The Prudential Regulation Authority

An overview

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1 Background and scope

A new structure of financial regulation was introduced in the UK from 1 April 2013 replacing the tripartite system under which responsibility for financial regulation was shared by HM Treasury, the Bank of England and the Financial Services Authority (the FSA). The tripartite system came under fire at the start of the financial crisis in 2007 for failing to address deficiencies within the financial system. Under the new structure the FSA ceases to exist and three new bodies have been created:

– the Financial Policy Committee (the FPC) in the Bank of England, which will be responsible for macro-prudential regulation – regulation of ability and resilience of the financial system as a whole;

– the Prudential Regulation Authority (the PRA), which will become the UK’s prudential regulator for deposit-takers, insurance companies and some investment firms; and

– the Financial Conduct Authority (the FCA) which will have responsibility for conduct of business and markets regulation of all authorised firms, and prudential responsibility for all firms not prudentially regulated by the PRA.

The FSA has been operating a ‘twin peaks’ model internally since 2 April 2012, which foreshadows the new structure. Under the ‘twin peaks’ model there are two groups of supervisors within the FSA, one focusing on prudential and one focusing on conduct. The changes are intended to ensure a smoother transition at legal cutover in April 2013.

This paper reviews the PRA. It concentrates on the PRA’s:

(a) remit/scope and objectives;
(b) approach to regulation/supervision;
(c) statutory powers, accountability and possible challenges;
(d) interaction with the two other authorities and potential problem areas of overlapping powers/authority; and
(e) interaction with the European System of Financial Supervisors.

Schedule 1 and Schedule 2 of this paper contain, respectively, a diagram setting out the regulatory structure of the new regime and a table outlining the functional overview of the PRA.
**Legislation and papers**

The core provisions establishing the new architecture of financial services regulation are found in the Financial Services Act 2012 (the **Act**), which received royal assent in December 2012. The Act has substantially amended the Financial Services and Markets Act 2000 (**FSMA**) and the Bank of England Act 1998, the Banking Act 2009 and s785 of the Companies Act 2006, to reflect the new structure.

The policy objectives and approach of the PRA towards regulation are further set out in a number of papers that have been published by the Bank of England, the FSA and the Treasury. The most recent paper, *The Bank of England, Prudential Regulation Authority: The PRA’s approach to banking supervision* dated October 2012 (the **PRA Approach Paper**), sets out how the PRA will carry out its role in respect of deposit-takers and designated investment firms. There is a second paper *The Bank of England, Prudential Regulation Authority: The PRA’s approach to insurance supervision* setting out the approach to be taken to insurance companies. These papers provide further detail on the approach set out in: *The Bank of England, Prudential Regulation Authority: Our approach to banking supervision* (the **PRA Position Paper**) published in May 2011. The Treasury also produced a paper *A new approach to financial regulation: the blueprint for reform* (the **HMT Paper**), published in June 2011.
2_PRA: Review of scope/remit and objectives

2.1_Scope/remit

*Who the PRA regulates*

The PRA is responsible for the prudential supervision of:

– deposit-takers;
– insurance companies; and
– investment firms that have the potential to present significant risk to the stability of the financial system, designated for supervision by the PRA.

The approach to PRA designation of investment firms is found in the Financial Services and Markets Act 2000 (PRA-Regulated Activities) Order. This statutory instrument sets out the proposed conditions for PRA-regulation. In addition to deposit-takers and insurers, persons that deal in investments as principal will be conducting PRA-regulated activities if:

(a) the person investing as principal is an investment firm that meets the requirement under Article 9 of Directive 2006/49/EC on the capital adequacy of investment firms and credit institutions to have an initial capital of EUR730,000 (or would meet this requirement if the firm was subject to the Directive 2006/49/EC); and
(b) the PRA considers PRA supervision desirable having regard to its objectives.

The factors which the PRA must have regard to in considering (b) above include the assets of the firm, and if the firm is a member of a group, the assets of any other firms within the group which have permission to deal in investments as principal and are required to have EUR730,000 capital, whether any other firms in the group have been designated, and whether the firm’s activities could have a material impact on the PRA’s ability to promote the safety and soundness of other PRA-authorised entities in the group. The explanatory note to the Order states that designations relate to particular firms, rather than a class of firm.

The PRA Approach Paper estimates the PRA will supervise around a thousand deposit-takers, including 330 banks, 50 building societies and 600 credit unions. In addition it will also supervise a small number of investment firms that have the potential to present significant risk to the stability of the financial system.

There have been indications that the PRA will also be ready to scrutinise the ‘shadow banking’ sector, for potential financial stability impact. In particular, unregulated firms within PRA consolidated groups should be prepared for potential enhanced scrutiny in the future.
International firms

The PRA will supervise UK-headquartered and international firms. PRA supervised international firms will include branches passported into the UK from within the EEA, branches from outside the EEA and UK-owned subsidiaries of international firms. Where the PRA does not have direct powers against such firms, it will raise any concerns that it has with the firm’s home state supervisor or at the appropriate international forum. The PRA will be prepared to take a more interventionist approach, including prescribing subsidiarisation for non-EEA branches not subject to equivalent supervision elsewhere. This reflects the increasing trend in both UK and European regulation for a tougher approach to incoming third country firms.

