BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Annual Report

Annual Report

1 March 2018–28 February 2019

Prudential Regulation Authority
Annual Report[1]
1 March 2018 to 28 February 2019

Presented to Parliament pursuant to paragraph 19(4) of Schedule 1ZB of the Financial Services and Markets Act 2000 as amended by the Financial Services Act 2012, and the Bank of England and Financial Services Act 2016.

1 Including the PRA Annual Competition Report, and the annual report of the Prudential Regulation Committee to the Chancellor of the Exchequer on the adequacy of PRA resources and the independence of PRA functions.

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On 7 October 2019, ‘Table 1: Section 166 review by areas of focus’ was amended to show that the ‘Total for 2018–19’ column was not restated as originally indicated, and to show that the ‘Total for 2018–19’ number for ‘Prudential-Deposit-takers, recognised clearing houses, and PRA-designated investment firms’ was 4. The number previously stated was 47.

The second paragraph on page 44 under ‘Meeting with auditors’ was also amended to read ‘…For the period to 28 February 2018, we reported to the PRC that the overall quality of the relationship between auditors and supervisors was satisfactory’. This previously read ‘…For the period to 28 February 2019 we reported to the PRC that the overall quality of the relationship between auditors and supervisors was satisfactory’.

This report is made by the Prudential Regulation Authority (PRA) under the Financial Services and Markets Act 2000 (FSMA) as amended by the Financial Services Act 2012, and the Bank of England and Financial Services Act 2016. It is made to the Chancellor of the Exchequer and covers the year ended 28 February 2019.

The report covers the requirements of paragraph 19 of Schedule 1ZB of FSMA.

The Bank of England Annual Report and Accounts for year ending 28 February 2019 is available on the Bank's website at www.bankofengland.co.uk/annual-report/2019. The PRA's audited accounts for the reporting year ending 28 February 2019 are set out on pages 152–160 of the Bank of England Annual Report and Accounts. HM Treasury has issued an accounts direction; disclosures relating to this can be found on pages 156–157 of the Bank of England Annual Report and Accounts.

Additional material can be found on the Bank's website at www.bankofengland.co.uk/prudential-regulation.

Any enquiries related to this publication should be sent to us at praannualreport@bankofengland.co.uk.

Consultation

Members of the public are invited to make representations to the PRA on the:

- PRA Annual Report;
- way in which the PRA has discharged, or failed to discharge, its functions during the period to which the report relates; and
- extent to which, in their opinion, the PRA's objectives have been advanced and the PRA has considered the regulatory principles to which it must have regard when carrying out certain of its functions (contained in section 3B of FSMA), and facilitated effective competition in the markets for services provided by PRA-authorised firms in carrying on regulated activities in accordance with section 2H of FSMA.

Please address any comments or enquiries to:
PRA Communications
Prudential Regulation Authority
20 Moorgate
London EC2R 6DA
praannualreport@bankofengland.co.uk

The consultation closes on Friday 13 September 2019.

Privacy and limitation of confidentiality notice

By providing representation to the PRA on this annual report, you provide personal data to the Bank of England ('Bank'). This may include your name, contact details (including, if provided, details of the organisation you work for), and opinions or details offered in the representations.

The representations will be assessed to inform our further work as a regulator. We may use your details to contact you to clarify any aspects of your response.

Your personal data will be retained in accordance with the Bank's records management schedule. To find out more about how we deal with your personal data, your rights or to get in touch please visit www.bankofengland.co.uk/privacy.

Information provided in response to this report, including personal information, may be subject to publication or disclosure to other parties in accordance with access to information regimes including under the Freedom of Information Act 2000 or data protection legislation, or as otherwise required by law or in discharge of the Bank's functions.

Please indicate if you regard all, or some of, the information you provide as confidential. If the Bank receives a request for disclosure of this information, we will take your indication(s) into account, but cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system on emails will not, of itself, be regarded as binding on the Bank.

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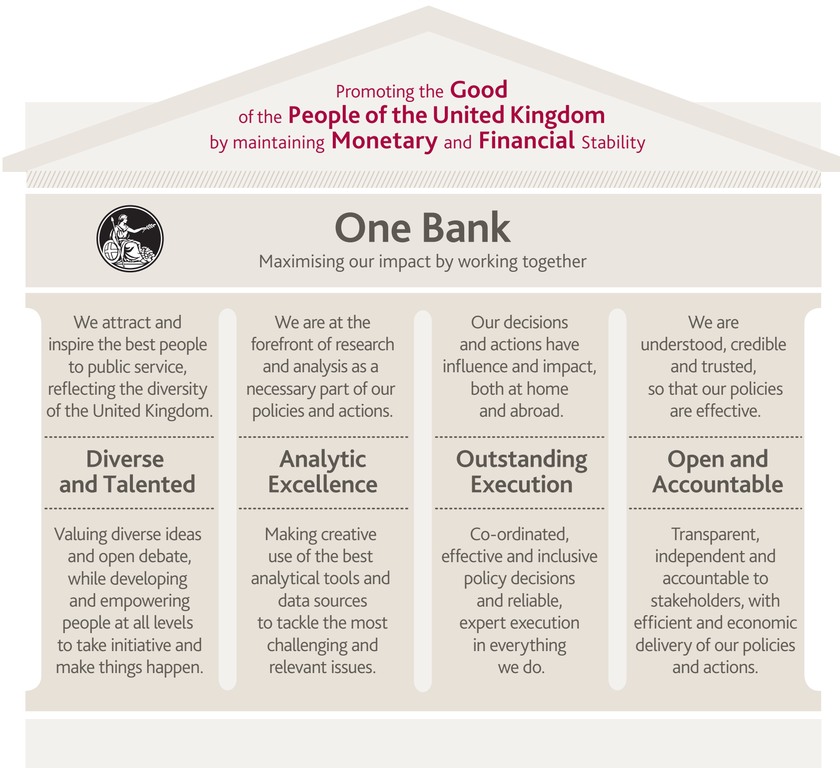


Foreword by the Chair

Mark Carney
Governor,
Chair of the Prudential Regulation Committee

The finance of the future needs the regulator of the future. A decade on, the PRA has in place reforms that address the failings that caused the crisis. Ring-fencing provides structural protection for retail bank customers, while our focus on management ensures senior managers at banks and insurers understand their responsibilities and can be held accountable. Now, the PRA is putting an increasing emphasis on emerging risks: Brexit, cyber, and climate. Looking forward, we will take the opportunities technology offers to supervise more effectively and efficiently. That means innovation in the UK financial system will continue to serve the UK and global economy, underpinned by the highest standards of prudential supervision and regulation.

Over the last decade, the PRA has transformed the prudential regimes for banks and insurers.

Most visibly to customers, we have now completed ring-fencing reforms to protect critical UK retail banking services from the risks that come with wholesale banking activity. This is the largest ever reform to the structure of the UK banking system. It has been an enormous effort that has drawn on resources from across the PRA as well as the wider Bank.

The results are impressive. £1.2 trillion of core deposits are now protected in ring-fenced banks, and over £800 million of assets have been transferred using the ring-fencing transfer scheme. That meant over 100 regulatory transactions including three new bank authorisations. All this was completed seamlessly, despite over a million customers receiving new sort codes. The work is not over — we now have to supervise the ring-fenced entities to promote the safety and soundness of the financial institutions on which the people of the UK most rely.

In contrast to ring-fencing, few households and businesses will have noticed the introduction of the Senior Managers Regime (SMR) for insurers. But it is no less important.

This now means we have a single regime for identifying the most senior decision-makers in banks, insurers and major investment firms, and setting requirements on them. This clearly establishes the link between seniority and accountability. It both strengthens individual accountability and reinforces collective responsibility among boards. Rolling out the SMR to insurance managers is vital to the PRA promoting the safety and soundness of insurers, and protecting policyholders.

This year marked the fifth anniversary of the PRA's secondary competition objective (SCO). Building on the success of the New Banks Start-up Unit, we have introduced the New Insurer Start-up Unit, to make sure that new firms can introduce new ideas to the market. Now fully embedded in the PRA's policy processes and supervisory approach, the SCO will help us maintain a regulatory environment that promotes innovation.

The PRA is also adjusting its approach to mitigate emerging risks, such as those that arise from Brexit, cyber, and the financial risk challenges that come with climate change.

The PRA, along with the rest of the Bank, has worked to make sure the core of the UK financial system is ready for Brexit, whatever form it takes. Our banks are liquid and suitably capitalised — thanks in part to the FPC and PRA stress tests, they have capital ratios three and a half times higher than before the financial crisis. The PRA has, with other authorities and HM Treasury, ensured that the necessary legal instruments, regulations, authorisations, and supervisory arrangements are in place to ensure continuity. The UK's regulatory framework will be fully functional when EU law ceases to apply directly in the UK.

As financial firms use technology to an ever greater extent, cyber risk becomes inherent. The PRA is at the forefront of promoting cyber resilience, and is working closely with UK and other international regulators. To improve firms' cyber defences, the largest banks at the core of the UK financial system are subject to penetration tests (known as CBEST) and we are asking them to address any deficiencies. In parallel, to ensure resilience, we have begun setting standards for how quickly critical financial institutions must be able to restore vital services following a cyber attack. This is consistent with the wider approach the PRA, the Bank, and FCA are pursuing on operational resilience, ensuring firms plan for failure, and can recover critical functions appropriately quickly.

Financial firms must also grapple with climate risks. The cost of climate-related events is increasing rapidly, and a shift to low-carbon technologies will require a massive reallocation of capital. Companies and industries that fail to adjust to this new world will fail to exist. This year, the PRA consulted on its expectations and approach to supervising firms' management of the financial risks from climate change. Our supervisors will be looking for suitable governance arrangements, risk management, forward-looking scenario analysis, and enhanced disclosures.

Looking to the future, the PRA will seize the opportunities offered by new technologies to do its job more effectively, and more efficiently. Machine learning will transform the way firms assess their risks, and the Cloud will become essential to operational resilience. As firms embrace such technologies, so must we. The finance of the future needs the regulator of the future.

The PRA's approach has always been forward looking and grounded in the judgement of its supervisors — that is, human judgement. That will not change. But simply applying current supervisory approaches to new technology is not enough. This year, the PRA completed a proof of concept for machine learning, showing that we can use this technology to assess the unstructured data that firms provide to us. These methods, already being used in the legal and medical professions, can sometimes spot patterns quicker, speeding up diagnostic tests and investigations. Smart use of this technology will leave more time for supervisors to focus on the forward-looking assessment and critical judgement that underpins the PRA's approach.

Technology also changes the role of regulation. It will sometimes create new market failures. But other technological developments can address existing market failures more efficiently than regulation. Both channels can have distortive effects on competition. For example, Cloud services can materially reduce the costs of entering the market for new financial firms, building on existing platforms to reduce operational risks. However the risks inherent in outsourcing arrangements need to be managed prudently, especially if contracts are concentrated with particular firms. The PRA will need to ensure that firms continue to compete on the right dimensions, creating a race to the top, not a race to the bottom.

The UK's financial sector will continue to innovate. To serve UK households and businesses, it must be resilient. The PRA is building on the progress of the last decade to become the regulator and supervisor of the future, for the good of the people of the United Kingdom.

21 May 2019

Report by the Chief Executive

Sam Woods
Deputy Governor, Prudential Regulation,
Chief Executive of the PRA

My colleagues will no doubt chastise me for creating a hostage to fortune by writing this, but this is likely to be my last foreword covering big, structural changes to the UK's prudential regulatory framework following the financial crisis. That's because this year we largely finished implementing the key post-crisis reforms, and we are now moving into a different phase.

Perhaps the biggest milestone of the past year was the completion of ring-fencing on 1 January 2019: all in-scope firms successfully separated core retail services for households and small businesses from trading activities. And while ring-fencing involved some of the largest transformation programmes ever seen in the UK banking sector, extensive preparations meant that they were mostly non-events for customers and counterparties. Our 'border patrol' will now make sure ring-fenced banks are operating in the way intended by Parliament. As part of this we are reporting annually on the sector's compliance with ring-fencing requirements, with the first edition in this year's Annual Report.

Another key element of the completion of the post-crisis reforms was the extension of the Senior Managers and Certification Regime (SM&CR) to insurers in December 2018. Clear individual accountability for senior managers across all PRA-authorised firms is in my view a crucial part of the PRA's supervisory toolkit: we expect senior managers to be allocated responsibilities for delivering specific priorities. If they do not, our supervisors will hold them to account using all of our tools.

A third example of the post-crisis reform era nearing an end is in the insurance sector. Alongside various refinements to our implementation of Solvency II, including to take account of points raised by the Treasury Select Committee, we had a close look at the matching adjustment (MA). We and the industry have a shared interest in ensuring the MA framework remains robust in its application to all eligible assets to avoid any risk that the credibility of this important element of the prudential framework is undermined. As part of this, we clarified and strengthened the prudential treatment of equity release mortgages, an important and growing asset class, to ensure that policyholders are appropriately protected against adverse macroeconomic scenarios.

As we complete the reform effort, our attention has been shifting to defending the framework we've put in place as well as proactively tackling new risks and challenges.

A key part of this is our horizon-scanning programme, aimed at preventing firms from risking up excessively or in ways that are not properly controlled or capitalised, and to identify and remove opportunities for regulatory arbitrage. In this context, we are looking closely at things like lending moving up the risk curve, declining mortgage risk weights and areas of complexity in the regulatory framework.

We are also on track to embed operational resilience within our supervisory framework. We published a Discussion Paper, jointly with the Financial Conduct Authority and the Bank as supervisor of financial market infrastructures, setting out our thinking in this area. We will consult on policy later this year, which will likely propose that firms should identify the services they provide which could put their safety and soundness, financial stability, market integrity, or consumer protection at risk if disrupted. They should then set a minimum acceptable level of performance for these services, and demonstrate their ability to stay within their tolerance.

In line with our secondary competition objective, we have over the past few years taken numerous actions to reduce barriers to entry by smoothing the authorisation process and applying proportionality in prudential requirements. Our latest initiative in this area was the setting up of the New Insurers Start-up Unit, which recently authorised its first new insurance firm. Our attention is now shifting to the next set of questions in the space of competition, including whether there are any regulatory barriers to growth for firms once they have entered the market.

Another area where we have become more active over the past year is climate change, which is increasingly recognised as an important long-term risk for both banks and insurers. The most visible output of this work this year was the publication of our supervisory statement setting out expectations on how firms should address the financial risks from climate change through appropriate governance, risk management, scenario analysis, and disclosures. As part of this, we introduced a requirement for firms to identify and allocate responsibility for identifying and managing these risks to a Senior Management Function.

Alongside all this, the PRA, other areas of the Bank of England, and firms have put a tremendous amount of effort into preparing the financial sector for various Brexit outcomes, including a potential cliff-edge scenario. This job is largely done, though we will keep closely engaged with firms to manage risks appropriately in what remains a challenging, uncertain, and more complex environment. Much of this work — most importantly onshoring EU rules — has required close engagement with colleagues in Government and Parliament.

In conclusion, 2018–19 has been another busy period for the PRA as we completed the key post-crisis reforms and tackled new challenges. I would like to thank all PRA staff for their hard work over the past year, and I look forward to the year ahead.

21 May 2019

Prudential Regulation Committee

Members and responsibilities

Members at 21 May 2019*

Top row, left to right

Mark Carney
Governor, Chair of the PRC

Andrew Bailey
Chief Executive of the Financial Conduct Authority
1 March 2017 –

David Belsham
External member
Term: 1 March 2017 – 30 April 2021

Julia Black
External member
Term: 30 November 2018 – 29 November 2021

Middle row, left to right

Sandy Boss
External member
Term: 1 March 2017 – 31 August 2020

Ben Broadbent
Deputy Governor, Monetary Policy

Norval Bryson
External member
Term: 1 March 2017 – 31 August 2021

Sir Jon Cunliffe
Deputy Governor, Financial Stability

Bottom row, left to right

Jill May
External member
Term: 23 July 2018 – 22 July 2021

Sir Dave Ramsden
Deputy Governor, Markets and Banking

Sam Woods
Deputy Governor, Prudential Regulation and Chief Executive of the PRA

Mark Yallop
External member
Term: 1 March 2017 – 30 November 2020

The PRC is the body within the Bank responsible for exercising the Bank's functions as the Prudential Regulation Authority (PRA) as set out in the Bank of England Act 1998 and the Financial Services and Markets Act 2000 (FSMA). The PRC is on the same legal footing as the Monetary Policy Committee and the Financial Policy Committee.

The PRC's terms of reference provide for 12 members, consisting of five Bank Governors and officials, the Chief Executive of the Financial Conduct Authority (FCA), and at least six members appointed by the Chancellor of the Exchequer.

The PRC is independent in all its decision-making functions, including making rules and the PRA's most important supervisory and policy decisions.

The PRA functions are exercised by the Bank and are funded by PRA fees, with the PRC responsible for consulting on and setting the level of those fees.

