stress testing, recovery plans, capital, and liquidity as well as high frequency information on P&L) while joint work and joint reviews are common. The PRA has also taken supervisory actions in a number of instances (changes in booking arrangements, changes in

⁴² For example, foreign banking organizations with significant U. S. broker dealer investment banking operations must form intermediate holding companies supervised by the Federal Reserve.

governance arrangements) and several examples have been shared with the FSAP team. Where the PRA see material gaps in the home state approach, it may impose limitations on the branch's operation or require subsidiarization. To date, the PRA has not required a branch to be subsidiarized.

50. This approach has however certain limitations and raises practical challenges.

Notwithstanding the fact that by construction the PRA has greater supervisory control over and oversight responsibility for subsidiaries than branches and has less tools at its disposal to supervise branches (no capital, liquidity and leverage requirements, no Board minutes, etc.), the PRA's approach to supervising branches presents some limitations and challenges:

- While CIB business lines may be managed globally, it is important that they remain subject to adequate risk management at group and entity level where necessary. During the meetings with the FSAP team, the PRA has indicated that when exposures are booked in the United Kingdom, adequate controls should be in place. That said, there are few explicit regulatory requirements on branches. Governance and risk management requirements are less detailed and prescriptive than those applying to U.K. based legal entities. While supervisory expectations that have been defined are more detailed than in many other jurisdictions and the PRA has recently proposed to enhance them, the fact remains that these expectations are non-binding.⁴³
- As the formal prudential reporting is more limited in scope (branch return and whole-firm liquidity reporting⁴⁴), information is collected from firms (MI) and HSS to inform the PRA analysis which is eventually included in the PSM pack. Since ad hoc information is provided by firms on a non-standard basis, it is more difficult to ensure comparability. While the PSM pack for branches includes relevant information on safety and soundness of the parent, it may contain limited information on the branch itself, on its risk profile and the way risks are managed in the United Kingdom.
- For the approach to be effective, a great level of cooperation between supervisors is needed, as the PRA largely relies on the HSS. Although the PRA has reached a steady state level of enhanced cooperation with most but not with all HSS, the interest and perspective of home and host authorities may not always be fully aligned, as the banking activities conducted in the

⁴³ Branches are required to have one individual approved as Head of Overseas Branch (SMF 19) under the SMCR. The PRA expects risk control arrangements to include the appointment of a branch head of risk and the establishment of a branch risk management oversight team where necessary (SS4/16). The PRA has proposed to enhance its expectations (SS 5/21): in addition to having an individual holding the SMF19 function, systemic wholesale branches should also consider, whether they need a Chief Risk Officer (SMF 4), a Chief Finance Officer (SMF 2), and a Chief Operations Officer (SMF 24); PRA approval may also be required where an individual based in a parent or group entity has influence over a U.K. entity (SMF 7). More detailed expectations about risk management will also be included, but they do not include for example detailed expectations about market risk management.

⁴⁴ The branch return template has been updated in 2020 (some new data points have been added while unnecessary data fields have been removed) and a Branch Return reporting tool has been introduced to assist supervisors in analyzing the information. The branch return provides a limited range of information on the main risks taken by branches. Firms should also submit to the PRA on a semi-annual basis liquidity information at group (whole firm) level as reported to the HSS.

United Kingdom. may differ from those undertaken by the parent company (e.g., more CIB focused on the United Kingdom). The authorities may also share different views on the major supervisory priorities and the main risks that deserve a supervisory response. For example, in a PSM pack for one non-U.K. GSIB, it is mentioned that the HSS was more optimistic than the PRA on the situation of the banking group and that *"it can at times be more difficult to obtain a critical view or Group-level financial metrics"*. Lastly, the PRA and HSS may not always use the same regulatory and supervisory tools (e.g., one HSS is still developing its supervisory approach to operational resilience). This adds another layer of complexity.

- One of the strengths of the PRA resides in its ability to understand as a host supervisor the risks taken by a U.K. based entity from a group wide perspective (how risks are originated and transferred across a group, etc.). One of the potential drawbacks would be to spend too much time and energy on the group as a whole without conducting sufficiently in-depth assessments of the activities managed locally in U.K. branches. Another limitation stems from the fact that group-wide recommendations may be sent to senior managers in the United Kingdom who are not necessarily fully empowered to initiate group-wide remediation plans. However, as part of its SMCR regime, the PRA can designate and hold to account Senior Managers who may be based overseas but have significant influence on the U.K. entity. Overall, the supervisory approach to branches requires not only to identify risks in a timely fashion but also to influence the HSS to take group-wide corrective measures as the range of tools that can be used by the PRA on a standalone basis in a business-as-usual model is more limited. In extreme cases the PRA may however require a foreign bank to operate as subsidiary or take enforcement action if possible.⁴⁵
- Lastly, the approach may raise level playing field issues in the United Kingdom, as U.K. banks and U.K. subsidiaries of international banks must comply with similar prudential requirements while branches do not. It also means that in instances where a large number of banks fail to understand, assess, and mitigate risks arising from the same type of transactions (an issue which is not uncommon), capital-related measures such as an increase of the Pillar 2 buffer or a revision of the prudential treatment of these transactions would have limitations, as branches would not be subject to these measures.

51. It will therefore be critical to reevaluate regularly whether the approach to supervising international firms delivers over time the expected supervisory outcome. This approach that has been codified recently will be implemented in a changing environment, with more firms operating as systemic branches. Also, the cooperation with the EU supervisors regarding U.K. branches of EU banks is relatively new. In this context, given some of the limitations and challenges, it will be important as the PRA has done in recent years, to reassess whether the PRA remains able to contribute and influence the supervisory strategy of foreign banking groups, form a view on the risks they take and how they manage them, and reach an agreement with HSS to take actions in a

⁴⁵ The PRA has enforcement powers over branches. That said, while the PRA rule book applies to branches, the fact remains that it does not contain requirements on governance and risk management for branches.

timely manner when concerns are identified and raised. So far, supervisors have not felt themselves constrained in exercising supervisory powers or in securing changes to firms' governance and risk management. It will also be important to continue to assess the consistency of approaches across UKDT and ARTIS firms, as further detailed below. The frequency of deep dive C-SREP is lower for Category 1 ARTIS firms. Furthermore, ARTIS Category 1 firms have not been subject to credit AQR and have not been included in the data collection exercise on IFRS 9 during the COVID-19 crisis.

52. While relevant from a supervisory perspective, the introduction of CIB activities of international banks in the scope of the AST exercise would have limitations given the entity-neutral approach. CIB activities of foreign banks are not subject to any supervisory stress test in the United Kingdom. The 2016 FSAP recommended to include CIB activities of international banks, but the recommendation has not been implemented by the PRA on the ground that (i) these activities are included in the firms' internal capital adequacy assessment process (ICAAP) carried out at the level of U.K based subsidiaries and (ii) the PRA has access to results of stress tests conducted by HSS.

- The FSAP team continues to consider that including CIB activities in the scope of supervisory stress tests would be relevant from a supervisory perspective given the importance of these subsidiaries that are classified as DSIBs in the United Kingdom. It would also improve the consistency of the setting of the PRA buffer (currently based on the AST for some firms, based on the ICAAP for the others). While interpreting the results of stress tests at the level of subsidiaries is certainly difficult, the fact remains that several other supervisory authorities hosting major financial centres (e.g., U.S. FBAs, ECB) find it valuable to include subsidiaries in the scope of their supervisory stress tests. Furthermore, the argument made by the PRA is not entirely convincing as (i) firms operating in the United Kingdom are facing the same issues when they conduct their own ICAAPs⁴⁶ and (ii) to the extent that the PRA has effectively access to the detailed results of stress tests conducted by all HSS (the process is deemed to be less mature for at least one important HSS), the PRA has no influence on the scoping, scenario design, and main methodological aspects of those stress tests, which makes a fundamental difference with its own exercise.
- That said, considering that international banks can operate as subsidiaries or branches, can book transactions either in subsidiaries or branches, and can transfer exposures from subsidiaries to branches, and vice versa, a revision of the perimeter of the supervisory stress tests—limited to subsidiaries by construction—may be of limited interest.

⁴⁶ If it is not relevant to focus on a subset of activities when conducting supervisory stress tests at the solo level (at the level of the U.K. based entity), it is unclear why it would be more relevant to focus on the same activities as part of the ICAAP.

Box 3. Supervision of International Firms

The PRA launched in January 2021 a consultation exercise (CP 2/21) setting out its proposed approach to supervising the U.K. activities of international banks. This Consultation Paper (CP) largely consolidates and codifies the existing approach to international banks and expands on the PRA's principles originally set out in SS1/18 applicable to branches. CP 2/21 links the size and systemic importance of firms together with the degree of integration between United Kingdom and foreign operations of the firm or group with the information and controls the PRA expects to see from firms and HSS. The more visibility the PRA has on the risks of the wider group, and the better its controls, the more is willing to let it operate in a highly integrated way, and the more options the firm has for how it operates. Conversely, where the information or cooperation the PRA receives are such that the PRA's expectations for effective supervision are not fully met given the degree of operational integration that an international bank currently has, then the PRA will consider taking measures to require the U.K. operations of the international bank to be more independent.^{1/}

The PRA expectations of information to be received from the firm and overseas supervisors are detailed in SS5/21 which was published, following CP2/21, in July 2021. They include baseline information from all firms and additional information in respect of highly integrated subsidiaries and systemic wholesale branches. The PRA also expects firms (both branches and subsidiaries) to have a clear booking arrangement in place setting out what they will book in each entity and how its application will be verified. The firms and groups in respect of which the PRA would expect to receive the most information are the largest U.K. subsidiaries and the systemic branches, including those belonging to groups designated as globally systemically important, and those which are most interconnected with the group's overseas business. The information required is largely standard across branches but there will be specific information that the PRA expects to receive from HSSs where there is greater risk from a branch to financial stability in the United Kingdom. The PRA is now taking steps to ensure that the rules and expectations of third country branches are more clearly set out in one place.

The PRA applies a consistent approach to third country branches, which now includes U.K. branches of EU banks. The PRA authorizes the firm as a whole; that is, the entire legal entity and not only the U.K. branch, and so the firm as a whole must meet Threshold Conditions). The PRA has regard to the size of a firm's U.K. footprint in deciding whether to determine that a wholesale branch is systemically important, specifically whether it exceeds an average of £15 billion total gross assets. In such instances, in addition to the equivalence conditions, the PRA expects the degree of cooperation with the HSS to increase (for the branch to remain in its risk appetite). If the firm fails to meet the PRA's expectations and /or the PRA is unable to gain sufficient assurance at the level of the whole firm through cooperation with the home supervisor, it could impose additional regulatory requirements on systemic branches (e.g., restriction on business growth, deposit taking). In extreme cases, the PRA may require firm to only operate in the United Kingdom as a subsidiary. The PRA has specific expectations for businesses that engage in retail banking activities, since those activities tend to have a greater effect on financial stability in the United Kingdom. In general, the PRA does not accept that branches undertake deposit-taking activities from retail customers and small companies beyond the de minimis levels. The PRA has introduced articulated expectations about risk management and governance of third country branches, which is commendable (but expectations are not requirements and in certain key areas such as market risks, they could be more detailed as explained below). Even though branches are subject to HSS requirements which are deemed to be equivalent, those rules may not necessarily specify how risk management should be structured and conducted in foreign branches.

^{1/} The more systemic and the more highly integrated the U.K. operations are with the overseas group, the more group information and assurance over group risk management and controls the PRA expects to see. Where this information is not able to be provided on a systematic basis, and/or where the PRA does not have sufficient influence on supervisory outcomes, the PRA may ultimately expect either a branch or a subsidiary to operate on a more standalone basis.

Non-Systemic Firms

53. The intensity of supervision on non-systemic firms has slightly increased since the 2016 FSAP, with a clear focus on new and growing banks. The PRA has increased resources applied to non-systemic U.K. domestic firms which include smaller banks and building societies (+6 percent over the past two years), while the number of these supervised firms has remained broadly the same on a net basis (100 in 2016, 102 in 2020). The extra specialist and analytical resources have enabled the PRA to undertake more in-depth capital and liquidity/ALM reviews (C-SREP and L-SREP) and more frequent credit quality assessments of small firms, and particularly the newer banks. The PRA has undertaken a number of pieces of cross-firm thematic work, including looking at the faster growing firms to assess their capitalization and longer-term viability. Separately the PRA has undertaken a set of desk-based capital stress tests of smaller U.K. banks and building societies not subject to the annual stress testing regime. Going forward, the PRA should carefully weigh pros and cons before readjusting and lowering the frequency of certain supervisory tasks for smaller firms, which is currently envisaged in the PRA strategic review. As already discussed in 2016, while the disorderly failure of a smaller firm may pose limited risk to the stability of the U.K. financial system, it could affect the reputation of the PRA.

54. As part of its secondary competition objective under FSMA, the PRA and FCA have encouraged the authorization of new banks consistent with their primary objective.⁴⁷ The PRA and FCA jointly assess applicants under the terms of a MoU in a single process with the FCA focusing on conduct and the PRA on prudential considerations. A successful applicant must meet each regulators' Threshold Conditions on an ongoing basis and must be resolvable with a minimal impact on the financial system. The regulators have adopted a proportionate approach to authorizing new banks, to maintain a competitive banking market, while being consistent with their primary safety and soundness objectives. Fostering competition by authorizing new banks has not been achieved by lowering key licensing requirements. The PRA and FCA have established a New Bank Start-up Unit to provide applicants with guidance, information, and material they need to navigate the licensing process. The new bank authorization process, if measured by the number of new banks authorized, appears to meet its competition goal (since 2016, 20 new non-systemic U.K. banks have been authorized).