PRA-authorised persons are dual regulated, with their conduct of business being regulated by the FCA. The FCA regulates both the conduct of business and prudential matters of all remaining firms. This is intended to allow the PRA to concentrate its prudential regulation on institutions with the most significant potential impact on the stability of the UK economy. For further information on the relationship between the FCA and the PRA see section 7.1 below.

Areas the PRA regulates

Prudential regulation by the PRA encompasses three key areas:

– policies and rules on firms’ resilience covering such areas as capital adequacy, liquidity and leverage in order to maintain an effective regulatory framework for financial stability;

– supervisory assessments and interventions in order to reduce the probability of a firm’s failure and ensure that, if a firm does fail, it does so in an orderly manner; and

– policies and mechanisms to support resolution in order to reduce the impact of a firm’s failure on the financial system.

The PRA will work closely with the rest of the Bank, including the FPC, in order to combine firm-specific supervision with oversight and risk management of the financial system as a whole. The FPC will have responsibility for reducing risks to the financial system as a whole and will be able to recommend changes to PRA policies and rules on a ‘comply or explain’ basis.
2.2 Objectives

The General Objective

The PRA will have one general objective that it must advance in discharging its general functions. The PRA’s general objective is: promoting the safety and soundness of PRA-authorised persons. The PRA is required to advance this objective primarily by seeking to:

– ensure that the business of PRA-authorised persons is carried on in a way which avoids any adverse effect on the stability of the UK financial system; and

– minimise the adverse effect that the failure of a PRA-authorised person could be expected to have on the stability of the UK financial system.

Nothing in the Act should be regarded as requiring the PRA to ensure that no PRA-authorised person fails. Responsibility for the prevention of a firm’s failure lies with each firm’s management, board of directors and shareholders. The PRA will not view the failure of an institution in an orderly manner as regulatory failure, but as a feature of a properly functioning market. There is a clear intention to send strong signals to the market regarding the lack of any future implicit Government guarantee for failing firms.

The Insurance Objective

In addition to its general objective, the PRA, has an insurance objective. The PRA’s insurance objective is: contributing to the securing of an appropriate degree of protection for those who are or may become policyholders. The PRA must, when discharging its general functions so far as they relate to the effecting or carrying out of contracts of insurance or PRA-authorised persons carrying on that activity, so far as is reasonably possible:

– act in a way which is compatible with its general objective and its insurance objective; and

– act in a way which the PRA considers most appropriate for the purpose of advancing those objectives.

The express reference to the “protection of policyholders” in the insurance context raises some potential questions over whether this could lead to an imbalance vis à vis the interests of banking business, given the lack of any parallel consumer protection obligations for the PRA in this sector. While it is clear from the FSA/government commentary to date that consumer protection will generally be the FCA’s domain, and duplication of functions should be avoided, the FCA’s supervisory role over banks is relatively narrow; and the PRA and FCA will need to co-operate carefully to ensure that the interests of different financial sector consumers are appropriately balanced. This will be particularly important given the proposals in the Independent Commission on Banking’s report, which recommends the implementation of prudential measures (e.g. higher capital requirements) designed primarily to protect retail depositors.
The Specified Objective

The amendments made to FSMA by the Act state that the Treasury may extend the regulated activities that are PRA-regulated and specify additional objectives (the specified objective) in relation to the additional activities.

Guidance on objectives

The PRA must give guidance on how it intends to advance its objectives when discharging its general functions. Such guidance will be with reference to different categories of PRA-authorised persons and different PRA-regulated activities. The PRA must consult the FCA before giving or altering guidance. The PRA must publish such guidance.

Regulatory principles

When discharging its general functions in pursuit of its objectives, the PRA is to have regard to the following eight regulatory principles, which will also govern the approach of the FCA:

- efficiency: the PRA should use its resources in the most efficient and economic way. The PRA should consider the cost-effectiveness and value-for-money of regulation. To reinforce this principle the PRA will be subject to audit by the National Audit Office;
- proportionality: the burden or restriction imposed on a person or activity should be proportionate to the benefits which are expected as a result;
- sustainable growth: the desirability of sustainable growth in the UK economy in the medium or long term. This was introduced to ensure that the regulators did not act in a way that unnecessarily constrained the growth of the financial services sector through pursuing excessive regulation;
- consumer responsibility: the general principle that consumers should take responsibility for their decisions;
- senior management responsibility: the responsibilities of senior management to comply with the regulatory framework;
- business differences: the desirability of recognising differences in the nature and objectives of the businesses of regulated persons;
- openness and disclosure: the desirability, where appropriate, of publishing information about regulated persons or requiring them to publish information; and
- transparency: the PRA should exercise its functions as transparently as possible. This principle aims to ensure that appropriate information is provided on regulatory decisions and that the PRA is more open and accessible to the regulated community and the general public.

The PRA must also have regard for the need to minimise any adverse effect on competition in the relevant markets that may result from the manner in which the PRA discharges those functions.

Interplay of the FPC, PRA and FCA objectives

The FPC, PRA and FCA are each to have their own strategic and operational objectives. In certain areas the ‘boundaries’ between their responsibilities are not entirely clear.

