The Prudential Regulation Authority

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The Prudential Regulation Authority (PRA), as part of the Bank of England, will become the United Kingdom's prudential regulator for banks, building societies and credit unions (collectively deposit-takers), insurers and major investment firms in 2013. This is part of a wider reform of the UK regulatory framework, which will also see the creation of a Financial Policy Committee within the Bank, and a new conduct regulator, the Financial Conduct Authority. This article provides a brief description of the PRA's role and its intended supervisory approach. It summarises some of the key themes of the two more detailed documents about the PRA's intended approach that were published jointly by the Bank and the Financial Services Authority in October 2012.[2]

Introduction

A new regulatory framework for the United Kingdom's financial sector is expected to come into effect in April 2013. This new framework results from reforms proposed in the Chancellor of the Exchequer's Mansion House speech in 2010.[3]

Under the new framework (illustrated in **Figure 1**), the Financial Services Authority (FSA), which is currently responsible for regulation of financial firms from both a 'prudential' and 'conduct' perspective, will cease to exist in its current form. Most aspects of its role will be performed by two new authorities:

- The **Prudential Regulation Authority** (PRA) will, as a subsidiary company, be a part of the Bank of England and responsible for the prudential regulation of banks, building societies and credit unions (collectively 'deposit-takers'), insurers and major investment firms.[4] As prudential regulator, the PRA will promote the safety and soundness of these firms, seeking to minimise the adverse effects that they can have on the stability of the UK financial system; and contribute to ensuring that insurance policyholders are appropriately protected. The PRA's role is described in more detail in this article.

- The **Financial Conduct Authority** (FCA) will be responsible for ensuring that relevant markets function well, and for the conduct regulation of all financial services firms. It will also be responsible for the prudential regulation of those financial services firms not supervised by the PRA, for example asset managers. The FCA will be a separate institution.

The Bank of England will have a responsibility for financial stability, based on an amended statutory objective to protect and enhance the stability of the financial system of the United Kingdom. And, in support of this objective, the **Financial Policy Committee** (FPC) will be established within the Bank, charged with identifying, monitoring and taking action to remove or reduce systemic risks. The FPC, which already exists in interim form, will be able to make recommendations and give directions to the PRA and the FCA on specific actions that should be taken in order to achieve the FPC's objectives.[5]

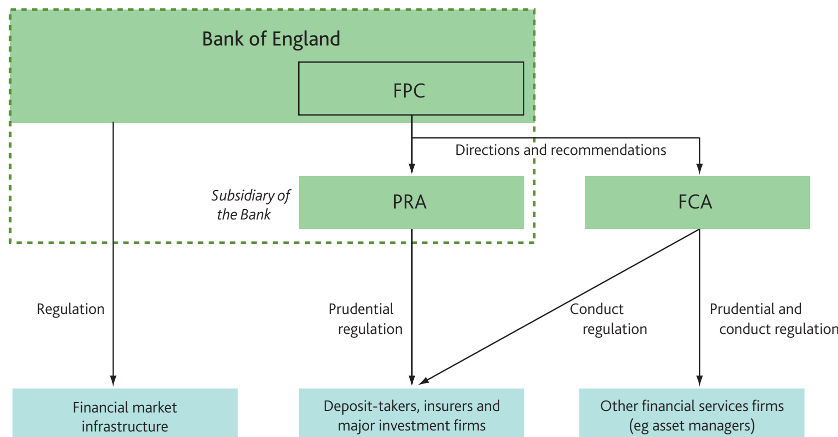
The Bank will also assume responsibility for supervision of central counterparties and securities settlement systems, and will play an increased role in co-ordinating financial sector resilience.

Interaction between the PRA and other authorities

The PRA's objective to promote safety and soundness and the Bank's financial stability objective are complementary. And having the PRA as part of the Bank, with close links to the FPC, will allow the authorities to combine ***firm-specific*** supervision

(1) The authors would like to thank George Speight, as well as Alan Adkins, Marie Bogdan, Deborah Chesworth, Heeral Chhatralia, Robert Dedman, Martin Etheridge, James Farquharson, Nigel Fray, Alex Holmes, Mounir Kenaissi, Gordon McDowall, Diane Moore, Rob Price, Stephen Senior, Anna Sweeney, Ian Tower and Peter Vipond, for their contribution to the two documents on which this article is based.
(2) See www.bankofengland.co.uk/publications/Documents/other/pra/bankingappr1210.pdf and www.bankofengland.co.uk/publications/Documents/other/pra/insuranceappr1210.pdf.
(3) See www.hm-treasury.gov.uk/press_12_10.htm. For more details of the proposals, see www.hm-treasury.gov.uk/d/consult_newfinancial_regulation170211.pdf (note that some details have changed since publication in February 2011; for an up-to-date account, see the Financial Services Bill at http://services.parliament.uk/bills/2012-13/financialservices.html).
(4) The PRA will not regulate all investment firms, only a small number that could present significant risks to the stability of the financial system.
(5) See www.hm-treasury.gov.uk/d/condoc_fpc_tools_180912.pdf.