- The authorization process is flexible and permits a limited mobilization option for newly authorized banks for up to 12 months. Mobilization permits a new bank to build out its infrastructure during its first 12 months with lower initial capital requirements and limits on its deposit taking authority (i.e., a £50,000 deposit limit). Full authorization requires that all applicable conditions to be met.
- Some applicants fail to complete the PRA's authorization process indicating a level of rigor to the authorization process. Since 2016, 15 applicants withdrew their authorization applications because they were not able to address specific concerns raised by the PRA and FCA. Since 2016,

⁴⁷ [New Bank Start-Up Unit | Bank of England; https://www.fca.org.uk/firms/innovation/regulatory-sandbox.](https://www.fca.org.uk/firms/innovation/regulatory-sandbox)

12 non-systemic U.K. banks were wound down or sold. This is not an insignificant number of new bank wind downs, and it confirms the higher risks associated with new banks. Supervision of new banks has been enhanced as evidenced by the PRA's issuance of its revised supervisory approach in 2021. While new banks may fail, the impact of on financial stability has not been material and the PRA has tried to offset that risk through its policy of facilitating orderly solvent exit.

55. The PRA has clarified and improved its approach to supervising non-systemic new and growing firms in response to common weaknesses displayed by the cadre. During the PRA's supervision of new and growing banks common issues and weaknesses were identified. The PRA found that new and growing banks display rapid growth, losses, reliance on regular capital injections, significant and rapid changes in strategy and business model, and immature controls. New and growing firms also have a higher likelihood of failure during their first few years due to their inability to obtain initial and additional capital to support growth or their inability to execute their business model and reach expected earnings targets. The PRA revised and strengthened its supervisory approach to new and growing banks in April 2021 as a direct result of its experience with these firms (SS3/21). PRA's expectations of banks increase as the bank matures. Supervisory Statement SS3/21 transparently addresses the PRA's general expectations, business model profitability and organic capital generation, good governance, conflicts of interest, sound risk management and controls, outsourcing, capital, and stress testing requirements. The PRA's supervision program identified these weaknesses in new and growing firms and has acted where firms breach or threaten to breach Threshold Conditions.

56. The PRA's approach applies to new and growing U.K. subsidiaries of international banks with modifications. New and growing subsidiaries of international groups are subject to the same regulatory requirements and follow the same supervisory framework as for a U.K. headquartered firm. The PRA reserves the authority to tailor its supervisory approach depending on the nature, scale and complexity of a firm's U.K. operations and the potential impact of the bank subsidiary on financial stability in the United Kingdom. The PRA's expectations on governance matters and the level of independence of a new U.K. subsidiary board may exceed those for a domestic U.K. bank. Boards of significant regulated subsidiaries need to be independent in order to ensure that they are effective and make decisions to protect the safety and soundness of the new U.K. subsidiary. This is consistent with its approach to international bank branch and subsidiary supervision as outlined in its Supervisory Statement SS5/21. The PRA may also adjust its approach to profitability, governance, recovery, resolution, and solvent wind down (SWD) for subsidiaries of international firms.

57. The PRA looks to offset new and growing banks' higher risk of failure by insisting upon realistic and deployable orderly exit plans and strategies and by requiring a simplified capital buffer.

- While firms may fail at any stage, the likelihood of failure may be higher during a firm's early development. The PRA's stated policy objective is not to ensure no firm fails. Consequently,

Supervisory Statement 3/21 focuses on orderly exit, including effective recovery and resolution planning. Since 2016, the PRA has successfully managed the wind down or sale of 12 non-systemic U.K. banks. The PRA should devote sufficient resources to the supervision of new and growing banks to identify and address emerging weaknesses early so that orderly exit plans can be successfully executed by the bank, if necessary.

- A significant feature of Supervisory Statement 3/21 relates to the capital buffer for new banks. An alternative approach to calculating the PRA buffer for new banks was first introduced in 2013 based on the bank's estimate of solvent wind down costs. Prior to the Supervisory Statement, new and growing banks had varying approaches to calculating the PRA wind down buffer. The Supervisory Statement now clarifies the purpose of the buffer and simplifies its calculations. The PRA buffer for new and growing banks is calibrated to allow banks time to find alternative sources of capital or make business model adjustments, in the event of a loss of investor support. The PRA believes that six months is sufficient time to pursue alternative options. Therefore, banks are expected to have the PRA buffer equal to six months of projected operating expenses. The PRA may in exceptional circumstances, deviate from the PRA buffer calculation for new and growing banks, if it creates a disproportionate level of capital relative to financial stability risks or where the PRA identifies heightened risks. The PRA should periodically reassess whether the revised capital buffer calculation framework for new and growing banks is effective.

B. Methods of Ongoing Supervision

Governance and Risk Management

58. Corporate governance and risk management systems are assessed as an integral part of the supervisory process. Risk Management is one of the central elements of the PRA's risk framework. Furthermore, the question of individual accountability has received a lot of attention in the United Kingdom, which has been driven by prevalence of conduct issues and weak risk cultures in firms prior to the GFC that exposed a lack of clarity of responsibilities and accountability as well as more recent conduct-related scandals. The implementation of the SMCR complements board responsibility while the application of regulatory requirements on variable remuneration reinforces individual accountability and helps align individual incentives and behaviors. The FCA's "5 Conduct Questions Programme" and research published on conduct and culture complement the remuneration regime.

59. The PRA has a well-developed focus on corporate governance. The PRA requires firms to ensure that members of the board have both individual and collective knowledge, skills and experience to effectively perform their duties and uses the SMCR to regularly review proposed appointments to firms' boards.⁴⁸ The PRA reviews the governance of firms through onsite and desk-

⁴⁸ Supervisory Statement 5/16 Corporate governance: Board responsibilities also sets the expectation that for firms that are listed at least half of the firm's board should be independent non-executives and smaller firms should have

(continued)

based reviews, such as governance and board effectiveness reviews that consider the ability of the board to discharge its oversight function, as well through continuous supervisory assessment, which also provide an insight into the effectiveness of a firm's governance framework.⁴⁹ The PRA may also commission a S-166 Review for a third party to undertake a governance and/or board effectiveness review. The PRA has challenged and taken action against firms for weaknesses in their governance arrangements. Where the PRA assesses a firm's risks management and/or governance to be significantly weak or require strengthening, it may also set a risk management and governance (RMG) capital scalar that forms part of the PRA capital buffer.

60. A solid Second Line of Defense at a firm is key to the PRA's safety and soundness

objectives. Risk management processes and policies at the largest firms are subject to a continuous process while non-systemic firms are assessed as part of the annual supervisory visit. An assessment of banks' risk management frameworks is formally presented and reviewed at annual PSMs (updated at midyear reviews). For Category 1 firms, formal meetings with CROs at both Group and subsidiary level take place at least quarterly and review various aspects. Discussions at Executive and Board level are used to assess the strength of the voice of risk department in the firm. Non-systemic firms are formally assessed as part of the annual supervisory visit during which supervisors interview the head of risk and the chair of the Risk Committee, as well other members of the executive and board of directors, but can often be subject to more frequent engagement, particularly for Category 2 firms. The detailed C-SPEP and L-SREP reviews that happen periodically (every year for Category 1 firms and every 2 or 3 years for the others) involve a further assessment of how well the risk function had provided input and challenge on capital/liquidity issues and may result in communication of firm specific expectations for improvement. Lastly, the assessment of the second line of defense is included in most reviews.

61. The potential that banks' risk management becomes complacent should not be

underestimated. A continued low yield environment is traditionally prone to search for yield strategies within financial systems and potentially excessive risk taking.⁵⁰ Banks with CIB activities continue to play an active role to structure certain products and provide funding to certain entities. In this context, ensuring that banks' business models remain sustainable and banks' risk management does not become excessively complacent will be paramount. Recent events (e.g., Archegos failure) have revealed that several banks were unable to appropriately monitor, measure, assess and mitigate risks arising from complex CIB activities. During the meetings with the private sector, several banks also indicated that risks from leveraged loans are rising (reduced time for due

at least two independent non-executive members. The PRA also has expectations in respect of the independence of the Chair and requirement for the Chair of the Audit Committee to be independent.

⁴⁹ As an example, during a desk-based examination, supervisors will review existing material held by supervisors and materials requested from the firm. If the desk-based review raises concerns about the design of a firm's governance framework supervisors may choose to also assess the effectiveness of a firm's governance through on-site examination.

⁵⁰ E.g., higher exposure to illiquid and complex products, pressure to accept lower quality assets as collateral, weaker covenants in the case of leverage loans, etc.

diligence, higher debt to EBITDA, less stringent covenants, etc.). Under this heightened risk environment, the potential for excessive complacency should not be minimized. The PRA is well aware of that concern that have been discussed internally, flagged in key risk dashboards, and emphasized publicly.⁵¹

62. In this context, further attention should be given to risk management:

- As already observed during the previous FSAP, the PRA requirements and expectations with respect to banks' credit risk-management are quite general and are not fully articulated. The approach to Pillar 2 is set out in the Pillar 2 Statement of Policy and the approach to the SREP and ICAAP processes are set out in a supervisory statement. These guidelines are clearer and more detailed than the PRA Rulebook as regards the supervisory expectations on banks' credit risk management, but as statements of policy they are not binding.
- For Category 2-5, an assessment of banks' risk management frameworks is conducted during the annual visit, mainly through interviews, which has limitations. For Category 1 firms, the number of meeting with firm's senior management is very high, which helps discuss a range of critical issues ranging from the risk department's performance in general to specific incidents where risk limits have been breached by the first line or where policies have not been followed. However, more could be done to further probe risk management processes.
- The PRA could do more to proactively identify risk management issues to be remediated. The PRA explained that risk management is either assessed directly when a review examines risk management practices in a certain area of the firm, or it is examined as part of a wider review, for example of a certain business line, looking at how risk management has performed (how well a risk department understands the business, whether it has challenged the business and what the result has been, etc.). The FSAP team was provided with a range of onsite reviews conducted by the PRA. It appears that (i) the assessment of risk management is sometimes rather limited, (ii) findings are not always detailed, and (iii) some reviews do not include explicit recommendations on risk management processes and procedures.

63. The U.K. financial regulators have focused increasingly on individual accountability.

The SMCR is a joint regime, which provides the PRA and FCA with supervisory tools to address both prudential and conduct of business risks. The main objective is to reinforce a change in culture at all levels in firms through a clear identification of responsibilities to all individuals responsible for running key areas and activities. The SMCR is intended to make it easier for both firms and U.K. financial regulators to hold individuals to account. The most senior decision-makers who undertake one or more Senior Management Function (SMF) at a firm must be assessed as fit and proper, have clearly defined responsibilities, and be subject to enhanced conduct requirements, including the

⁵¹ The Dear CEO letter highlighting the main priorities for ARTIS firms sent in December 2020 indicates that "a focus of our supervisory engagement through 2021 will be to assess how firms are ensuring robust credit risk management practices that are appropriate for the current situation, including in determining provision levels, and maintaining an appropriate risk appetite for trading businesses".

duty to take reasonable steps in fulfilling their responsibilities. Individuals seeking to hold SMFs must be approved by the PRA and/or the FCA.⁵² To strengthen individual accountability, SMFs must have a clearly articulated Statement of Responsibilities outlining the duties for which they are responsible, including Prescribed Responsibilities that must be allocated across SMFs (e.g., responsibilities covering the adoption of the firm’s culture). The PRA expects that responsibility for a firm’s key risks and supervisory priorities (as identified by the PRA) should be allocated to a relevant SMF and reflected in their Statement of Responsibilities. This includes issues that relate to a firm’s governance. Firms also need to produce Management Responsibilities Maps, which consolidate information on a firm’s management and governance arrangements.

64. The SMCR has improved individual accountability. As emphasized by the previous FSAP team, the SMCR is a “major and welcome improvement” and “an important step towards bolstering public confidence in the banking system”. After several years of implementation (the SMCR was not in force yet at the time of the previous assessment), it is now time to take stock of what has been achieved to date. The evaluation carried by the PRA in December 2020 concluded that the introduction of the SMCR has helped ensure that senior individuals in PRA-regulated firms take greater responsibility for their actions and has made it easier for both firms and the PRA to hold individuals to account. The SMCR and the remuneration regime forces firms to be more disciplined in mapping responsibilities and resulted in greater consistency and transparency on acceptable remuneration practices. Firms appear to welcome the clarity of this approach. In addition, although some industry observers and participants highlighted the complexity of implementation of the SMCR in foreign groups, those concerns were not raised during the meetings the FSAP team had with several firms.⁵³ Additionally, PRA supervisors are making more extensive use of the SMCR, which gives them additional traction with firms. This is evidenced in a number of letters to regulated firms following key meetings with the PRA, which ask for a Senior Manager to be identified as responsible for addressing key risks that have been identified. This was reemphasized in a speech by the CEO of the PRA who also noted that success or failure in addressing those key risks should be reflected in their remuneration.⁵⁴

65. Further enhancements are, however, necessary:

- In a number of instances, mitigation actions could have been—but were not—linked to responsible individuals in supervisory letters sent to firms. Furthermore, data on adjustments to

⁵² SMFs include those that hold specific executive roles (such as CEOs and heads of finance and operations), and also non-executives holding particular oversight roles (such as board chairs and those chairing audit, risk, and remuneration committees). Assessments may include interviews at the PRA’s and/or FCA’s discretion.