For example, the FPC is required to exercise its functions with a view to contributing to the Bank of England’s achievement of its financial stability objective, which will inevitably overlap with the PRA meeting its general objective.
3_PRA’s approach to regulation/supervision

The PRA’s approach to regulation will consist of both policy making and the application of those policies through effective supervision. It inherits the prudential aspects of the FSA’s policies and handbook. However, the emphasis of supervision will be different.

The PRA’s approach to supervision will be:

- **Forward-looking** – the PRA will go beyond monitoring ‘tick box’ compliance with current rules. It will seek to assess whether, on the balance of risks, there are vulnerabilities in firms’ business models, capital and liquidity positions, governance, risk management and controls that give rise to concerns regarding their future financial position.

- **Supervision according to risk** – the nature and intensity of the PRA’s supervisory approach will be commensurate with the level of risk a firm poses to the stability of the system. Risks to the stability of the system will be assessed using a risk assessment framework (the Risk Assessment Framework) (for further information, see below).

- **Early intervention** – once a potential threat to the safety and soundness of an institution has been identified, the PRA will take supervisory action at an early stage in order to reduce the likelihood of a disorderly failure. A proactive intervention framework (the Proactive Intervention Framework) will support early identification of risks to a firm’s viability and ensure that both firms and authorities take appropriate remedial action to reduce the probability of failure and, where appropriate, prepare for the failure and resolution of a firm (for further information, see below).

- **Focus on the ‘big picture’** – the PRA will seek to understand where the main risks to the stability of the financial system lie so that supervisory interventions will be clearly and directly linked to reducing risk to the stability of the system. An assessment of the significance of a firm to the stability of the financial system will enable supervision according to risk. The PRA will concentrate its resources and actions on firms posing the greatest risks to the stability of the UK financial system.

Firms will be expected to consider the spirit of the rules when managing their businesses. As such, the PRA will not tolerate ‘creative’ compliance with the PRA’s rules and policies, designed to mask the riskiness of their activities or financial exposures.

A corollary of the judgment-led approach is that the PRA will be given considerable discretion in its supervision of firms, which has given rise to some concern. The commentary in the PRA Position Paper, for example, which discusses the PRA’s intention to evaluate and make prescriptions regarding firms’ ‘culture’, but without any ‘right culture’ in mind, could leave firms facing uncertainty over expectations around governance. In response, the Government has stated in the HMT Paper that the PRA’s judgment-led decision making must be “rigorously evidence-based”. In addition, the PRA will put in place the necessary management and oversight processes to support the judgments required from supervisors in its approach. Risk assessment and supervisory interventions for firms will be overseen by PRA senior management.

In order to underscore the specialist expertise of the PRA in exercising judgment in its regulatory and supervisory role, the Upper Tribunal will not be able to substitute its opinion for that of the PRA as to the regulatory action which should be taken by the PRA (except for disciplinary matters and those involving specific third-party rights). This is discussed further in paragraph 5.1 below.
The Risk Assessment Framework

Risks to the stability of the system will be assessed via the Risk Assessment Framework which incorporates a forward-looking approach, taking into account the likelihood of firm failure, the impact of firm failure on the stability of the system, and the feasibility and credibility of orderly resolution. It therefore captures three key elements:

– the potential impact on financial stability both by the way it carries on its business and in the event of coming under stress and failure. Assessment of impact will capture impairment to the capacity of the financial system as a whole to carry out systemically important activities, such as payment services, credit and risk transfer. Normal business activity can adversely affect financial stability where there is risky behaviour or activities that create the possibility of future stress. On failure, the impact of a firm on the stability of the financial system may arise either directly, through the effect of the firm’s failure on real economic activity or the soundness of other intermediaries, or indirectly, through behavioural effects, where weaknesses in one firm affects market confidence in other similar firms;

– how the macro-economic and business risk context in which a firm operates might affect the viability of its business model in a variety of scenarios. This will include a consideration of system-wide risks, taking into account the FPC’s view of the macro-prudential environment and market information gathered by the Bank and the PRA, and actions by the FCA which may materially affect the prudential soundness of PRA-regulated firms. Business risk will be assessed at the level of the sector or of the firm, as appropriate, taking into account peer analysis. Supervisors will consider a firm’s vulnerability to particular events with the potential to create systemic consequences. Firms posing the greatest risk to the stability of the system will be subject to a detailed review including analysis of performance targets, risk appetite and their balance sheets; and

– mitigating factors, which determine the safety and soundness of a firm, that may reduce the potential risk a firm poses to the stability of the financial system. A central factor is the resolvability of the firm, as a firm which can be resolved in an orderly manner will pose a lower risk to the stability of the financial system. The PRA will evaluate a firm’s financial strength, examining the quantity and quality of capital it requires on a forward-looking basis and the adequacy of a firm’s liquidity in quantitative and qualitative terms, to assess its ability to meet its liabilities on an ongoing basis. It will also assess concentrations of risk and undertake forward-looking stress testing. The PRA will assess the quality of a firm’s risk management functions and the strength of its governance arrangements, and take into account the firm’s culture (given the underlying role that it has in influencing business strategy), in order to ensure that the firm is able to marshal data on risk exposures and respond quickly to any deterioration in key indicators.
The Proactive Intervention Framework

The Proactive Intervention Framework aims to:

(a) support early identification of risks to a firm’s viability and ensure that firms take appropriate remedial action to reduce the probability of failure; and

(b) flag actions that the authorities will need to take in advance to prepare for the failure and resolution of a firm, in co-ordination with the Special Resolution Unit (SRU) (as resolution authority) and the Financial Services Compensation Scheme (FSCS) (as operator of the deposit guarantee scheme).