Figure 1 Simplified picture of the new regulatory framework



Note: In this diagram, 'Financial market infrastructure' refers to central counterparties, securities settlement systems and recognised payment systems.

with work to protect and enhance the resilience of the financial ***system as a whole***. The Chief Executive Officer of the PRA will be a member of the FPC, and will also be a Deputy Governor of the Bank. The PRA will co-operate closely with the rest of the Bank on, for example, oversight of financial market infrastructure. It will also work with the Bank's Special Resolution Unit (SRU) — which plans for and implements resolutions of failing UK banks and building societies — on resolution and operational resilience.

The PRA will also co-operate closely with the FCA. The key principle underlying this co-operation will be that each authority should focus on the key risks to its own objectives, while being aware of the potential for concerns of the other. Separate mandates of the PRA and FCA for prudential and for conduct regulation will allow both regulators to apply more focus to their respective areas than has previously been the case.

The international environment will also affect the operation of the new authorities. Reflecting the international nature of the banking and insurance industries, the PRA will play a full and active role with its counterparts globally and in the European Union. In particular, it will seek to assist in developing and implementing prudential standards, and in supervising firms with international operations.

This article discusses how the PRA will deliver on its statutory objectives. It is organised as follows. The first section describes the PRA's statutory objectives and its overall approach to advancing them. The second section sets out some of the key practices that the PRA will expect of firms in ensuring that they act in a safe and sound manner, consistent with the stability of the financial system and policyholder protection. The third section describes how the PRA will assess the risks that firms pose to its objectives.

The PRA's objectives

The PRA's role as prudential regulator will be grounded in its two statutory objectives:

- To promote the **safety and soundness** of all the firms it regulates. This involves firms having **resilience against failure** and — in the event they do fail, or simply in the course of business — **avoiding harm resulting from disruption to the continuity of provision of financial services**. In promoting safety and soundness, the PRA will be required to focus primarily on the harm that firms can cause to the **stability of the UK financial system**.

- Specifically for insurers, to contribute to the securing of an **appropriate degree of protection for those who are, or may become, policyholders**.

Both of these objectives are underpinned by the principle that a stable financial system, which is resilient in providing the critical financial services the economy needs, is a necessary condition for a healthy and successful economy.

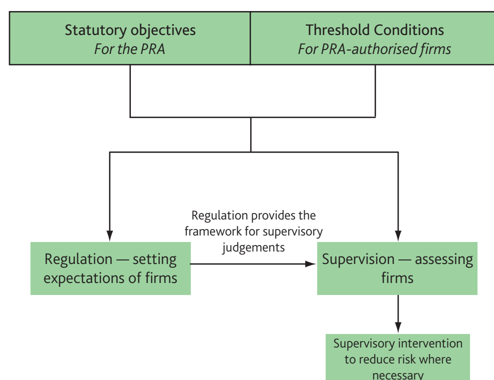
The statute is explicit that it is not the PRA's role to ensure that no firm fails. Indeed, a key principle underlying the PRA's approach will be that it will not seek to operate a 'zero-failure' regime. Rather, the PRA, working with the SRU, will seek to ensure that any firms that fail do so in a way that avoids significant disruption to the supply of critical financial services. This will depend on the efficacy of any statutory resolution regime in place, including any arrangements to compensate depositors and policyholders through the Financial Services Compensation Scheme. Assessing, and planning to contain, the impact of failure will be a core part of the PRA's work.

The statute also requires firms to meet, and continue to meet, certain statutory 'Threshold Conditions' to be permitted to

engage in activities regulated by the PRA. These Threshold Conditions require, for example, firms to maintain appropriate capital and liquidity, and to have suitable management. Though they will be distinct in law, the Threshold Conditions are closely related in substance to the objectives, since they will promote the safety and soundness of firms and policyholder protection. They will be crucial to the operation of the new regime.

The PRA will advance its objectives and promote adherence to the Threshold Conditions by two means. First, by setting out standards, or 'policies', including both detailed rules and higher-level expectations, that it will expect firms to meet — that is, **regulation**. And second, by assessing the risks that firms pose to the PRA's objectives in the context of these policies, taking action where necessary to reduce them — that is, **supervision**. This framework is illustrated in **Figure 2**.