⁵³ E.g., difficulty to allocate a clear set of responsibilities to group level senior managers and to define how responsibilities will be shared with U.K.-based senior managers, multiplicity of designated SMFs at both parent and subsidiary/branch levels, with some senior managers undertaking senior management functions in several U.K. entities. See chapter 3 (experience with U.K. regime) in KPMG “Individual accountability”, February 2020.

⁵⁴ Speech by Sam Wood, Deputy Governor, Prudential Regulation and Chief Executive Officer, October 2018: “we will simply ask, when we set out those priorities, which senior manager is on the hook to deliver them, and what will happen if they do not?”

variable pay for material events does not point to an additive effect of the SMCR on remuneration practices. Therefore, as noted by the PRA, there is room for improvement to better link the two approaches and ensure that failures to deliver a major supervisory priority have effective consequences on variable pay.

- More broadly, the U.K. financial regulators may incur a reputational risk, should an approved senior manager be involved in excessive risk-taking and/or severe misconduct issues. Ongoing assessments of Senior Manager suitability is carried out through BAU supervisory interactions, including through meetings with relevant individuals in firms (e.g., the Chair), where regulators can express their concerns. As ultimate responsible for assessment of fitness and propriety sits with the firm, regulators may first rely on softer powers, before choosing whether to take more formal action through revoking approval, possibly creating a time lag if firms do not cooperate (an issue that may be compounded by the fact that the PRA gives a one-off approval which is typically⁵⁵not time limited).⁵⁶ Consequently, it is critical for the PRA to exercise the full range of its formal powers on top of its supervisory interventions. To date the PRA has not yet issued a formal rejection notice and instead has permitted certain applications to be withdrawn by firms. Firm mitigation actions could be linked more often to responsible individuals. Sanctions that have been taken to date have not been based upon breaches of the SMCR framework. Formal enforcement actions for individuals' significant failures to comply with regulatory requirements or to discharge their responsibilities are just an option.

66. Regulatory requirements on variable pay provide a complementary mechanism for promoting individual accountability and aligning incentives and behaviors. The PRA and FCA approach to supervising remuneration arrangements and outcomes are integrated within their respective supervisory approaches. The FCA focuses on the key drivers of culture within firms, including their approach to rewarding and incentivizing staff. The PRA prioritizes firms with the potential to adversely impact the United Kingdom's financial system. Firms are required to adopt remuneration policies that are consistent with and promote sound risk management, eliminate incentives towards excessive risk-taking, and align employee incentives with the longer-term interests of the firms, while taking account of the timeframe over which financial risks crystallize.⁵⁷ In the case of banks, senior individuals – including Senior Managers – whose professional activities could have a material impact on the risk profile of their firm are known as material risk-takers (MRTs). The variable pay of MRTs is subject to qualitative and quantitative requirements, which include payments in instruments other than cash and the deferral of variable pay for a specified period depending, among other aspects, on the role and seniority of the individual and application of downward adjustments after variable pay was granted. The PRA also expects firms to use the

⁵⁵ [Senior Managers Regime | Bank of England](#)

⁵⁶ Even though firms have a legal obligation to satisfy themselves that an SMF candidate is and remains fit and proper (i.e., before applying for approval and once the approval is given), this may only provide a limited degree of protection against conduct-related scandals involving a PRA/FCA approved SMF.

⁵⁷ PRA rules on remuneration in the Remuneration Part of the PRA Rulebook and the Supervisory Statement (2/17) set out the PRA's expectations for firms in relation to aligning rewards with risk.

remuneration rules in assessing their exposure to risks arising from their remuneration policies, as part of their ICAAP. There is evidence of firms holding individuals to account through adjustments to variable pay. In the period 2014–2018, the available data shows that firms reported nearly 400 material risk events that prompted them to adjust downwards the variable remuneration of a responsible individual.

67. The PRA reviews, assesses, and challenges firms’ remuneration policies and practices on a yearly basis, but there are areas for further improvement. Category 1 firms must submit to the PRA annually a Remuneration Policy Statements (RPS).⁵⁸ Supervision holds regular meetings with management responsible for remuneration matters (including risk and finance functions) and at least on an annual basis with the Chair of the Board Remuneration Committee who holds the prescribed responsibility to ensure the firm’s compliance with PRA rules and expectations. Formal written feedback through a joint letter with the FCA is provided to all firms at the end of each year’s compensation cycle. Where issues in a firm relating to remuneration pose a significant risk to the PRA’s objectives, supervisors can also use supervisory activities such as firm visits and regular engagement meetings (including outside the annual discussion on remuneration). The FSB peer review emphasized that U.K. financial regulators have implemented financial sector compensation reforms that are consistent with FSB Principles and Implementation Standards for Sound Compensation Practices and can serve as examples of good practice for other jurisdictions to consider. The review also suggested to strengthen the framework in a few areas, including by considering additional supervisory approaches for assessing the effectiveness of the regime (additional thematic reviews and onsite activities such as sample testing and processes/systems walkthroughs). The review recommended that the U.K. financial regulators consider whether a more structured approach to data collection, to include a wider range of firms, not limited to Category 1 firms, could be useful.

Credit Risk

68. The PRA uses a range of tools to supervise credit risk which assumes particular significance in the current environment. Assessing credit risk has been a challenge during the pandemic as widely used payment deferral schemes might have contributed to mask the full extent of credit quality deterioration. Even when payments have resumed at the end of moratoria, it remains difficult to assess the effect of the COVID-19 crisis as government relief measures are still in place. Going forward, the PRA anticipates a rise in nonperforming exposures in the wake of the COVID-19 crisis as support measures are progressively unwound. The PRA assesses credit risk through offsite surveillance and onsite review activities. It has put in place an offsite monitoring system through regular data collection (e.g., retail secured LTVs and Commercial Real Estate LTVs, leverage lending), which helps identify outliers or banks with an evolving risk profile. Furthermore, the supervision of individual firms is increasingly supported by cross-firm and thematic reviews. During the COVID-19 crisis, the PRA has taken a broad range of decisive actions in a timely manner

⁵⁸ All material risk takers remuneration is recorded in the tables alongside aggregated bonus amounts and performance measures.

and the supervisory response has involved a combination of targeted credit calls with firms, additional credit reviews for the most at-risk firms, regular thematic analysis of firms' management information to monitor for emerging trends in firms' credit risk, and thematic reviews focusing on topical issues (retail payment holidays, potential fraud, and credit risk in firms' BBLs portfolios).

69. Credit risk is assessed through "Asset Quality Reviews" (AQR) that bring significant benefits but could nevertheless be improved. The AQR coverage program started in 2018 to better assess the quality of banks' credit risk management and overall credit risk. The program was paused in 2020 and is expected to restart in 2021.

- Credit AQRs can deal with one firm or can be thematic, focusing on two or more firms. Covering retail and wholesale activities, credit AQRs can focus on a portfolio or an element of a firm's credit risk management controls and processes that might be of particular concern. They should include a review of provision cover relative to asset quality and peer benchmarking.⁵⁹ Credit coverage requirements to be achieved over a three-year period for assets in scope are quite high for Category 1 firms (between 40 and 60 percent) while credit reviews are conducted every three years for material portfolios in individual non-systemic firms, which has helped intensify the supervision on non-systemic firms.
- However, Category 1 ARTIS firms have not been subject to credit AQRs and concerning UKDT firms the most complex activities are not included in the scope (e.g., project finance). Certain areas of higher risk business have received detailed attention during the supervisory process, for example, leveraged lending and CLO warehousing, but have not been included in credit AQRs. Moreover, in the case of non-systemic firms, the AQRs have mainly been based on desk-based analysis of firms' data, with limited use of detailed transaction testing. Since 2018 the PRA has conducted around 445 credit reviews. The largest U.K. firms' reviews may involve detailed loans reviews, but only 19 AQRs have included credit file reviews before the program was suspended in March 2020. The PRA would generally not conduct detailed file reviews within retail credit portfolios. When sample file reviews are carried out, the number of credit files selected is usually low (10 to 15 files) but is targeted using specific criteria to test the quality of the risk function overall. Given the importance of transaction testing to assess the effectiveness of credit risk management processes and procedures, detect a deterioration in lending standards, and help ensure accuracy of banks' loan classification and adequacy of provisions, there is room for further improvement (more reviews and testing while expanding the scope to include all ARTIS firms and more complex activities giving rise to credit risk). Also, while feedback is provided to firms when provisions look low compared to a peer group, banks are not formally requested to make loan reclassifications and/or adjust the level of provisioning.⁶⁰ The PRA has explained that it would consider applying a Pillar 2 surcharge if a bank's provisions were judged insufficient, but this would not be an immediate response. Lastly, as already discussed, while the main findings

⁵⁹ Around five non-systemic firms have been given feedback in the past 24 months that their provisions look low relative to asset quality and when benchmarking with peers which have similar quality portfolios.

⁶⁰ Certain reviews are not extremely conclusive as mentioned above.

are included in the annual PSM letter to firms, the full report with all detailed findings is not shared with firms.

70. The PRA regards the effective implementation of the IFRS 9 expected credit loss (ECL) approach to be important in ensuring the safety and soundness of PRA-authorized firms.

Although it is not the PRA's role to set, interpret, or enforce accounting standards, the PRA considers it has an interest in how the accounting standards are implemented where the application of standards has an impact on its statutory objectives. A range of approaches have been deployed:

- The PRA has a regular dialogue with category 1 firms regarding provisioning, based on tools such as the AQRs (focusing on assets in Stage 3), thematic and data-analysis work, bilateral meetings with firms' external auditor and the results of Written Auditor Reporting (WAR).⁶¹ WAR has focused on how firms are accounting for credit loss provisions since the introduction of IFRS 9, including the criteria firms use to assess whether a significant increase in credit risk (SICR) has occurred, the economic scenarios and their probability weighting, as well as models and data limitations. The PRA has used auditors' responses to identify high quality practices and encouraged firms through "Dear CFO" letters to adopt them. In addition, UKDT undertook in January 2019 a one-off exercise to compare IFRS 9 provisions across Category 1 firms and different asset classes (e.g., CRE, SME, Large Corporates). Lastly, in the context of COVID-19, the PRA has collected specific IFRS 9 data covering firms' scenarios and ECLs for Category 1 UKDT firms and selected smaller firms since Q2 2020, which is scheduled to continue through 2021. However, Category 1 ARTIS firms were not included in the scope of work. Also, no deep dives on ECL models have been conducted by the PRA.
- The approach taken to non-systemic firms places greater emphasis on identification of outliers through desk-based analysis and peer benchmarking. A credit monitoring tool led by credit risk specialists is used to benchmark firms' provisions by asset type and identify outliers relative to the level of credit risk to which banks are exposed. Moreover, UKDT undertook in October 2019 a thorough thematic review of IFRS 9 provision cover relative to risk ranking and asset quality for the retail portfolios of twenty Category 2-4 firms.⁶² It led to detailed generic feedback to all firms and specific feedback to individual firms where concerns were identified.⁶³

⁶¹ Since end 2016, PRA rules require the auditors of firms in scope (with £50 billion or more in assets) to report to the PRA on matters that the PRA requests. Each year policy experts consult with risk and supervisory colleagues to identify the key themes of supervisory concern.

⁶² The review began in October 2019 with an information request followed by analysis from Q4 2019 to Q1 2020. The findings were delayed by COVID work. A thematic feedback letter was sent in October 2020 to all firms with specific annexes for firms involved. Findings were again shared for all Cat 2-5s in the December 2020 CEOs Conference.

⁶³ Seven firms were identified as outliers: their retail portfolio provisions looked low relative to asset quality and when benchmarking with peers with similar quality portfolios. Around 10 firms exhibited a lack of sensitivity to risk in their models. The PRA observed significant differences in how responsive firms' models were to changes in the time horizon used to calculate PD and to economic scenario weightings. A number of firms' models showed little or no sensitivity to changes in these factors, raising concerns that the approaches used will not respond sufficiently as economic conditions change.

71. More work is needed to ensure the adequacy of ECL allowances and the accuracy of methodologies.

IFRS 9 is a relatively new framework that has been tested during COVID-19 and the quantification of ECLs faced serious challenges during the pandemic (unprecedented level of uncertainty, difficulty with measuring the impact of support measures, etc.). In this context, the pragmatic approach taken by the PRA that relied significantly on benchmarking and peer review analysis as well as on extensive engagement with auditors and firms was certainly appropriate as a first step.