The Proactive Intervention Framework is expected to have five distinct stages. A firm will be placed in a particular stage by reference to an assessment of its viability in both current and future states of the world, but will be revisited in response to specific concerns arising in the external environment in which the firm operates as part of the ongoing supervisory process. Firms will be routinely made aware of where they sit on the framework.

Where the risks to a firm’s viability are judged to be low, that firm will be placed in Stage 1 of the Proactive Intervention Framework. This indicates a normal or ‘baseline’ level of supervisory monitoring and actions. As a firm moves up the stages of the Proactive Intervention Framework, the intensity of supervisory monitoring and the intrusiveness of supervisory actions increases. An example of how a firm might move through the Proactive Intervention Framework and the presumed actions that might be taken at each stage is set out in Schedule 3 of this paper. A number of respondents to the consultation process expressed concern that there was no mechanism in place to protect highly sensitive information such as Proactive Intervention Framework scores from public disclosure. The concerns focused on the fact that any attendant publicity could contribute to the downward trajectory of the firm in question.
4_Statutory powers of the PRA

The government has indicated that the PRA's preference will be to use its statutory powers to secure remedial action which will mean that enforcement action should be relatively rare. In the first instance, it is proposed that the PRA will request that a firm makes suggested changes, giving a clear rationale for the request. If the firm does not act upon the PRA's request or recommendation, and in order to pre-empt risks before they crystallise, the PRA would look to its statutory powers to compel firms to address the emergence of risk where it judged that a firm's failure to take action could result in risk to the stability of the financial system. Where necessary, the PRA will have the power to restrict a firm's permission to operate.

New powers provided by the government to the PRA include:
- power to publish warning notices;
- power to veto certain decisions of the FCA; and
- increased investigative powers.

4.1_Entities covered by PRA rules

Definition of PRA authorised person

Any rules made by the PRA under this section must relate to a “PRA-authorised person”. The definition is broad enough to cover EEA firms establishing branches in, or providing cross-border services into, the UK. The fact that prudential regulation (with the exception of liquidity) is a right reserved to the Home State supervisor means that the PRA would have to work closely with Home State competent authorities to regulate such firms in an effective manner. It would seem strange to unilaterally alter the traditional position, and may not be possible in practice for the PRA to be involved in the regulation of EEA passporting firms. We support the suggestion that the definition be refined.

Unregulated parent undertakings

The PRA has the power, under section 192B of FSMA, to impose requirements on unregulated parent undertakings of PRA-regulated firms. The aim of the power is to ensure that the regulatory framework for the supervision of financial groups is applied as intended, so that the same level of oversight and supervisory powers can be applied irrespective of the legal structure of the group. This power is also available to the FCA, and both regulators must consult each other before exercising it. The requirements that the PRA may impose under this power include a requirement to take specified action or refrain from taking specified action. This would ensure seamless regulation of capital and liquidity over a group structure. However, it could result in the PRA requiring directors of holding companies to breach fiduciary duties or deploy assets to the detriment of creditors.
Approvals and designation criteria

The PRA has the power to develop its own designation criteria in order to determine which firms are within its remit. The power compliments the new section 22A of FSMA, which states that the Treasury may by order specify regulated activities that are “PRA-regulated activities”.

The government has proposed that the PRA should have primary responsibility for designating Significant Influence Functions (SIFs), but where the PRA has not designated a SIF the FCA will be able to, should it choose to do so. A “Significant Influence Function” is defined at the new section 59(7B) of FSMA. The uncertainty in the designation of SIFs is another area of concern for consultation respondents and many bodies expressed the view that consultation and coordination between the PRA and FCA will be key. The PRA and FCA are required to consult each other before specifying a “controlled function” and before withdrawing approvals given by the other.

In terms of permission to carry on regulated activities, the PRA has the power to determine whether a firm’s business model is “suitable”. Once the decision has been taken, the PRA will be able to publish their determination on the issue of “suitability”. No further guidance is given in the legislation as to how this power will be exercised. There is concern about the potentially significant adverse effects the publication of such a determination could have on the reputation of the firm in question. Any publication of a PRA determination that a business model is not “suitable” could, in the words of one respondent, affect “ultimately whether the firm is able to stay in business”.

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4.2 Warning notices

While it is envisaged that the proposed new power allowing regulators to publish information about matters to which warning notices relate will be mainly exercised by the FCA, the PRA will also be given this power. Of the twelve types of warning notice available, only five of them apply to the PRA. The government envisages that the PRA will take a forward-looking approach to prudential issues, requiring remedial action to be taken in advance of problems arising (for example, through restrictions on a firm’s business activities imposed via variations in a firm’s permission to undertake regulated activities) and so while the PRA will have the same powers as the FCA to impose penalties on authorised persons, it is expected that, under the PRA’s approach, disciplinary actions will be relatively rare.

The government’s response to industry concerns is that the power to publish warning notices is expressed as a right rather than a duty, and regulators will be expected to exercise discretion in making decisions about publication on a case-by-case basis. Further, there is an obligation for the regulator to consult with the person about whom the publication is being made.