Figure 2 Stylised diagram of the PRA's approach



The PRA's supervisory approach

The PRA's supervisory approach will have three defining characteristics:

- **A judgement-based approach.** The PRA will use judgement in determining whether firms are safe and sound, whether insurers protect policyholders appropriately, and thus whether firms meet, and are likely to continue to meet, the Threshold Conditions. Judgements will be based on evidence and analysis.

- **A forward-looking approach.** The PRA will assess firms not just against current risks, but also against those that could plausibly arise in the future. Understanding the external economic environment will be crucial in this regard. Where the PRA judges it necessary to intervene, it will generally aim to do so at an early stage.

- **A focused approach.** The PRA will focus on those issues and those firms that pose the greatest risk to the stability of the UK financial system and to policyholders. The frequency and intensity of supervision applied to a particular firm will therefore increase in line with the risk it poses to the PRA's objectives.

The PRA's regulatory decision-making will be rigorous and well documented, consistent with public law. Its most significant supervisory judgements will be taken by its Board — comprising the Governor of the Bank of England, the Deputy Governor for Financial Stability, the Chief Executive Officer of the PRA (and Deputy Governor for Prudential Regulation), and independent non-executive members.(1) The Board will be accountable to Parliament, in the same way as the Bank's other statutory decision-making bodies: the Monetary Policy Committee and the Financial Policy Committee.

How firms can pose risks to the PRA's objectives in practice

In promoting the safety and soundness of firms, the PRA must focus primarily on avoiding adverse effects on the stability of the UK financial system.

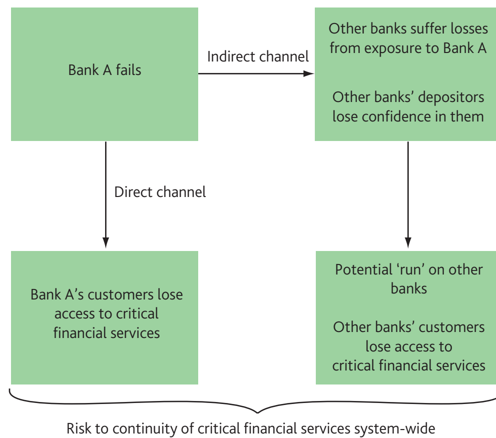
Firms can affect the stability of the system through the way in which they carry on their business. For example, a bank could compete for business too aggressively and thus contribute to risky behaviour across the system as a whole. And the investment strategy of general or life insurance companies might have consequences for the rest of the system if the scale of their assets allows their investment decisions to accentuate movements in asset prices.

Firms also have the potential to affect the stability of the financial system adversely by failing. These effects can be direct; for example, the failure of a bank could prevent its depositors from accessing their funds and hence from undertaking economic activity. They can also be indirect; for example, the failure of a bank could affect confidence in other banks and financial intermediaries more generally. Indirect effects are of particular concern for deposit-takers, given their role in providing 'maturity transformation' of deposits and other short-term liabilities on the one hand, into longer-term assets — typically loans — on the other. This maturity mismatch makes deposit-takers vulnerable to contagion following the failure of other firms. These direct and indirect channels are illustrated in **Figure 3**.

Traditional insurers do not generally threaten the stability of the financial system in the same way as deposit-takers. Nonetheless, their failure has the potential to affect the real economy adversely. For example, the sudden withdrawal of general insurance in areas such as compulsory motor insurance, trade finance, or marine or aviation cover has the

(1) Non-executive members who participate in decision-making — of which there will be at least as many as Bank executive members — will be individuals with a proven successful track record in public service, banking, insurance or other relevant financial services. They will be appointed by the Court of the Bank with the approval of HM Treasury. The CEO of the FCA will also be a non-executive member of the Board, but will not take part in regulatory decisions.

Figure 3 Channels through which the failure of a deposit-taker can affect financial stability



potential directly to affect the ability of individuals or companies to undertake real economic activity. This underlies the PRA's other objective, to contribute to securing an appropriate degree of protection for insurance policyholders. Specifically, the PRA will seek to ensure that there is a reasonably high probability that an insurer can meet claims from, and material obligations to, policyholders as they fall due; and to ensure that adverse consequences for policyholders of an insurer's failure are minimised.(1)

The box on page 358 describes why a prudential regulator is required in greater detail.