The PRC is required to report annually to the Chancellor of the Exchequer on the adequacy of resources allocated to the PRA functions and the extent to which the exercise of those functions is independent of the exercise of the Bank's other functions.[1]

Since February 2016 members of the PRC have been indemnified by the Bank against personal civil liability on the same terms as members of Court.[2]

* The Bank of England Act 1998 provides for one member to be appointed by the Governor with the approval of the Chancellor. The Governor appointed Ben Broadbent.

1 Available on pages 10–11 in this report.

2 See page 137 of the Bank of England's Annual Report and Accounts 2018–19 available at www.bankofengland.co.uk/annual-report/2019.

The statutory objectives of the PRA, which underpin its forward-looking, judgement-based approach to supervision are:

- a general objective to promote the safety and soundness of the firms it regulates;
- specifically for insurers, to contribute to the securing of an appropriate degree of protection for those who are or may become insurance policyholders; and
- a secondary objective to, so far as is reasonably possible, act in a way which facilitates effective competition in the markets for services provided by PRA-authorised persons in carrying on regulated activities.

On 8 March 2017, HM Treasury issued 'Recommendations for the Prudential Regulation Committee'.[1] This sets out aspects of the Government's economic policy to which the PRC should have regard when considering how to advance its objectives, and when considering the application of the regulatory principles in FSMA.

FSMA also requires the PRA to review, and if necessary revise, and publish annually its strategy in relation to how it will deliver its statutory objectives. The strategy is set by the PRC, in consultation with the Bank's Court of Directors. The PRA's strategy for 2019/20 was published with the PRA Business Plan on Monday 15 April 2019.[2]

1 www.bankofengland.co.uk/about/people/prudential-regulation-committee.

2 www.bankofengland.co.uk/prudential-regulation/publication/2019/pra-business-plan-2019-20.

Annual report of the PRC to the Chancellor of the Exchequer[1]

The adequacy of resources allocated to the performance of PRA functions and the extent to which the exercise of PRA functions is independent of other Bank functions.

This is the annual report by the Prudential Regulation Committee (PRC) to the Chancellor of the Exchequer under paragraph 19 of Schedule 6A to the Bank of England Act 1998 (as amended). It relates to the period of 1 March 2018 to 28 February 2019. The Prudential Regulation Authority (PRA) publishes this report as part of its commitment to transparency.

Background

Since 1 March 2017, the PRA has been part of the legal entity of the Bank of England (Bank). The PRC is a statutory committee of the Bank. The PRC is on the same statutory footing as the Bank's Monetary Policy Committee (MPC) and Financial Policy Committee (FPC), and is responsible for the exercise of the Bank's functions as the PRA. The PRA Annual Report summarises the PRC's responsibilities and the statutory framework under which the PRA operates. Under this statutory framework, the PRC is responsible for strategy, policy and rule making, and the adoption (with the approval of Court) of the budget for the PRA. These functions cannot be delegated.

The performance of PRA functions

The PRA has published approach documents setting out how it implements its statutory objectives: the PRA's approach to banking supervision and the PRA's approach to insurance supervision.[2] It is a key principle underlying the PRA's approach that it does not seek to operate a zero-failure regime. Informed by the approach, and the operating model and risk tolerance also agreed by the PRC, each year the PRC sets the PRA strategy and business plan, and adopts the PRA's budget.

The adequacy of resources

The PRA is fully funded by fees paid by regulated firms, and the PRA consults each year on the allocation of fees between firms. The PRA received two responses to its fees consultation proposals in 2018–19;[3] after due consideration, neither resulted in changes to the proposals. The PRA has the ability, after consultation, to raise additional funds during the year for material changes. This was not done during the financial year.

The PRC seeks to ensure that its financial and non-financial resources are appropriately allocated to the work that best advances the PRA's objectives. In making judgements on the allocation of resources, the PRC takes into account a wide range of relevant considerations. These include the wider legislative and policy framework under which the PRA operates, including the duty to have regard to certain factors under the Financial Services and Markets Act 2000 (FSMA), and the Legislative and Regulatory Reform Act. The PRC also takes into account HM Treasury's recommendation letter,[4] which contains recommendations about aspects of the Government's economic policy which the PRC should have regard to when considering how to advance the PRA's objectives, and when considering the application of the regulatory principles set out in FSMA. In addition, the PRA plans its resources to deliver multi-year programmes of work (such as climate change or operational resilience), and responds to changes to the external environment and risk profile of the firms regulated by the PRA.

The PRC receives and reviews regular updates on the PRA's performance and on how the PRA's financial and non-financial resources are allocated and monitored, as well as how any resource risks are being mitigated,

1 Please note: this report for 2017–18 was first published on 9 April 2018, and subsequently included within the PRA Annual Report 2017–18; www.bankofengland.co.uk/prudential-regulation/publication/2018/annual-report-2018. As set out in the letter from the PRC to the Chancellor, published on 9 April 2018, it was agreed that future reports would be included in the PRA Annual Report; www.bankofengland.co.uk/prudential-regulation/letter/2018/the-adequacy-of-pra-resources-and-the-independence-of-pra-functions.

2 www.bankofengland.co.uk/prudential-regulation/publication/2018/pra-approach-documents-2018.

3 www.bankofengland.co.uk/prudential-regulation/publication/2018/regulated-fees-and-levies-rates-proposals-2018-19.

4 www.bankofengland.co.uk/about/people/prudential-regulation-committee.

through: performance and assurance reporting; discussion of Committee papers; and Committee members' regular interaction with the PRA, including meetings with senior management and other staff. In particular, the regular reporting to PRC covers progress against strategic goals; budget and headcount position; staff turnover; technology availability; and the PRA's risk profile. The Bank's internal control functions also apply equally to the PRA, including the Bank's risk management framework, Internal Audit function, and the Audit and Risk Committee of Court. PRC members also have the benefit of their own engagement with industry though meetings and events across the year. The reports and other evidence provided to the PRC during the year indicate the PRA has used its financial and non-financial resources to deliver its functions, in line with its business plan.

Since 2018–19 the Bank has sought to operate a flat nominal budget for controllable costs.[1] There have been particular demands on resources in 2018–19 which has led the PRA reprioritising some of its activities, and to decide to carry over some work into 2019–20. The PRA will be making similar prioritisation decisions in 2019–20. In addition, as a result of lower than anticipated income from authorisation and other fees, the PRA will seek to raise an additional £2.9 million (1% of the PRA's total budget) within the 2019–20 fee rates consultation.[2]

The extent to which the exercise of PRA functions is independent of other Bank functions

The PRA has a number of safeguards in place to ensure it retains sufficient operational independence, including the independence of the PRC and the funding and reporting arrangements set out in FSMA and the Bank of England Act 1998.

The PRC is independent in all its decision-making functions, which include making rules and the PRA's most important supervisory and policy decisions. The PRC also maintains its independence by ensuring that actual and potential conflicts of interest across its members are identified and managed on a continual basis, and by having its own internal infrastructure and processes. PRC members' remuneration is also determined by the Bank's Remuneration Committee.

Locating the PRA within the Bank helps ensure there is effective policymaking on financial stability as the PRA needs to work closely with many other areas of the Bank. This is done in a way which maintains the respective distinct roles and responsibilities and respects the Basel Core Principles. For example, in accordance with the relevant legislation, the Bank has arrangements in place to ensure that the Bank's functions as the UK's resolution authority and its supervisory functions are operationally independent of one another and has issued a statement setting out these arrangements.[3]

The PRC maintains separation from the FPC and MPC structurally by having different external membership. The PRC and FPC hold almost all meetings separately, but hold some joint meetings to discuss matters of mutual interest (for example, the annual concurrent stress test). The FPC sometimes takes decisions that may constrain the decisions that can subsequently be taken by the PRC. The FPC also has specific powers of Direction over prescribed macroprudential measures and can make Recommendations to the PRA, among others.

The fee income generated from regulated firms can only be used for the functions covered by the statutory framework under which the PRA operates. A variety of mechanisms are in place to ensure that the financial resources of the PRA are managed independently from those of the rest of the Bank. As well as PRA direct costs, the PRA's budget covers indirect costs charged by the Bank, including centralised functions such as Finance and Human Resources. The Bank's external auditors have identified the allocation of indirect costs charged by the Bank as an area of audit focus, providing external assurance that costs have been allocated appropriately.

1 Readers are referred to the Bank's Annual Report and Accounts 2018–19, where controllable costs are costs excluding pension costs, the costs of Notes Issuance, and the costs of the real time gross settlement (RTGS) renewal programme; www.bankofengland.co.uk/annual-report/2019.

2 www.bankofengland.co.uk/prudential-regulation/publication/2019/regulated-fees-and-levies-rates-proposals-2019-20.

3 www.bankofengland.co.uk/-/media/boe/files/about/legislation/statement-structural-separation.

Senior leadership team
as at 21 May 2019*

Sam Woods
Deputy Governor, Prudential Regulation, and CEO of the PRA (FPC, PRC)

Vicky Saporta**
Executive Director
Prudential Policy

Lyndon Nelson
Deputy CEO, and Executive Director Supervisory Risk Specialists and Regulatory Operations

Phil Evans
Director
Financial Prudential Policy

Charlotte Gerken
Director
Cross-cutting Prudential Policy

Rebecca Estrada-Pintel
Director
Supervisory Risk Specialists

Nick Strange
Director
Supervisory Risk Specialists

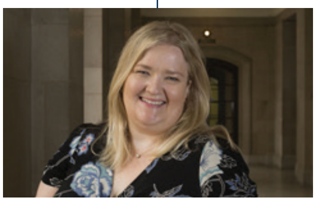
* In April 2019 the Bank made an internal announcement regarding changes at Executive Director level, including James Proudman leaving the Bank with effect from 30 June 2019. Further information will be issued in due course.

** Also reports to Deputy Governor, Financial Stability.

David Rule
Executive Director
Insurance Supervision

Sarah Breeden
Executive Director
International Banks Supervision

James Proudman
Executive Director
UK Deposit-takers Supervision



Anna Sweeney
Director
Insurance Supervision

Duncan Mackinnon
Director
International Banks Supervision

Melanie Beaman
Director
UK Deposit-takers Supervision

Find out more online
www.bankofengland.co.uk/about/people/prudential-regulation-committee

Review of 2018–19

The PRA's activities in 2018–19 were directed by the PRA's Business Plan (as set out in the PRA Business Plan 2018/19).[1]

This section of the Annual Report outlines the work completed in pursuit of our 2018–19 strategic goals and in support of our statutory objectives. Readers may also find it helpful to refer to the 'PRA Business Plan 2019/20' that sets out the PRA's strategy and workplan for the coming year,[2] and the PRA approach documents.[3]

Box 1: Examples of how the PRA delivered its 2018–19 strategic goals

Have in place robust prudential standards comprising the post-crisis regulatory regime

- Delivered the implementation of the ring-fencing of core retail services from wholesale and investment banking (structural reform).
- Implemented a series of improvements to refine our implementation of the Solvency II regime.
- Continued to support financial stability through our policy development and implementation of various initiatives, eg implementing the systemic risk buffer and monitoring the FPC's loan to income flow limit.

Continue to adapt to changes in the external market and to hold regulated firms, and those who run them, accountable for meeting our standards

- Explored how the implementation of new technologies could impact the safety and soundness of the firms we supervise.
- Extended the Senior Managers and Certification Regime to insurance firms.
- Used our statutory powers to conduct investigations and initiate enforcement action where needed to tackle threats to safety and soundness in PRA-authorised firms.
- Continued to look ahead and perform horizon scanning to pre-empt and mitigate risks to our objectives.

Ensure that firms are adequately capitalised, and have sufficient liquidity, for the risks they are running or planning to take

- Continued to assess the financial resilience of firms through our supervision at firm and sector level.
- Contributed to the work of the Basel Committee on Banking Supervision as it finalised revisions to the market risk framework, and continued to support the International Association of Insurance Supervisors in the development of the Insurance Capital Standard.
- Consulted on proposals to enhance banks' and insurers' approaches to managing the financial risks from climate change.
- Collaborated with the Bank's Financial Stability Directorate to deliver the annual concurrent stress test for the banking sector, and worked with insurance firms following the European Insurance and Occupational Pensions Authority's stress test exercise.

1 www.bankofengland.co.uk/prudential-regulation/publication/2018/pra-business-plan-2018-19.

2 www.bankofengland.co.uk/prudential-regulation/publication/2019/pra-business-plan-2019-20.

3 'The PRA's approach to banking supervision' and 'The PRA's approach to insurance supervision', available at www.bankofengland.co.uk/prudential-regulation/publication/2018/pra-approach-documents-2018.

Develop our supervision of operational resilience in order to mitigate the risk of disruption to the provision of critical economic functions

- Published a joint Discussion Paper with the Bank and FCA on how the operational resilience of the financial services sector could be enhanced.
- Continued, jointly with the FCA, to undertake threat intelligence-led cyber penetration tests (known as CBEST) on the largest firms.
- Ran a cyber exercise for over 400 individuals from 33 organisations including banks, authorities, and financial market infrastructures, with the scenario involving the crystallisation of a large-scale cyber threat in the UK.

Ensure that banks have credible plans in place to enable them to recover from stress events, and that we have a credible resolution strategy to manage a firm's failure — proportionate to the firm's size and systemic importance — in an orderly manner

- Published proposals with the Bank to introduce a Resolvability Assessment Framework (RAF) for banks.
- Implemented operational continuity in resolution rules.

Facilitate effective competition by actively considering the proportionality of our approach as it contributes to the safety and soundness of the UK financial system

- Facilitated entry in the insurance sector by setting up, jointly with the FCA, the New Insurer Start-up Unit, building on our experience with the New Bank Start-up Unit.
- Extended the leverage ratio framework to ring-fenced banks whose groups are already subject to the leverage ratio on a consolidated basis.
- The Annual Competition Report sets out our work over 2018–19 to support the delivery of our secondary competition objective on pages 48–53.

Deliver a smooth transition to a sustainable and resilient UK financial regulatory framework following the UK's exit from the EU

- Delivered activity to ensure a fully functioning legal and regulatory framework for financial services, including in the event that the UK left the EU without a deal.
- Prioritised activity to reduce risks to firms' safety and soundness as the UK prepares to leave the EU covering work across policy development, authorisation, and supervision.

Operate effectively by ensuring that resources are allocated to work that best advances our strategy and reduces the greatest risks to the delivery of our statutory objectives

- Continued to make improvements to data storage and analytics to support our assessment of firms' safety and soundness, for example the implementation of new tools for the collection and analysis of structural reform data which led to the creation of a new suite of supervisory reports.
- Continued to co-ordinate with the FCA across a range of supervisory and policy matters.
- Feedback from firms gave us assurance on the effectiveness and quality of our supervisory framework and approach.

Have in place robust prudential standards comprising the post-crisis regulatory regime

Structural reform — delivering the implementation of ring-fencing of core retail services from wholesale and investment banking

The global financial crisis revealed the need for fundamental changes to how large banks are structured. In response, the Government developed legislation to require UK banks to separate the provision of core services (broadly retail deposits, and payments and overdrafts relating to those deposit accounts) from other activities within their groups, such as investment and international banking.[1]

These requirements are known as structural reform (also referred to as ring-fencing) and came into effect on 1 January 2019 for UK banking groups with more than £25 billion of core retail deposits. As at 1 January 2019, the following UK banking groups are in scope of ring-fencing and contain at least one ring-fenced body (RFB): Barclays, CYBG (including Virgin Money), HSBC, Lloyds Banking Group, Royal Bank of Scotland, Santander UK, and TSB. Our activity relating to ring-fencing advances our general safety and soundness objective with a particular focus on RFBs.[2]

Ring-fencing required new legal structures and ways of operating to be delivered through large and complex restructuring programmes. During 2018 the largest banking groups used a court-approved 'ring-fencing transfer scheme' pursuant to Part VII of FSMA to transfer their assets and liabilities within their banking groups, including to new entities authorised by the PRA, to ensure they complied with ring-fencing requirements. Firms also completed their outstanding Senior Manager Function (SMF) applications to ensure they had full boards in place for their RFBs and other regulated entities in their groups. Many RFBs also needed to join a number of UK and international payment systems as direct members, and a number of changes to bank sort codes were made to facilitate segregation.

We undertook a programme of activities to review the implementation of RFBs' new structures and processes. This included the review and approval of regulatory transactions necessary for firms to implement their new group structures, as part of which we authorised three new banking entities, approved new board members and senior staff, and considered a number of applications for waivers or modifications. All of the permissions we granted in relation to structural reform are set out on the Financial Services Register.[3]

The arrangements to collect and analyse data submitted by the new RFBs were also finalised. Ahead of implementation, we have revised our supervisory processes to ensure they are appropriately focused on RFBs and ring-fencing.

All groups in scope of structural reform have completed the ring-fencing of their retail operations and have done so with limited disruption to their customers and counterparties.

1 The requirement for large UK banking groups to ring-fence their core UK retail services and activities by 2019 is set out in FSMA 2000 (as amended by the Financial Services (Banking Reform) Act 2013).

2 Key information and materials relating to ring-fencing, including the list of RFBs, is available on our dedicated webpage; www.bankofengland.co.uk/prudential-regulation/key-initiatives/structural-reform.