- The analysis conducted by the PRA has, however, revealed a wide range of approaches across UKDT firms, with significant differences in terms of management overlays. Given that IFRS 9 is principle-based and involves an important degree of judgment, those analyses have not always been conclusive. As firms, legal auditors and financial regulators gather more experience with the new framework both in normal times and crisis period, the approach to ECL provisioning deserves now to be strengthened to ensure the adequacy of provisioning coverage for all firms, including ARTIS firms. In this regard, thorough and in-depth reviews by the PRA of the models, methodologies and inputs used to quantify ECLs estimate (deep dives) would help achieve that objective. Benchmarking could also be more granular (i.e., comparison of probability of default (PD) and loss-given default (LGD) data by sector, by geographies, etc.). In addition to performing its own checks, the PRA may also consider pursuing and expanding (to ARTIS firms) the scope the data collection exercise covering firms' scenarios and ECLs that was launched during the COVID-19 crisis, which proved to be helpful, and review more extensively Stage 3 assets during AQRs (as discussed above).
- The PRA has commenced work to develop an approach to more formally assess provision adequacy for retail assets. The approach will seek to assess the overall provisions in aggregate, while assessing comparative provision levels across banks to highlight outliers. Once the retail asset approach is finalized, the PRA's objective is to follow with an approach for assessing corporate assets, which may prove to be more challenging as these assets are less homogenous. It will be critical for the PRA to complete that approach as benchmarking firms to identify outliers is one thing but assessing the appropriateness of the ECLs allowance is quite another.

72. Supervision of concentration risk is based on an overall robust process. Concentration risk is addressed under the Pillar 2 framework. Firms are required to articulate their risk -appetite, risk profile, and capital and liquidity strength in their ICAAP reviews, which must be conducted at least annually. The PRA explained to the FSAP team that firms are expected to set limits on their single name, geographic and sectoral risk concentrations as part of their ICAAP.⁶⁴ The PRA reviews firms' ICAAPs within the SREP.

⁶⁴ This expectation is, however, not explicitly mentioned in the Supervisory Statement on the ICAAP and SREP (31/15).

- BoE staff regularly monitor the growth rates in bank exposures to a range of sectors.⁶⁵ This analysis also reviews whether any banks are particularly exposed to such sectors. The choice of stress scenarios in the FPC's annual stress test exercise is targeted on potential areas of vulnerability to the major U.K. banks.
- The PRA does not set limits for credit concentration risk (although it does limit exposures to single counterparties or groups of connected clients under the large exposures regime). In line with its overall philosophy, the PRA reviews banks risk concentrations in a judgement-based way. While it has the power to require banks to mitigate their potential negative outcomes, the PRA does not necessarily expect firms to change their portfolio composition where they exhibit concentration risk. Such portfolio compositions may be inherently part of some business model strategies. Instead, the PRA requires firms to mitigate concentration risks through additional capital add-ons under Pillar 2A as part of the SREP to reflect sectoral and geographic concentration risk and risks arising from lack of granularity of lending portfolios.

73. Credit risk models used for regulatory purpose are being assessed through a combination of periodic thematic reviews, undertaken on a cross-firm basis and firm-specific reviews. 20 banks have been given the permission to use internal ratings-based (IRB) approaches; for counterparty credit risk, there are currently 10 banks authorized to use the internal model method (IMM). Since 2016 the PRA has granted new IRB permissions to two banks and is currently considering four additional new IRB permissions.⁶⁶ One noticeable trend is that smaller banks have applied or are considering applying for IRB permission for more favorable capital treatment. The PRA relies on two dedicated unit within SRS.⁶⁷

- *Initial permission.* The FSAP team was provided with samples of internal model reviews which show the thoroughness of the PRA approach to assessing internal models. However, the PRA does not validate model input data, review IT systems and processes and does not test the implementation of models. Going forward, it will be important to maintain a rigorous assessment process of the performance of internal models as new firms may view IRB models as a way to reduce RWAs without being completely aware of the requirements. Considering that new firms may also struggle with data quality and effective implementation, supervision should

⁶⁵ Including, but not limited to, owner-occupied mortgages, buy-to-let mortgages, commercial real estate, SME loans, leverage loans, vulnerable euro area countries, EMEs and the oil sector.

⁶⁶ The PRA finalized in 2019 a review of the approach to IRB credit risk model applications for smaller banks and building societies to facilitate the approval access for these firms. This has led to the introduction of new modular approach which provides greater clarity and transparency to firms regarding the application process. The PRA provides non-binding feedback at completion of each phase, which allows banks to take corrective measures where necessary in due time. Banks are aware that positive feedback does not guarantee approval since the final decision is only taken at completion of the full review. Given the time and resources needed to develop IRB models, it makes sense to ensure regularly that banks do not take a wrong direction. Going further and helping banks to find solutions (like a consultant) would however raise concerns, but this has not been the case up to now.

⁶⁷ The Credit Risk Measurement Team (CRMT) in SRS Credit Division is specialized in credit risk modelling (IRB models), model risk management and governance. There is also a team within the Traded Risk division specializing in the assessment of market risk and counterparty credit risk internal models.

play a more active role going forward to ensure that these firms comply with use test requirements.

- *Ongoing monitoring.* The PRA has also focused on already approved models to assess their performance after the initial permission is granted and review material model changes.⁶⁸ This work is paramount to reduce unwarranted variability of RWAs and ensure that banks continue to devote sufficient resources to the maintenance of internal models. CRMT has carried out several pieces of thematic work since 2016 (review of mid corporate PD models, review of wholesale LGD model, impact of COVID-19 on IRB models). The PRA has also embarked on a review program to assess banks' adoption of the EBA Roadmap to repair IRB models. This thematic review is expected to make it easier to identify outliers and good implementation practices across banks.
- *Model changes.* In addition to thematic work, the PRA has carried out bank specific reviews, usually triggered by banks' model changes. The breadth and depth of these reviews depend on the nature, materiality and impact of the model changes and are also driven by the availability of CRMT resources which are somewhat stretched. During the meetings, banks mentioned several times that the delay with processing their applications for model change is quite long.

74. All in all, the PRA has been very active on several fronts:

- First, the regulatory framework has been adjusted to address various issues. Concerns raised by the FPC about differences in risk weights for mortgages across banks and overall trend of decreasing risk weights and about the potential impact on financial stability have led to a multi-year project intended to developing an in-depth understanding of the issue, potential impacts and materiality. It ultimately resulted in a Supervisory Statement setting out PRA expectations for mortgage IRB models, including the need for all banks to move to a hybrid calibration approach for mortgages. To complement the work on hybrid models, the PRA has also introduced standards and guidelines as part of the 2016 EBA roadmap to repair IRB models.⁶⁹ It should however be noted that the implementation of hybrid PD models, which is expected to reduce procyclicality (compared to a point-in-time (PIT) approach) is limited to mortgages. The SRPC decided in 2019 that firms should be permitted to continue using PIT approached for their

⁶⁸ For credit risk model changes, the definitions and notification/approval processes to be followed by firms are set out in the relevant onshored EBA RTS. As IMM models are not covered by an EBA RTS, the definition of material changes is set out in the PRA supervisory statement on counterparty credit risk (SS12/13).

⁶⁹ The PRA has onshored the Regulatory Technical Standards for the materiality threshold for credit obligations past due as well as the Guidelines designed to harmonize the definition of default across U.K. firms and improve consistency in the way U.K. firms apply regulatory requirements to their capital positions. The PRA has also implemented the Guidelines on PD and LGD estimation and the Guidelines on downturn LGD). Requiring all firms that use the IRB approach to use the same materiality thresholds and number of days past due definition ensures greater consistency of approach across IRB firms.

unsecured retail exposures. Also, no guidelines on the recalibration of IRB models in the context of COVID-19 have been set out by the PRA.⁷⁰

- Second, following IRB model reviews that usually identify limitations and sometimes deficiencies in firms' models, firms are expected to set out credible and timely plans for return to full compliance. Action taken by banks to address those issues are discussed during Continuous Assessment meetings with banks. In a number of instances, the PRA has taken tougher action, such as introducing model level floors, model level RWA add-ons, portfolio level add-ons and removal of IRB permissions, including for very large banks. Overall, post-model adjustments imposed on firms have resulted in a significant increase in RWAs (11 percent). It is however worthwhile mentioning that banks' remediation efforts are not tracked centrally (each model reviewer is performing its own follow-up after a review).

75. One of the main challenges for the PRA will be to move to a more proactive review approach on a larger scale with a view to covering the full range of credit models. Given that the initial IRB permissions were granted quite a long time ago when Basel II was implemented (well before 2016), most of the work on internal model reviews has been reactive by nature, as it is usually triggered by firms' model change applications.

- Over the years, as mentioned above, the PRA has carried a number of reviews in a proactive manner, but these have been mainly ad hoc in nature. Following the clarification provided the PRA regarding the calibration of PD and LGDs for residential mortgages based on hybrid approaches, banks have recalibrated their mortgage models and CRMT is currently reviewing these model changes.
- Going forward, as waiting for the firms to identify weaknesses with their internal models and initiate model changes applications certainly has intrinsic limitations, a more structured proactive review approach implemented in a systematic fashion would help identify banks, portfolios and modelling techniques that deserve in-depth investigations to ensure that regulatory requirements are complied with and models outcomes are reliable. Such an approach is currently envisaged by the PRA but due to resources constraints is unlikely to be implemented before 2023 (until end 2022, the review agenda will be driven by banks' submissions – Hybrid Mortgages and IRB Roadmap submissions). What has been done with the calibration of parameters for residential mortgages is exemplary but deserves to be expanded, reinforced, and systematized by covering a wider range of portfolios and models, including IMM. This would increase the PRA degree of confidence that any overall capital reductions achieved are balanced with models that (i) are as accurate as possible (compared to the somewhat simplified measurement approach contained in standard approaches) and (ii) always use robust methodologies. This approach would, however, necessitate increased resources.

⁷⁰ PDs are a long-term average of observed default rates covering good years and bad years. The question will arise as to how banks will include the default rates for the year 2020. Guidelines would be helpful to prevent excessive variability of approaches among firms.

Market Risk

76. The regulatory framework for market risk is comprehensive and includes approaches to account for risks not captured adequately in internal models. The United Kingdom's Capital Requirements Regulation and the PRA rulebook set binding requirements. The PRA's approach to market risk is set out in a dedicated Supervisory Statement (SS13/13). Like in other major jurisdictions, the revision to the market risk framework adopted by the BCBS in January 2019 has not yet been implemented. Market risk is one significant risk factor for banks with large CIB activities, which are usually using internal models to calculate capital charges covering market risks arising from transactions in the trading book. While it is true that the use of internal models typically leads to lower capital charges (compared to the use of standardized approaches), it is worthwhile highlighting that the PRA applies a number of overlays to ensure that banks using internal models are sufficiently well capitalized against market risks (i.e., risks-not-in-VaR (RNIV) framework under Pillar 1 and the Pillar 2A illiquid, one-way, and concentrated risks assessment). The application of these overlays can materially add to a firm's capital requirements. For example, the total RNIV add-ons increased overall requirements by 40 percent (as of December 31, 2020). Similarly, the impact of Pillar 2A assessments (which focus on exposures that cannot be liquidated over a 10-day horizon as envisaged under Pillar 1) can be sizeable for firms' exotic derivatives portfolios.

77. There is a strong emphasis and attention on market risks throughout supervisory processes, with a clear focus on Category 1 firms, which is justified. Supervisory teams and SRS rely on skilled resources to assess market risk.⁷¹

- The PRA conducts Continuous Assessment meetings with all Category 1 firms to form a cross-market view of risks and emerging themes.⁷² Based on this, cross-firm thematic reviews and firm-specific work may be decided to focus on specific risks or specific segments. Banks have to provide detailed information (VaR exposures, Market risk sensitivities for key risk factors, Counterparty risk measures such as current exposure and potential future exposure (PFE), etc.), but U.K. branches of non-U.K. banks do not have to supply this information on a routine basis.
- Another important aspect of the PRA's assessment of market risk is the deep-dive SREP review that is undertaken periodically (annually for Category 1 UKDT banks, but only at least every 3 years for Category 1 ARTIS banks). They assess the extent to which the minimum capital requirements materially cover the market risks taken by a bank, using a range of firm-specific measures and cross-firm benchmarks. For example, stress-based measures proposed by the

⁷¹ SRS division includes: (i) a dedicated team within the Traded Risk division specializing in the assessment of market risk and counterparty credit risk internal models; and a (ii) Valuation and Product Control team assessing banks' compliance with the framework for prudential valuation adjustments.

⁷² Monthly meetings follow the submission of monthly trading book P&L and risk data packs to measure and monitor levels of market risk at each individual bank (including branches?). Reviews of risks, valuation adjustments, model performance and capital data for banks with internal model permissions are conducted on a quarterly basis based on documents submitted by firms (regulatory back testing, performance of their models). These quarterly submissions are followed up with a comprehensive semi-annual review to assess the regulatory compliance and embeddedness of risk management and controls on specific risk themes of systemic importance.

bank (and challenged by the PRA) are typically used to assess illiquid, concentrated, and one-way exposures.

- Market risk models are being assessed through a combination of periodic thematic reviews, undertaken on a cross-firm basis, and firm-specific reviews.⁷³ All material VaR models (FX VaR, interest rate VaR, equity VaR, credit VaR) have been reviewed in the last 5 years and IRC models have been reviewed twice. Issues identified in models' reviews (e.g., missing risk factors) often lead to additional RNIV requirements while firms introduce corrective measure to improve VaR modelling.