Regulation — setting expectations of firms

Advancing the PRA's objectives will ultimately rely on firms conducting their business in a safe and sound manner, consistent with the stability of the financial system and policyholder protection. The PRA will therefore **regulate** firms, setting out expectations it will have of them and which they must meet if the PRA's objectives are to be advanced. The PRA will expect firms to adhere to the spirit as well as to the letter of its expectations, and to maintain sight of the overall principles of safety and soundness and, in the case of insurance firms, policyholder protection.

In large part the PRA's expectations will reflect the statutory Threshold Conditions that firms will legally be required to meet. In broad terms, the Threshold Conditions will require firms: to have an appropriate amount and quality of capital and liquidity; to have appropriate resources to measure, monitor and manage risk; more generally to conduct their business prudently; to be 'fit and proper';(2) and to be capable of being supervised effectively by the PRA.

The PRA will communicate these, and further expectations relevant to its objectives, under the broad headings of management and governance, risk management and controls, capital, liquidity and resolvability. Robustness in all of these areas will be critical to reducing the risks that firms pose to the PRA's objectives. The PRA's main expectations in each of these areas, and the rationale for its interest, are described below.

Management and governance

It is the responsibility of each firm's board and management to manage their firm prudently, consistent with safety and soundness, the stability of the financial system and, in the case of insurance firms, policyholder protection. The PRA will therefore take a significant interest in the way that firms are run, and in ensuring that firms and their management are fit and proper.

The overall culture of a firm is a key determinant of its behaviour, and hence whether it acts in a manner consistent with the PRA's objectives. The board and senior management of a firm are responsible for setting and embedding that firm's culture. While there is no single 'right' culture, the board should ensure that the principles of safety and soundness and, where applicable, policyholder protection, are embedded throughout the whole organisation. This includes firms following the PRA's policies in line with their spirit and intended outcome — not managing their business only to the letter, or gaming the rules. It includes boards holding management to account. And it includes firms having in place sufficient controls to minimise incentives for excessive risk-taking, for example remuneration structures that reward careful and prudent management.

Firms need to be run by people who are competent to fill their roles. It is the responsibility of boards and senior management to ensure this. The PRA will also have the power under statute to require individuals with a significant influence on the affairs of a firm (for example, the Chair and the Chief Executive) to seek PRA approval before taking up their position. Such individuals will be expected to demonstrate competence, probity and integrity.

Firms need also to be structured in a way that enables management to run them prudently, and enables the regulator to supervise them effectively. This includes clear structures of accountability and delegation of responsibilities. And, crucially, it requires that the group structure within which a firm sits does not impede that firm's effective supervision.

Risk management and controls

The PRA will attach particular importance to firms managing risk effectively, because it is the crystallisation of risk, or

(1) Policyholders will also be protected by the FCA as conduct regulator. The FCA will seek to ensure that consumers are treated fairly in their dealings with insurers.
(2) This includes a firm complying in an appropriate manner with obligations imposed by the PRA, and having management that acts with probity and has adequate skills and experience.

Why do we need a prudential regulator?

It is likely that, in the absence of prudential regulation, deposit-takers, insurers and investment firms would be less resilient against failure, and risk more disruption to the continuity of financial services, than is in the public interest. This box explains the key factors driving this, and which prudential regulation aims to counter.

Banks, building societies and credit unions

Prudential regulation of banks, building societies and credit unions is necessary for a number of reasons.

First, because of the typically **liquid nature of its liabilities**, it is possible for a deposit-taker to be subject to a 'run' — whereby a large number of customers attempt to withdraw their deposits at the same time — even if the deposit-taker is solvent. This outcome unnecessarily destroys economic value. Deposit guarantees and central bank liquidity insurance can address this problem. But these backstops in turn reduce the incentives for firms to manage their business in a prudent manner (so-called 'moral hazard'), creating the potential for excessive risk-taking in the absence of prudential regulation.

A second motivation for prudential regulation relates to the potential for the failure of a deposit-taker to **harm the stability of the financial system more widely**. For example, a bank that fails could cause depositors to lose confidence in other banks with similar business models, triggering a run as described above. ***At an individual level***, firms have no incentive to take into account such system-wide effects, but ***collectively*** they share an interest in a stable financial system. They thus face a 'collective action' problem. And, crucially, the risk that the failure of a firm could cause wider disruption to the financial system underpins expectations of the state providing solvency support to them. This moral hazard again compounds incentives for excessive risk-taking and reduces market discipline. Prudential regulation aims to address these issues.(1)

Insurers

A variety of difficulties for policyholders in monitoring and influencing the behaviour of insurers motivate the involvement of a prudential regulator.