3 www.fca.org.uk/firms/financial-services-register.

FSMA requires that the PRA must report on certain aspects of ring-fencing in its Annual Report.[1] These statements are set out within the 'Complying with FSMA' section on pages 44–47.

Solvency II — refining our approach as we get used to operating the new regime, and identifying any risks arising as firms adapt to it

Over the past year, we continued to refine our approach to supervision under Solvency II, in order to meet our statutory objectives. This included publishing final policy that set out expectations of firms in respect of application of the matching adjustment,[2] and updated expectations of firms in respect of the model change process.[3]

This was followed by the publication of a series of policy developments in October 2018, including:

- removing the external audit requirement for the Solvency Financial Condition Reports of 'small insurers';[4]
- clarifying expectations in respect of firms seeking approval to apply a volatility adjustment (VA);[5]
- the modelling of 'dynamic' VA for internal model firms;[6] and
- updating internal model output reporting.[7]

We also set out our expectations for adjusting for the reduction of loss absorbency where restricted Tier 1 own fund instruments are likely to be taxed on write down in light of tax changes introduced by HM Revenue and Customs in the Budget on Monday 29 October 2018.[8]

For life insurers, the asset side of the balance sheet has remained a particular area of focus and, in particular, ensuring that the matching adjustment framework remains robust in its application to all eligible assets, and to avoid any risk that the credibility of this important element of the prudential framework is undermined. We also consulted on the treatment of the no negative equity guarantee present in equity release mortgages (ERMs).[9]

For general insurers, we prioritised an in-depth review to assess the adequacy of firms' oversight of underwriting and associated risks given market trends in wholesale insurance and reinsurance markets. Our primary prudential concern about current market conditions is that pressure on pricing will lead to weakening of underwriting standards, under-reserving against risks and insurers being tempted to take shortcuts on capital. This work has

1 Paragraph 19(1A) of Schedule 1ZB.

2 Supervisory Statement (SS) 7/18 'Solvency II: Matching adjustment', July 2018; www.bankofengland.co.uk/prudential-regulation/publication/2018/solvency-2-matching-adjustment-ss.

3 SS2/16 'Solvency II: Changes to internal models used by UK insurance firms', July 2018; www.bankofengland.co.uk/prudential-regulation/publication/2016/solvency2-changes-to-internal-models-used-by-uk-insurance-firms-ss.

4 'Small insurers' is defined in Policy Statement (PS) 25/18 'Solvency II: external audit of the public disclosure requirement'; www.bankofengland.co.uk/prudential-regulation/publication/2018/solvency-ii-external-audit-of-the-public-disclosure requirement.

5 PS22/18 'Solvency II: Supervisory approval for the volatility adjustment'; www.bankofengland.co.uk/prudential-regulation/publication/2015/solvency-2-supervisory-approval-for-the-volatility-adjustment.

6 PS23/18 'Solvency II: Internal models — modelling of the volatility adjustment'; www.bankofengland.co.uk/prudential-regulation/publication/2018/solvency-ii-internal-models-modelling-of-the-volatility-adjustment.

7 PS24/18 'Solvency II: Updates to internal model output reporting'; www.bankofengland.co.uk/prudential-regulation/publication/2018/solvency-ii-updates-to-internal-model-output-reporting.

8 PS4/19 'Solvency II: Adjusting for the reduction of loss absorbency where own fund instruments are taxed on write down', February 2019; www.bankofengland.co.uk/prudential-regulation/publication/2018/solvency-ii-adjusting-for-reduction-loss-absorbency-where-own-fund-instruments-taxed-on-write-down.

9 Consultation Paper (CP) 13/18 'Solvency II: Equity release mortgages', July 2018; www.bankofengland.co.uk/prudential-regulation/publication/2018/solvency-ii-equity-release-mortgages.

included reviews of underwriting controls, exposure management, and reserving. We continued to share our observations from this work with firms, including through our letter to Chief Actuaries in September 2018.[1]

Contribution to financial stability

We have contributed to the Bank's objective of maintaining financial stability through our policy development and implementation, for example:

- To support a smooth transition as the UK withdraws from the EU we worked to develop a fully operable prudential rulebook and detailed our approach to authorising the provision of financial services in the UK. For more information on our work on EU withdrawal please see page 35.

- We ran our annual stress test of the largest UK deposit-takers, which was completed on the basis of the changes to financial reporting under International Financial Reporting Standard (IFRS) 9. This informs policymaking by the PRC and the FPC. The results of the stress test were published on 28 November 2018.[2] For more information on stress testing see page 28, and for IFRS see page 29.

- The UK legislation implementing the systemic risk buffer (SRB) required the FPC to establish a framework for an SRB that applies to large building societies and RFBs from 1 January 2019. This year we set out our approach to the implementation of the SRB[3] and expanded the leverage ratio framework to RFBs.[4]

- We monitored firms' implementation of the FPC's loan to income flow limit.

- We worked with other areas of the Bank and the Financial Conduct Authority (FCA) to seek assurance that firms understand the risks associated with the transition from the London Interbank Offered Rate (LIBOR) to risk-free rates and are taking appropriate action ahead of end-2021.[5]

1 Letter from Anna Sweeney, 'Market conditions facing specialist general insurers: Feedback from recent PRA review work', May 2018; www.bankofengland.co.uk/prudential-regulation/letter/2018/market-conditions-facing-specialist-general-insurers-feedback-from-recent-pra-review-work.

2 www.bankofengland.co.uk/stress-testing/2018/stress-testing-the-uk-banking-system-2018-results.

3 Statement of Policy (SoP) 'The PRA's approach to the implementation of the systemic risk buffer', December 2018; www.bankofengland.co.uk/prudential-regulation/publication/2016/the-pras-approach-to-the-implementation-of-the-systemic-risk-buffer-sop.

4 PS28/18 'UK leverage ratio: Applying the framework to systemic ring-fenced bodies and reflecting the systemic risk buffer', November 2018; www.bankofengland.co.uk/prudential-regulation/publication/2018/uk-leverage-ratio-applying-the-framework-to-systemic-rfbs-and-reflecting-the-srb.

5 'Firms' preparations for transition from LIBOR to risk-free rates', September 2018; www.bankofengland.co.uk/prudential-regulation/letter/2018/firms-preparations-for-transition-from-libor-to-risk-free-rates.

Continue to adapt to changes in the external market and to hold regulated firms, and those who run them, accountable for meeting our standards

The prudential regulatory framework must be responsive to changes in the structure of the financial system and the external market. We continued to work with other areas of the Bank to monitor firms and the financial environment so that the appropriate responses were put into place. During 2018–19 we communicated where issues have been identified and good practice is available to share, using channels including letters, speeches, and publications.[1]

- We continued to facilitate market entry in the banking sector through the joint PRA/FCA New Bank Start-up Unit (NBSU).[2] There remains a significant pipeline of prospective applicants for which we have provided ongoing support and which led to a new bank being authorised at the end of 2018. Building on the success of the NBSU, the joint PRA/FCA New Insurer Start-up Unit (NISU) was established in August 2018,[3] with the aim of giving information and support to prospective new insurers wishing to operate in the UK.

- We explored how the implementation of new technologies could impact the safety and soundness of the firms we supervise. This included: monitoring the implementation of Open Banking and firms' ability to identify and manage associated risks; the implications of large technology companies entering financial services; defining an approach to the use of Cloud, based on our existing regulatory regime; and developing our understanding of the use of artificial intelligence and machine learning in the financial sector.

- We sent a letter regarding existing or planned exposure to crypto-assets, which reminded firms of their relevant obligations under PRA rules, and communicated the PRA's expectations regarding firms' exposure to crypto-assets.[4]

- We set out our expectations in relation to firms' governance and risk management in respect of algorithmic trading activity.[5]

- We set out feedback regarding areas where we think that firms can do more to ensure the prudent management of cyber risk exposures.[6]

1 Examples include the letters 'Market conditions facing specialist general insurers: feedback from recent PRA review work', 'Joining the dots — the Actuarial Function, underwriting, capital and reserving', 'Firms' preparations for transition from LIBOR to risk-free rates', and 'Disclosure about IFRS 9 expected credit losses'. All published materials are available from the prudential regulation section of the Bank's website: www.bankofengland.co.uk/prudential-regulation.

2 See the dedicated web page for more information and materials at www.bankofengland.co.uk/prudential-regulation/new-bank-start-up-unit.

3 See the dedicated web page for more information and materials at www.bankofengland.co.uk/prudential-regulation/new-insurer-start-up-unit.

4 Letter from Sam Woods, 'Existing or planned exposure to crypto-assets', June 2018; www.bankofengland.co.uk/prudential-regulation/letter/2018/existing-or-planned-exposure-to-crypto-assets.

5 PS12/18 'Algorithmic trading', June 2018; www.bankofengland.co.uk/prudential-regulation/publication/2018/algorithmic-trading.

6 Letter from Anna Sweeney, 'Cyber underwriting risk: follow-up survey results', January 2019; www.bankofengland.co.uk/prudential-regulation/publication/2018/algorithmic-trading.

Box 2: International engagement

The UK is a global centre for the activities of banks and insurers. As the host regulator for all internationally headquartered global systemically important banks (G-SIBs) and several internationally headquartered global systemically important insurers (G-SIIs), we have an essential role in global consolidated supervision. Given the international nature of the largest wholesale firms operating here as both branches and subsidiaries, we need to understand the nature and extent of the risks facing these firms and their wider groups, and need an open, transparent and proactive exchange of information and views with the home state regulators. We have well-established co-operative relationships with home regulators and group parent companies to support us in delivering supervisory priorities efficiently and effectively.

Over the past year we have focused our bilateral engagement with regulators from around the world, including with the US, the EU, China, Switzerland, Japan, and Canada, and more broadly have actively participated in European and global colleges. Our relationship with EU regulators will be crucial in the context of the UK's withdrawal from the EU both as a partner host supervisor and also as the home state regulator for European firms operating in the UK. We therefore engaged in a series of workshops to establish supervisory dialogue on firm-specific issues relating to EU27 firms with activity in the UK, and we have also conducted workshops with the Single Supervisory Mechanism (SSM) to share our experience of supervising third-country groups with major UK operations which are establishing subsidiaries now being authorised by the SSM in Europe. Working with the FCA we also reached agreement with the European Banking Authority (EBA) and the European Insurance and Occupational Pensions Authority (EIOPA) on Memoranda of Understanding (MoUs) with EU regulators, which are the foundation for information sharing and effective supervisory co-operation.

Strong relationships with overseas regulators are core to achieving better supervisory outcomes. Our supervisory engagements include regular calls, information sharing, and joint on-site supervisory reviews. In addition we have hosted secondees from overseas regulators and also send PRA staff overseas as secondees. Examples of joint working with other regulators include: sharing our approach to operational resilience and solvent wind down; joint reviews of cross-border reinsurance arrangements, booking models and transfer pricing; on-site reviews covering structured finance and business models and processes; and a review of electronic foreign exchange business.

Accountability – delivering and embedding the governance regime for banks and insurers including the principle of proportionality

The strengthened accountability regime for banking and insurance helps to support a change in culture at all levels in firms through a clear identification and allocation of responsibilities to individuals responsible for running them.

In March 2016 we introduced the Senior Managers and Certification Regime (SM&CR) for deposit-takers and PRA-designated investment firms. Last year, we extended the full SM&CR regime to insurance firms with the extension applied with effect from Monday 10 December 2018.[1] There is now a common accountability framework for all PRA-authorised firms, although some differences between insurers, banking firms, and credit unions will remain, reflecting differences in the respective regulatory framework and the business models of these

1 PS15/18 'Strengthening individual accountability in insurance: Extension of the SM&CR to insurers', July 2018; www.bankofengland.co.uk/prudential-regulation/publication/2018/strengthening-individual-accountability-in-insurance-extension-of-the-smcr-to-insurers.

firms. We expect firms to identify the most senior individuals responsible for key areas and activities, including the delivery of supervisory priorities, and to document their responsibilities. We can and have continued to take supervisory or enforcement action if our red lines are crossed (see Box 3 on page 22).

The specific accountabilities of individual directors established by the SM&CR are additional and complementary to the collective responsibility shared by directors as members of the board. Ultimate responsibility for maintaining the safety and soundness of a bank, insurer, or any other regulated firm lies with the board. Therefore, reviewing the effectiveness of governance and control arrangements in firms, including board effectiveness, remain central to our supervisory approach.

Individual accountability is reinforced by requiring that a significant proportion of the variable remuneration of key decision-takers must be deferred for a period, in some cases for seven years, to ensure that it can be clawed back over the period in which conduct issues might come to light. In October 2018 we published a letter setting out our updated approach to supervising remuneration compliance for firms with total assets exceeding £50 billion.[1] We will no longer provide a 'non-objection' statement to the proposed communication or distribution of variable remuneration awards by these firms. Our oversight over remuneration practices will increasingly seek to draw upon the principles for governance as set out in the SM&CR, and we will ask how the pay of a senior manager who is tasked with delivering supervisory priorities is affected by their success or failure in that task.

We continued to engage actively in the work of international standard setters in the fields of governance and remuneration. For example, we contributed to the Financial Stability Board (FSB) toolkit to mitigate misconduct risk, published in April 2018, which included tools to promote individual accountability,[2] and the FSB recommendations on reporting on the use of compensation tools to address potential misconduct risk. We continued to participate in the International Association of Insurance Supervisors (IAIS) Governance Working Group which we have chaired since the start of 2019. In December 2018 Sir John Kingman published his review of the Financial Reporting Council.[3] Two recommendations (74 and 75) referred to the PRA in relation to the regulation of actuaries. The Department for Business, Energy & Industrial Strategy stated in the consultation document it issued in March that the Government will reflect on the two recommendations and bring forward proposals in due course.[4]

This year we have also worked to ensure that our regimes remain appropriate in light of developments arising from the UK's withdrawal from the EU. For instance, we worked with colleagues in other areas in the Bank to clarify the interaction between the PRA's and FCA's proposals for applying the SM&CR to firms in the temporary permissions regime (TPR).[5]

1 Letter from James Proudman, 'Change to supervising remuneration compliance for Level One firms', October 2018; www.bankofengland.co.uk/prudential-regulation/letter/2018/change-to-supervising-remuneration-compliance-for-level-one-firms.

2 www.fsb.org/2018/04/fsb-publishes-toolkit-to-mitigate-misconduct-risk/.

3 'Financial Reporting Council: review 2018'; www.gov.uk/government/publications/financial-reporting-council-review-2018.

4 www.gov.uk/government/consultations/independent-review-of-the-financial-reporting-council-initial-consultation-on-recommendations.

5 www.bankofengland.co.uk/prudential-regulation/publication/2019/application-of-smcr-to-firms-in-tpr-clarification-of-pra-and-fca-proposals.

Box 3: Enforcement: tackling threats to safety and soundness and strengthening accountability in PRA-authorised firms

At the start of 2018–19 we had six open cases comprising investigations into firms at two PRA-authorised groups and 13 individuals. In the financial year 2018/19 we opened eight new cases. These comprised investigations into eight PRA-authorised groups and six connected senior individuals. We also completed two cases, both of which led to public outcomes:

- In May 2018 we and the FCA concluded our investigations into Barclays Bank plc and its Chief Executive Officer, Mr James Staley, and concluded that Mr Staley failed to handle an anonymous ‘whistleblowing’ letter appropriately. The PRA considers that protection for whistleblowers is an essential part of keeping the financial system safe and sound. This resulted in the PRA and FCA, in May 2018, each imposing requirements on Barclays Bank plc in respect of its handling and reporting of whistleblowers, and a financial penalty on Mr Staley of £321,230 and £321,200 respectively, and a public censure.[1]

- In November 2018, we imposed financial penalties on two individuals, Mr Akira Kamiya, former Chair of Mitsubishi UFJ Securities International plc (MUS (EMEA)) (£22,700), and Mr Takami Onodera, former non-executive director of MUS (EMEA) (£14,945). This arose from their failure to disclose to the PRA the possibility that Mr Kamiya would be restricted from conducting US banking activities by the New York Department of Financial Services. This was information which could have had implications for Mr Kamiya’s role as Chair of MUS (EMEA). We took action because it is vital that firms and responsible individuals at those firms are completely open and co-operative with us, and that they disclose appropriately any information of which we would reasonably expect notice.[2]

As at 28 February 2019, we have 12 open cases, comprising investigations into firms at nine PRA-authorised groups and 12 individuals. These cover the full spectrum of PRA-authorised firms and the individuals who run them from Category 1 to 5 firms across a range of industry sectors including insurers, banks, and credit unions.[3]

1 www.bankofengland.co.uk/news/2018/may/fca-and-pra-jointly-fine-mr-james-staley-and-announce-special-requirements-at-barclays.

2 www.bankofengland.co.uk/news/2018/november/pra-imposes-financial-penalty-on-akira-kamiya-takami-onodera-for-failure-to-disclose-information.