This response, however, leaves a considerable level of uncertainty about the circumstances and safeguards surrounding the publication of these notices. These are as follows:

– while the PRA may not publish a warning notice if, amongst other things, it considers publication of this information would be “unfair to the person with respect to whom the action was taken (or proposed to be taken)” there is currently no detail about what the PRA will consider to be “unfair” and how it would go about making this decision;

– the process for challenging a decision to publish a warning notice is uncertain as it is not clear whether the process and timing will remain the same as that currently used for giving a warning notice under section 387 of FSMA;

– while section 391(6) of FSMA gives the FCA the right not to publish a warning notice where such publication would be detrimental to the stability of the UK financial system, this safeguard is not replicated in section 391(6A) which covers the PRA. The safeguard concerning publication being detrimental to the safety and soundness of PRA authorised persons does not mean the same thing.
4.3_PRA veto

The new section 3H of FSMA gives the PRA the power to intervene to prevent the FCA from taking action where it considers that action could lead to the disorderly failure of a firm or wider financial instability. The threshold for exercise of this power is high, with three conditions that must be met. Firstly, the FCA must be proposing to exercise its powers in relation to PRA-authorised persons. Secondly, the PRA must be of the opinion that exercise of the power in the manner proposed may threaten the stability of the UK financial system or result in the failure of a PRA-authorised person in a way that would adversely affect the UK financial system. Thirdly, the PRA must be of the opinion that it is necessary to exercise the veto in order to avoid the possible consequences to the UK financial system outlined above.

The PRA may use the veto but is not required to do so. It was suggested during the consultation process that the wording should be amended to create an obligation to exercise the veto where all three conditions are satisfied. The wording leaves uncertainty as to the circumstances in which the PRA may exercise its power. Several commentators have noted that it will be important to ensure that the power of veto by the PRA does not have the effect of relegating the FCA to the role of “junior partner”.

4.4_Statutory guidance

The PRA’s power to issue statutory guidance is limited to matters concerning its objectives as detailed under section 2H of FSMA. It has been noted by some respondents to the consultation that the lack of other statutory framework for PRA guidance is not sufficiently “future-proof”. It was noted that the FCA has the power to issue guidance under section 139A and that no similar provision exists for the PRA. It was also noted that the lack of statutory framework means that the PRA will be entitled to choose whether or not to enter a consultation and make its view public in certain areas. Concerns were raised over the fact that if the PRA chooses to publish informal guidance it will not be required to hold a consultation. It was felt that consultation should not be left to the PRA’s discretion and it was consequently recommended that the PRA be given statutory powers to issue general guidance that mirror those of the FCA. Of further concern was the loss to affected firms of statutory safe harbours should the guidance issued be informal rather than statutory.
Investigations

The government has provided the PRA and FCA with powers equivalent to those held by the FSA to carry out investigations into firms and individuals for enforcement or other purposes. In addition to this, the Government has made the following changes to assist with investigations:

(a) regulators or investigators may retain original documents for as long as necessary for the purpose for which they were requested or until any legal proceedings are concluded;

(b) uniform statutory provisions are to be put in place relating to the execution of warrants and the powers exercised by those accompanying the constable in the execution of the warrant;

(c) original documents seized under a warrant may be retained as long as necessary, but the owner may apply for a court order requiring their return. This will align the period with the retention period available under section 22 of the Police and Criminal Evidence Act 1984; and

(d) the PRA has the power to appoint a skilled person to “collect or update” information where a PRA regulated firm or a PRA-authorised person has contravened a rule that requires it to collect and update information.

This last point has been controversial and has been described as a “significant extension to powers”. Greater clarity will be required as to when the power is proposed to be used. Concerns have also been raised as to the potential cost of this new power to affected firms.
Reporting duty

Both the PRA and the FCA are under a statutory duty to make a report to the Treasury where there may have been a regulatory failure. The trigger for this duty is set out in the Financial Services Act and has two main limbs:

– where public funds have been provided to or in respect of certain persons and where this may have not occurred but for regulatory failure; or

– where serious damage has been caused to the values underpinning the PRA’s objectives and this might not have occurred but for regulatory failure.

If the statutory trigger has been met, the PRA must conduct an investigation and make a report to the Treasury on the results of that investigation. The legislation is drafted in such a way that it is left to the discretion of the PRA as to whether the trigger has been met. However, the Treasury has the power to direct the PRA to conduct an investigation should it believe the trigger to have been met, or that an investigation would be in the public interest. As with many other powers and duties of the PRA outlined above, concerns have been expressed as to how the legislation will guard against disclosure of confidential information that may be included in reports to the Treasury.
5_Challenging the PRA

5.1_Impact of decisions of the Upper Tribunal on PRA decisions

Although the grounds of making a reference will remain unchanged, the courses of action available to the Tribunal in the event that it disagrees with the PRA have been reduced. Under the previous system, the Tribunal had the power to make its own decision in place of one made by a regulator with which it disagrees. Under the Act, that will remain the position for a disciplinary reference or a reference in connection with specific third party rights, but the Tribunal will no longer have the power to substitute its own decision for that of the regulator. The Tribunal will be entitled to either dismiss the reference or remit the decision back to the regulator with a direction to reconsider it and reach a decision in accordance with the findings of the Tribunal on law or fact.