There is fundamental uncertainty associated with insurers' liabilities — over the total size and timing of future payments to policyholders. This can mean that it is difficult for policyholders to assess the financial strength of their insurer. Additionally, policyholders (especially those with long-term contracts) may have little scope to influence the behaviour of insurers once policies have been taken out. And while commercial or wholesale policyholders may be better equipped to monitor and exert some discipline on insurers, they are hampered by the opacity of the value of insurers' assets and liabilities. These factors help to explain why an insurer may have the opportunity to take more risk than is in the interests of policyholders and other creditors. Prudential regulation must address this.

Common factors

There are, in addition, some common factors that obstruct firms from being run in a sufficiently prudent manner. For example, the owners of a firm often cannot control the firm effectively, due to a lack of information and difficulties in co-ordinating themselves (since they are often a wide and diverse group of shareholders). This can allow the management of the firm to pursue its own objectives, which may be to prioritise short-term reward over long-term soundness. And even where owners have adequate control over their firm, it may still be in their interest (if they are private shareholders) to have the firm take excessive risk — more than is in the public interest — since their liability in the event of failure is limited, while their potential gains from successful risk-taking are not.

(1) See for example Acharya and Yorulmazer (2007) and Aikman, Haldane and Nelson (2010).

concerns about risks crystallising in the future, that causes problems for firms' safety and soundness. Appropriate risk management is a key aspect of overall prudent management and governance.

Firms need to understand the risks to which they are exposed and take appropriate steps to manage them. This is not to say that firms should be able to withstand all conceivable stresses — by considering the most extreme circumstances, it will always be possible to identify a stress scenario in which a firm fails. Rather, it is vital that the boards and senior management of firms reach a considered decision on the level of risk that they are willing to take, and have appropriate controls to ensure this 'risk appetite' is reflected in their business in practice. The level of risk that firms are willing to take should be consistent with the PRA's objectives.

A firm's 'control framework' encompasses the processes, delegated authorities and limits that put into effect its approach to risk management and financial and operational control. This framework needs to be comprehensive in its coverage of the whole firm and all classes of risk, commensurate with the nature, scale and complexity of the firm's business, and to deliver a properly controlled operating environment. In part in order to support this framework, firms must have available robust information allowing their senior management, with a reasonable amount of effort, to form a

clear view of the risks being run by the business. And firms should have internal functions (for example, internal audit, risk management and finance functions) that are able to support and challenge their risk management approach effectively, consistent with the nature, scale and complexity of their business.

Firms must also observe high standards in operational risk management, having procedures in place to ensure continuity in the critical services they provide.

Capital

Capital acts as a buffer to absorb unexpected losses. Having enough capital of sufficiently high quality therefore reduces the risk of a firm becoming unable to meet the claims of its creditors. Given its ability to absorb losses, capital is also crucial for maintaining the confidence of those creditors. This is particularly important for deposit-takers and investment firms given that their liabilities are usually of shorter maturity than their assets and that they are therefore vulnerable to 'runs' (see the box on page 358). The PRA will take a strong interest in ensuring that firms are adequately capitalised.

In terms of quality, a significant part of a firm's capital needs to be ordinary shares and reserves. These are the highest-quality form of capital, allowing firms to absorb losses without prompting the winding up or legal reorganisation of the firm and consequent disruption and loss of value. Lower-quality capital (for example, subordinated loan capital) can play a role if a firm has failed, but its value in terms of the PRA's objectives is less.

As in all areas, firms in the first instance need to take responsibility themselves for ensuring that they maintain adequate capital. They should stress test their capital requirements against a range of plausible yet severe scenarios. And firms should consider plausible recovery actions that they could take, designed to return them to a stable, sustainable position following firm-specific or market-wide stress.

While firms should take responsibility themselves for maintaining adequate capital, they are also typically obliged to meet certain regulatory standards regarding the quantity of capital they should maintain, not least because a firm may have incentives to run its business less prudently than is in the public interest (see the box on page 358). The PRA will therefore itself form a judgement on the minimum requirements that firms should meet, consistent with relevant European and other international regulatory standards for capital adequacy.

Supplementing their regulatory capital requirements, firms should also consider whether their degree of leverage is appropriate. And they should ensure that their business is appropriately diversified, for example by observing prudent limits on large exposures to individual counterparties.

Reflecting the importance of combining firm-specific supervision with oversight of the financial system as a whole, there will, in addition, be macroprudential elements of the capital regime. These will fall under the purview of the FPC.

Liquidity

Liquidity reflects a firm's ability to meet its liabilities (for example, individuals withdrawing funds from their current accounts, or policyholders making insurance claims) as they fall due. Liquidity is a vital aspect of a firm's soundness, so the PRA will attach great importance to firms taking a prudent approach to liquidity management.