3 For descriptions of the different categories of firms, see the PRA’s approach to banking and insurance supervision documents; www.bankofengland.co.uk/prudential-regulation/publication/2018/pra-approach-documents-2018.

Ensure that firms are adequately capitalised, and have sufficient liquidity, for the risks they are running or planning to take

Our objective to promote the safety and soundness of PRA-authorised firms is delivered in part through ensuring that firms have adequate financial resources for the risks they are running or planning to take. We assess the financial resilience of firms through our supervision at firm and sector level, and use stress testing to examine how firms cope with severe economic scenarios.

Banking

In November 2018 we communicated our approach to the European Union Securitisation Regulation and certain aspects of the revised Capital Requirements Regulation (CRR) (575/2013) banking securitisation capital framework.[1] This set out expectations in relation to: the incoming European Union Securitisation Regulation; the incoming securitisation capital framework introduced by Amendments to the CRR; and firms that intend to sponsor Simple, Transparent and Standardised Asset Backed Commercial Paper programmes. Together with the FCA we also published the final direction on the manner in which firms must make information regarding 'private' securitisations available to their UK competent authorities.[2]

In July 2018 we consulted on our proposed approach to implementing a roadmap of three products developed by the European Banking Authority (EBA) to reduce unwarranted variability in the risk-weighted assets calculated using banks' internal ratings based (IRB) models.[3] We also clarified our expectations regarding the eligibility of financial collateral as funded credit protection, and the eligibility of guarantees as unfunded credit protection under the CRR.[4]

We finalised policy relating to our groups policy framework to ensure that it remains fit for purpose. For example, we published policies in April and June 2018 relating to double leverage and changes to our large exposures framework.[5] Our overall approach to groups policy, and review of the existing policies, has been guided by four principles:

(i) banking groups should be resilient;
(ii) resources should be located close to risks;
(iii) risks of intragroup contagion should be limited; and
(iv) where appropriate, intragroup relationships should be recognised when setting prudential requirements on an individual basis.

1 PS29/18 'Securitisation: The new EU framework and Significant Risk Transfer'; www.bankofengland.co.uk/prudential-regulation/publication/2018/securitisation-the-new-eu-framework-and-significant-risk-transfer.

2 January 2019; www.bankofengland.co.uk/prudential-regulation/publication/2018/securitisation-regulation-pra-and-fca-joint-statement-on-reporting-of-private-securitisations.

3 CP17/18 'Credit risk: The definition of default' (see page 2 of 2); www.bankofengland.co.uk/prudential-regulation/publication/2018/credit-risk-the-definition-of-default.

4 See CP6/18 'Credit risk mitigation: Eligibility of guarantees as unfunded credit protection', February 2018, www.bankofengland.co.uk/prudential-regulation/publication/2018/credit-risk-mitigation-eligibility-of-guarantees; and CP1/19 'Credit risk mitigation: Eligibility of financial collateral', January 2019, www.bankofengland.co.uk/prudential-regulation/publication/2019/credit-risk-mitigation-eligibility-of-financial-collateral.

5 PS9/18 'Groups policy and double leverage': www.bankofengland.co.uk/prudential-regulation/publication/2017/groups-policy-and-double-leverage; and PS14/18 'Changes to the PRA's large exposures framework': www.bankofengland.co.uk/prudential-regulation/publication/2017/changes-to-the-pras-large-exposures-framework.

For systemic RFBs, we published final policy applying the leverage ratio framework and reflecting the SRB,[1] and established a framework for an SRB that applies to large building societies and RFBs.[2] These changes support the implementation of the SRB from 2019, and complement the risk-weighted capital framework by guarding against the risks of relying only on models or standardised approaches to set capital requirements.

In February 2018 we finalised our approach to the assessment and mitigation of significant sources of liquidity risk under the Pillar 2 liquidity framework which covers risks not captured, or not fully captured, in Pillar 1 of the Liquidity Coverage Requirement.[3] We have previously stated our intention to set out proposals on the overall calibration of the liquidity framework in 2018. However, we have taken the decision to postpone finalisation of our proposals in order to conduct further analysis on the appropriate level of liquidity guidance. This includes the potential for some recognition in the Pillar 2 liquidity framework of the ability to draw on Bank of England liquidity facilities, where firms have access arrangements and appropriate collateral in place.

We also published policy in January 2019 to delay terminating the existing 'daily flows' and 'enhanced mismatch' liquidity reports (FSA047 and FSA048) for a limited period.[4] The purpose of the change is to mitigate risks to the supervision of liquidity in the initial period following the introduction of the new PRA110 report on 1 July 2019. During 2018–19 we received 126 individual queries from firms and reporting technology providers,[5] and published 34 clarifications on the PRA110 reporting template. We have further refined the template and instructions to ensure the most accurate measurement of firms' liquidity risks; these changes are consulted on in CP6/19 'Pillar 2 liquidity: updates to the framework'.[6]

We contributed to the work of the Basel Committee on Banking Supervision (BCBS) as it finalised revisions to the market risk framework, the Fundamental Review of the Trading Book (FRTB). The FRTB: developed a new, more robust approach to establishing minimum capital requirements for market risk; incentivises banks to produce reliable models and prevents the use of internal models for capital purposes where they are not reliable; and introduces a new, more risk-sensitive standardised approach as a robust fallback. This is the last of the major post-crisis global reforms and the BCBS has agreed that it should be implemented by 1 January 2022.

One of the key post-crisis G20 reforms is the obligation to clear certain over-the-counter derivatives contracts (the clearing mandate). We played a leading role in the assessment, by the FSB and other standard-setting bodies, of whether firms have incentives to clear. Following that report the BCBS has now consulted on potential revisions to the leverage ratio treatment of client margin in cleared derivatives.[6] These proposals are in line with statements made by the FPC on the treatment of client cleared margin in the leverage ratio.

1 See footnote 4 on page 18.

2 See footnote 3 on page 18.

3 PS2/18 'Pillar 2 liquidity'; www.bankofengland.co.uk/prudential-regulation/publication/2016/pillar-2-liquidity.

4 PS1/19 'Liquidity reporting: FSA047 and FSA048, and PRA110'; www.bankofengland.co.uk/prudential-regulation/publication/2018/liquidity-reporting-fsa047-and-fsa048.

5 As part of an FAQ process established in July 2018 to supporting interim PRA110 reporting.

6 March 2019; www.bankofengland.co.uk/prudential-regulation/publication/2019/pillar-2-liquidity-updates-to-the-framework.

Significant progress has also been made on EU measures to implement some of the remaining aspects of revised international standards. In February 2019, EU ambassadors endorsed revisions to the Capital Requirements Directive and Capital Requirements Regulation (CRD V/CRR II).[1]

Insurance

Domestically we continued to implement forward-looking, judgement-based supervision of UK insurers, including publishing final policy on the matching adjustment and VA (see page 17).

At the international level, we continued to support the development of international regulatory standards, such as the Insurance Capital Standard (ICS). The IAIS began work on an ICS for Internationally Active Insurance Groups in 2014. The ICS is intended to provide a global solvency standard for international insurance groups, enabling enhanced supervisory co-operation between countries, and supporting decision making by investors and policyholders. We have been actively involved in shaping the open technical issues in the development of the ICS for international insurance groups as part of the ongoing field-testing process.

A third consultation paper on ICS version 2.0 closed on Tuesday 30 October 2018. We encouraged UK insurance groups to take part in this consultation and in the final round of field testing next year. The ICS will be finalised in 2019 ahead of a five-year monitoring period starting in 2020. During this period the reference ICS will only be for confidential reporting to group-wide supervisors, for discussion in regulatory colleges.

We will also contribute to the finalisation of the IAIS's holistic framework for the mitigation of systemic risk in the insurance sector, which will be presented to the FSB in late 2019 ahead of its planned implementation from 2020 onwards.

Investment risk, credit risk, and asset quality

Insurance

Since the introduction of Solvency II, UK life insurers have increased their holdings of illiquid assets such as infrastructure, commercial real estate, and ERMs to back annuity liabilities. These assets can be a good match for long-term annuity liabilities. However, they can also be complex and may lack observable market prices as well as external credit ratings. It is therefore more difficult for insurers to assess credit and other risks. In April 2018 we highlighted three areas of risk arising from bulk purchase annuity transactions, including: investment due diligence; and asset selection, rating and valuation.[2]

The illiquid asset category in which exposures have been growing most quickly is ERM lending. Our priority is that insurers capture the compensation for the risks to which they are exposed so that the matching adjustment is not overstated, and hold appropriate capital against these risks. In 2018–19 we issued our detailed approach in respect of using an Effective Value Test as a diagnostic tool to ensure compliance with Solvency II requirements relating to the calculation of the matching adjustment benefit where liabilities are matched by ERMs, recognising in particular the risks arising from the no negative equity guarantee feature.[3]

1 CRD V/CRR II will apply the following Basel III measures in the EU: a binding leverage ratio; the net stable funding ratio (NSFR); an interest rate risk in the banking book (IRRBB) framework; a revised large exposures (LE) framework; a new Standardised Approach to Counterparty Credit Risk (SA-CCR); a revised treatment of equity investments in funds; a revised treatment of exposures to central counterparties (CCPs); new disclosure requirements; and amendments to introduce total loss absorbing capacity (TLAC) requirements. The package will also cover certain EU-specific measures not prescribed by international standards, including a revised Pillar 2 framework, a requirement for certain firms to establish intermediate parent undertakings (IPUs) in the EU, a new regime for the approval of holding companies and, a revised remuneration framework.

2 Speech by David Rule, 'An annuity is a very serious business', April 2018; www.bankofengland.co.uk/speech/2018/david-rule-2018-conference-on-bulk-annuities-and-longevity-risk-transfer.

3 The policy will take effect from 31 December 2019 with the calibration of the test strengthening on 31 December 2021 after a two-year phasing period. The policy is available at www.bankofengland.co.uk/prudential-regulation/publication/2018/solvency-ii-equity-release-mortgages.

In addition to our policy, we reviewed the approaches of various insurers to the equity release asset class through a thematic study covering the governance, investment appetite, asset origination, and prudential parameters.

We conducted deep dive reviews on a sample of investments of large annuity firms to assess the quality of assets and the appropriateness of their ratings. In addition, we developed the capability to assess the robustness of the internal rating framework of insurers and completed the review of such frameworks for select asset classes on a pilot basis.

We exercised our powers under section 166 of FSMA to seek independent rating opinions and also reviewed the opinions obtained by firms at their own initiative.

For general insurers, we reviewed the investment risk management capability and allocations by some non-life insurers, as they have also been under pressure to generate financial income in a low interest rate environment.

In 2018–19 we reviewed the liquidity risk management practices in some insurers, and in planning for our consultation on liquidity risk we have interacted with a number of firms and experts and identified areas of good practice.[1]

Banking

For the banking sector, credit risk remains a dominant risk. Over 2018–19 we continued to assess credit risk and asset quality in PRA-authorised banks using:

- supervisory tools such as continuous assessment (meetings and regulatory returns data reviews), written auditor reports, and interactions with auditors;
- specialist-led reviews including assessments of firms' credit risk management, provision coverage, and asset quality;
- thematic reviews, combining financial stability and risk specialist resources to provide both micro- and macro-impact assessments for particular asset classes and sectors;
- annual stress testing under the new IFRS 9 accounting standard for the reporting of expected credit losses; and
- reviews of firms' Internal Capital Adequacy Assessment Processes (ICAAPs).

Reviews were undertaken either by asset class (eg mid-market and small and medium-sized enterprises (SME) corporate, or owner-occupied mortgages) or by risk lifecycle stage. The reviews were conducted on a risk-based approach across domestic and international banks and building societies. Work has also been undertaken to assess firms' preparedness for EU withdrawal with respect to credit risk.

For retail assets, having completed a consumer credit review at the start of this period, the focus moved to assessing UK mortgage asset quality across the largest UK banks. For corporate assets, thematic reviews were undertaken in respect of the UK SME and mid-corporate portfolios of the larger UK firms. Leveraged lending was also a focus of reviews, with further work in progress. In respect of the international exposures of our regulated firms, we have undertaken reviews of US and Asian retail and corporate portfolios.

1 CP4/19 'Liquidity risk management for insurers' was issued in March 2019; www.bankofengland.co.uk/prudential-regulation/publication/2019/liquidity-risk-management-for-insurers.

Our approach to the supervision of banks' trading activities was broadly similar to that for credit risk. Over 2018–19 we continued to assess market risk, counterparty credit risk, and valuations risk in PRA-authorised banks, with our thematic reviews covering a range of topics including risk limit frameworks, day-one profit and loss recognition, risk management of equity block trades, and risk management/capitalisation of secured financing transactions.

During 2018 we began a process of regular dialogue with banks in relation to the implementation of new market risk capital requirements (the FRTB). While the final implementation date agreed by the Basel Committee is 2022, this is a very significant undertaking for banks which was expected to take years to develop and roll out fully, particularly in relation to the internal models approach (where banks calculate requirements using their own models, subject to regulatory approval). By engaging at an early stage through a series of firm-specific meetings, we aim to understand banks' intended modelling approaches and provide feedback to help ensure they are able to meet expectations.

We also continued to assess firms' asset quality through various cross-firm exercises, such as the annual concurrent stress test of the largest UK banks (see stress testing on page 28). The implementation of IFRS 9 has had a significant impact on impairment processes of firms subject to IFRS and was a key area of focus in our work on stress testing and other reviews (see IFRS on page 29).

Enhancing banks' and insurers' approaches to managing the financial risks from climate change

We have identified climate change as a future financial risk that is relevant today.[1] Over the past year, we have examined the impact of the financial risks from climate change on firms, and have sought to drive change in how the financial sector is responding to and managing these risks. Specifically, we have:

- engaged with the banking and insurance sectors as well as liaising domestically and internationally with other regulatory bodies;
- published a report on the impact of climate change on the UK banking sector based on a survey covering 90% of the sector;[2]
- carried out an outreach exercise with the insurance sector between May and July 2018 to update our findings from the 2015 insurance sector report;[3]
- consulted on our proposed supervisory expectations on how firms should address the financial risks from climate change through appropriate governance, risk management, scenario analysis, and disclosures;[4]
- established the Climate Financial Risk Forum with 17 organisations including banks, insurers, and asset managers to build capacity and share best practice, co-chaired with the FCA;[5] and

1 Speech by Sarah Breeden, 'The shared response to climate change: turning momentum into action', May 2018; www.bankofengland.co.uk/speech/2018/sarah-breeden-remarks-to-the-green-finance-initiative-and-green-finance-committee.

2 'Transition in thinking: The impact of climate change on the UK banking sector', September 2018; www.bankofengland.co.uk/prudential-regulation/publication/2018/transition-in-thinking-the-impact-of-climate-change-on-the-uk-banking-sector.

3 'The impact of climate change on the UK insurance sector', September 2015: www.bankofengland.co.uk/prudential-regulation/publication/2015/the-impact-of-climate-change-on-the-uk-insurance-sector.

4 See CP23/18 'Enhancing banks' and insurers' approaches to managing the financial risks from climate change', and the final policy, subsequently published in April 2019; www.bankofengland.co.uk/prudential-regulation/publication/2018/enhancing-banks-and-insurers-approaches-to-managing-the-financial-risks-from-climate-change.

5 The first meeting was on 8 March 2019; www.bankofengland.co.uk/news/2019/march/first-meeting-of-the-pra-and-fca-joint-climate-financial-risk-forum.

- committed to consider conducting a climate-focused biennial exploratory scenario to measure the system-wide risks from climate change.

Our desired outcome is that firms take a strategic approach to managing the financial risks from climate change, taking into account current risks, those that can plausibly arise in the future, and identifying the actions required today to mitigate current and future financial risks.

Stress testing

For the banking sector, we supported the Bank's 2018 stress test, results for which were published on 28 November 2018.[1] The 2018 annual cyclical scenario (ACS) incorporated simultaneous recessions in the UK and global economies that were more severe overall than the global financial crisis, and that were combined with large falls in asset prices and a separate stress of misconduct costs. For the second time since the Bank launched its concurrent stress test in 2014, no bank needed to strengthen its capital position as a result of the test.

An important objective of the Bank's concurrent stress-testing framework is to support a continued improvement in banks' own risk management and capital planning capabilities. In April 2018 we published our expectations to support effective practices in model risk management for stress testing.[2] This outlines that firms participating in the Bank's annual concurrent stress test should adopt the principles in full, and firms not participating in the Bank's annual concurrent stress test should seek to apply the principles on a proportionate basis, taking into account their size, complexity, risk profile, and the relevance to them of using stress test models.

A key focus of the qualitative review in the 2018 ACS was an assessment of participating banks' stress-testing model risk management frameworks. This showed that some banks had made good progress against our expectations. However, other banks needed to make substantial improvements to raise the management of model risk to a standard required for stress testing. In addition, the PRC judged that the boards of a majority of the banks were yet to have an adequate understanding of limitations in their key stress-testing models. We provided feedback to banks detailing areas requiring improvements.

