BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

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Dear Chief Executive Officer,

Prudential Regulation Authority (PRA) UK Deposit Takers Supervision: 2021 Priorities

We are writing to update you on our 2021 priorities for UK deposit takers. This complements our ongoing supervision and the feedback you will have received following the most recent Periodic Summary Meeting (PSM) for your firm. These priorities are sent to the wide and diverse range of UK based deposit takers of all sizes and so this list is not exhaustive, but this letter is intended to provide a helpful overview of our priorities for 2021.

The Covid-19 pandemic and the measures taken to contain it are having a significant and ongoing impact on the UK and around the world. The PRA took a number of actions to help PRA-regulated firms deal with Covid-19 and firms have acted quickly to respond to a new operating environment. Further adjustments may be needed as the pandemic continues, and as such, Covid-19 represents an over-arching issue with implications across the 2021 priorities set out in this letter.

1. Financial resilience

The UK financial system as a whole remains resilient reflecting the build-up of substantial buffers of capital since the global financial crisis.[1] Financial resilience is important so that the banking system can carry on supporting businesses and households through the economic disruption caused by Covid-19. We will continue to monitor our regulatory regime to ensure it does not act in a procyclical way, including ensuring firms can draw down on capital and liquidity buffers where necessary.[2]

Reflecting this, the PRA has judged that there is scope for large UK banks to recommence shareholder distributions; and that bank boards should make decisions about 2020 distributions.[3] Large UK banks will operate within temporary guardrails set by the PRA, as a stepping stone back towards its standard approach to capital-setting and distributions through 2021.

However the economic consequences of Covid-19 are expected to continue and will cause additional impacts on banks and building societies, particularly once the cushion of temporary government support schemes and supervisory measures starts to recede. We will remain focused on the challenges some firms have in establishing or maintaining sustainable business models in the continued low rate environment, with potential pressure on net interest margins, and wider global economic headwinds, coupled with adjustment to the post-Brexit world.

1 'Financial Stability Report' – December 2020: https://www.bankofengland.co.uk/financial-stability-report/2020/december-2020.

2 'Q&A on the usability of liquidity and capital buffers', April 2020: https://www.bankofengland.co.uk/prudential-regulation/publication/2020/buffer-usability-qanda.

3 'PRA statement on capital distributions by large UK banks' December 2020: https://www.bankofengland.co.uk/prudential-regulation/publication/2020/pra-statement-on-capital-distribution-by-large-uk-banks.

As set out in the December Financial Stability Report, the Bank of England will conduct a stress test in 2021 to explore the financial resilience of major UK banks and building societies.[4] Stress testing remains a core PRA tool and supervisors will continue to work with firms as they seek to enhance their own internal stress testing and scenario development capabilities in response to the current environment.

2. Credit risk

We anticipate an increase in customers in financial difficulty, arrears and default over 2021. We will maintain engagement across the sector, as appropriate, to assess whether firms have robust credit risk management practices, and whether they are considering an appropriate range of scenarios in determining provisioning levels, including appropriate use of staging within IFRS9 or other applicable accounting regimes. We will also continue to monitor the interaction of credit supply and demand given the important role of the banking system in supporting businesses and households through economic disruption.

Our assessment of firms' credit risk will continue to be a risk-based blend of thematic and firm-specific reviews. Three thematic reviews are currently underway (buy-to-let, SME, and retail collections); and we anticipate further thematic work on wholesale portfolios in potentially Covid-19 vulnerable sectors, plus some international portfolios subject to challenging economic and credit risk conditions. While payment deferrals remain of interest (in particular risk characteristics and associated changes in risk appetite, lending criteria and portfolio stress testing), the intensity of data collection is expected to ease over 2021 and we will look to re-assess our temporary Covid-19 data collections at the appropriate time.

3. Operational risk and resilience

Enhancing the operational resilience of the financial sector remains a strategic priority for the PRA, and Covid-19 has reinforced its importance. Although firms responded to ensure operations could continue, in some instances they have adjusted risk appetites to accommodate deficiencies in controls as a result of temporary changes to their operating environment. We will continue to challenge how firms are ensuring that risk and control frameworks are operating effectively under the current working environment. This includes the capabilities of the three lines of defence, and the monitoring of material residual risks against risk appetites. Firms should not become complacent in their preparations for other operational disruptions or from the ongoing impact of Covid-19.

Following our consultations we intend to set standards for operational resilience and outsourcing during 2021 and we expect firms to consider the steps they will need to take to meet these.[5] We encourage firms to address the lessons learned from the pandemic, and review how these experiences might influence the development of operational resilience as a continuing discipline. We will be following up with firms as part of our supervisory approach, to understand how they will be taking this forward.

4. Transition from LIBOR to alternative risk-free rates

The continued reliance of global financial markets on LIBOR poses a risk to financial stability that can only be reduced through a transition to alternative risk-free rates. While progress was made in certain areas during 2020, Covid-19 made other areas such as client engagement more challenging. The time for action is reducing, so we will expect to see intensive efforts and early progress in 2021.

We will be monitoring firms' progress against the targets of the Working Group on Sterling Risk Free Reference Rates (RFRWG) and targets for non-GBP exposures where relevant, as we expect all firms to play their part in meeting these milestones.[6] We will also be closely monitoring how firms are managing

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4 'Financial Stability Report, In focus The resilience of the UK banking sector' – December 2020: https://www.bankofengland.co.uk/financial-stability-report/2020/december-2020.

