Supervision of firms by PRA and FCA

The classification of a firm by PRA and FCA will have a direct impact upon the type and intensity of supervision it will receive from the regulators\(^1\). Those firms categorised as high risk (i.e. PRA Category 1 and 2 and FCA C1 and C2 firms) will have dedicated (named) lead supervisors and be subject to frequent and intrusive regulatory review of their business at both planning and operational levels.

Those firms categorised as low risk will not be allocated dedicated supervisory staff. Their supervision will be based largely around the analysis of standardised returns with supervisory action being focussed on instances where those returns appear to be out of line with the peer group. Additional supervisory action may arise following any specific incident or complaint involving the firm concerned.

PRA Supervisory Approach - Prudential

The PRA aims 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”. In order to arrive at this regulatory view the PRA will assess on a continuous cycle a range of core supervisory activities supplemented, where necessary, by additional supervisory tools (examples of which are shown in the table below).

| Examples of Supervisory Tools to be used principally for the PRA for Category 1 and 2 firms |
|----------------------------------|--------------------------------------------------------------------------------------------------|
| Senior Management                | Regular dialogue (alone or in groups) with Directors, Non-Exec Directors and Senior Managers of the firm. |
| Regulatory Reporting             | Review of routine reports submitted by the firm. Additional firm specific information may be requested. |
| Meetings with Supervisors        | Strategic, information gathering or analytical meetings with management and staff of the firm. |
| On-site testing/review           | On-site inspection and review of particular areas of the firm. Review of firms approach to stress testing and/or bespoke stress tests lead by PRA staff. |
|                                  | Use of firm’s Risk, Compliance and internal Audit to identify and measure risks may be used if PRA feels it can rely on their effectiveness. |
| External Auditors                | Open and constructive two-way dialogue with firm’s external auditors. |
| Statutory powers – Information Gathering | PRA will make increased use of statutory powers including the commissioning of s.166 reports by Skilled Persons. |

\(^1\) See Regulatory Briefing Note 1/12 for details on the classification of firms by PRA and FCA
FCA Findings

PRA will make use of the FCA's finding on firms' key conduct risks including money laundering and, where appropriate, prudential regulation by FCA of FCA authorised group subsidiaries.

Fraud

Focus on adequacy of a firm's anti fraud control framework rather than individual instances of fraud that may arise.

Annex 1 provides a summary of the PRA’s proposed approach to the supervision of those firms posing the lowest risk to stability of the UK financial system (i.e. Category 3 to 5 firms). Notwithstanding the information shown in Annex 1 the PRA may invoke any of the supervisory tools shown in the table above where it felt such action was appropriate regardless of the categorisation of the firm.

Supervisors will be required to take a view on the likelihood or proximity to failure of a firm. In effect this process will be subject to continuous assessment with more focussed supervisory action being taken against/with those forms deemed most at risk of failure.

The PRA will place firms in one of 5 clearly defined points or stages on the Proactive Intervention Framework ("PIF"). The management of a firm will be expected to take such (remedial) action as is required to reduce the likelihood of failure. The authorities (undefined but assumed to include the Bank (SRU), PRA, FCA and FSCS) will ensure appropriate preparedness for resolution. The five stages in the PIF are shown in summary form below:

<table>
<thead>
<tr>
<th>Stage</th>
<th>Possible Actions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stage 1 – Low risk of viability of firm</td>
<td>Normal supervisory risk assessment and actions including recovery and resolution planning.</td>
</tr>
<tr>
<td>Stage 2 – Moderate risk of viability of firm</td>
<td>Increased supervisory activity – firm required to take specific actions within defined timeframe. PRA and SRU will review firm’s resolution plan and FSCS will identify obstacles to payout or deposit transfer.</td>
</tr>
<tr>
<td>Stage 3 – Risk to viability absent action by the firm</td>
<td>PRA may require: change of management/Board, restrictions on capital distribution (dividends and variable remuneration), restrictions on business activities and/or balance sheet growth. SRU will intensify engagement with the firm.</td>
</tr>
<tr>
<td>Stage 4 – Imminent risk to viability of the firm</td>
<td>PRA likely to require additional recovery action within a defined timetable. Firm to take action in short order and demonstrate actions were credible and will produce material results. SRU and FSCS to confirm all actions taken ready for resolution of firm.</td>
</tr>
<tr>
<td>Stage 5 Firm in resolution or being actively wound up</td>
<td>PRA to trigger use of SRR, SRU will oversee resolution/winding up. FSCS may be required to effect depositor payout and/or fund deposit transfer or resolution.</td>
</tr>
</tbody>
</table>

Where the PRA feels that there is a risk of failure (e.g. Stages 2 and 4 of the PIF) the actions they are likely to take represent a significant increase in the manner in which a regulator will intervene in the running of a firm.

A firm’s PIF stage will be reviewed at least annually and, where necessary, in response to relevant, material developments.

FCA Supervisory Approach - Conduct
The FCA intends to adopt a different supervisory model to that used by the PRA although there are similarities such as the focus on the firms with the highest potential impact. The FCA will base supervisory activities around three key factors:

i) A Systemic Risk Framework ("FSF") which is designed to assess a firm’s conduct risk. This will be preventative work driven by a structured conduct assessment of firms;

ii) Event-driven work with the FCA taking faster and more decisive action to deal with problems emerging or that have happened. The aim is to secure customer redress and/or remedial work and cover issues that arise outside of the standard FSF assessment cycle.

iii) Issues and products where the FCA intends to undertake fast and intensive campaigns on sectors within the market or products within a sector that are putting or may put investors at risk.