In the insurance sector, firms use stress and scenario testing to consider the potential impact of certain adverse circumstances on their business. It is an important element in firms' planning and risk management processes, helping them to identify, analyse and manage risks. A number of large UK insurance groups took part in the 2018 European Insurance and Occupational Pensions Authority (EIOPA) stress test exercise, conducted for the third time on a Solvency II basis.[3] The exercise ran from May to November 2018, and examined the overall impact of an adverse market 'yield-curve up' scenario (coupled with lapse and claims inflation stresses) and an adverse market 'low-yield' scenario (coupled with longevity stresses). Separately, general insurance-exposed portfolios ran a series of European natural catastrophe events.

UK insurers' capital positions were most affected by the adverse market low-yield scenario (coupled with longevity stresses). The adverse market yield-curve up scenario and natural catastrophe scenarios had a limited impact on UK groups because of their close asset and liability matching, limited guaranteed return products, and effective use of reinsurance programmes. The results were published by EIOPA on 14 December 2018. The PRA is taking forward the recommendations applicable to PRA-regulated firms.

1 See footnote 2 on page 18.

2 SS3/18 'Model risk management principles for stress testing', April 2018; www.bankofengland.co.uk/prudential-regulation/publication/2018/model-risk-management-principles-for-stress-testing-ss.

3 https://eiopa.europa.eu/Pages/Financial-stability-and-crisis-prevention/Stress-test-2018.aspx.

International Financial Reporting Standards (IFRS)

From January 2018, IFRS 9 introduced a fundamentally new way of accounting for credit losses. We have continued to work closely with firms and their auditors to understand their approach to expected credit loss (ECL) and the implications of those approaches for banks' capital ratios, and for us as we encourage greater consistency of outcomes and high quality disclosures about ECL.

Under IFRS 9, banks provide for ECL on all loans. This differs from the previous accounting standard — IAS 39 — under which credit losses were taken only after there was objective evidence of impairment (such as a loan repayment becoming overdue). The earlier recognition of losses under IFRS 9 should enhance transparency and market confidence in book measures of banks' capital positions, including in a downturn, thereby promoting the safety and soundness of individual firms, and so financial stability.

We, the FCA, and the Financial Reporting Council are sponsoring the work of the Taskforce on Disclosures about Expected Credit Loss. The Taskforce involves preparers and market participants working together to try to reach a consensus on what good ECL disclosure looks like. The Taskforce's first report was published in November 2018.[1] We sent a letter to Chief Financial Officers of firms participating in the Taskforce reminding them that we expect them to be looking to adopt the recommendations in full, and to encourage them to make as much progress as possible in adopting the recommendations for their next annual reports.[2]

Alongside the introduction of IFRS 9, arrangements have been put in place under EU law to offer banks transitional relief as they adapt to the new standard. These arrangements allow banks to 'add back' to common equity Tier 1 (CET1) capital a specified percentage of 'new' provisions made due to the adoption of IFRS 9. These arrangements will be gradually phased out, with 85% of 'IFRS-related' provisions being added back to CET1 capital in 2019, falling thereafter with full recognition of IFRS 9 taking effect from 2023.

We continued to work on the impact of the implementation of IFRS 9 on banks' capital positions. For the first time, the Bank's stress test was conducted in the context of IFRS 9 with results assessed on a transitional basis under the assumption of perfect foresight of the stress scenario. The Bank judged that it was appropriate to adjust the 2018 stress-test hurdle rates to take account of the earlier timing of losses under IFRS 9, subject to constraints that ensure system-wide resilience is maintained. Please see page 28 for further information on stress testing.

We are considering the extent to which ECL, over a 12-month period, is covered by Pillar 1 requirements, to inform the setting of Pillar 2A capital requirements for firms on standardised approaches to credit risk that are using IFRS 9. In addition, in November 2018 we held a roundtable on IFRS 9 for non-systemic banks and building societies. This roundtable was largely an opportunity for firms to share their experience regarding embedding IFRS 9 into their capital planning.

We also continued to monitor the development and implementation of IFRS 17 which will replace IFRS 4 on accounting for insurance contracts.

1 www.frc.org.uk/getattachment/dbd534bb-a25e-43f5-9c76-4319cf624c83/DECL-Report-November-2018.pdf.

2 Letter from Victoria Saporta, 'Disclosures about IFRS 9 expected credit losses', January 2019; www.bankofengland.co.uk/prudential-regulation/letter/2019/disclosures-about-ifrs9-expected-credit-losses.

Develop our supervision of operational resilience in order to mitigate the risk of disruption to the provision of critical economic functions

The operational resilience of the financial sector remains a key priority for us.[1] The challenges for operational resilience have become even more demanding given a hostile cyber environment and large-scale technological changes. As recent disruptive events illustrate, operational resilience is a vital part of protecting the UK's financial system, institutions, and consumers.

Defining and shaping policy

In July 2018 we published a joint Discussion Paper (DP) with the Bank and FCA to share our thinking on how the operational resilience of the financial services sector could be enhanced.[2] The paper signalled that our supervisory approach will primarily focus on the continuity of the services that a firm's customers and the wider economy rely upon. As part of this, we set out that we would expect firms to quantify the amount of disruption to these services which they will tolerate in severe but plausible scenarios. We noted that firms should acknowledge that disruptive events will happen and be able to recover within their set tolerance for a wide range of severe but plausible scenarios. The DP, along with responses from firms, are informing a consultation paper for operational resilience due to be published in the second half of 2019.

Aligning our supervisory approach

Key elements of the existing supervisory approach, such as testing the effectiveness of firms' governance and risk management functions, will continue to be important components in assessing firms' operational resilience capability. Similarly, firms' existing business continuity, incident management, change management, and third party management functions are within scope of our existing rulebook and should support firms' operational resilience.

During 2018–19 we started reviewing the existing tools and approaches to identify what refinements could be required for future supervision.

CBEST, Cyber Triage Questionnaire, Cloud outsourcing, and operational resilience reviews

CBEST is a joint PRA and FCA framework for assessing the cyber resilience of firms' critical business functions through threat intelligence-led penetration testing. The PRA conducts assessments on a three year cycle. In 2018 the PRA and FCA initiated eight CBEST assessments; a further ten tests are due to start in 2019.

A pilot CBEST-type cross-jurisdictional assessment was initiated in 2018, due for completion in 2019. This pilot will work across five separate jurisdictions to assess the global cyber resilience of the participant firm. This will reduce the regulatory burden on firms and provide guidance to other jurisdictions with varying frameworks.

The Cyber Triage Questionnaire (CTQ) provides a view of how a firm delivers cyber resilience. The data collected is used to identify and prioritise potential areas for future supervisory focus, including remediation activity, and to support firm and sector-level analysis. The PRA and FCA are currently working together to create an updated CTQ, which will incorporate lessons learnt from previous work.

1 Speech by Lyndon Nelson, 'Resilience and continuity in an interconnected and changing world', June 2018; www.bankofengland.co.uk/speech/2018/lyndon-nelson-regulatory-keynote-address-at-opsrisk-europe.

2 DP1/18 'Building the UK financial sector's operational resilience'; www.bankofengland.co.uk/prudential-regulation/publication/2018/building-the-uk-financial-sectors-operational-resilience-discussion-paper.

In 2018–19 the PRA's work on operational resilience included:

- Engaging with firms through continuous assessment (CA) meetings, to explore operational resilience through topics including governance, strategy, risk management, change, and third-party dependencies.

- Assessing firms' planning for, and implementation of, major IT change projects. Reviews spanned the use of outsourcing by payment system providers and firms' IT and operational readiness for ring-fencing and the UK's withdrawal from the EU.

- Monitoring firms' remediation and resolution of major IT incidents, including the post-incident restoration of a major organisation-wide IT systems and operations incident.

- A detailed review of firms' use of Cloud technology, assessing the scale and nature of current and planned outsourcing activity. We also reviewed a number of specific Cloud outsourcing notifications from firms, and continued to monitor developments across the industry.

- Actively supporting international policy development, engaging with EBA and BCBS working groups covering matters including: development of IT risk management related guidelines; regulatory responses to the opportunities and risks posed by Financial Technology (FinTech) developments in financial services; and enhancing banks' risk data aggregation and reporting.

- Assessing compliance with the EBA's Guidelines on Information and Communication Technology Risk Assessment under the supervisory review and evaluation process (ICT SREP).

- Fostering engagement with the financial sector on operational resilience through roundtable discussions with representatives of the financial services industry, advisory and legal firms, and industry bodies.

Exercising

We run a sector exercising programme on a two-yearly cycle, alternating between industry-led technical assessments, and Bank and/or PRA-led market-wide events, which focus on industry collective response capabilities. The 2018 exercise involved over 400 individuals from 33 organisations including banks, authorities, and financial market infrastructures. The scenario involved the crystallisation of a large-scale cyber threat in the UK, including the operational paralysis of a global systemically important bank. Key findings from the exercise are now being addressed through industry working groups.

We have also been involved in the development of the G7 Cross-Border Co-ordination Exercise (CBCE). In 2018 we helped to develop the G7 financial authorities' cyber incident response protocol. This is intended to enhance the response and communication capabilities of the G7 authorities in the event of a cyber incident affecting one or more jurisdictions.

Ensure that banks have credible plans in place to enable them to recover from stress events, and that we have a credible resolution strategy to manage a firm's failure — proportionate to the firm's size and systemic importance — in an orderly manner

As set out in the PRA Business Plan 2019/20, our supervisory approach recognises that firms can face periods of financial stress. To ensure an efficient, competitive banking system that supports growth, firms should be allowed to fail; this means accepting that we do not operate a zero-failure regime.

During the financial crisis, governments were forced to bail out failing banks, some of which were too big to be allowed to fail. As part of addressing the 'too big to fail' problem, firms are required to draw up recovery plans, to ensure they are prepared for periods of financial stress, can stabilise their financial position, and recover from financial losses. Recovery planning is an important component of the regulatory reform agenda and addresses the risk that firms concentrate disproportionately on growth opportunities at the expense of managing downside risk.

Recovery planning is now embedded in our supervisory framework, with firms regularly submitting their plans to supervisors. Firms are expected to have a number of recovery options, and maintain and test their plans in line with the updated supervisory expectations, which became applicable from 2018.[1] Among other things, our supervisory expectations emphasise the importance of 'playbooks', which should be readily usable by both a firm's board, and specific affected business areas. It is important that boards can quickly navigate and understand their recovery plan as they will take the key decisions in a stress.

However, if a firm does fail, the Bank, as the UK's resolution authority, must ensure that it does so in an orderly manner, reducing risks to depositors, the financial system and public finances — a process known as resolution.

The Bank as resolution authority works closely with the PRA. For example, the Bank consults the PRA when it prepares resolution plans and when it produces its assessment of firms' resolvability. The Bank also works with us to identify and remove impediments to resolvability.

In December 2018 we and the Bank published proposals to introduce a Resolvability Assessment Framework (RAF) for 'in scope firms',[2] the final major piece of the UK's resolution framework that enables banks to fail in an orderly way.[3] The RAF is designed to make resolution more transparent, better understood, and more successful by ensuring banks are, and are able to demonstrate they are, resolvable — creating a common assessment framework across all firms. The framework will build on the significant body of policies and standards already in place. The proposals for the RAF have three main components:

(i) how the Bank as resolution authority intends to assess resolvability, building on work that both firms and the Bank have already done;

1 PS29/17 'Recovery planning', December 2017; www.bankofengland.co.uk/prudential-regulation/publication/2017/recovery-planning.

2 'In scope firms' are defined as 'in scope as UK banks and building societies with retail deposits greater than or equal to £50 billion on an individual or consolidated basis, as at the date of their most recent annual accounts. This scope is intended to capture UK banks and building societies whose failure would pose the greatest threat to UK financial stability' in CP31/18 'Resolution assessment and public disclosure by firms'; www.bankofengland.co.uk/prudential-regulation/publication/2018/resolution-assessment-and-public-disclosure-by-firms.

3 Readers are encouraged to first read the 'Introduction to the Resolvability Assessment Framework'; www.bankofengland.co.uk/paper/2018/introduction-to-the-resolvability-assessment-framework.

(ii) new PRA rules that would require the largest UK firms to perform an assessment of their preparations for resolution, in which firms should identify any risks to successful resolution and the plans in place to address them, submit a report of that assessment, and publish a summary of their most recent report ('public disclosure'); and

(iii) that the Bank makes a public statement concerning the resolvability of each firm in scope of the PRA rules when finalised. In so doing, the Bank would identify any shortcomings where it believes there is more work to do.

It is anticipated that in-scope firms would submit the first round of self-assessments from 2020. For branches or material subsidiaries of overseas banking groups, the RAF will be used by the Bank to engage with relevant home authorities to ensure that these overseas banking groups have the ability to execute a successful resolution.

In support of firms' resolvability, we published rules with respect to operational continuity in resolution (OCIR). The rules focus on ensuring that firms identify the functions that are critical, and the services, infrastructure, assets, contracts, and third party services they would rely upon to ensure critical functions would continue in the event of resolution. Over the course of 2018–19 we focused on ensuring firm readiness ahead of the rules taking effect from 1 January 2019. This meant supervising and reviewing firms' progress in implementing the rules, and testing firms' deliverables such as service catalogues and service mapping arrangements. This work spanned both UK and international firms. OCIR will help to inform the work on the RAF and supports evidencing of how firms are overcoming operational barriers to resolution.

In October 2017, the EBA consulted on changes to the Implementing Technical Standards (ITS) on information for resolution planning with the aim of further harmonising data collections and facilitating data exchange within resolution colleges. In August 2018 we issued an update on resolution planning information and expectations noting that we would delay resolution pack Phase 1 submissions for relevant firms until 2020 as we assess the impact of the ITS.[1]

In June 2018 the Bank published its approach to setting internal minimum requirements for own funds and eligible liabilities (MREL) and the setting of external MREL for multiple point of entry groups,[2] and we set out our final expectations for the reporting on MREL. This will help us and the Bank to monitor firms' progress towards meeting end-state MREL requirements. UK firms will be subject to interim MREL requirements from 1 January 2020, with final requirements coming into force in 2022.

Solvent wind-down programme

In 2018–19 we continued to develop solvent wind-down capabilities at firms with significant trading activities, in collaboration with the Bank's Resolution Directorate, the FSB, and international regulators to ensure a co-ordinated and effective approach. This has focused on firms developing their analytical frameworks and planning capabilities for the exit of these faster moving, and potentially more complex, elements of the balance sheet. We are now in a position to move towards establishing the target end-state capabilities firms will need to develop to wind down their trading and derivative books in an orderly manner, and respond with appropriate speed to changes in market conditions.

1 SS19/13 'Resolution planning'; www.bankofengland.co.uk/prudential-regulation/publication/2013/resolution-planning-ss.

2 'The Bank of England's approach to setting a minimum requirement for own funds and eligible liabilities (MREL)'; www.bankofengland.co.uk/paper/2018/boes-approach-to-setting-mrel-2018.

Resolvability for insurers

The UK's resolution regime does not extend to insurers. Our work continues with international partners to develop an integrated regime of resolution powers for insurance companies. To achieve this, we have actively engaged with the IAIS to update the Insurance Core Principle 12 on 'Exit from the market and resolution'[1] and on the resolution framework covered in the Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame).

We continue to stay sighted on EU developments in this area. EIOPA published its 'Discussion paper on systemic risk and macroprudential policy in insurance' in March 2019,[2] which discusses the benefits of potential tools to identify or mitigate systemic risk, including recovery and resolution framework for (re)insurers to deliver increased policyholder protection and financial stability in the EU. The European Systemic Risk Board (ESRB) also published its report 'Macroprudential provisions, measure and instruments for insurance' in November 2018.[3] The ESRB report describes systemic risks in the insurance sector and makes the case, from a macroprudential perspective, for a harmonised EU-wide recovery and resolution framework for insurers.

In addition, we have continued our work with systemically important insurers to implement the FSB's 2016 guidance 'Developing effective resolution strategies and plans for systemically important insurers',[4] and have continued to develop and enhance our resolution plans and resolvability assessments.

1 www.iaisweb.org/page/supervisory-material/insurancecore-principles/file/69884/draft-revised-icp-12.

2 https://eiopa.europa.eu/Pages/News/EIOPA-publishes-Discussion-Paper-on-Systemic-Risk-and-Macroprudential-Policy-in-Insurance.aspx.

3 www.esrb.europa.eu/news/pr/date/2018/html/esrb.pr181126.en.html.

4 www.fsb.org/2016/06/developing-effective-resolution-strategies-and-plans-for-systemically-important-insurers/.

Deliver a smooth transition to a sustainable and resilient UK financial regulatory framework following the UK's exit from the EU

The UK's withdrawal from the EU is a large and complex process that has implications for the way we discharge our responsibilities, and has continued to be a significant focus of our work over the past year. A key priority has been to ensure continuity in the event that the UK has not approved a withdrawal agreement when the UK ceases to be a member of the EU. We have worked closely with affected firms to ensure robust contingency plans are in place; and the UK has taken legislative steps to avoid disruptions to cross-border services in a no-deal scenario. And consistent with the Bank's wider statutory objective of financial stability, we continue to support the FPC in identifying, monitoring, and mitigating financial stability risks arising from the UK's withdrawal from the EU.[1]

A major part of our work to prepare for EU withdrawal has been the authorisation of firms using their EEA passport to operate in the UK. Under the new temporary permissions regime (TPR), EEA firms that have been passporting into the UK can continue to operate for a limited time after the UK leaves the EU while they seek authorisation. We have been in close contact with firms and home supervisors throughout the year and will continue to work closely with them on their applications in the next period.