5 'Operational Resilience: impact tolerances for important business services', December 2019: https://www.bankofengland.co.uk/prudential-regulation/publication/2018/building-the-uk-financial-sectors-operational-resilience-discussion-paper.

6 'Transition to sterling risk-free rates from LIBOR': https://www.bankofengland.co.uk/markets/transition-to-sterling-risk-free-rates-from-libor.

the risks associated with transition, through regular review meetings with a range of firms and by reviewing the data we collect on firms' exposures. We will consider a range of supervisory tools for use where we see insufficient progress, or incidents of poor risk management or governance of transition.

5. Competition and future regulatory frameworks

One of the biggest drivers of successful innovation in financial services is competition, which is enhanced by having a regulatory regime that encourages fair competition through setting a level playing field and providing banks clarity as they enter, grow and exit the market.

Our proposed approach for new and growing banks was set out in Consultation Paper (CP) 9/20 and we aim to finalise this in the first half of 2021.[7] Our intention is that providing clarity on our approach to new banks as they grow will reduce uncertainty, and allow such firms to flourish, plan their growth, and compete effectively.

As Sam Woods set out in his recent Mansion House speech, we are also considering a 'strong and simple' framework for smaller non-systemic UK banks and building societies as we gain more room to tailor a prudential regime once the UK fully leaves the EU.[8] We have no intention of weakening prudential regulation, but we believe there is scope to achieve simplification of rules without reducing the overall robustness of the regime for smaller firms, and without harming financial stability. We plan to publish a discussion paper in the first half of 2021 and we encourage affected firms to engage fully in the discussion.

The Bank of England has been reviewing aspects of its MREL (Minimum Requirement for own funds and Eligible Liabilities) framework and intends to make an initial publication by end 2020.[9] The Financial Policy Committee and Prudential Regulation Committee also intend to conduct a review of the UK leverage ratio framework.[10] We encourage you to engage with relevant CPs and discussions.

6. Financial risks arising from climate change

Climate change represents a material financial risk to firms and to the financial system and remains a key PRA priority. It is also an area of increasing focus in the UK, as evidenced in the Chancellor's November 2020 announcement of a roadmap towards mandatory disclosures, though the creation of a joint taskforce on climate-related financial disclosures. Minimising the future risks from climate change requires action now.

This increased focus builds on the 2019 supervisory statement and 2020 letter to CEOs,[11] which set expectations for banks and insurers to enhance their approaches to managing climate-related financial risks and to fully embed these by the end of 2021.[12] The use of scenario analysis is key to understanding the risks and the Bank of England has announced that it will be undertaking a system-wide climate scenario exercise in June 2021.[13] Firms should continue to take a proportionate approach that reflects their exposure to climate-related financial risk and the complexity of their operations.

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7 Non-systemic UK banks: The Prudential Regulation Authority's approach to new and growing banks, July 2020: https://www.bankofengland.co.uk/prudential-regulation/publication/2020/new-and-growing-banks.

8 Strong and simple speech by Sam Woods - Mansion House 12 November: https://www.bankofengland.co.uk/speech/2020/sam-woods-city-banquet.

9 'The Bank of England's approach to setting a minimum requirement for own funds and eligible liabilities', November 2020 https://www.bankofengland.co.uk/paper/2018/boes-approach-to-setting-mrel-2018.

10 'Financial Stability Report', December 2019: https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/2019/december-2019.pdf.

11 'Enhancing banks' and insurers' approaches to managing the financial risks from climate change'. April 2019: https://www.bankofengland.co.uk/prudential-regulation/publication/2019/enhancing-banks-and-insurers-approaches-to-managing-the-financial-risks-from-climate-change-ss.

12 Letter from Sam Woods 'Managing climate-related financial risk'. July 2020: https://www.bankofengland.co.uk/prudential-regulation/letter/2020/managing-the-financial-risks-from-climate-change.

13 'The 2021 biennial exploratory scenario on the financial risks from climate change'. December 2019: https://www.bankofengland.co.uk/paper/2019/biennial-exploratory-scenario-climate-change-discussion-paper.

In addition to the six priorities set out in this letter, we continue to see strong governance at firms as being key to underpinning progress in meeting our expectations; and to view diversity as important for improving decision-making and providing effective challenge. We will continue to make full use of the Senior Managers Regime to support our objectives in 2021.

We are grateful for the efforts made by firms in providing additional data in response to Covid-19, which has been helpful in shaping the PRA's response to the pandemic. The submission of complete, timely and accurate regulatory returns continues to be the foundation of effective supervision, and as such the PRA expects all firms to continue to take action, as necessary, to ensure the integrity of their returns. The PRA has been running a pilot project to assess the standard of regulatory returns, which will continue in 2021.[14]

This letter in conjunction with the PSM letter should convey a sense of our planned work for next year.

We look forward to working with you over the coming year.

Yours sincerely

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[14] Letter from Sarah Breeden and David Bailey 'Reliability of regulatory returns' October 2019: https://www.bankofengland.co.uk/prudential-regulation/letter/2019/reliability-of-regulatory-returns