78. The approach to supervising market risk could be improved in several key areas:

- While thematic reviews have been extremely useful in emphasizing the risks from rapidly growing activities and highlighting best practices to strengthen firms' risk management and control environment, there is a need from time to time to go beyond generic findings and increase the pressure on firms when progress is not sufficient. In that respect, follow-up firm-specific reviews could be used more often in the wake of thematic reviews to arrive at more targeted firm-specific findings, with clear recommendations and requested actions plans to be implemented within a prescribed timeline.⁷⁴
- As discussed above, developments on P&L in the PSM packs are somewhat short and evidence of effective use of onsite firm-specific reviews such as front to back reviews is rather limited.⁷⁵
- Supervising market activities conducted by branches has some intrinsic limitations as the range of supervisory tools is obviously narrower than it is for subsidiaries. It was explained to the FSAP team that whenever transactions are booked in a U.K. entity, that entity needs to have robust and effective controls in the United Kingdom. The PRA's articulated expectations about risk management and governance of third country branches to supplement HSS requirements are less detailed than those applying to U.K. based entities (for example, there are no expectations for the management of market risk). Furthermore, information collected to form a view on the risk taken might not be as granular as it is the case for subsidiaries (no required regulatory return, more limited MI on a routine basis).⁷⁶ As in the case of branches the PRA is not involved

⁷³ Cross firm work included for example: a review of Secured financing transactions (2018); and a review of IRC model calibration (2019-2020). They covered 10 firms, and involved a pre-visit information request, a desktop review of materials, meetings with firms (3-4 hours duration), and a number of follow-up questions/calls.

⁷⁴ For example, in relation to secured financing activities, a letter was sent by the PRA in September 2018 to a number of firms that were included in a cross-firm review of trading controls in the front and back office. While this letter which also refers to the main conclusion of the prime brokerage quantitative fund thematic review is detailed, it does not contain actionable recommendations with a clear timeline.

⁷⁵ The FSAP got access to a number of PSM pack that include the supervisory work plan. In a number of instances (banks with CIB activities), such reviews were not planned or their number were very limited.

⁷⁶ While the PRA expects relevant information to be received from the Group and/or the HSS, the fact remains that the PSM pack for branches includes relevant information on the parent but may contain limited information on the branch itself, on its risk profile and the way risks are managed in the U.K. (as discussed above).

in the approval process of internal models, it also has by construction less information on how market risks are captured and measured by these models. Based on some onsite reports, including reports produced with HSS, it is sometimes unclear which legal entity in the group is taking and managing the risk, which therefore necessitates close cooperation between the PRA and HSS. This is probably less relevant from a group-wide perspective on a going concern basis, but this would matter in the case difficulties arise.

79. When certain regulatory requirements were eased temporarily during the COVID-19 crisis, the PRA introduced additional checks after a period of regulatory forbearance. To address excessive pro-cyclicality in market risk capital requirements at the onset of the COVID market stress in March 2020, firms were temporarily allowed until September 2020 to neutralize the impact of back-testing exceptions when calculating risk-based capital requirements based on VaR models.⁷⁷ This temporary approach was withdrawn in October 2020 and firms have been required since then to formally apply for exceptions to be discounted (only those exceptions approved by the PRA can be deducted from the calculation of the VaR multiplier). To ensure that exceptions do not result from model weaknesses (e.g., due to missing risk factors), SRS reviewed in Q4 2020 the rationale for why each exception should be discounted. In some cases, firms were not able to provide sufficient evidence that this was not the case, and consequently not all applications to discount exceptions have been approved. However, checks were not conducted before October 2020 when the temporary approach was used.

Liquidity Risk

80. The PRA assesses firms against prescribed liquidity requirements that reflect their liquidity risk profile. To this end, the PRA uses a range of tools:

- The PRA requires firms to have robust strategies, policies, processes and systems for the identification, measurement, management, and monitoring of liquidity risk over an appropriate set of time horizons, including intraday, in order to maintain adequate levels of liquidity buffers. The Internal Liquidity Adequacy Assessment Process (ILAAP) is the initial basis for assessing the adequacy of a firm's liquidity resources. The PRA, through the supervisory review and evaluation process (L-SREP), determines an appropriate liquidity risk profile and level of liquidity resources for that firm, and also identifies any improvements to the qualitative arrangements for managing liquidity.

⁷⁷ When the number of back-testing exceptions is high (i.e., the loss incurred on a single day is greater than the loss indicated by the model), a penalty is usually applied by banking regulators in the form of a multiplier. Considering that some exceptions may be explained by an increase in market volatility and not by models deficiencies, several regulators (ECB, OSFI, FINMA) have introduced exemptions concerning the number of back-testing exceptions that are taken into consideration to determine whether a multiplier needs to be applied to capital requirements. This was done in the United Kingdom by offsetting capital increases due to higher VaR multipliers with commensurate reductions in risks-not-in-VaR (RNIV) requirements. It is however important that supervisors understand the reasons behind a large number of back-testing exceptions and ensure that the performance of models remain satisfactory.

- The Liquidity Coverage Ratio (LCR) calculated as the percentage of High-Quality Liquid Assets/Stressed net outflows over 30 days is the key measure of liquidity risk. The PRA is also in the process of adopting the longer time horizon Net Stable Funding Ratio rule (NSFR). The PRA collects LCR data through month-end LCR reporting, proxy LCR produced by the PRA110 liquidity reporting template, and MI received from firms. The frequency with which this data is received may depend on the size of the firm. Firms are encouraged to use HQLA buffers in a stress environment. Buffers generally were not breached during the COVID-19 period because of BoE and government support measures. If a firm falls or expects to below 100 percent of LCR, it is expected to inform the PRA and submit a restoration plan.
- The PRA reviews and assess other liquidity risk metrics. In 2019, the PRA introduced a liquidity dashboard that provides supervisors and risk specialists with a platform for reviewing and interrogating liquidity metrics on a single and cross-firm basis, which has served as a particularly valuable tool during the COVID-19 period. Under PRA110, firms are required to report on a weekly basis, unless there is a specific liquidity stress or market liquidity stress, in which case the PRA110 will be reported every business day. Through MI received from firms, supervisors also monitor banks' own liquidity metrics such as survival days and low points under their internal stress tests against their board's own liquidity risk appetites, which firms are required to produce under the PRA's Overall Liquidity Adequacy Rule (OLAR). To inform its analysis, the PRA generally uses surplus above 100 percent of LCR, firms' internal LCR targets and risk limits as benchmarks.

81. The PRA uses a proportionate approach to reviewing liquidity at large and smaller firms:

- The PRA assesses the quality of liquidity risk management and controls, including contingency planning for all banks through the L-SREP. Category 1 firms are subject to an annual L-SREP that includes a supervisory-led assessment of the firm's ILAAP and an SRS-led reassessment of the Pillar 2 liquidity guidance. A deep-dive L-SREP assessment is conducted every third year. Category 2 medium sized firms are subject to an L-SREP at least every two years and Category 3 and 4 firms undergo an L-SREP once every three years. International firms are subject to L-SREP reviews at least every three years on a proportionality basis. The L-SREP also examines ALM and treasury risk management. Liquidity is considered as a firm risk element during the PSM process.
- The PRA also conducts qualitative risk management reviews. In 2019 for example, SRS conducted a horizontal thematic review of liquidity and capital risk management at the largest U.K. firms focusing on: Management Information, risk appetite and three lines of defense. The review found that MI was of a high quality at most firms but there were a number of weaknesses in how firms applied risk appetites and inconsistencies in how they had applied the lines of defense model. Other cross-firm reviews assessed firms' liquidity risk-management practices and liquidity stress testing capabilities. In 2019, SRS carried out liquidity reviews of EU GSIBs applying for third country branch authorizations focusing on risk management practices, governance, and controls both for the proposed branch and entity levels.

Interest Rate Risk in the Banking Book

82. The PRA has effectively communicated its expectations relative to interest rate risk in the banking book (IRRBB) to large and small firms. The PRA has published a comprehensive set of requirements and supervisory expectations for firms to monitor and manage IRBB risks.⁷⁸ Firms are required or expected to identify, measure, evaluate, monitor, report and control or mitigate interest rate risk in the banking book on a timely basis. Several standards have been modified to consolidate all requirements and expectations, include substantive elements of the EBA guidelines on the management of IRRBB and introduce the new BCBS standardized framework for measuring economic value of equity relating to IRRBB.⁷⁹

83. The PRA uses economic value and earnings-based measures to monitor firms' IRRBB. For the larger firms, the PRA employs a comprehensive approach by assessing their gap risk, basis risk (including swap spread risk) and risks arising from embedded optionality and changes in assumptions. For the smaller firms, the PRA assess their gap risk and basis risk:

- All firms submit the regulatory gap report (FSA017), which provide data on the impact of parallel shock to the yield curve on banks' economic value measures. For larger firms, the PRA also collects structured data through "Non-traded Market Risk" returns in addition to FSA017 that provides comparable and consistent repricing gaps based on parallel shock scenarios and basis risk information by material currencies. These returns form the basis of quarterly supervisory risk reports, produced by IRRBB specialists, used to identify emerging trends or to highlight outlier firms. For the outlier test assessment on larger firms, the PRA reproduces the gap report against the six supervisory shock scenarios based on the firms' "Non-traded Market Risk" returns.
- For smaller firms, the PRA also collects voluntary returns that capture basis risk exposures in addition to the FSA017. While the returns are technically voluntary, in practice all category 2-5 firms submit them every quarter. FSA017 is used for assessing gap risk, and the PRA reproduces the gap report across the six supervisory shock scenarios for the outlier tests assessment based on the smaller firms' FSA017 returns. The PRA uses the basis risk exposures returns to monitor a gross basis mismatch measure across the small firms' population.

⁷⁸ See PRA Rulebook, as well as SS31/15 "The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP)" and SS 20/15 "Supervising building societies' treasury and lending activities. Firms are also expected to do their best effort to comply with the PRA's implementation of the EBA "Guidelines on the management of interest rate risk arising from non-trading book activities" (EBA/GL/2018/02). Additionally, the detailed methodology of the assessment of firms' IRRBB exposures and capital resources set against firms' IRRBB is included in the Statement of Policy "The PRA's methodologies for setting Pillar 2 capital".

⁷⁹ See PS29/20 "Capital Requirements Directive V (CRD V)", which sets out future revisions to the PRA Rulebook, updated SS31/15 and updated SS20/15 that will apply from December 31, 2021.

84. The PRA obtains and monitors firm management information reports on IRRBB risk measures, limits, and controls:

- For larger firms, the PRA receives internal management information relating to IRRBB in line with firms' internal reporting timetable and at least quarterly. They include IRRBB exposures and limits based on firms' internal calculations. Supervisors review these submissions regularly. IRRBB risk exposures are also subject to a comprehensive risk assessment process that involves the collection and processing of granular risk data provided by firms, and a review process including firm meetings and discussion. Lastly, larger firms are also subjected to stress-testing on exposures to IRRBB as part of the annual stress-tests conducted by the BoE that aims to assess the impact of stressed financial periods on the individual banks and the system as a whole.
- Smaller firms calculate and report the impact on their economic value measures from a parallel shock to the yield curve as a percentage of capital in the FSA017 returns. They also have an obligation to inform the PRA of breaches to the supervisory outlier test. The smaller firms IRRBB risk limits and controls are not routinely reported, but these are assessed regularly as part of the L-SREP process.

85. The PRA reviews firms' policies and processes to determine that an appropriate and properly controlled interest rate risk environment exists:

- For Category 1 firms, offsite assessments occur quarterly with a more comprehensive annual review that includes an assessment of a firm's Pillar 2A capital requirement for IRRBB. The frequency of onsite visits for the larger firms is determined using a risk-based approach informed by the results of the quarterly IRRBB monitoring process and by regular engagement with firms. Any assessment involves a review of the relevant policies, key assumptions, risk appetite, limit and escalation framework, quality and frequency of risk MI and governance processes. Changes and trends in IRRBB risks being run are identified and focused upon where appropriate.
- For the non-systemic firms, risk management of IRRBB is assessed onsite as part of the L-SREP cycle⁸⁰ (at least every 2 years for Category 2 firms and every 3 years for the smaller firms). During the L-SREP, meetings are conducted with Treasury, Risk, Audit, senior executives, and Board members covering IRRBB risk management and governance as one of the aspects of a broader review. Pillar 2A capital is set based on the C-SREP cycle, which runs the same periodicity, but in non-L-SREP years. This means that Category 2 firms receive some level of IRRBB assessment every year and for the smaller firms, 2 out of every 3 years.

⁸⁰ Smaller firms are currently assessed against EBA guidelines. Beginning on December 31, 2021, the revised PRA Rulebook as well as the revised supervisory statements (SS31/15 and SS20/15) will be applicable.

Operational Risk

86. The PRA's operational risk management framework and capital expectations are clearly articulated. The U.K. CRR sets out binding requirements for firms relating to the calculation of capital charges for operational risk. The PRA requires operational risk-management frameworks that are commensurate with a firm's scale, nature, and complexity. The ICAAP part of the PRA rulebook sets out requirements for firms relating to their methodologies for managing operational risk. Supervisory expectations are further detailed in SS31/15 that sets out the ICAAP and SREP and in a Statement of Policy on the PRA's methodologies for setting Pillar 2 capital including for operational risk. The PRA and the FCA already consider the extent to which firms have reduced the likelihood of operational incidents occurring; can limit losses in the event of severe business disruption; and whether they hold sufficient capital to mitigate the impact when operational risks crystallize. The new policy on operational resilience will complement those requirements.