We have worked closely with HM Treasury and other regulatory authorities (including the FCA) to ensure that the domestic regulatory framework for PRA-authorised and regulated firms is fully functional at the point at which EU law ceases to apply in the UK. This has included reviewing over 10,000 pages of legislation, working with HM Treasury to develop necessary amendments to legislation which have now been delivered through 50 statutory instruments, and providing technical advice for the development and drafting of the EU (Withdrawal) Act.

Building on our previous engagement with firms on their preparations around EU withdrawal, in October and December 2018 we consulted on changes to PRA rules, and binding technical standards (BTS) arising from EU withdrawal. Those consultations also set out guidance on the process for authorisation for incoming European Economic Area (EEA) firms, including the TPR. In February 2019, we published communications, including 'near-final' policy,[2] which sought to do three things:

(i) confirm our intention to provide firms with broad transitional relief with respect to changes to their regulatory obligations in the event that the UK withdraws from the EU without an Implementation Period;

(ii) confirm our approach to changes to PRA rules and BTS as a result of EU withdrawal; and

(iii) set out the roles and responsibilities the Bank will be taking on if the UK leaves the EU without an Implementation Period.

We and the FCA have been working closely with EU authorities to secure agreements between relevant authorities which will ensure continued close co-operation and information sharing in order to carry out our supervisory responsibilities when the UK leaves the EU.

1 The FPC's assessment of the resilience to the UK financial system to Brexit at the end of the 2018–19 reporting period was contained on pages 5–7 of 'Financial Policy Summary and Record — March 2019'; www.bankofengland.co.uk/financial-policy-summary-and-record/2019/march-2019.

2 www.bankofengland.co.uk/news/2019/february/amendments-to-financial-services-legislation-under-the-eu-withdrawal-act-2018-ps-and-other-materials. In preparation for circumstances where a withdrawal agreement is not agreed between the EU and UK, on Thursday 18 April 2019, the Bank and PRA published final policy materials including EU Exit Instruments, Supervisory Statements (SSs), and a Statement of Policy (SoP) (the appendices to Section B of PS5/19).

Operate effectively by ensuring that resources are allocated to work that best advances our strategy and reduces the greatest risks to the delivery of our strategic objectives

Embedding the plan for PRA IT

In line with the implementation of our regulatory change agenda, we have continued to make incremental improvements to data storage and analytics to support our assessment of firms' safety and soundness. This has included the initial implementation of new tools that allow us to build reports with more in-depth and visual representations of data — for example the collection and analysis of structural reform data from the new ring-fenced banks, that has led to the creation of a new suite of supervisory reports. As part of our commitment to developing regulatory technology, we will continue to develop our supervisory desktop solution, with further developments to incorporate authorisations-related processes and the management of our firms' master data.

Building on our work over recent years to implement a more consistent approach to new regulatory reporting requirements (recognised with the 'Best Use of RegTech' award at the Banking Technology Awards 2018),[1] we have also collaborated with other areas of the Bank on our RegTech strategy which aims to ensure that we continue to identify improvements to our ways of working and make good use of new and available technology. This includes collaboration with other regulators to share knowledge and good practice.

In 2018–19 we completed a proof of concept that showed machine learning techniques could help us analyse the unstructured management information we receive from firms. We are progressing with a project that will scale up this capability across the PRA, and also investigating other ways that machine learning and other technologies could improve the efficiency of our operating procedures.

Risks to the delivery of the PRA Business Plan, unforeseen events, and execution risk

Our approach to risk management is part of the Bank's risk framework and in 2018–19 we continued to provide additional granularity for risks and issues most relevant to the PRA. Our internal planning horizon remains on a three-year cycle, which allows management and the PRC to take a strategic view of resource needs and availability. Our business planning cycle captures our risk mitigation plans, which provides increased oversight of how these risks are aligned with our risk assessment framework. We have also continued to strengthen our risk and performance reporting against our annual business plan to ensure that we have a view of progress against plans, which is reviewed periodically by the PRC.

Internal factors

Recruitment has remained focused and targeted throughout 2018–19 to ensure we evolve our staff skills in line with the changing financial landscape. We continue to deliver targeted training to develop our staff, and we have been working with our internal training specialist to develop our learning frameworks. Our prioritisation of work and resource has strengthened to ensure we are focusing on doing what matters most.

The PRA has worked with other areas of the Bank to identify and mitigate General Data Protection Regulation (GDPR) risks during 2018–19 since it was implemented on 25 May 2018. Controls have been strengthened to ensure that processes handling personal data are appropriately documented.

1 For more information, see https://awards.bankingtech.com/.

Measuring progress
In 2018–19 we continued to draw on a variety of information to monitor the progress of delivery against our statutory objectives, strategy, and business plan on an ongoing basis.

The PRC and the Supervision, Risk, and Policy Committee received information on a regular basis, both quantitative and qualitative measures and indicators, to enable an assessment of delivery against the PRA strategy, business plan, statutory objectives, and risk tolerance. This enabled the PRC to report to the Chancellor of the Exchequer on the adequacy of resources and provide sufficient information on supervisory processes and outcomes (see pages 10–11).

FCA: effective regular co-ordination
We have continued to co-ordinate with the FCA across a range of supervisory and policy matters, and assessed our performance every quarter against the statutory Memorandum of Understanding (MoU). In particular, we and the FCA have worked collaboratively on the UK's withdrawal from the EU, covering a wide range of policy, authorisation, and supervisory matters.

The co-ordination between supervisory, policy, and specialist teams has continued to be strong, with open dialogue, ongoing engagement, and co-ordination of activity on matters of joint interest, notably cyber security and operational resilience. We have both proactively shared information, where appropriate, with ongoing discussions on replacing systems, sharing regulatory data, and developing shared principles.

Enforcement also continues to be an area of close collaboration. Joint investigations have been conducted in accordance with the MoU and its annexes through regular meetings and scheduled updates (see Box 3 on page 22 for an overview of enforcement activity for 2018–19). Both regulators have also worked closely on the authorisation of new firms and applications for the SMR.

We have also continued to engage with the relevant teams at the FCA to share the outcomes of respective firm feedback surveys, and to embed suggested changes to strengthen the current regulatory landscape.

Firm feedback
We seek input from firms on the effectiveness and quality of our supervisory framework and approach. One of the ways we do this is through the annual firm feedback survey. The survey gives PRA-authorised firms the opportunity to comment on their experience of being supervised. The survey seeks views from a range of firms on a number of topics, including:

- our understanding of firms and their markets;
- firms' understanding of our regulatory objectives and expectations;
- the level of challenge from us to the firm;
- effectiveness of firms' relationship with us; and
- our co-ordination with other regulators.

We ask a combination of standard questions and provide firms with the chance to make additional comments.

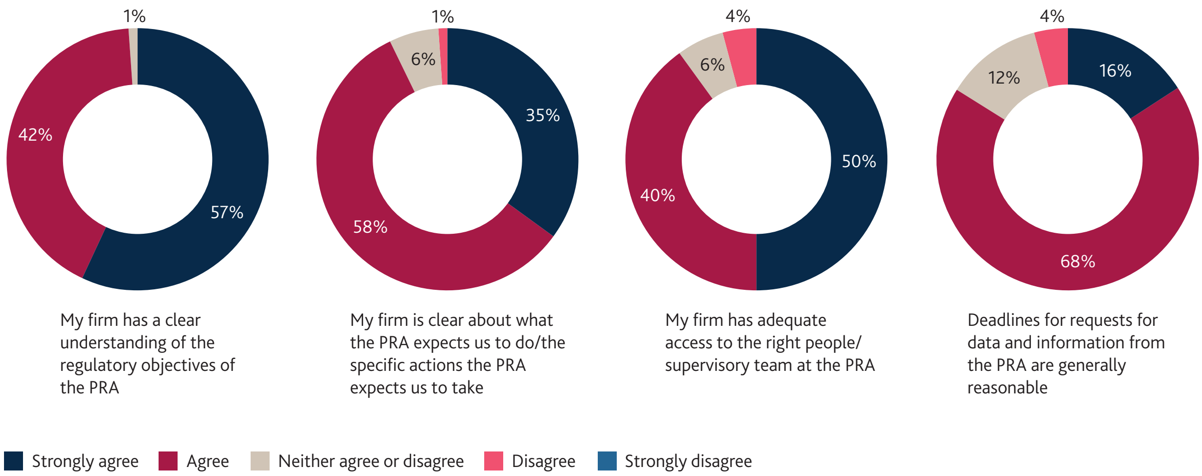
For this year — our sixth — the level of engagement with the survey increased slightly with a response rate of 82%. Follow-up meetings were also held with 25 of the largest firms, and we plan to trial the expansion of firm feedback meetings to a sample of smaller firms.

Overall, the results were broadly in line with last year's survey and there was a further modest improvement in survey response scores. The most positive responses were around understanding the PRA's objectives and the supervisory relationship. Firms also commented positively around co-ordinated messaging between us and the FCA on key high-level issues, such as the UK's withdrawal from the EU or cyber risk.

The feedback did, however, suggest a number of areas for improvement:

- Our rationale and deadlines for information requests continues to be raised by some firms. Survey responses have, however, become more positive in recent years following measures to improve efficiency in the number and content of requests made.
- Some firms commented that they could not meet a deadline for giving feedback on a 'public working draft' (ie a technical report that is a work in progress) that was published alongside a consultation about technical changes to a reporting format. We will in future explain the purpose of materials on which we are seeking feedback and, where possible, give advance warning to allow firms sufficient time to respond.
- A number of firms raised issues with navigating the prudential regulation section of the Bank's website and, where we have been given specific examples, we are looking to make improvements. In addition, some firms flagged difficulties with our secure email portal system, which have since been resolved.

Figure 1: Selection of firm feedback survey results 2018–19[1]



1 The full results are available on the Bank's website; www.bankofengland.co.uk/prudential-regulation/supervision.

Box 4: Parliamentary accountability

Our objectives are set by Parliament. We take our accountability to Parliament very seriously and representatives of the PRA aim for the highest standard in this regard.

Sam Woods, Sandy Boss, David Rule, Jill May, Julia Black, David Belsham, Sarah Breeden and Lyndon Nelson collectively appeared at seven public hearings with parliamentary committees, including the Treasury Select Committee (TSC) and the National Security Strategy Committee (NSSC), as follows:

- The UK's economic relationship with the European Union, 29 January 2019 (TSC).[1]
- The work of the Prudential Regulation Authority, 23 January 2019 (TSC).[2]
- The UK's economic relationship with the European Union, 4 December 2018 (TSC).[3]
- Appointment of Jill May as an external member of the Prudential Regulation Committee, 12 September 2018 (TSC).[4]
- Appointment of Julia Black as an external member of the Prudential Regulation Committee, 12 September 2018 (TSC).[5]
- The work of the Prudential Regulation Authority, 11 July 2018 (TSC).[6]
- Cyber Security: Critical National Infrastructure, 23 April 2018 (NSSC).[7]

As well as appearing before Committees, representatives of the PRA wrote to parliamentary committees to answer queries or requests for information. Written submissions to parliamentary inquiries included:

- Amendments to financial services legislation under the European Union Withdrawal Act 2018, 28 February 2019.[8]
- Audit of Goldman Sachs, 16 July 2018.[9]
- Investigation of the Co-operative Bank plc during the period 2008–13, 11 June 2018.[10]

1 http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/treasury-committee/the-uks-economic-relationship-with-the-european-union/oral/95642.html.

2 http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/treasury-committee/the-work-of-the-prudential-regulation-authority/oral/95451.html.

3 http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/treasury-committee/the-uks-economic-relationship-with-the-european-union/oral/93283.html.

4 http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/treasury-committee/appointment-of-jill-may-as-external-member-of-the-prudential-regulation-committee/oral/89510.html.

5 http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/treasury-committee/appointment-of-julia-black-as-external-member-of-the-prudential-regulation-committee/oral/89509.html.

6 http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/treasury-committee/the-work-of-the-prudential-regulation-authority/oral/86831.html.

7 http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/national-security-strategy-committee/cyber-security-critical-national-infrastructure/oral/81998.html.

8 www.parliament.uk/documents/commons-committees/treasury/Deputy%20Governors%20Bank%20of%20England%20to%20Chair%20re%20Amendments%20to%20financial%20service%20legislation%20(1).pdf.

9 www.parliament.uk/documents/commons-committees/work-and-pensions/Correspondence/180716-Sam-Woods-to-chair-audit-of-goldman-sachs.pdf.

10 www.parliament.uk/documents/commons-committees/treasury/Correspondence/2017-19/Senior-Responsible-Officer-PRA-to-Chair-re-Prudential-regulation-of-the-Co-operative-Bank-11-june-2018.pdf.

Box 5: Communications — supporting the PRA's objectives

A vital part of the delivery of our statutory objectives and supervisory approach is the PRA's industry-wide communications. This includes publications, briefings, speeches, and letters to firms and industry participants on both policy and supervisory activity.

In 2018–19 we:

- Provided communications to industry to support key initiatives, including preparations for EU withdrawal to ensure a fully functioning legal and regulatory framework for financial services, implementing the ring-fencing of the largest UK banks' retail banking services, delivering a series of improvements to our implementation of Solvency II, and developing the microprudential supervisory approach to operational resilience.
- Continued to provide updates on dedicated webpages for initiatives such as strengthening accountability, structural reform, Solvency II, CRD IV, and stress testing, and supported the Bank in the creation and updating of pages on initiatives such as EU withdrawal and climate change.
- Published a number of documents across the range of our regulatory and supervisory activities — including policy aligned with other areas of the Bank and the FCA. We also published 9 speeches, 15 letters, and 15 other publications. Areas covered included the risks posed by cyber and other operational incidents, our work on climate change, updates on disclosures about IFRS 9 expected credit losses, Solvency II-related updates, and updates on our policy to deliver a smooth transition ahead of the UK's withdrawal from the EU.
- Continued to issue the monthly PRA Regulatory Digest, which remains one of our most downloaded publications.
- In addition to the written word, continued our engagement with firms and other industry participants in a variety of forms. We have hosted briefings on a range of topics, and provided speakers and panellists for a number of events hosted by others, including the FCA, overseas counterparts, trade and professional bodies.

2018–19 policy publications[1]

1
Discussion Paper

29
Consultation Papers

37
Policy Statements

49
Supervisory Statements

5
Statements of Policy

1 www.bankofengland.co.uk/prudential-regulation/policy.

Complying with FSMA

This section covers a number of issues that we take into account when carrying out our duties or other areas that we report on.

These include:

- complying with FSMA;
- complying with the Regulators' Principles and Code;
- our complaints scheme;
- details of how we have used the provisions of section 166 of FSMA; and
- sections 339A and 339B of FSMA relating to firms' auditors.

Complying with FSMA

In carrying out our functions during the reporting period, we were required to, so far as was reasonably possible: (i) act in a way which advances our general objective to promote the safety and soundness of PRA-authorised persons; and (ii) specifically for insurers, act in a way which contributes to the securing of an appropriate degree of protection for those who are or may become policyholders (sections 2B and 2C of FSMA). This report sets out how we have discharged our functions and the extent to which, in our opinion, the objectives have been advanced. Section 3B of FSMA sets out a number of regulatory principles to which the PRA must have regard (under section 2H(2) of FSMA) in discharging its general functions. These are the:

(a) need to use resources in discharging our general functions in the most efficient and economic way;

(b) 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) desirability of sustainable growth in the economy of the UK in the medium or long term;

(d) general principle that consumers should take responsibility for their decisions;

(e) responsibilities of the senior management of persons subject to requirements imposed by or under FSMA, including those affecting consumers, in relation to compliance with those requirements;

(f) desirability where appropriate of exercising our functions in a way that recognises differences in the nature of, and objectives of, businesses carried on by different persons (including different kinds of persons such as mutual societies and other kinds of business organisations) subject to requirements imposed by or under FSMA;

(g) desirability in appropriate cases of publishing information relating to persons on whom requirements are imposed by or under FSMA, or requiring such persons to publish information, as a means of contributing to the advancement by the PRA of its objectives; and

(h) principle that the PRA should exercise its functions as transparently as possible.

We take these principles into consideration when carrying out our functions, including when making policy.

Further, in carrying out our functions during the reporting period, we were required to, so far as was reasonably possible, act in a way which facilitated effective competition in the markets for services provided by PRA-authorised persons in carrying on regulated activities (section 2H(1) of FSMA). There are several examples of how meeting this requirement was achieved in the PRA Annual Competition Report on pages 48–53.