Firms should observe a prudent 'maturity mismatch' profile. Maturity mismatch — where firms lend at longer maturities than they borrow — is at the heart of a deposit-taker's business. Insurers, in contrast, must ensure that the liabilities incurred in writing insurance policies are matched with assets of an appropriate nature and term. But a principle common across all firms is that they should be prudent in their approach. For example, banks should not rely excessively on short-term wholesale funding sources that may prove difficult to secure during times of stress. And insurers should ensure that their assets are of an appropriate maturity and liquidity to allow them to meet their expected profile of liabilities.

To ensure that they are able to meet their liabilities given the degree of maturity mismatch that they have adopted, deposit-takers and investment firms should maintain a buffer of high-quality unencumbered assets that can be reliably liquidated, even in stressed circumstances. This buffer should be of a sufficient size to allow firms to withstand a wide range of severe but plausible stresses. The PRA will expect and allow a firm's buffer to be used in stressed circumstances.

Similar to the case of capital, firms should take responsibility themselves for ensuring that they are sufficiently resilient to liquidity risk. But the PRA will also specify to most deposit-takers and investment firms what it regards as an appropriate size and quality for their liquid asset buffer, given the incentives that firms have to behave less prudently than is in the public interest.

Those deposit-takers eligible to do so should ensure that they have access to the Bank of England's liquidity insurance facilities, which can provide liquidity support in the event of actual or prospective stress.[1] Firms should, however, manage their liquidity needs in the market rather than turn to the Bank as a matter of routine; the Bank's liquidity insurance facilities are designed in such a way as to encourage this.

(1) Full eligibility criteria and a description of the Bank's operations in the sterling money markets are set out at www.bankofengland.co.uk/markets/Pages/sterlingoperations/redbook.aspx.

Insurers generally do not suffer from the same liquidity risks as banks. Nonetheless, insurers should maintain at all times sufficient liquid assets to enable them to meet their liabilities as they fall due, including under a range of severe but plausible stress scenarios. This applies also to insurance firms that engage in non-traditional, non-insurance activities (for example, entering into liquidity swaps or collateral upgrade transactions) which have the potential to pose greater liquidity risks.

Macroprudential liquidity considerations will fall under the purview of the FPC.

Resolvability

The PRA's objectives will require it to minimise adverse effects resulting from disruption to the continuity of financial services. But the statute is also clear that the PRA will not be expected to prevent all firm failures. It is therefore vital that firms are able to fail in an orderly way, without posing risks to the PRA's objectives: that is, that they are 'resolvable'. And allowing the possibility of firm failure reflects the view that they should be subject to the disciplines of the market. Assessing and planning to contain the impact of failure will be a core part of the PRA's work.

Firms will be expected to assist the PRA and, where appropriate, the SRU, in assessing their resolvability and, as required, drawing up plans for their resolution. This will include firms providing the information needed to assess the critical financial services that they provide and the potential consequences for financial stability or policyholders if they were to be disrupted. Where significant barriers or obstacles to resolvability are identified, firms will be expected to propose and implement changes to remove them.

Additionally, deposit-takers will be expected to produce a single, consistent view of each depositor's funds, to enable the Financial Services Compensation Scheme to implement rapid payout in the event of the firm's failure.

There is currently no special 'resolution regime' for investment firms or insurers that provides the authorities with additional tools for dealing with their failure.(1) HM Treasury plans to introduce a special resolution regime for investment firms. And, in August 2012, HM Treasury sought views on whether improvements are required to the current insolvency framework for insurers, and whether a comprehensive resolution regime with stabilisation powers is also required for systemically important insurers.

Making new policy

The PRA will set out its expectations in its published policy material. The PRA will aim to establish and maintain this material so that it is clear in intent and as concise as possible, and therefore usable by the senior management of firms. The PRA will perform careful analysis to determine whether and what revisions to its set of policies may be appropriate, whether negotiating policy internationally or acting autonomously. And it will solicit constructive comment on policy proposals, for example on the likely impact of proposed reforms and on different ways of achieving its intended policy outcome.

Supervision — assessing firms and mitigating risks

The previous section described the broad expectations the PRA will have of firms if they are to remain safe and sound and protect policyholders appropriately. This section examines how the PRA will **supervise** firms to ensure that they meet these expectations — including the Threshold Conditions — and, more broadly, to assess the risks that they are posing to the PRA's objectives. It will communicate its judgements to firms, and require them to take action, where appropriate, as a result.