87. The PRA examines firms for operational risk and requires corrective action where warranted. All firms are subject to offsite operational risk assessments under the Continuous Assessment process, which may occur quarterly or annually. Systemic firms' operational risk frameworks are reviewed once every 3 years. Where necessary, the PRA requires firms to address identified deficiencies in their operational risk management framework. The PRA may increase firms' capital requirements where inputs to a firm's model for setting operational risk capital are not deemed to be fit for purpose, loss data are of poor quality or incorrectly categorized or the operational risk capital model is not fit for purpose.

88. The new policy on operational resilience will place additional requirements on firms. The COVID-19 pandemic has underscored the importance of having an adequate operational risk framework and renewed attention on business resumption and contingency planning in key bank operations. Business resumption and contingency plans have been assessed through reviews of the effectiveness of firms' business continuity planning arrangements as part of the existing supervisory process and will be further assessed as the supervisory approach to operational resilience develops:

- In 2020, the PRA conducted a thematic review of 12 firms' business continuity planning arrangements, including high and low impact firms. Findings and feedback were provided to firms. For most firms, identified weaknesses included: a lack of scenario testing for data loss and customer channels interoperability; gaps in IT disaster recovery (ITDR) testing and independent challenge and monitoring weakness for most firms. In 2020/2021, the PRA assessed the impact of COVID-19 on firms' continuity plans for critical functions and services throughout the pandemic. The focus was on how the highest impact firms identified and mitigated the key medium-term risks to critical functions and service continuity, arising from COVID-19 and related disruptions to people, processes, and technology. Robustness of operating models and business continuity plans, the risk posed by material dependencies on external outsourcing, impact of any service continuity as a result of the crisis, weaknesses existed in primarily in staff location, work from home capability, communications and geographical concentrations were all reviewed.

- The PRA has increasingly emphasized the importance of operational resilience. Because of the global and interconnected nature of large financial firms, the PRA has fostered international supervisory cooperation regarding operational resilience. This is evidenced by the December 2020, joint statement with the ECB and the Federal Reserve Board on operational resilience and the need to recover from natural disaster and cybersecurity incidences. Based upon its supervisory experience and the events of 2020-2021, the PRA issued in March 2021 a Policy Statement on Operational resilience: Impact tolerances for important business services (PS6/21), which applies to most firms. The new policy will place additional requirements on firms to limit the operational impact of disruptions when they occur by continuing to provide their important business services. Now that the policy work has been completed, the focus will shift to implementation. Work is under way to develop the supervisory approach. The PRA plans to consider business continuity policy alongside operational resilience policy. The focus will be on whether (i) banks' recovery priorities for their operations prioritize the delivery of important business services within impact tolerances, (ii) the allocation of resources and communications planning for business continuity planning focuses on the delivery of important business services; and (iii) business continuity plan tests are integrated with testing of disruption scenarios and relate to impact tolerances.

89. The PRA monitors significant, or material outsourcing and will collect standardized data on third party dependencies and third-party audit reports of firms' material outsourcing arrangements.

- The PRA and FCA adhere to the EBA's guidelines on outsourcing. The PRA issued in late 2019 a consultation paper on "Outsourcing and third-party risk management" (CP30/19), which is intended to complement the policy proposals on operational resilience (CP29/19), clarify how the PRA expects banks to approach the EBA's guidelines on outsourcing in the context of its own requirements and expectations, and elaborate on the expectations included in the EBA guidelines (for example on data security business continuity and exit plans). The final policy was published in March 2021 (SS2/21). The FCA has published its own guidance on outsourcing. Firms using outsourced and other third-party service providers remain responsible for managing the associated risks. Greater levels of risk management are expected from firms that are heavily dependent on outsourcing and third-party service providers.
- The PRA recognizes the potential for higher operational risk where firms rely on outsourcing and third-party providers for core or material services. Consequently, firms are required to notify the PRA when "entering into, or significantly changing, a material outsourcing arrangement" for the purpose of monitoring firms' most important outsourcing arrangements with service providers involved. The PRA does not currently maintain a central repository of these notifications. The policy on outsourcing and third-party risk management will standardize the information that firms filed in these notifications and create an online portal that will pool the information

provided by firms to identify concentrations in firms' third-party dependencies.⁸¹ It will also require firms to require outsourcing firms to give the PRA access to third party audit reports and certifications relevant to firms' material outsourcing arrangements. Currently, audit reports can be requested in the context of individual supervisory inspections of specific firms or thematic reviews, but the PRA does not currently collect them systematically.

- The PRA assesses firms' approaches to outsourcing. PRA supervisors and specialists assess the effectiveness of firms' in the following areas: strategy and rationale for outsourcing; level of inherent risks are (e.g., concentration risk, lack of contingency); level of governance and oversight in place; level of understanding and mitigation of third party risks; and the suitability, frequency and rigor of the firm's monitoring and testing of third party resilience (e.g., Exit testing). The PRA also has made outsourcing a Prescribed Responsibility in the SMCR. Once the PRA's policy to outsourcing third-party risk management is in force, the PRA will assess firms against this policy.

90. Cloud outsourcing presents a need for heightened supervisory attention and technological understanding. The PRA and FCA align to the EBA's Guidelines on Outsourcing Arrangements but have developed them further and integrated them into their broader approach to operational resilience.⁸² Given the financial sector's increasing adoption of cloud services, the PRA reviews several material cloud outsourcing notifications from firms and monitors developments across the industry and with cloud providers. The PRA also reviews firms' oversight of multi-year transformation and digitization programs, to enhance its understanding of any idiosyncratic and collective risks. The PRA does not have express statutory authority to directly review or examine any critical services that cloud, and other third party service providers provide to regulated firms, unless the firms' contracts with these providers authorize such regulatory access (the PRA and FCA require firms to include clauses granting regulatory access in their contracts in their contracts with cloud providers and other "material" third party service providers).⁸³ Banks increasing use of the cloud to perform core services presents heightened operational and potentially systemic risks given the relatively small number of providers and the current lack of substitutability of the providers and many of their services. Given these risks, the BoE/PRA and FCA should seek legislation authorizing their direct supervisory access to cloud firms or mandate that firms insert comparable regulatory access terms in their contracts with cloud providers. The PRA and FCA also should hire or develop additional staff with the appropriate technological skills to understand and assess the risks of cloud outsourcing and individual firms' mitigation strategies. Alternatively, the PRA and FCA should utilize

⁸¹ <https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/consultation-paper/2019/cp3019.pdf?la=en&hash=4766BFA4EA8C278BFBE77CADB37C8F34308C97D5>

⁸² <https://www.eba.europa.eu/sites/default/documents/files/documents/10180/2170121/5fa5cdde-3219-4e95-946d-0c0d05494362/Final%20draft%20Recommendations%20on%20Cloud%20Outsourcing%20%28EBA-Rec-2017-03%29.pdf?retrv=1>

⁸³ Likewise, authorities in most but not all jurisdictions do not have the legal authority to directly supervise specific services provided to banks by third-party providers. However, the OCC in the US in coordination with other federal banking agencies conducts examinations of services provided by significant technology service providers (TSP) based on supervisory and enforcement authorities granted by the Bank Service Company Act.

statutory powers under Section 166 of FSMA authorities to engage Skilled Person Reviews to fill any existing staffing and skills gaps. Effective mitigation of cloud outsourcing risks will necessarily require cross-sectoral and cross border regulation and cooperation. As noted by FPC, the Bank, PRA and FCA, working with HMT, are planning to develop additional measures to manage the risks stemming from Critical Third Parties, including: a framework to designate critical certain third-party service providers; resilience standards; and resilience testing.⁸⁴

Capital Adequacy, Pillar 2, and Capital Buffers

91. Capital adequacy requirements are broadly aligned with BCBS standards and guidance.

The United Kingdom's Capital Requirements Regulation (U.K. legislation) and the PRA rulebook set binding regulation.

- There are requirements contained within the onshored U.K. CRR that diverge from the Basel standards on some specific aspects. The U.K. authorities will revisit these in their implementation of the remaining Basel III framework.⁸⁵ The PRA has already decided it will not follow the prudential treatment of software assets introduced by the EBA in October 2020, meaning that banks will continue to be required to fully deduct all intangible assets from regulatory CET1 capital.
- Concerning non-risk-based capital requirements, the U.K. leverage ratio framework currently requires firms with retail deposits equal to or greater than £50 billion to satisfy a minimum Tier 1 leverage ratio of 3.25 percent on a measure of exposures that excludes qualifying central bank reserves. The leverage ratio framework also includes regulatory buffers that must be met only with CET1: an additional leverage ratio buffer for systemically important banks and a countercyclical leverage ratio buffer. Proposed changes to the leverage ratio framework have been made by the FPC and PRA in June 2021.⁸⁶

92. The PRA routinely sets Pillar 2 requirements based on a detailed and complex methodology which has been revised on several occasions.

Pillar 2 capital requirements are imposed on all PRA-regulated banks, building societies, designated investment firms and all PRA-approved or PRA-designated holding companies to reflect risks that are not captured or not fully captured under Pillar 1 (Pillar 2A capital), and risks to which banks may be exposed under stressful

⁸⁴ Paragraphs 68 – 74 of the Q3 2021 FPC record, <https://www.bankofengland.co.uk/-/media/boe/files/financial-policy-summary-and-record/2021/october-2021.pdf>

⁸⁵ The onshored U.K. CRR allows the splitting of residential mortgage loans into lending qualifying for a 35% risk weight and lending not qualifying for this preferential treatment, which is not envisaged under the Basel framework for the standardized approach for credit risk. Similarly, the U.K. CRR allows for lower risk weights to be applied to non-defaulted small and medium-sized enterprises (SME) exposures, which does not comply with the Basel framework.

⁸⁶ Minimum leverage requirements and calibration would remain unchanged but the scope of application of the framework would be expanded to capture more firms such as designated investment firms (all firms with non-UK assets equal to or greater than £10 billion, including would be subject to leverage requirements). Updates to the exposure measure set out in Basel III would also be included in accordance with international standards.

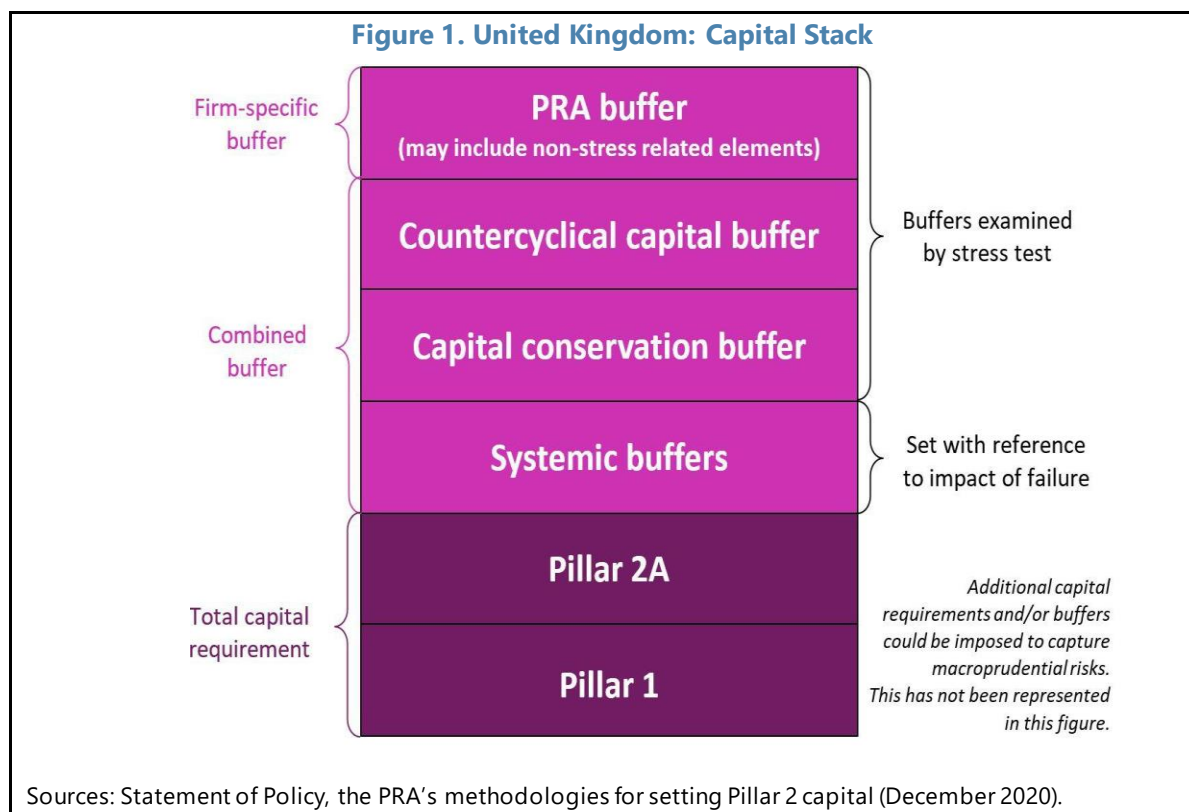
conditions over a forward-looking planning horizon (Pillar 2B capital or PRA buffer).⁸⁷ Several modifications (adjustments for non-systemic firms, offsetting between CCyB and P2A add-on) have resulted in a complex Pillar 2 framework. The approach to Pillar 2 is set out in the Pillar 2 Statement of Policy and the approach to the SREP and ICAAP processes are set out in a supervisory statement.