Details of how we have met our general duty to consult (under section 2L of FSMA) and consider any representations made (undersection 2N of FSMA) can be found on page 40, which also explains how the PRA engages with firms more generally. These arrangements include the establishment and maintenance of the PRA Practitioner Panel (the Panel) under section 2M of FSMA. The Panel is an independent body representing the interests of practitioners in the financial services industry. It plays an important role in PRA policymaking by providing appropriate challenge and scrutiny. As well as PRA policies, the Panel also considers items from other directorates within the Bank of England whose policies have a potential prudential impact.

In 2018–19 the Panel met four times and provided the PRC and senior management from across the PRA and Bank with feedback on topics including structural reform, IFRS 9 implementation, climate change, and preparations for our work on the UK withdrawing from the EU. The Panel continued to provide input into policy at different stages of development — from practical insights into implementation, to proposals under consultation, to early stage policy development. In 2018 we decided to create a new Insurance sub-committee of the Panel, to provide a dedicated forum to discuss our policies and practices related to the insurance sector. The sub-committee met for the first time in July 2018. Details of the Panel, including its annual reports, can be found on the Bank's website.[1]

The PRA and FCA have a duty to ensure a co-ordinated exercise of functions and to maintain a memorandum of understanding describing how they intend to comply with that duty (under sections 3D and 3E of FSMA respectively). Details of how this has been managed effectively is covered on page 37.

We have the power to require the FCA to refrain from taking certain actions, specified under section 3I of FSMA, or to give a direction to the FCA in relation to with-profits policies (section 3J of FSMA). We did not exercise this power during 2018–19.

Section 354B of FSMA outlines our duty to co-operate with other persons (whether in the UK or elsewhere) who have functions similar to us, or have functions relevant to financial stability. Details of how we have complied with this duty are set out in Box 2 on page 20, and page 37.

Regulators' Principles and Code

In accordance with sections 21 and 22 of the Legislative and Regulatory Reform Act 2006 and the Legislative and Regulatory Reform (Regulatory Functions) Order 2007, the PRA, when exercising its functions, is required to have regard to the following Regulators' Principles and Code.

Regulators' Principles

- Regulatory activities should be carried out in a way which is transparent, accountable, proportionate and consistent.
- Regulatory activities should be targeted only at cases in which action is needed.

Regulators' Code

- Regulators should carry out their activities in a way that supports those they regulate to comply and grow.
- Regulators should provide simple and straightforward ways to engage with those they regulate and hear their views.
- Regulators should base their regulatory activities on risk.
- Regulators should share information about compliance and risk.
- Regulators should ensure clear information, guidance and advice is available to help those they regulate meet their responsibilities to comply.
- Regulators should ensure that their approach to their regulatory activities is transparent — including publishing on a regular basis, details of their performance against their service standards, including feedback received from

1 www.bankofengland.co.uk/prudential-regulation/pra-practitioner-panel.

those they regulate and data relating to complaints about them. Details of firm feedback is set out on pages 37–38; details of complaints are set out below; and the PRA's statutory performance report is published on the Bank's website.[1]

PRA's complaints scheme

As part of the statutory Complaints Scheme (under Part 6 of the Financial Services Act 2012), we are responsible for ensuring formal complaints against us are dealt with in an efficient and effective manner. During the reporting period we received four formal complaints. Three of those complaints were excluded as the subject matter was not within the scope of the scheme. The remaining complaint was not upheld. In this period the Financial Regulators Complaints Commissioner separately considered one complaint against the PRA which dated from 2013. This related to an aspect of the complaints process in 2013 that was reviewed and amended by the PRA in 2014. This complaint was upheld and details of this can be found on the Commissioner's website.[2]

Section 166 reports by skilled persons

Section 166 (s166) of FSMA provides a regulatory tool which gives us powers to obtain an independent expert review of aspects of a regulated firm's activities. Such reviews can be undertaken where we seek additional information, further analysis, expert advice and recommendations, or assurance around a particular subject. In 2018–19 we used the s166 tool 17 times (2017–18: 16 times). We commissioned nine reviews (2017–18: three) where we contracted directly with the skilled person.

The reviews mainly covered regulatory reporting, prudential capital, and risk management and controls. The reviews fell within the areas shown in **Table 1**.

Table 1: Section 166 reviews by areas of focus

Lot	Total for 2017–18	Total for 2018–19
Prudential — Deposit-takers, recognised clearing houses, and PRA-designated investment firms	7	4
Prudential — Insurance	6	7
Controls and risk management frameworks	3	5
Governance and individual accountability	0	1

The total estimated cost of commissioned s166 reviews in 2018–19 was £4.2 million (2017/18: £6.5 million) and the cost per review ranged from £84,000 to £499,000 (2017/18: £40,700 to £2.3 million).[3] Of this total, the cost of the nine reviews where we contracted directly with the skilled persons is estimated to be £2.4 million[4] (2017/18: three at a cost of £1.1 million). The costs disclosed include actual costs incurred by the firms or an estimate where actual costs are not yet available.[5]

1 www.bankofengland.co.uk/prudential-regulation/authorisations.

2 http://frccommissioner.org.uk/.

3 The comparative figures have been revised from the figures reported in the PRA Annual Report 2017–18 to reflect actual costs incurred.

4 Costs of directly contracted s166 reviews include VAT.

5 We do not have a reliable estimate of the cost for one review commissioned late in the period and therefore no cost has been included in the total cost of commissioned s166 reviews in 2018–19. We expect to be able to include the cost for this review in the comparatives reported in the PRA's Annual Report for 2019/20.

Meeting with auditors

Under section 339A(2) of FSMA the PRA is required to issue and maintain a code of practice which includes arrangements on the: (i) sharing with auditors of PRA-authorised persons of information that we are not prevented from disclosing; and (ii) exchange of opinions with auditors of PRA-authorised persons. We published Legacy SS7/13 'The relationship between the auditor and the supervisor: a code of practice' (the Code) in April 2013.[1] Section 339B of FSMA states that we must make arrangements for meetings to take place at least once a year with the auditor of any PRA-authorised person to which section 339C of FSMA applies. 34 firms (2017–18: 38) fell within the scope of section 339B FSMA during the reporting period and we conducted 46 meetings (2017–18: 51) with the auditors of these firms. At least one meeting with the auditor of each such firm was held during the reporting period.

We look to auditors to contribute to effective supervision by directly engaging with us in a proactive and constructive way. We also report to the PRC annually on the quality of the relationship between auditors and supervisors. For the period to 28 February 2018, we reported to the PRC that the overall quality of the relationship between auditors and supervisors was satisfactory.

Structural reform

From 1 January 2019, the PRA's general safety and soundness objective has been amended to reflect the aims of structural reform (also referred to as ring-fencing). The PRA's amended objective requires us to discharge our functions in a way that seeks to:

(i) ensure that the business of RFBs is carried on in a way that avoids any adverse effect on the continuity of the provision in the UK of core services;

(ii) ensure that the business of RFBs is protected from risks (arising in the UK or elsewhere) that could adversely affect the continuity of the provision in the UK of core services; and

(iii) minimise the risk that the failure of an RFB, or of a member of an RFB's group, could affect the continuity of the provision in the UK of core services.

Schedule 1ZB of FSMA requires the PRA to report in its Annual Report in general terms on certain aspects of ring-fencing including: the extent to which RFBs have complied with the ring-fencing provisions in legislation and PRA rules; the steps taken by RFBs to comply with the ring-fencing provisions; the steps the PRA has taken to enforce the ring-fencing provisions; the extent to which RFBs are undertaking activities that would be excluded or prohibited but for an exception in the legislation; and the extent to which RFBs appear to have acted in accordance with PRA guidance relating to the ring-fencing provisions.

Banking groups have had a degree of discretion when deciding how to comply with ring-fencing requirements, reflecting their current operations and preferred business strategies. The legislation specifies the activities that must be conducted by RFBs, as well as the activities RFBs are prohibited from undertaking. Any activities falling outside those two categories — for example taking deposits from large corporates, or mortgage and credit card lending — can sit either side of the ring-fence in the new group structures. As a result, some groups have restructured so that the vast majority of their business will sit within their ring-fence, with only a small amount of

1 www.bankofengland.co.uk/prudential-regulation/publication/2013/the-relationship-between-the-external-auditor-and-the-supervisor-a-code-of-practice-ss.

prohibited activity sitting outside, while others have chosen to place as much activity outside their ring-fence as the legislative requirements allow.

In the past year, firms have taken a number of steps to restructure their groups to ensure their compliance ahead of the implementation deadline. These steps varied to some extent across firms as a result of their chosen implementation strategies but included:

- Establishing new banks.
- For the largest firms, using a court approved 'ring-fencing transfer scheme' to transfer assets and liabilities between legal entities in their group in order to separate core services from activities that are prohibited or excluded by the ring-fencing legislation. Independent 'skilled persons' were required to review the banks' plans; we and the FCA provided views to the court and representations from the public were invited before the courts made their decisions. Each transfer received approval from the courts and all were executed smoothly in 2018.
- Implementing sort code changes.
- Completing a number of SMF changes to ensure the groups had full boards in place for their RFBs and other entities in their groups.
- Joining relevant payment systems where the RFB was not already a direct participant.
- Putting in place new policies and procedures, or restructuring existing arrangements, in relation to transactions and arrangements between group entities to ensure that RFBs comply with rules on independent decision-making and intragroup arrangements. For example, the need for an RFB to interact with its wider group only on arm's length terms, as it would with third parties.
- Reviewing and amending contracts with service providers to ensure the services required by the RFB to carry out core deposit taking cannot be disrupted as a result of the acts or omissions of its group.

The ring-fencing provisions are numerous, detailed and wide-ranging, touching on many aspects of the operations of the banks subject to them. While RFBs, for the most part, complied with the individual ring-fencing provisions and associated guidance, we were notified about a small number of isolated instances of non-compliance. For example, some firms had not updated all of their contracts with service providers to ensure compliance with the rules by 1 January 2019. However, all non-compliance issues of which we were notified were resolved promptly or, where immediate rectification was not possible, firms put remediation plans in place. Overall, we consider that all firms have successfully delivered structural reform in a manner that supported the PRA's objectives and was consistent with the intended outcomes of the ring-fencing regime.

We have not taken any enforcement action in respect of the ring-fencing provisions in the past year.[1]

1 For information on the use of the PRA's statutory powers see www.bankofengland.co.uk/prudential-regulation/pra-statutory-powers.

RFBs' use of exceptions

The activities of RFBs are restricted by the ring-fencing legislation. For example, the legislation[1] prohibits RFBs from carrying on 'excluded activities' and 'prohibitions', including:

- dealing in investments or commodities as principal;
- incurring exposures to relevant financial institutions (RFIs);
- accessing payment systems indirectly; and
- having branches or subsidiaries in a country which is not an EEA Member State.

The legislation also sets out certain permitted exceptions to these 'excluded activities' and 'prohibitions' to allow RFBs to carry out activities which they would otherwise be prohibited from undertaking.

We require an RFB to have policies in place ('exceptions policies') which specify in detail the circumstances in which it will make use of exceptions relating to hedging, liquid assets, and collateral. Throughout ring-fencing implementation we have assessed RFBs' use of exceptions, which included detailed reviews of RFBs' exceptions policies. This has informed our assessment of the extent to which RFBs undertook activities that would be excluded or prohibited but for an exception in the legislation.

The legislation includes exceptions to permit RFBs to deal in investments as principal or to incur exposures to RFIs where the sole or main purpose of the associated transaction is to hedge risks. These hedging exceptions are important as they allow RFBs to manage the financial risks on their balance sheet prudently. The vast majority of the hedging exceptions used by RFBs were those relating to hedging changes in interest rates and hedging changes in exchange rates. In comparison, the exceptions related to hedging other risks, such as changes in share price indices or consumer price indices, were used less. RFBs also use the liquid asset exception which allows them to hold liquid assets and manage their liquidity.

RFBs used the exceptions available to them that permit dealing in investments for the purpose of providing collateral in connection with a transaction, the sole or main purpose of which is to hedge risks. These exceptions were most commonly used by RFBs to hold collateral associated with derivatives transactions and, in particular, derivatives transactions used for the purpose of hedging changes in interest rates and changes in exchange rates.

The legislation also provides exceptions to the excluded activities and prohibitions to permit RFBs to provide certain services to its customers that it would otherwise be prevented from providing, for example, providing trade finance services or selling simple derivatives to its account holders. Not all RFBs are utilising these exceptions. Where an RFB is making use of the exceptions to sell derivatives to their account holders, the extent to which it can conduct this activity is restricted by volume and risk limits defined in ring-fencing legislation.

There is a transitional provision in the legislation that permits an RFB to retain or sell investments after 1 January 2019, provided that: (a) the investment in question was acquired before 1 January 2019; and (b) the investment is due to mature by 31 December 2020. RFBs used this exception to varying degrees — some used it for a comparatively large number of transactions while others did not make use of it at all. This was mainly dependent on the way firms structured themselves to deliver structural reform and their approaches to the ring-fencing transfer scheme.

1 FSMA 2000 (Excluded Activities and Prohibitions) Order 2014, as amended by the FSMA 2000 (Ring-fenced Bodies, Core Activities, Excluded Activities and Prohibitions) (Amendment) Order 2016.

RFBs used exceptions to access certain payment systems indirectly, which includes where the PRA has granted permission for indirect access due to exceptional circumstances.[1] RFBs used these exceptions to access a large number of international payment systems indirectly. This was mostly where an RFB used the system irregularly or where the RFB had small volumes and values in the system. Generally, RFBs were direct participants in the main UK payment systems that they used, or, where those payment systems were accessed indirectly, this was through another RFB in the same group. During the reporting period, there were a small number of cases where an RFB was not directly accessing a UK payment system that it used, but in those cases the RFBs in question had plans in place to join the relevant systems in 2019.

The legislation permits an RFB to have a participating interest in a non-EEA undertaking where that undertaking is an ancillary services undertaking and does not carry on any activities that would be regulated activities if carried on in the UK (eg non-EEA services companies). A small number of RFBs have relied on this exception.

Going forward we will be conducting ongoing supervisory activities relating to the use of exceptions. RFBs are also required to report annually to us on their use of certain exceptions. The first set of these reports will be available to us in March 2020, covering the period of January to December 2019.

1 The PRA's policy on granting such permissions is set out in SS8/16 'Ring-fenced bodies (RFBs)', December 2017; www.bankofengland.co.uk/prudential-regulation/publication/2016/ring-fenced-bodies-ss.

Annual Competition Report — June 2019[1]

Part 1: Application of the secondary competition objective in our work

This section of the Annual Competition Report (ACR) provides an update on key areas in which we have delivered against the secondary competition objective (SCO). The focus of these areas is to reduce barriers to entry and expansion in the banking and insurance sectors, identifying opportunities for delivering a proportionate regime, while also considering the sustainability of firms' business models.

1.1 Facilitating effective competition in retail banking: an update on the progress made so far

Update on the New Bank Start-up Unit (NBSU)

The NBSU is a joint initiative between us and the FCA. The NBSU's aim is to give information and support to firms thinking of becoming a bank in the UK. The NBSU has three principal ways of working with prospective new banks: (i) a single point of contact; (ii) a dedicated website;[2] and (iii) the provision of periodic seminars. The NBSU also provides an alternative route to becoming a fully operational bank — 'mobilisation' — introduced in 2013 as part of 'A review of requirements for firms entering into or expanding into the banking sector: one year on'.[3]

We have authorised 40 new banks since the PRA was formed in April 2013, 17 of which are UK-based banks. The remaining 23 are subsidiaries set up to comply with ring-fencing, and subsidiaries or branches of overseas banks. There continues to be a healthy pipeline of potential new entrants, with interest from around 52 firms, 10 of which have formally applied to become a bank. This pipeline represents a diverse range of potential business models, the majority of which leverage technology to service customers. Business models include: the provision of digital retail banking and business banking services, including current account offerings; consumer credit, secured and unsecured lending; and SME lending, the latter often focussing on niche markets, for example by sector or by geographic location.

We noted that in December 2018, the FCA published an evaluation report[4] on changes to entry into the UK banking sector. The report concluded that the changes have had a positive impact on the number of firms entering the banking sector and provided better outcomes for some consumers. However, the report also concluded that it has not yet had a substantial effect on competition and the broader retail banking sector.

Specifically, as set out in its report, the FCA found that in the four years since 2013:

- The UK has seen an increase in the number of firms authorised relative to the average for the other EU jurisdictions.
- Entrants offer between 30 to 100 basis points more on interest rates for fixed-term deposit accounts compared to other banks. In addition, comparing similar loans taken out in 2017, mortgages by post-review entrants are

1 The Annual Competition Report (ACR) has been produced in response to a request from the Government included in HM Treasury's 2015 Productivity Plan 'Fixing the foundations: creating a more prosperous nation' that the PRA should publish an annual report setting out how it is delivering against its secondary competition objective (SCO) and, in particular, 'the steps it is taking to drive more competition and innovation in financial services markets and to help ensure that the right incentives exist for new banks to enter the market'. All versions of the ACR are available on the Bank's website; www.bankofengland.co.uk/prudential-regulation/secondary-competition-objective.

