BRIEFING

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INTRODUCTION

In April 2013 the Prudential Regulation Authority ("PRA") will assume responsibility for regulating UK deposit-takers, insurance companies and designated investment companies in succession to the FSA. In anticipation of this, it has published new guidance on how it intends to approach its statutory functions.

THE PRA'S OBJECTIVE

The PRA's overriding objective will be to "*promote the safety and soundness of firms*", and thereby protect wider financial stability. Whilst seeking to ensure firms are more resilient, it will not be empowered to usurp the disciplines of the market and ensure no firm fails; it will aim rather at stopping such failures from causing significant disruption to the supply of critical financial services.

Firms will be required to meet 'Threshold Conditions' – minimum requirements necessary to carry on regulated activity. The draft conditions require:

- A firm's head office to be in the UK if it is incorporated in the UK
- A firm's business to be conduct in a prudent manner, with:
  - Appropriate financial resources to meet its liabilities
  - Appropriate non-financial resources to identify, measure and reduce risks to the firm's safety and soundness.
- A firm to be 'fit and proper' and appropriately staffed
- A firm and its group to be capable of being effectively supervised

The PRA will continue the FSA's principles-based approach to regulation. Firms will be expected not merely to meet the letter of the requirements placed upon them, but to act in accordance with their spirit and the overriding principle. A précis of the PRA's most relevant principles is set out below.

SAFEGUARDING SAFETY AND SOUNDNESS

A firm must have adequate measures in place to safeguard its safety and soundness in light of the risks it both faces and poses. The greater the risk, the higher the standards of risk mitigation expected.

(i) Management and governance

A firm's culture should support prudential management. For example,

- Risk management and control functions must carry real weight.
- All employees should have a responsibility to act in accordance with the PRA objective.
- The firm and its employees should cooperate openly with the PRA and other regulators.
- The board should engage with management, and ensure they are held to account. This responsibility is both collective and individual.

The firm must be run competently, with the appropriate mix and balance of skills. It should not unduly dependent on a single individual. As part of this requirement, certain positions may only be filled by individuals specifically approved by the PRA. These approved persons may be liable to disciplinary action by the PRA if their actions are inconsistent with its *Statement of principles and code of practice of Approved Persons*.

The firm should be structured so as to ensure clear accountability and delegation of responsibilities. This should also include checks and balances in order to prevent any single individual becoming too dominant. Whatever structure is adopted, the board has a non-delegable responsibility for ensuring business is conducted in a prudent manner.

(ii) Risk management and controls

Risk encompasses both operational and financial risk. A firm must put in place a robust framework for risk management consistent with the nature, scale and complexity of the business. Firms should express how much risk they are willing to take in order to achieve their strategic objectives. This risk appetite must of course be consistent with the PRA objective.

A control framework should address the firm's approach to risk – i.e. the processes, delegated authorities and limits put in place to address risk management. These risk management and control functions should be adequately resourced. Moreover, where the nature of the business justifies it, these functions should be separate from the firm's revenue-generating functions.

Internal audits should provide independent assessments of the firm's risk management and governance procedures.

THE PRA'S SUPERVISORY ROLE

(i) The PRA's approach

The intensity of the PRA's supervision of a particular firm will increase in line with the risk it poses to the stability of the financial system. Its assessment will be not be limited to current risks, but will attempt to be forward looking.

The PRA will conduct its assessment of a firm on a continuous cycle. This supervision will not be formulaic but rather will be governed by a firm's particular circumstances.

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The PRA will analyse data in the public domain and will also make additional firm-specific requests for information. It will be empowered to conduct on-site testing, carry out inspections and validate data submitted by a firm. During its investigations, a firm's external auditors will be expected to cooperate. Indeed, they should disclose to the PRA emerging concerns within the firm which may be of interest.

In the course of an assessment, the PRA will discuss issues identified with the management, and will consider representations made. This process of consultation should not, however, be mistaken for a negotiation.

A supervisor will assess a firm's 'proximity to failure', which is broken down into five categories. These assessments will not routinely be disclosed to the market for fear of undermining confidence. Currently, this information will also not be disclosed to the firm in question, since the firm may then be obliged to disclose the assessment publically.

Following an assessment, the PRA will identity the risks in question and the outcome it desires. The way a firm achieves a given outcome, however, falls within their own discretion.

(ii) Methods of enforcement

The PRA will possess a number of formal powers which can be used in the course of its supervision. The guidance makes clear it will not hesitate to use these if it considers them the appropriate way to achieve a desired outcome. They will *not* be used merely as a last resort. Factors which may influence its decision to use them include:

- Supervisors' confidence that a firm will respond appropriately to PRA requests
- The firm's proximity to failure
- The impact the PRA is trying to mitigate

The use of disciplinary powers is intended to be rare since the PRA's primary focus will be on remedial action. However, where directions and restrictions are ignored, 'appropriate sanctions' will be available. In approaching this issue regard will be paid not only to the need to reinforcing the PRA's objective but also to upholding confidence in it as a regulator.

CONCLUSION

The PRA's guidance makes it abundantly clear that it intends to continue the principles-based regime operated by the FSA in recent years. While the considerable discretion which such an approach accords to the new regulator will provide it with greater freedom of action for the pre-emption of disruptions to the market, the wide ambit of its supervisory regime has caused considerable uncertainty in the industry. The ambit of a supervisor's discretion is inevitably vague; only time will tell whether the PRA will strike the right balance between firms' commercial interests and the wider public interest.