- A firm must carry out an ICAAP to assess on an ongoing basis the amounts, types, and distribution of capital that it considers adequate to cover the level and nature of the risks to which it is or might be exposed (capital resources and capital requirements should be projected over a three-to-five-year horizon). This assessment should cover the major sources of risks to the firm's ability to meet its liabilities and should incorporate stress testing and scenario analysis. The PRA carries out an assessment of firms' ICAAP as part of the SREP to determine whether all of the material risks have been identified and that the amount and the quality of capital identified by the firm is sufficient. Adjustments have been made in a transparent manner to clarify and provide more details on the PRA methodology to setting the buffers (e.g., the PRA clarified that the PRA buffer can be used to absorb losses in a stress) and to reduce procyclicality.⁸⁸ Supervisory files shared with the FSAP team show that the PRA conducts in-depth reviews and regularly challenges firms on their ICAAP. SREP were put on hold during the COVID-19 crisis and a return to a normal supervisory cycle is expected for 2021 or 2022.
- The PRA sets Pillar 2A capital requirements in light of both the calculations included in a firm's ICAAP and the results of the PRA's own Pillar 2A methodologies. Detailed methodologies have been defined to inform the setting of a firm's Pillar 2A capital requirement through the ICAAP and SREP process. Setting a Pillar 2A capital requirement is also subject to peer group reviews to ensure consistency of decisions across firms. It should however be noted that SME lending included in the retail portfolio (as defined in the CRR) and sovereign exposures are excluded from the calculation of the sector concentration risk measure. Also, residential mortgage portfolios on the standardized approach are not taken into account for the calculation of geographic concentration risk measure.
- Following the SREP, the PRA also notifies each firm of an amount of capital that it should hold as a PRA buffer (Pillar 2B capital), which is an amount of capital that firms should maintain in addition to their total capital requirements (TCR) and their combined buffer to absorb losses that may arise under a severe stress scenario (as estimated under either the BoE Annual Stress Test (AST) for the Category 1 firms, or own stress tests as part of the ICAAP, for the Category 2-5

⁸⁷ The PRA sets Pillar 2A capital for credit, market, counterparty, and operational risks where Pillar 1 capital requirements are found to underestimate risk, and for IRRBB, credit concentration risk and pension obligation risk, which are not captured under the Pillar 1 regime.

⁸⁸ For example, Pillar 2A capital requirement is a fixed amount and is no longer based on RWAs, which means that if RWAs under Pillar 1 do increase, the amount of capital that banks have to hold under Pillar 2 does not increase in parallel.

firms).⁸⁹ Where the PRA assesses a firm's risk-management and governance to be significantly weak, it may also set the PRA buffer to cover the risks posed by those weaknesses until they are addressed. To avoid duplication with the combined buffers, the component of the PRA buffer that relates to the impact of the stress is calculated as the excess amount of capital required above the CCB and CCyB to withstand a severe but plausible stress (as depicted in Figure 1).⁹⁰



93. The setting of the PRA buffer is more consistent and informed by a wider range of information for large firms, but progress is under way to enhance the consistency of buffers' assessment across firms. The frequency of calibration of the PRA buffer is aligned to a firm's ICAAP/SREP cycle (annually for major U.K. firms, and every two to three years for other firms). Deep dives SREPs are conducted annually for UKDT Category 1 firms but only every three years for ARTIS Category firms. The adequacy of a firm's stress testing and scenario design is assessed regularly for

⁸⁹ TCR is the sum of pillar 1 plus pillar 2A capital requirements. A stress test measures the amount by which a bank's capital ratio declines under stressed conditions. The PRA determines how much CET1 capital a bank needs to hold to reduce the risk that, as a result of the stress, a bank's CET1 capital would fall below the TCR.

⁹⁰ The combined buffer comprises the Capital Conservation Buffer (CCB), the Countercyclical Buffer (CCyB), the buffer for global and other systemically important institutions (G-SIIs and O-SIIs) and (for ring-fenced banks and the largest building societies) the Systemic Risk Buffer (SRB). The CCB and the CCyB aim to ensure the banking system has sufficient capital to absorb system-wide losses that could occur in stress, while the PRA buffer aims to ensure that firms can meet their TCR at all times and withstand the impact of in a severe but plausible stress. A portion of the amount of capital firms need to meet their TCR in stress is therefore already captured by the CCB and CCyB, and double counting between the buffers should be avoided.

all firms through the capital SREP, resulting in PRA buffers being set. For the major U.K. firms, this is supplemented by the AST, which helps set the PRA buffer in a more consistent manner as the same scenarios are used for all Category 1 firms. The scenario used in the AST is published to all firms and serve as a template and severity benchmark to help firms that are not part of the AST to develop and calibrate their own internal scenarios. Supervisors can also cross-refer to the loss rates and other parameters of similar portfolios derived from the AST exercise to help assess a firm's own stress-testing outputs as part of its ICAAP, calibrate individual Pillar 2B buffer requirements and enhance the consistency of results between ICAAP reviews and AST outcomes. That said, the use of these scenarios is not mandatory. A project to introduce "enhanced ICAAP" that would require Category 2 firms to use the AST scenarios and comply with data requirements (like Category 1 firms) has been put on hold in 2020 because of the COVID-19 crisis. Going forward, as envisaged by the PRA it will be important to enhance consistency by mandating some firms to use standardized scenarios. The PRA could usefully explore the possibility to continue undertaking desk-based stress tests to identify outliers.

94. Various adjustments to the Pillar 2 framework have been introduced for non-systemic firms. Changes to the methodologies have been introduced to "*mitigate aspects of the capital regime which have been regarded as disadvantageous for non-systemic banks*" (SS3/21). These changes do not raise significant concerns, but they do not contribute to simplify an already complex Pillar 2 framework:

- As smaller banks are likely to be less geographically and/or sectorally diversified than larger banks, and thus are more likely to be required to hold additional capital against concentration risk, supervisors are allowed (since 2015) to exercise judgement for small firms where they identify that the credit concentration risk methodology could overstate risks reflected in the Pillar 2A framework that was initially developed for large firms.
- Supervisors are also allowed (since December 2017) to exercise judgement to adjust variable Pillar 2A add-ons for firms using the standardized approach for credit risk.⁹¹ To date, 25 firms have benefited from a reduction to their Pillar 2A add-ons, with an average adjustment of 1.44% of risk-weighted assets.
- As discussed above, the PRA has introduced specific expectations for capital management in new and growing banks, which includes a simplification of the PRA methodology for calibrating the PRA buffer for these banks.⁹² The P2B buffer for new banks is not calibrated on the basis of a stress test as according to the PRA the requirement to have enough capital to survive a severe but plausible stress scenario could lead to a disproportionate level of capital relative to the

⁹¹ The PRA's methodology to assess whether a firm should hold additional capital for credit risk under Pillar 2 allows portfolios where there is excess capital relative to IRB benchmarks (i.e., the SA Pillar 1 capital charge is higher than the IRB capital charge) to offset the capital of credit risk portfolios where there is a shortfall (SA Pillar 1 capital charge is lower than the IRB capital charge). Supervisory judgement is then used to determine the credit risk add-on.

⁹² The PRA's expectations for Pillar 2B of new and growing banks are set out in SS3/21 "Non-systemic U.K. banks: The PRA's approach to new and growing banks".

financial stability risks posed by new banks. Instead, the PRA buffer is calibrated to allow banks time to find alternative sources of capital or make business model adjustments, in the event of a loss of investor support and is therefore equal to projected operating expenses projected over a six-month horizon.

95. The decision to shift the balance of capital requirements from minimum requirements towards buffers provides more flexibility but comes at the expense of simplicity and may favor banks with complex activities.

Several important decisions have been taken by the FPC and the PRA prior to and during the COVID-19 crisis. (1) In December 2019, the FPC increased the CCyB rate in a standard risk environment from 1 percent to 2 percent. Reflecting the additional resilience associated with higher macroprudential buffers in a standard risk environment, the PRA indicated at the same time that it would consult on a proposal to allow firms to offset the 1 percentage point increase in the CCyB by an equivalent reduction in Pillar 2A add-ons, provided that certain conditions are met and subject to supervisory judgement (low risk profile of firms, a one percent floor applies to P2A add-on)⁹³. (2) In March 2020, the FPC reduced the CCyB rate to 0 percent to sustain lending to the real economy. (3) Following a consultation period, the PRA decided in July 2020 to implement a reduction to Pillar 2A capital requirements as initially proposed while increasing temporarily the PRA buffer for all firms that receive a P2A reduction until the CCyB rate increase towards 2 percent.⁹⁴

- By shifting the balance of capital requirements from minimum requirements that should be maintained at all times towards buffers that can be released and drawn down as needed, the policy increases the proportion of bank's CET1 that can be useable in the event of a stress, which may help banks to absorb losses while maintaining lending to the real economy through the cycle.
- That said, the capital stack in the Basel framework is notoriously complicated and this approach does not contribute to reduce the level of complexity. More importantly, the current framework introduces potential confusion between different policy objectives (enhancing flexibility vs. ensuring that risks are adequately captured under Pillar 2). In this regard, there is a danger that macroprudential buffers cannot absorb losses from the same risks currently capitalized in Pillar 2A. Once the buffers are released and if they are used, there will be less capital (i.e., lower Pillar 2A) to cover risks that are highly unlikely to disappear when a crisis hits banks (e.g.,

⁹³ In principle, all firms are eligible for an initial reduction of 50 percent of firms' U.K. CCyB pass-through rate. Firms whose MREL is equal to TCR and are considered to have a low risk profile by the PRA, are eligible for an additional reduction of 50 percent in the firm specific U.K. CCyB pass-through rate of the increase in CCyB, subject to firms' remaining variable P2A capital requirements staying above 1 percent. Where a firm's variable P2A requirements would be below 1 percent after the initial reduction, no additional reduction would be applied.

⁹⁴ See Policy Statement (PS 15/20) "Pillar 2A: reconciling capital requirements and macroprudential buffers". The FPC expects to maintain the 0 percent rate for at least 12 months, any subsequent increase would not be expected to take effect until March 2022 at the earliest. The PRA has increased temporarily the P2B given the high uncertainty surrounding the extent of the stress caused by the pandemic.

concentration risk, one-way risk, risk arising from illiquid exposures, etc.).⁹⁵ Based on its own cost benefit analysis, the PRA judges that, conditional on a firm having exhausted its buffers, the proposed reduction in Pillar 2A would not materially affect the remaining resilience provided by minimum requirements.

- In addition, only banks with substantial P2A capital add-ons (typically those with large illiquid exposures and excessive concentration risks) will be in a position to offset the increase in the CCyB. Lastly, this policy may provide limited incentives to better manage certain risks (e.g., limiting concentration risk or wrong way risk) and reduce P2A capital requirements, as a lower add-on reduces offsetting possibilities.
- Monitoring the effect of the policy through time will therefore be important ahead of the PRA review of its P2A methodologies, which is scheduled for 2024.

Corrective Actions and Sanctions

96. The PRA and FCA have a full panoply of legal powers at their disposal to use in the supervision of firms. Those powers include sanctions under the SMCR, imposing requirements (including a requirement to do or not do a specified action), Threshold Conditions modifications, self-wind downs among others.⁹⁶ The PRA and the FCA are also empowered to issue unlimited financial penalties and publicly censure firms and individuals.⁹⁷ The PRA and FCA have issued statements of policy or handbooks outlining their approach to enforcement.⁹⁸

97. The PRA and FCA should use their broad sanctioning authorities as supervisory tools where appropriate. The PRA and the FCA tend to resolve matters informally during the supervisory process. Moral suasion by the PRA and FCA has been generally effective in addressing and correcting deficiencies at individual firms. The PRA applies a “comply or explain” approach and the FCA applies an “assertive supervision” approach over resorting to more formal sanctions or

⁹⁵ As indicated by the BCBS, “as Pillar 2 may capture additional risks that are not related to system-wide issues (e.g., concentration risk), capital meeting the countercyclical buffer should not be permitted to be simultaneously used to meet these non-system-wide elements of any Pillar 2 requirement” (see BCBS Guidance for national authorities operating the countercyclical capital buffer, December 2010).

⁹⁶ The regulators’ enforcement powers are set out in sections 56 and 66 FSMA (in relation to individuals), in section 192K (in relation to parent undertakings) and in sections 205 through 206A (in relation to firms) and are governed by procedural requirements in Parts V and XIV FSMA. The power to require a firm to do or not do a specified action is governed by section 55L and section 55M of FSMA.

⁹⁷ The PRA and FCA may apply sanctions to individual approved persons, including those within a firm performing a Significant Influence Function (SIF), where they breach FCA or PRA rules of conduct or are knowingly involved in a breach by the firm of the PRA or FCA’s rules or requirements. Sanctions may include making public statement of the misconduct; imposition of fines; and suspension from performing their approved functions. Where the PRA or the FCA consider that a person is not “fit and proper” to carry out functions in a regulated firm, it may withdraw the person’s approval to do so, or prohibit the individual from carrying out any functions in a firm for such period as it considers suitable.