2 www.bankofengland.co.uk/prudential-regulation/new-bank-start-up-unit.

3 www.bankofengland.co.uk/prudential-regulation/publication/2014/review-of-requirements-for-firms-entering-into-banking-sector.

4 www.fca.org.uk/publication/corporate/ep18-3.pdf.

an average of 25 basis points cheaper for two-year fixed mortgages and an average of 45 basis points cheaper for five-year fixed mortgages compared to other banks.

- Entrants have grown their deposit-taking and lending activities faster than entrants have before 2013 and have gained almost twice the market share of lending and deposits than entrants had in the four years before 2013. However, the share of post-2013 entrants was only around 0.5% of lending by all banks and around 0.8% of all banks' deposits by the end of June 2017.

Delivering on IRB model applications for small firms

We finalised a review of our approach to IRB credit risk model applications from smaller banks and building societies in October 2017.[1] Facilitating access of smaller banks and building societies to IRB models removes a competitive disadvantage. The alternative, standardised approach raises these firms' funding costs above that of their rivals using IRB risk models. We clarified our expectations for applying for IRB model approval because of the review. We now focus on: (i) how firms can demonstrate that they meet the requirements of the CRR on 'prior experience' of using IRB approaches; and (ii) the use of external data to supplement internal data for estimating probability of default and loss given default for residential mortgages. At the same time, we introduced a pre-engagement programme to deliver early bilateral discussions with firms seeking to use an IRB model, and developed a modular review process to provide greater transparency and earlier feedback to firms that apply for permission to use an IRB model.

Since launching the review, we have approved three additional firms. This brings the total number with IRB permission to 19. Feedback received from one of those firms indicated that the new modular approach is succeeding in providing greater clarity and transparency to firms regarding the review process and on how they are progressing as intended. There are now 18 firms at different stages in the pipeline: eight firms have indicated they are considering pre-engagement; five firms are actively planning an application; three firms are engaging to identify any major issues and to receive preliminary feedback before application; and two firms have applications under review (as at 28 February 2019).

Implementing the refinements to the Pillar 2 capital framework

In December 2017, we finalised our refinements to the Pillar 2A capital framework.[2] These provide a framework applied as part of a capital review for supervisors to consider systematically the appropriateness of a reduction in variable Pillar 2A add-ons for firms using the standardised approach for credit risk to ensure the total amount of a firm's capital does not exceed the amount necessary to ensure the sound coverage of risks. To date, a significant number of firms have benefited from a reduction to their Pillar 2A add-ons of between 0%–2%.

1.2 Recent application of the SCO in our work

This section of the ACR presents recent examples demonstrating how we have taken the SCO into account in the course of developing new and reviewing existing policies. This section does not feature the various occasions where the SCO has been engaged with respect to supervisory, firm-specific decisions that could be perceived as defining a policy position because they are precedent setting.

1 PS23/17 'Internal Ratings based (IRB) approach: clarifying PRA expectations'; www.bankofengland.co.uk/prudential-regulation/publication/2017/internal-ratings-based-approach-clarifying-pra-expectations.

2 Statement of Policy 'The PRA's methodologies for setting Pillar 2 capital': www.bankofengland.co.uk/prudential-regulation/publication/2015/the-pras-methodologies-for-setting-pillar-2-capital.

Facilitating entry in the insurance sector

In August 2018, we (jointly with the FCA) launched the New Insurer Start-up Unit (NISU),[1] building on our experience with the NBSU. The NISU aims to improve the authorisation process for prospective new insurers. The NISU is part of the regulators' ongoing work to develop bespoke and clear guidance on the authorisation process, and provide ongoing information and support to applicant firms. The NISU will ensure authorisation processes in the UK are effective and efficient. The NISU webpage received more than 2,300 visits in the six months since its launch.

We also held a series of industry roundtable discussions to gather feedback from experts on the authorisation process, and hear how a strong pipeline of new insurers can be further facilitated. We are interested to hear from others on perceived barriers to entry in the insurance industry and possible measures to address them.[2]

As part of its next steps, we and the FCA are considering how the approach to authorising and supervising new insurance firms could be adapted. Potentially, this may allow for a mobilisation (or 'authorisation with restriction') phase, as is available for new banks.

In 2017, following HM Treasury introducing the Risk Transformation Regulations (RTR), we launched our UK Insurance Linked Securities (ILS) regime, creating the regulatory framework allowing Solvency II compliant UK insurance special purpose vehicles (ISPVs) to be established. ISPVs perform a regulated activity called 'insurance risk transformation': assuming insurance risk from insurers/reinsurers and facilitating the issuance and selling of ILS in the capital markets to fund the reinsurance.

We and the FCA have authorised five ISPVs since the RTR was introduced in 2017, four of which were in the period 1 March 2018 to 28 February 2019. The authorisations include the first two multi-arrangement ISPVs, which allow vehicles taking on more than one contract for risk transfer from one or more cedants. A more streamlined process has been developed for authorising UK ISPVs, and applications that represent a relatively straightforward proposal, and are supported by good quality documentation have been authorised within two months.

In line with our commitment to work closely with the industry, we have sought feedback from previous applicants in order to review whether any further enhancements can be made to the ISPV application process. We intend to release further guidance to the market to provide more information to potential applicants and share some of our early experience.

Nine new firms were authorised in 2018–19

4 Banks	1 Insurer	4 ISPVs

1 www.bankofengland.co.uk/prudential-regulation/new-insurer-start-up-unit.

2 Further information, including contact details for feedback and input, is available on the NISU webpage; www.bankofengland.co.uk/prudential-regulation/new-insurer-start-up-unit.

Facilitating effective competition by clarifying expectations regarding the prudential treatment of equity release mortgages held by insurers

ERMs are designed to convert accumulated equity into regular income, drawdowns and/or initial lump sum while allowing borrowers to remain in their homes. They are designed for older borrowers, typically 55 years or older. There are generally no monthly repayments and any repayments can be ceased at the option of the borrower. Compound interest is added to the loan each year, and the loan and accumulated interest are repaid usually from the sale of the property when the borrower dies or goes into long term care. Under the 'no negative equity guarantee' (NNEG), repayments are limited to the value of the underlying property. Therefore, the risk faced by the lender resulting from the NNEG is higher the longer the borrower lives, and also higher when the growth in property prices is lower.

Following our prior work and publications in this area, we consulted on proposals in July 2018 to ensure that insurers investing in ERMs do not underestimate the NNEG risk to which they are exposed.[1] Encouraging a common approach to measuring the level of NNEG risk across firms means that a more level playing field is achieved, and so facilitating effective competition with sustainable pricing strategies and firms properly reflecting the risks to which they are exposed.

Levelling the playing field by extending the leverage ratio framework

As of January 2019 we began to apply leverage ratio requirements on a sub-consolidated basis to those RFBs whose groups are already required to meet leverage ratio requirements on a consolidated basis.[2]

Under leverage ratio requirements, banks are required to hold a minimum level of Tier 1 capital against their assets regardless of the individual risk weightings applied. The aim of the leverage ratio is to maintain consistency with the risk-weighted framework by guarding against the danger that models or standardised regulatory requirements fail to assign risk weights that reflect the true underlying risk of assets. The leverage ratio can also protect banks against scenarios which are thought to be 'low risk' or are unforeseen altogether until they occur. It also limits firms' incentives to respond to increases in risk-weighted capital requirements by reducing estimates of risk weights or shifting asset composition.

The application of the leverage ratio requirements to RFBs holds domestic systemically important banks to a higher standard that is commensurate with the additional risks they pose to the UK economy. In addition, the leverage ratio may aid competition by reducing the barriers to entry and expansion for firms that do not have permissions to use internal models to risk weight some of their assets. The risk of competitive distortion between firms with internal models and those following a standardised approach may be reduced where this proposal leads to an increase in capital requirements for firms that become constrained by the leverage ratio.

1 This followed CP13/18 'Solvency II: Equity release mortgages' published in July 2018; www.bankofengland.co.uk/prudential-regulation/publication/2018/solvency-ii-equity-release-mortgages.

2 PS28/18 'UK leverage ratio: Applying the framework to systemic ring-fenced bodies and reflecting the systemic risk buffer', November 2018; www.bankofengland.co.uk/prudential-regulation/publication/2018/uk-leverage-ratio-applying-the-framework-to-systemic-rfbs-and-reflecting-the-srb. This proposal came into force in January 2019.

Increasing proportionality by focusing the requirements under the Resolvability Assessment Framework on larger banks

In December 2018, alongside a Bank consultation, we consulted on proposed rules for large banks and building societies to assess their preparations for resolution, submit a report of their assessment to the PRA, and publish a summary of their report ('public disclosure').[1] These proposals are designed to ensure that firms that pose the greatest risk to UK financial stability are adequately preparing for resolution. To this end, these proposals are aimed at increasing firms' accountability and encouraging ownership of their progress by ensuring that market participants and firms' stakeholders are informed of these preparations.

These proposals will facilitate effective competition to the extent that they improve confidence of market participants that large firms can exit the market in an orderly fashion. The proposals would not raise barriers to entry in retail banking as they currently focus on firms with retail deposits greater than or equal to £50 billion because their failure would have the largest impact on financial stability.

Part 2: Implementing the SCO

This section of the ACR sets out how we have continued the process of embedding the SCO into our policy and supervisory decision making. It also provides a summary of our competition-focused research activities and engagement with external stakeholders.

2.1 Effective processes

Previous versions of the ACR have outlined the steps we have taken to put effective processes in place which ensure that our staff responsible for developing and reviewing prudential policy always consider the SCO. As part of our continued effort to embed the SCO, a new internal competition e-learning training programme, which is complementary to existing training on the SCO, is being made available for all of our staff. In addition, the internal governance process has been strengthened further by requiring that an explanation of the impact on the SCO arising from the issue under consideration, which is already included from the start of the development of any response to an issue, is explicitly included upfront in all papers submitted to the PRC.

The 2017 ACR[2] explained how we had continued the process of embedding the SCO into our policy and supervisory decision making in response to the recommendations made by the Bank's Independent Evaluation Office (IEO) in its 2016 review of our approach to the SCO.[3] The IEO has recently undertaken a final review of our response to its recommendations, confirming that all of them have been fully implemented.

2.2 Research agenda

We are committed to maintaining a flow of policy-oriented research projects aimed at deepening our understanding of the complex relationship between prudential regulation, financial stability, and effective competition. The research agenda is important as it helps our understanding of competition in the sectors that we regulate and helps inform us of the impact policy initiatives are likely to have on competition. Since the publication of last year's ACR: (i) the Staff Working Paper that was featured in the 2017 ACR has been published in

1 CP31/18 'Resolution assessment and public disclosure by firms'; https://www.bankofengland.co.uk/prudential-regulation/publication/2018/resolution-assessment-and-public-disclosure-by-firms.

2 www.bankofengland.co.uk/prudential-regulation/publication/2017/pra-annual-competition-report-2017.

3 www.bankofengland.co.uk/independent-evaluation-office/secondary-competition-objective-evaluation-march-2016.

the European Journal of Finance;[1] and (ii) a Staff Working Paper looking at the historical relationship between competition and financial stability in the UK banking sector has been published.[2] In addition, a new paper seeking to understand from a theoretical perspective how Open Banking might affect the relationship between competition and prudential regulation has been presented at a conference hosted by the European Central Bank in March 2019, as part of the 50th anniversary celebration of the Journal of Money, Credit and Banking (JMCB). The research proceedings of this conference will be published in a 50th anniversary special issue of the JMCB. Finally, the preliminary results from an ongoing research project looking to evaluate the impact of the refinements to the Pillar 2 capital framework are presented in Section 1.1 of this ACR.

2.3 Engagement with external stakeholders

On 17 January 2019, Governor Mark Carney hosted a roundtable event to mark the fifth anniversary of the SCO. Sam Woods, Deputy Governor for Prudential Regulation and PRA CEO gave a speech highlighting the concrete impact of the SCO.[3] The speech drew attention to the successes of the NBSU, highlighted the need to reduce the excessive gap between risk weights for low loan-to-value residential mortgages under the IRB and standardised approaches, and noted a number of related moves to help entry and expansion in the insurance sector. A number of questions for us on competition and the SCO were published in the speech, including:

- How does the PRA square the principle of proportionality with rising regulatory requirements as firms grow, and how can small firms become big firms given this potential barrier to expansion?

- How does the PRA manage the tension between efforts to encourage new and smaller players, with the need to maintain a close supervisory interest in monitoring small and fast-growing firms?

- How will new technology disrupt the banking sector, and will technology be a gateway to a bigger change?

- With a limited scope to take actions, will the inevitable slowing of new competition initiatives in the future be taken as a sign that the PRA's efforts on competition are reducing even though there is no such reduction in commitment?

The Governor then chaired a panel with commentary from Sir John Vickers (Professor of Economics at University of Oxford, previously Chair of the Independent Commission on Banking), Jill May (external member of the PRC, previously a member of the Competition and Markets Authority (CMA) Inquiry Group into retail banking), Dame Jayne-Anne Gadhia (recently appointed as an external member of the FPC,[4] previously CEO of Virgin Money), and Frédéric Jenny (Chair of the Organization for Economic Co-operation and Development (OECD) Competition Committee).

In the discussion, it was noted that institutional objectives of safety and soundness (and financial stability) and competition are aligned when policies address the problem of 'too-big-to-fail' banks. More broadly, if prudential standards are adequate there is no trade-off between these two objectives. It was argued that perhaps the most effective way to ensure that competition concerns are reflected in regulatory decisions is to give the regulator a formal secondary objective to facilitate competition, while meeting its primary objectives. In this respect, as one speaker noted, our SCO is not only a unique feature of the UK institutional architecture but unique from a global perspective too.

1 www.tandfonline.com/doi/abs/10.1080/1351847X.2019.1574270?journalCode=rejf20.

2 www.bankofengland.co.uk/working-paper/2018/bank-competition-and-stability-in-the-united-kingdom.

3 www.bankofengland.co.uk/speech/2019/sam-woods-secondary-competition-objective-five-years-on.

4 Set to join the FPC in April 2020.

Financial review of 2018–19

The PRA incurred operating costs in 2018–19 of £278 million (2017–18: £280 million). Costs continued to include exceptional and non-recurring items such as the Structural Reform Programme, and the UK's withdrawal from the EU. Where these exceptional costs are attributable to a particular segment of our authorised population we will typically raise a Special Project Fee, otherwise they will fall to our fees in relation to ongoing regulatory activity.

Against our budget (£274 million), the PRA came in above by £4 million, and due to additional income received in the year of £1 million the additional call on firms for the next financial year is £3 million. This was predominantly due to retiming of work relating to the UK's withdrawal from the EU carried over from 2017–18, and an increase in related activity.

Under the Bank of England and Financial Services Act 2016, the Bank is required to present financial and other disclosures in respect of its activities as the PRA. These are available on pages 152–160 of the Bank's Annual Report and Accounts 2018–19.[1]

1 www.bankofengland.co.uk/annual-report/2019.

Abbreviations

ACR	Annual Competition Report
Bank	Bank of England
BCBS	Basel Committee on Banking Supervision
CEO	Chief Executive Officer
CET 1	Common equity Tier 1
CMA	Competition and Markets Authority
Court	Bank's Court of Directors
CP	Consultation Paper
CRD	Capital Requirements Directive (2013/36/EU)
CRD IV	CRR and CRD collectively
CRR	Capital Requirements Regulation (575/2013)
DP	Discussion Paper
EBA	European Banking Authority
ECL	Expected credit loss
EEA	European Economic Area
EIOPA	European Insurance and Occupational Pensions Authority
ERM	Equity release mortgage
ESRB	European Systemic Risk Board
EU	European Union
FCA	Financial Conduct Authority
FinTech	Financial Technology
FPC	Financial Policy Committee
FSB	Financial Stability Board
FSMA	Financial Services and Markets Act 2000 (as amended)
IAIS	International Association of Insurance Supervisors
ICS	Insurance Capital Standard
IEO	Bank's Independent Evaluation Office
IFRS	International Financial Reporting Standard
ILS	Insurance linked securities
IRB	Internal ratings based
ISPV	Insurance special purpose vehicle
IT	Information Technology
LTI	Loan to income
MPC	Monetary Policy Committee
MoU	Memorandum of Understanding
MREL	Minimum requirement for own funds and eligible liabilities
NBSU	New Bank Start-up Unit
NISU	New Insurer Start-up Unit
NSSC	National Security Strategy Committee
OCIR	Operational continuity in resolution
PRA	Prudential Regulation Authority
PRC	Prudential Regulation Committee
PS	Policy Statement
RAF	Resolvability Assessment Framework
RegTech	Regulatory Technology
RFB	Ring-fenced body
RFI	Relevant financial institutions
SCO	Secondary competition objective
SMR	Senior Managers Regime
SM&CR	Senior Managers and Certification Regime
SRB	Systemic Risk Buffer
SS	Supervisory Statement
TPR	Temporary permissions regime
TSC	Treasury Select Committee
VA	Volatility adjustment

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