Assessing risk

The PRA will aim to develop a rounded, robust and comprehensive view of a firm, in order to judge whether it is being run in a safe and sound manner, consistent with the stability of the financial system and policyholder protection. It will undertake a varied set of supervisory activities — conducting its assessment on a continuous cycle — to inform this view. The composition, frequency and intensity of these activities will vary reflecting the particular circumstances of a firm. This is described in more detail below.

The PRA's focus

The PRA will be required to promote the safety and soundness of all the firms it regulates. But it will be entitled to prioritise its resources towards those firms with the greatest potential to affect policyholders or the stability of the financial system adversely.(2) The scale of a firm's 'potential impact' will depend on its size, complexity and interconnectedness with the rest of the system. For insurers, it will also take account of the size (including number of policyholders) and type of business undertaken.

The PRA will also vary the resource it applies to firms based on their proximity to failure and resolvability, given the possible adverse effects of disorderly firm failure on its objectives. The

(1) A 'special administration regime' currently exists for investment firms. There are two broad ways in which insurers may exit the market. First, 'run-off': where a firm is closed to new business and the liabilities 'run off' over time. Insurers may use a scheme of arrangement approved by a court to agree a compromise with their creditors and to accelerate the process. And second, an insolvent insurer may enter a modified administration or liquidation procedure.

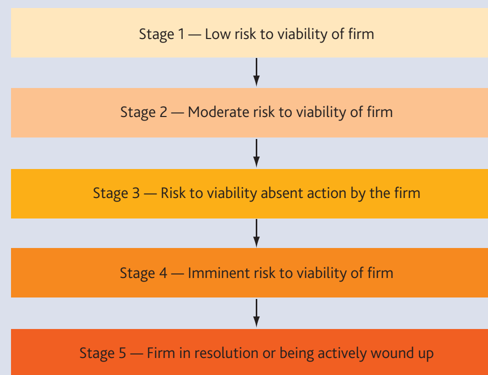
(2) Under this approach, firms that are unlikely to have a significant impact on the PRA's objectives on an individual basis, but which still have the potential to cause significant disruption collectively (for example, small credit unions), will be supervised on a portfolio basis and examined individually only occasionally, for example where a risk has crystallised. Large, complex firms, in contrast, will be subject to detailed supervision at an individual-firm level.

Proactive Intervention Framework

The PRA will take into account how close a firm is to failing when considering actions. Its judgement about a firm's proximity to failure will be captured in that firm's position within the Proactive Intervention Framework (PIF).[1]

The PIF is designed to ensure that the PRA puts into effect its aim to identify and respond to emerging risks at an early stage. There will be five clearly demarcated PIF stages, each denoting a different proximity to failure, and every firm will sit in a particular stage at each point in time (**Figure A**). As a firm moves to a higher PIF stage — that is, as the PRA judges that the firm's viability has deteriorated — the senior management of firms will be expected to ensure they take appropriate remedial action to reduce the likelihood of failure, and the authorities will ensure appropriate preparedness for resolution. For example, at Stage 3, a firm may be formally required to draw on the menu of options set out in its recovery plan (for example, to restore its capital position); at Stage 4 the authorities will confirm that all necessary actions to prepare for the firm's resolution have been taken.

Figure A Five stages of the PIF



(1) More information on the PIF is available in the PRA 'approach' documents at www.bankofengland.co.uk/publications/Pages/other/pra/pra.aspx.

PRA's 'Proactive Intervention Framework', which captures a firm's proximity to failure, is detailed in the box above. The PRA will also take into account the legal status of a firm (for example, whether it is a UK-authorised firm or a branch of a European Economic Area firm) in its approach.

Establishing the context for judgements

Any assessment of the risks facing firms requires an understanding of the external context in which they operate. The PRA's supervision will therefore include an assessment of how system-wide risks, for example from low interest rates, excess credit growth or international imbalances, are likely to affect firms. The PRA will draw on work by other parts of the Bank, including the views of the FPC on the macroprudential environment, in forming its view.

The PRA will also consider the particular risks that a firm faces and poses given its individual business model, in the context of that external economic environment. The PRA will examine both the threats to the viability of a firm's business model and the ways in which a firm could create adverse effects on other participants in the system by the way it carries on its business. This analysis will include an assessment of where and how a firm makes money, the risks it takes in so doing, and how it funds its activities. The analysis will take place at the level of the sector or the individual firm, as appropriate, with peer analysis providing an important means of identifying firms that pose different risks relative to their sector.

Supervisory activities making up the PRA's assessment

The PRA will not be formulaic about the supervisory activities it will perform, since its focus on the issues that pose the greatest risk to its objectives means that its work will depend on a firm's particular circumstances. Nonetheless, its supervisory work will comprise a selection of a set of possible activities which supervisors will deploy as they judge necessary.