⁹⁸ [SoP 'The PRA's approach to enforcement: statutory statements of policy and procedure' \(bankofengland.co.uk\); <https://www.handbook.fca.org.uk/handbook/EG/1/?view=chapter>](https://www.bankofengland.co.uk/sof-the-pras-approach-to-enforcement-statutory-statements-of-policy-and-procedure/)

enforcement measures. Where appropriate the PRA and FCA should not hesitate to impose requirements on firms (e.g., to do or not do a specified action under sections 55L and 55M of FSMA) or modifying/waiving rules. Supervisors would benefit from additional guidance on relevant supervisory and legal principles and risk factors to consider in order to facilitate the use of these powers in appropriate cases. Earlier collaboration between supervisors and their legal colleagues should continue be encouraged from the time a potential issue first arises. The PRA and FCA have not hesitated to act against firms and individuals.⁹⁹ The FCA has made changes to its approach to enforcement since the 2016 FSAP and employs a range of tools from formal investigations to early intervention measures. In 2020, the PRA imposed its largest financial penalty along with the FCA in a globally coordinated resolution with a firm. Contested proceedings before the PRA's Enforcement Decision Making Committee (EDMC) are relatively infrequent.

C. Recommendations

98. The authorities are strongly encouraged to further enhance the prudential framework by:

- Reflecting reputational risk in the potential impact (PI) methodology and providing guidance on how to embed climate-related financial risks when scoring firms' individual risk elements.
- Conducting more frequent and in-depth firm-specific onsite reviews of relevant activities, including CIB business lines and related risk management practices to supplement horizontal cross firm work and proactively identify risk management issues to be remediated.
- Sharing at the appropriate level of seniority detailed onsite reports following onsite reviews to increase transparency and ensure timely feedback to firms between two PSMs; providing more detailed findings and recommendations to be implemented within a given timeframe; and using S166 reviews in a proactive manner for a broader range of firms while developing PRA's own capabilities and expertise for certain skills (including technological skills) and subject matters.
- Using the forthcoming implementation of the Strategic Review findings to ensure better consistency of supervisory approaches across UKDT and ARTIS and carefully considering pros and cons before adjusting the supervisory intensity on non-systemic firms.
- Reassessing periodically whether the approach to supervising international firms delivers the expected supervisory outcome and continues to strike the right balance between protecting U.K. financial stability and encouraging an open global financial system.

⁹⁹ <https://www.bankofengland.co.uk/prudential-regulation/pru-statutory-powers> (PRA enforcement data 2014-2020); FCA Enforcement data- Annual Report 2020/21 July 2021.

99. The authorities could further strengthen the approach to governance, credit risk, operational risk, Pillar 2, and enforcement by:

- Using the whole range of powers provided for by the SMCR and remuneration framework as appropriate to ensure that individuals holding senior manager functions are fully held accountable; and introducing detailed binding requirements on governance and risk management for third country branches.
- Implementing a more active supervisory role in assessing loan classification and provisioning; conducting deep dives of models used for ECL calculation; and phasing out the guidance on payment deferrals to require banks to assess and classify loans on a case-by-case basis.
- Introducing a clear expectation that firms should set limits on their single name, geographic and sectoral risk concentrations as part of their ICAAP.
- Implementing a more proactive review of internal models; increasing resources devoted to the review of firms' internal models used for regulatory purposes; and providing guidelines on the calibration of IRB parameters after COVID-19.
- Seeking additional statutory powers to review and examine the resilience (including cyber resilience) of any critical services (including but not limited to cloud services) that third party providers provide to regulated financial institutions; and hiring more staff with the appropriate technological skills or using S-166 reviews to further increase capacities and better assess the risks of cloud outsourcing.
- Improving cross-firm consistency when setting the PRA buffer; aligning the frequency of deep dive C-SREPs for all Category 1 firms; and periodically reassessing whether the capital buffer calculation framework is effective for new banks.
- Monitoring through time the effect of the decision to shift the balance of capital requirements from Pillar 2 capital add-on towards buffers.
- Utilizing the full panoply of enforcement tools where appropriate and providing more guidance to supervisors on relevant legal principles and risk factors to consider when using these powers to increase their effectiveness and frequency.

Appendix I. Status of the Recommendations of the 2016 FSAP

CP	Recommendations of the U.K. FSAP 2016 for Banking Supervision	Status and IMF Staff View
1.	PRA to incorporate into its approach to risk an explicit consideration of reputational risk, including related to the possible failure of non-systemic banks.	Ongoing. Changes to the scoring methodology have been introduced to achieve more consistency between the scores and associated supervisory work, but the Potential Impact (PI) scope does not explicitly take into consideration reputational risk.
2.	Reevaluate the adequacy of PRA resources and of its operating model for the overall effectiveness of its supervisory activity.	Ongoing. There is flexibility in reallocating resources depending on the priorities, but overall resources are still stretched.
8.	Evaluate adequacy of supervision, especially of less systemically important firms, and whether current arrangements provide sufficient testing to ensure that all firms are operating safely and soundly and in compliance with laws, regulations, and supervisory expectations.	Ongoing. The intensity of supervision on non-systemic firms has intensified, but improvements are needed (testing and independent verification could be used more often).
9.	Seek more ways to validate and probe statements in banks. Evaluate whether “deep-dives” provide sufficient, ongoing insight into major firms, and whether key skills need to be developed within staff.	Partially implemented. The PRA has made increased use of cross firm thematic reviews that allow for a better understanding of the risks to the safety and soundness of banks, but firm-specific onsite reviews could be used more often.
14.	Promote efforts to make managers in financial institutions more accountable for actions or inactions. Ensure that corporate governance is appropriately supervised in firms beyond the largest and most systemically important, including through the implementation of recently released supervisory guidance.	Ongoing. The U.K. financial regulators have focused increasingly on individual accountability and the SMCR has produced positive results in term of accountability. These powers have not yet been fully tested, however.
16.	Revise the model change review policy to ensure that the reliability of large banks’ capital requirement calculations is adequately scrutinized.	Implemented.
17.	Provide more explicit guidance on supervisor’s expectations to the generality of banks. Consider establishing regular access to (and elaborations from) broad databases with loan level information.	Partially implemented. Loan level information is limited to owner occupier mortgage lending, buy-to-let lending, and loans over £100 million. Loan by loan data are rarely used during the supervisory process.
18.	Devise operational enhancements to secure a minimum level of direct scrutiny of banks’ asset classification and provisioning also for the generality of non-systemic banks. Require banks to set and periodically review an appropriate threshold for the identification of significant exposures.	Partially implemented. Credit risk is assessed through “Asset Quality Reviews”. Coverage requirements to be achieved over a three-year period is high for Category 1 firms (between 40 and 60 percent) while credit reviews are conducted every 3 years for material portfolios in non-systemic firms. However, there has been a limited number of AQR involving a review of credit files.
19.	Require banks to set thresholds for acceptable concentrations of risk.	Not implemented. The PRA judges that it is compliant in substance with CP 19 EC 3 (i.e., the supervisor determines that a bank’s risk management policies and processes establish

CP	Recommendations of the U.K. FSAP 2016 for Banking Supervision	Status and IMF Staff View
		thresholds for acceptable concentrations of risk) as the U.K. approach in PRA Rulebook goes beyond the requirement to set quantitative thresholds and requires firms to address and control their concentration risk, including through written policies and procedures). Supervision on concentration risk is based on an overall robust process, but the fact remains that banks are not formally required to set quantitative thresholds for acceptable concentration risk.
20.	Introduce regular infra-annual reporting of transactions with related parties for non-FINREP banks. Ensure regular monitoring of compliance with the rules on transactions with related parties for all banks.	Ongoing. CRD V introduces a requirement for data on loans to members of the management body and their related parties to be properly documented and made available to the supervisor on request. The PRA is proposing to amend the definition of related parties in the Related Party Transaction Risk Part to include the parties set out in CRD V.
21	Consider how to mitigate risks of missing issues in mid and small banks.	Partially implemented according to the authorities. CP 21 was not part of this targeted review.
24.	Continue to promote a closer alignment of the EU regulatory framework with international standards.	No longer applicable since Brexit.
25.	Evaluate assumptions underlying the deployment of SRS with regard to operational risk to ensure that all firms, and not solely systemically important ones, are managing this risk appropriately.	Ongoing.
29.	Propose stronger and more proactive backstops for evaluating banks in the lowest risk categories more frequently to assess the quality of their controls and risk-management to avoid exposures to financial crime.	Implemented. According to the authorities. CP 29 was not part of this targeted review. Key aspects of the AML/CFT regime are covered in the main FSAP discussions

Appendix II. Objectives and Regulatory Principles

This appendix provides relevant excerpts from the legislation as well as from policy statements.

Financial Services and Markets Act 2000 (FSMA)¹

2B The PRA's general objective

(1) In discharging its general functions, the PRA must, so far as is reasonably possible, act in a way which advances its general objective.

(2) The PRA's general objective is promoting the safety and soundness of PRA authorized persons.

2G Duty to have regard to regulatory principles

In discharging its general functions, the PRA must also have regard to the regulatory principles in section 3B.

3B Regulatory principles to be applied by both regulators

(1) In relation to the regulators, the regulatory principles referred to in section 1B(5)(a) and 2G are as follows:

(a) the need to use the resources of each regulator in the most efficient and economic way;

(b) 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; [...]

(c) the principle that the regulators should exercise their functions as transparently as possible.

New 9D (introduced by Art. 144C of the 2021 Financial Services Act)

When making CRR rules, the PRA must, among other things, have regard to:

(a) relevant standards recommended by the Basel Committee on Banking Supervision from time to time;

(b) the likely effect of the rules on the relative standing of the United Kingdom as a place for internationally active credit institutions and investment firms to be based or to carry on activities,

(c) the likely effect of the rules on the ability of CRR firms to continue to provide finance to businesses and consumers in the United Kingdom on a sustainable basis in the medium and long term,

(d) the target in section 1 of the Climate Change Act 2008 (carbon target for 2050), and

¹ [Financial Services and Markets Act 2000 \(legislation.gov.uk\)](https://www.legislation.gov.uk)

(e) any other matter specified by the Treasury by regulations.

Prudential standards in the Financial Services Bill: June update – Policy Statement from HMT²

HMT's legislative approach

1.13 As set out at Budget, HMT is committed to four overarching principles when legislating prudential standards in the Financial Services Bill:

- a. financial stability and, where relevant, the implementation of international standards, in particular the Basel III and 3.1 standards. The United Kingdom is signed up to these standards as a member of the G20;
- b. supporting the government's wider objectives on growth, competition, and competitiveness;
- c. a central role for the expert, independent U.K. Regulators in designing and implementing the detailed and technical requirements that will apply to firms;
- d. a flexible and proportionate approach, enabling the United Kingdom to both maintain a strong future partnership with the EU and other major economies, and to account for specificities in the U.K. financial services market.

1.14. HMT considers the most effective way to balance the principles in 1.13 is to delegate responsibility for the implementation of firm requirements to the Regulators, subject to an enhanced accountability framework.

1.15. This accountability framework will enable greater scrutiny of the Regulators' decision-making by enhancing transparency for Parliament, industry, and the public. [...]

1.16. To achieve this, HMT will legislate to create additional requirements for the Regulators to consider specifically when using their rule-making powers to introduce and maintain these regimes. These additional requirements are intended to be specified at the level of regulatory principles or equivalent. The PRA's primary and secondary objectives, and the FCA's strategic and operational objectives, will therefore keep the same status as they currently have.

1.17. The accountability framework will include additional requirements to ensure that the wider objectives of the government and Parliament are taken into account. This will include the impact of regulatory requirements on U.K. competitiveness, international developments in prudential regulation (including international standards, where applicable), and our relationships with other jurisdictions, such as financial services equivalence.

² [Prudential policy draft policy statement V4.pdf\(publishing.service.gov.uk\)](#)

Financial Services Bill – Explanatory Notes prepared by HMT³

- 526 Sections 144C and 144D introduce new accountability requirements for the PRA (taken together, these two sections will be referred to as ‘the accountability framework’). The accountability framework reflects the increased responsibility given to the PRA for setting prudential requirements which is granted to it through this Bill. It ensures the PRA considers additional policy priorities HMT has identified as relevant to the implementation of the Basel standards, and which are not currently captured within the PRA’s statutory obligations. It also aims to increase transparency of how these policy priorities impact rulemaking of the PRA through the reporting requirement.
- 527 Section 144C requires the PRA to have regard to a new list of matters, specified in this section, when making CRR rules. When having regard to the likely effect of the PRA’s CRR rules on these matters, the PRA should consider both their positive and negative effects. [...]
- 528 Section 144D imposes a new obligation on the PRA when it a) publishes consultations on draft CRR rules and b) makes final CRR rules. In both these scenarios, the PRA will be required to publish an explanation of the way in which having regard to the new matters listed in section 144C (1) has affected their draft or final rules. When the PRA makes final CRR rules, it must also publish a summary of their purpose. This is intended to increase transparency about PRA rulemaking when it implements the remaining Basel III changes and any further material updates to these regimes.

³ [HCB200 Financial Services Bill Explanatory Note .docx \(parliament.uk\)](#)



**BANK OF ENGLAND
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July 2021