Concerns have been raised that these changes will result in a diminution of the Tribunal reference process. Some commentators have perceived this to be an erosion of firms’ rights to an independent review of contested decisions.

5.2_Operational efficiency

The government proposed that the PRA complaints scheme, set up to handle external complaints dealing with operational matters (rather than regulatory judgments), will be run by the Bank of England.

Given that firms will bear a lot of the burden of regulatory costs, it is of vital importance that the PRA operates as efficiently as possible. The government has stated that the National Audit Office will be able to initiate value for money studies of the PRA.

Commentators have observed that while the PRA must be formally accountable, it should also be responsive to enquiries and concerns about its operational efficiency.
6_Governance of the PRA

6.1_Position within the Bank of England

The PRA is a subsidiary of the Bank of England, as illustrated in Schedule 1. The PRA’s objectives and scope of regulation will complement the role the Bank of England. The Bank of England has a statutory objective of financial stability, similar to that of the PRA. The Bank of England has a central role in the banking system and is responsible for operating the special resolution regime, which will interlink with the regulation of capital and liquidity and recovery and resolution by the PRA. It will be hoped that integrating the PRA into the structure of the Bank of England will also be an important part of delivering the necessary change in culture of the PRA.

6.2_Chairman and Board

The Governor of the Bank of England, the Deputy Governor for Financial Stability and the Chief Executive Officer (CEO) will be members of both the PRA board and the FPC. It is intended to promote co-operation between the bodies. However, there are concerns that it will weaken governance and increase the concentration of power. It could also lead to potential conflicts and self-review, particularly bearing in mind the FPC’s ability to make recommendations to the PRA and the PRA’s discretion whether or not to accept these. This would seem to present an inherent conflict of interest which it would be desirable, and possible, to avoid.

6.3_Information sharing

The PRA is under a statutory duty to disclose any information to the Bank of England that it thinks may assist the Bank in achieving its financial stability objective. This duty will apply regardless of whether the Bank has requested any such information, but does not extend to information which the PRA is prohibited to disclose, either by statute, EU obligation or through the risk of being in contempt of court.

6.4_Duty to consult

The PRA’s duty to consult is much narrower than that of the FCA. While Section 2J of FSMA places the PRA under a statutory duty to put in place arrangements for engaging with practitioners, it leaves the PRA with the discretion to determine how to fulfil this duty. It was noted during the consultation process that the establishment of an expert panel is left to the discretion of the PRA. This was deemed to be unduly vague and respondents called for a statutory PRA Practitioner Panel to be maintained. Commentators were rightly concerned that the absence of a Practitioner Panel will significantly weaken the regulator.
7_Interaction between the PRA and other authorities

7.1_Interaction between the PRA and FCA

Effective co-ordination and co-operation between the PRA and FCA and the PRA and other authorities will be essential to the PRA’s success. The principal focus of the PRA’s co-ordination with the FCA will clearly be at the firm-specific level. Common standards and rules for risks which are directly relevant to both the PRA and FCA’s responsibilities, e.g. governance and controls, will need to be considered.

FSMA does not set out operational arrangements for each of the authorities, e.g. in relation to whether the PRA and FCA will use the same reporting system. Each authority will develop its own regulatory culture and approach to engagement with firms. As a result, dual regulated firms will have to adapt to both.

The PRA and FCA will determine whether there is scope for sharing services. It will be necessary to wait and see what arrangements, if any, will be put in place for overlapping services and functions (particularly in light of the principle in FSMA that the PRA and FCA must each use their resources in the most efficient and economic way).

**Dual regulated firms**

The potential areas of overlap between the PRA and FCA are most prevalent in relation to dual regulated firms, i.e. those firms that will be subject to regulation by the FCA (in relation to conduct matters) and by the PRA (in relation to prudential matters), for example banks and building societies. It will be essential in the new architecture to ensure that a firm is not subject to conflicting rules or instructions from each of the PRA and FCA. The government has recognised this and it has been proposed that the PRA and FCA will put in place arrangements for co-ordinating their operations which will impact dual regulated firms, including:

- supervisory colleges;
- close co-operation during the authorisation process;
- provision for the FCA to notify the PRA before taking enforcement action;
- consideration of how best to put in place common standards and rules for risks which are directly relevant to both authorities’ responsibilities;
- co-ordination in setting rules and policy of each of the PRA and FCA;
- co-ordination in relation to the regulation of with-profits insurance; and
- a requirement that each of the FCA and PRA must include an account of how they have co-ordinated and co-operated in their annual accounts.
Secondary legislation may also require that a matter relating to dual regulated firms is a responsibility of the FCA or PRA.

Diagram 1 depicts the system of dual regulation envisaged by the Act and shows the interaction between the FCA and the PRA.

**Diagram 1: Conduct and Prudential Regulation: Interrelation Between the FCA and the PRA**

### FCA Scope
- Conduct of business and prudential: FCA regulated firms
- All other regulated firms

### PRA Scope
- Conduct of business: FCA regulated firms
  - Deposit takers
  - Insurers
  - Significant investment firms
- Prudential: PRA regulated firms

**Provisions in FSMA relating to co-ordination between the PRA and FCA**

**Statutory duty to co-ordinate**

FSMA contains a statutory duty to ensure co-ordinated exercise of the functions of the PRA and FCA. This includes consultation between the PRA and FCA where a proposed exercise of a function of one of the PRA or FCA may have a material adverse impact on the other regulator advancing its objectives. The duty to co-ordinate also extends to information sharing. However, this duty does not apply if it would not comply with the relevant regulator’s objectives or if it imposes a disproportionate burden on a regulator.