The FSF will involve the following:

a) Business and model strategy analysis by FCA to inform its view on the sustainability of a firm's business and the potential conduct risks it may pose in the future.

b) Assessment of how the firm embeds fair treatment of customers and ensures market integrity – this will involve a review of the governance and culture within a firm, product design, sales and transaction processes, post sales / services and transaction handling.

c) Identification of actions to be taken by the firm to address issues of concern to the FCA.

d) Communication to the firm setting out the assessment and the actions required.

FSF assessment will be made individually for each FCA C1 firm, C2 firms will be place in groups within the same industry sector and for C3 firms the FCA will look at a sample of firm’s business models across the sector. The approach for C4 firms will be similar to that of C4 but with a "lighter assessment”

The FSF review cycle for C1 and C2 firms will be bi-annual whereas that for C3 firms will be every four years. C4 firms may expect a “touch point” every four years that may involve attendance at a road-show, an interview, an on-line assessment or some combination of these.

**FCA Supervisory Approach - Prudential**

The FCA approach to prudential supervision will be largely one of focussing on the management of failure of a firm rather than seeking to reduce the possibility of such a failure. Key elements will be that when a firm fails it can be run down in such a manner that client assets are protected and that there is no adverse affect on consumers. The approach is deemed appropriate by the FCA as the majority of the firms subject to prudential regulation by it do not have the potential to have a significant impact on the integrity of the financial system as a whole.

The level of supervisory intensity will vary with the classification of the individual firm with CP1 (Prudentially Critical) Firms receiving the highest level of review/action. Firms can expect a detailed review of their Internal Capital Adequacy Assessments (ICAAP) and Individual Liquidity Adequacy Assessments (ILAA) where applicable. FCA will also review risk management practices within the firm and the firm’s wind down plan. CP1 firms can expect FCA to set Individual capital Guidance for the firm at the greater of the minimum of going-concern or orderly wind-down requirement.

CP2 (Potentially Significant) firms will be subject to limited going-concern with a review of ICAAP and ILAA only where the firm is designated a MiFID Investment Firm and is subject to the requirements of the Capital Requirements Directive. Supervisory effort will focus on FCA being satisfied that the firm’s orderly wind-down plan is achievable and that the firm holds adequate capital to fund that wind-down process.
CP3 (Prudentially Insignificant) firms will be monitored against minimum requirements and supervision will only increase where the firm is close to failure or failing.

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PRA Supervision of firms that pose little individual risk to financial stability

This note summarises the PRA’s approach to supervising firms with the lowest potential impact on the stability of the financial system. It is likely that there will be a very large number of firms within this category, made up in practice of small overseas banks (branches or subsidiaries) and credit unions.

At an individual level, these firms have almost no capacity to cause disruption to the UK financial system, either through the way they carry on their business or through idiosyncratic, orderly failure. Nevertheless, two considerations motivate a baseline level of supervisory monitoring for them. First, the PRA’s general statutory objective is to promote the safety and soundness of all of the firms that it regulates. And second, there is a risk that problems across a whole sector or subsector could generate some disruption to the continuity of financial services, i.e. several firms may fail together through a common exposure, with possible wider systemic impact (as occurred in the 1990s’ small banks’ crisis for example).

Given that such firms are likely to pose risks to financial stability at an aggregate level only, the PRA will supervise them on a portfolio basis. Automated tools, analysing firms’ regulatory returns, will issue alerts highlighting outliers and trends, and firms will in general be examined individually only when their regulatory returns trigger such an alert. The PRA will also seek to assure itself that these firms are resolvable, with a particular emphasis on their ability to facilitate depositor payout by the FSCS.

The PRA will also examine individual firms when a risk crystallises (as discovered through, for example, a visit to the firm, or an approach from the firm itself), or in response to authorisation requests from the firm (for example, a request to change its permissions to undertake regulated activities, or to extend the nature or scale of its business).

And the PRA will conduct peer group and trend analysis across sectors as a whole, to develop a clear understanding of the risks posed both by groups of small firms and by typical firms in the sector. The PRA will still conduct annual assessments of firms, but in large peer groups. In contrast to the higher-impact firms, those in the lowest category will contact the PRA through a centralised firm enquiries function and will not have an individual, named supervisor.

Small firms will not be visited by the PRA on a fixed, regular schedule. Notwithstanding this approach, all firms, regardless of category, will be subject to on-site work by the PRA — with some period of notice — at any time.

Credit unions

Credit unions will be the major constituent of the lowest-impact category. They will be subject to a specific prudential regime, as set out in the Credit Union Sourcebook, including specific minimum capital and liquidity requirements, their adherence to which will be monitored as described above. Credit unions are not subject to the Capital Requirements Directive, nor will they be issued with individual guidance for capital and liquidity.

Credit unions will be required to meet FSCS standards for rapid payout of depositors, but not otherwise to have recovery and resolution plans. Those individual credit unions posing a risk of contagion to other firms, for example through having uninsured depositors, will be subject to more intensive supervision.