The PRA will make use of data gathered in firms' regulatory returns, information in the public domain (for example, annual reports) and may also request other firm-specific data such as management information or forecasts.

As part of its information gathering and analysis, the PRA will require firms to participate in meetings with supervisors at a senior and working level. The PRA will also, as appropriate, conduct detailed on-site testing or inspections of a particular area. In-depth, focused reviews, for example of a firm's proprietary trading desks or its approach to valuations or risk weightings, will involve discussions with staff and reviews of internal documents. The PRA will involve its risk specialists and other technical staff in on-site work, stress testing and other assessments, as appropriate.

Firms' external auditors can and should play a role in supporting prudential supervision, given their ability to identify and flag to the PRA current and potential risks in a firm. Similarly, in the case of insurance firms, regular dialogue between actuaries and supervisors should form a key part of supervision. And the PRA may use firms' risk, compliance and internal audit functions to identify and measure risks, where it judges these to be effective.

Mitigating risk

The PRA will continually review its judgement of the risks that firms pose to its objectives on the basis of the supervisory

activities undertaken. It will communicate these judgements to firms and require them to take action as a result. The PRA will focus on outcomes when conveying supervisory messages to firms. As it is the responsibility of a firm to manage itself, the way in which firms achieve these outcomes will, in general, be up to them.

Consistent with its focus on key risks, the PRA will concentrate on material issues when engaging with firms. And there will be a clear and direct link between the risks that the PRA perceives to its objectives and the actions it will expect from firms in consequence. For example, if the PRA has identified deficiencies in a firm's forecasts of earnings, leading to risks to its financial health, the PRA will require the firm to take steps to tackle this, for instance via improvements to its forecasting, systems or governance.

Firms will sometimes disagree with the PRA's decisions. Furthermore, there will be occasions when events will show that the supervisor's judgement, in hindsight, was wrong. This is inevitable in a forward-looking regime. In order to minimise such outcomes, the PRA will need to be staffed by people with strong, relevant skills and experience. And its major judgements and decisions will involve the PRA's most senior and experienced staff and directors.

The PRA will, in general, discuss issues with firms in reaching its decisions, and will carefully consider representations made, not least to ensure that its decisions are made on the basis of all the relevant evidence. But firms should not approach their relationship with the PRA as a negotiation.

Use of legal powers

The PRA will have a variety of formal powers available to it under statute, which it will be able to use in the course of supervision if deemed necessary to reduce risks. For example, it may use its power to require information from firms, or commission a report by a third party into specific areas of interest. It may also vary a firm's permissions to undertake certain regulated activities, which may require a change to the firm's business model or future strategy.

While the PRA will look to firms to co-operate with it in resolving supervisory issues, it will not hesitate to use formal powers where it considers them to be an appropriate means of achieving its desired supervisory outcomes. This means that, in certain cases, the PRA will choose to deploy formal powers at an early stage and not merely as a last resort.

The PRA's preference will be to use its powers to address emerging risks. If successful, application of this approach should mean that enforcement actions are rare. The PRA will, however, have a set of disciplinary powers, including the power to impose financial penalties and publish public censures, for cases where such sanction is an appropriate response to the firm failing to meet the PRA's policies. The intention in deploying these powers might include sending a clear signal to a firm — and to the regulated community more widely — about the circumstances in which the PRA considers a firm's behaviour to be unacceptable, and so deterring future wrongdoing.

Conclusion

From next year, the PRA, as part of the Bank of England, will be the United Kingdom's prudential regulator for deposit-takers, insurers and major investment firms. It will be one part of a wider regulatory framework, working alongside the FPC, which will focus on risks to the stability of the financial system as a whole, and the FCA, which will be responsible for ensuring that relevant markets function well, conduct regulation of financial services firms and prudential regulation of financial services firms not regulated by the PRA.

The PRA will promote the safety and soundness of the firms it regulates, focusing on the adverse effects that they can have on the stability of the UK financial system; and contribute to ensuring that insurance policyholders are appropriately protected. It will make an important contribution to the Bank's core purpose of protecting and enhancing the stability of the UK financial system.

The PRA will advance its objectives by setting out expectations that firms should meet, and by assessing firms against these expectations, on a present and forward-looking basis, so as to judge the risks that they pose to its objectives. Where it considers a firm to pose an unacceptably high level of risk, the PRA will require the firm to take action to address this, intervening at an early stage, and using its legal powers if necessary.

The financial crisis has powerfully demonstrated the need for a new approach to financial regulation. The PRA's goal will be to focus on the things that matter most to achieving its statutory objectives and thus meeting its responsibility to the public.

References

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