The FCA Position Paper indicates that information gateways will be established between the PRA and FCA to allow the free flow of information where needed.
Duty to establish and maintain a memorandum of understanding

The PRA and FCA must publish and maintain a memorandum of understanding which covers how they will exercise their duty to co-ordinate and exercise those functions that relate to authorised persons and similar or related functions that each regulator undertakes. A draft memorandum has been published, however, it is a very high level summary of the interaction between the parties.

Directions from the PRA to the FCA

The PRA has the power to give directions to the FCA to require it to refrain from taking certain actions, where it proposes to take action in relation to dual regulated firms (or a class/particular dual regulated firm). However, the exercise of this power is limited to circumstances where the PRA considers that the FCA’s exercise of its powers may threaten the stability of the UK financial system or result in the failure of a PRA regulated firm in a way that would adversely affect the UK financial system.

We envisage that this power will therefore have limited application, except in times of crisis for a particular firm or the market more generally. The mere existence of the power sends a signal of which authority is expected to be dictating the tone of regulation.

Cross-membership of boards

The Bank of England’s Deputy Governor for prudential regulation sits on the board of each the PRA and the FCA and so the Act provides for cross membership of these authorities.

Enforcement action

Draft enforcement policy of the PRA recognises there may be cases where both the PRA and FCA have an interest in investigating. In such cases the two regulators will consult to determine which will investigate or whether both will investigate. If both investigate it may be done jointly or in co-ordination.

7.2_Interaction between the PRA and the Bank of England, including the FPC

The PRA must take appropriate steps to co-operate with the Bank of England in relation to the pursuit of its financial stability objective. Both the Bank of England and the PRA input into the macro-prudential supervision of firms. Under the new UK regulatory regime, macro-prudential policy and decisions are the responsibility of the FPC, which sits within the Bank of England. There will be a frequent two-way flow of information and exchange of views between the PRA and the FPC. Although the PRA is charged with making firm-specific decisions, it is inevitable that there will be overlap between such judgements and those which the FPC is making. This will be addressed through some common membership of the PRA board and the FPC.

In addition, the PRA will provide firm-specific information to feed into the FPC’s assessment of the macro-prudential outlook; and the FPC’s analysis of potential systemic risks will help inform the PRA’s judgements on specific types of institutions, sectors and asset classes, including its approach to stress testing and its assessments of future vulnerabilities.

The FPC will give recommendations and directions to the PRA (and the FCA) on the regulatory tools that should be deployed for macro-prudential purposes, including the formulation of those tools. The PRA will be responsible for implementing relevant FPC recommendations on a ‘comply or explain’ basis, and the FPC’s directions in relation to the use of specific macro-tools and for reporting on delivery.
7.3_Interaction between the PRA and the FSCS

The PRA’s assessment of impact will capture impairment to the capacity of the financial system as a whole to carry out activities important to the functioning of the economy. That does not of itself extend to preventing direct losses to uninsured depositors and other creditors. The PRA will recognise that deposit guarantee arrangements operated by the FSCS play an important role in reducing the impact of firm failure, and that surviving firms themselves will have to bear the cost of FSCS payouts.

7.4_International coordination

It is proposed that the Treasury, the Bank of England, the PRA and the FCA will enter into a memorandum of understanding on international co-ordination. This will be necessary to ensure effective co-ordination with the European Supervisory Authorities and other national regulators.

The memorandum of understanding to be entered into between the PRA and FCA will detail how they will co-ordinate relationships with competent authorities outside the UK and with the European Supervisory Authorities.
8_PRA’s interaction with the European System of Financial Supervisors

8.1_The European system of financial supervision

The European System of Financial Supervision (ESFS) came into force on 1 January 2011. The ESFS comprises:

– the European Systemic Risk Board (ESRB), a body charged with macro-prudential supervision;

– three European Supervisory Authorities (ESAs), comprising,
  – the European Banking Authority (EBA);
  – the European Insurance and Occupational Pensions Authority (EIOPA);
  – the European Securities and Markets Authority (ESMA);

– the Joint Committee of the European Supervisory Authorities (Joint Committee); and

– the competent or supervisory authorities in the Member States.

The ESAs operate alongside national regulators, carrying out a micro-prudential role with the aim of strengthening consultation at EU level, harmonising both rules and regulatory enforcement action. The ESAs have binding decision making powers vis à vis national authorities, and in certain circumstances vis à vis financial institutions too. These powers are extensive, and include powers for the ESAs to arbitrate between national authorities involved in the supervision of a cross-border group and where they need to agree or co-ordinate their position.

As a last resort, ESAs also have the power to adopt decisions addressed to individual financial market participants. This power is limited to exceptional circumstances where the competent authority does not comply with the formal opinion addressed to it in relation to: a breach in EU law; an emergency situation requiring coordinated action by national authorities; and disagreements between competent authorities in cross-border situations. This power is also limited to EU law which is directly applicable to financial market participants by virtue of existing or future EU Regulations.

The ESAs therefore have powers which allow them to make decisions which supersede decisions made by national authorities and even make decisions directly affecting financial institutions. The FSA published a number of papers which contain sections which discuss how it intends for the PRA to coordinate with the ESAs and how it views the PRA’s role in the European and global context.

8.2_The ESAs: National supervision versus European supervision

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Schedule 1

Regulatory Structure

Bank of England

FPC
(committee of Court of Directors of BoE)

Susidiary

PRA (limited company, wholly owned direct subsidiary of BoE)

FPC powers of recommendation and direction to address systemic risk

FCA (company limited by guarantee, same legal entity as current FSA)

Prudential Regulation

systemic infrastructure
(e.g. clearing houses)

Prudential Regulation

dual-regulated firms
(e.g. banks, building societies, investment banks)

Conduct Regulation

all other regulated firms
(e.g. investment managers)

Prudential & Conduct Regulation
# Schedule 2

## Functional overview of the PRA

<table>
<thead>
<tr>
<th>Entity</th>
<th>Responsibility</th>
<th>Firms Regulated</th>
<th>Objective(s)</th>
<th>Corresponding European Supervisory Authorities (ESAs)/International Bodies</th>
</tr>
</thead>
<tbody>
<tr>
<td>PRA</td>
<td>Micro-prudential regulation (firm-specific regulation of financial institutions that manage significant risks on their balance sheets) Joint responsibility with FCA for Financial Service Compensation Scheme (FSCS)</td>
<td>Systemically important 'dual regulated' firms (prudential regulation only): Banks, building societies, credit unions, insurers (including friendly societies), Lloyd's of London and Lloyd's managing agents, certain systemically important investment firms (i.e. investment banks) as determined by PRA</td>
<td>Promote safety and soundness of regulated firms In relation to regulated firms that are insurers, contribute to securing appropriate degree of protection for those who are or may become policyholders</td>
<td>European Banking Authority (EBA) voting seat European Insurance and Occupational Pensions Authority (EIOPA) voting seat</td>
</tr>
</tbody>
</table>
## Schedule 3

### Proactive intervention framework

<table>
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<tr>
<th>Stage</th>
<th>Presumed actions</th>
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</thead>
<tbody>
<tr>
<td><strong>Stage 1</strong>&lt;br&gt;Low risk to viability of firm</td>
<td>- Firm subject to the normal supervisory risk assessment process and actions, including recovery and resolution planning.</td>
</tr>
<tr>
<td><strong>Stage 2</strong>&lt;br&gt; Moderate risk to viability of firm</td>
<td><strong>Recovery</strong>&lt;br&gt; - The intensity of supervision would increase. The PRA might set additional reporting requirements, and/or make use of information gathering powers under Section 166.&lt;br&gt; - The PRA would require the firm to act to address deficiencies identified over an appropriate timeframe.&lt;br&gt; - The PRA would consider the case for setting restrictions on the firm’s business activities until such actions had been taken.&lt;br&gt; - The firm would be required to update its recovery plan and may activate it.&lt;br&gt; <strong>Resolution</strong>&lt;br&gt; - The PRA and SRU would undertake a joint review of the firm’s resolution plan in order to identify and initiate any necessary contingency planning, including information required, for resolution.&lt;br&gt; - The FSCS would evaluate the quality of data provided to support a single customer view and any obstacles to payout or deposit transfer.</td>
</tr>
<tr>
<td><strong>Stage 3</strong>&lt;br&gt; Material risk to viability of firm</td>
<td><strong>Recovery</strong>&lt;br&gt; - The PRA may require any of the following actions: a change to management and/or composition of the board; limits on capital distribution; restrictions on existing or planned business activities; a limit on balance sheet growth and/or stricter leverage limits; and setting tighter liquidity guidelines and/or capital requirements.&lt;br&gt; - The firm would be required to draw on the menu of options set out in its recovery plan as appropriate.&lt;br&gt; <strong>Resolution</strong>&lt;br&gt; - The SRU would intensify engagement on contingency planning for resolution and will have all means necessary to obtain the information it considers it needs to carry out that task.</td>
</tr>
<tr>
<td><strong>Stage 4</strong>&lt;br&gt; Imminent risk to viability of firm</td>
<td><strong>Recovery</strong>&lt;br&gt; - The PRA would restate the key deficiencies identified and the scale of the recovery actions needed (including in relation to liquidity and capital). The PRA would set out a timetable for implementation of recovery actions.&lt;br&gt; - Firm-led recovery actions would need to be effected in short order and the firm would need to demonstrate that these were credible and would produce material results.&lt;br&gt; - Actions initiated following activation of the recovery plan, including on asset disposal (or sale of firm) would need to be completed.&lt;br&gt; <strong>Resolution</strong>&lt;br&gt; - The SRU and FSCS would confirm that all necessary actions to prepare for the resolution of the firm had been taken, including that relevant data were readily available.</td>
</tr>
<tr>
<td><strong>Stage 5</strong>&lt;br&gt; Resolution/winding-up under way</td>
<td><strong>Resolution</strong>&lt;br&gt; - The PRA would trigger use of the SRR and the SRU would oversee its resolution/winding up.&lt;br&gt; - The FSCS may be required to effect depositor payout and/or to fund deposit transfer or resolution.</td>
</tr>
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