BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

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Dear Chief Executive Officer

**UK Deposit Takers Supervision: 2022 priorities**

We are writing to update you on the Prudential Regulation Authority's (PRA) 2022 priorities for UK deposit takers. These priorities are intended to complement our ongoing supervision and the feedback you will have received following the most recent Periodic Summary Meeting (PSM) for your firm. These are sent to the wide and diverse range of UK based deposit takers that we supervise; therefore this list is not exhaustive, but is intended to provide a helpful overview of our priorities for 2022.

## 1. Financial resilience

As economies continue to be impacted by Covid-19, the resilience of the financial sector remains paramount to ensure that the financial system can continue to support businesses and households. The banking sector remains resilient to outcomes for the economy that are much more severe than the Monetary Policy Committee's central forecast,[1] but risks to the recovery remain. It is important that firms take proactive steps to assess the challenges of a changing economic environment. Many firms' earnings have benefited from the accommodative macro environment and supportive government measures in the past year. As this environment evolves, firms will need to assess the implications for the sustainability of their business models.

The operating environment for all firms remains challenging and uncertain and broad structural changes – such as an acceleration of digitalisation in the banking sector – could amplify challenges faced by individual firms as they recover from the impact of Covid-19. We will continue to engage with firms to assess the challenges these changes bring to the sustainability of business models. As set out in the December Financial Stability Report, the Bank of England will conduct a stress test in 2022 using its Annual Cyclical Scenario framework to explore the financial resilience of major UK banks and building societies. Stress testing remains a core tool for the PRA, 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.

The default of Archegos Capital Management last year also brought to light deficiencies in banks' risk management governance and frameworks, many of which were symptoms of a broader root cause and manifestations of an inappropriate internal risk culture where lessons from the global financial crisis had not been sufficiently learnt.[2] This event further reinforced the need for firms to consider concentrated and leveraged exposures and to improve counterparty risk management. Assessing the risk culture and the incentives structures in place at firms, and the alignment of remuneration with risk management practices, will be a key priority of our supervisory work with firms engaged in equity finance and the broader prime

1 December 2021: 'Financial Stability Report - December 2021'.
2 December 2021: 'Joint letter to banks operating in the UK: Supervisory review of global equity finance businesses following the default of Archegos Capital Management'.

brokerage business. In addition, the cross-border nature of this event highlighted the importance of global regulatory cooperation, a theme that will continue into 2022.

## 2. Credit Risk and Model Risk

The full impact of Covid-19 on credit portfolios is yet to be seen, and recovery is likely to be uneven across sectors as official sector support schemes are withdrawn. Firms will need to closely monitor credit risk within their portfolios and the impact on provisioning. We addressed the challenges applying IFRS 9 Expected Credit Loss (ECL) in the current environment in our dear CFO letter on written auditor reporting,[3] which notes further progress is needed to embed high quality practices, and to consider how temporary changes made in Covid-19 can be made more permanent to strengthen ECL processes in stress.

We will continue to engage with firms to assess the robustness of their credit risk management practices. Our assessment of firms' credit risk will continue to be a risk-based blend of thematic and firm-specific reviews. Four thematic reviews are currently underway (wholesale problem debt management, unsecured personal loans, buy-to-let, and IFRS 9 retail models) and we anticipate follow up work on small and medium-sized enterprises and reviews of some international portfolios subject to challenging economic conditions. Risks associated with remediation of cladding and wider fire safety issues continue to be an issue for the sector that we will monitor closely, as are emerging risks from the competitive landscape in terms of pricing relative to risk, including newer products such as "buy now pay later".

The implementation of PRA policy on Hybrid mortgage models, EBA Internal Ratings Based (IRB) Roadmap, and IBOR (InterBank Offered Rate) transition for Internal Model Approach (IMA) models has tested and highlighted weaknesses in firms' model risk management (MRM) frameworks; including in development, testing, validation, change management, and governance. In 2022, we will continue to focus on the implementation of IRB Hybrid mortgage models and IRB Roadmap for non-mortgage portfolios, as well as work on IRB aspirant firm model applications. We will also have increasing focus on the effectiveness of MRM practices, and the remediation actions firms are taking.

## 3. Operational risk and resilience

Enhancing the operational resilience of the financial sector remains a strategic priority for the PRA. Covid-19 continues to reinforce the importance of the firms' ability to prevent, adapt, respond to, recover and learn from operational disruptions. We will continue to assess firms' progress in developing dynamic, effective operational risk and control frameworks to manage the threat of operational disruptions. We expect firms to develop their security controls and capabilities to manage the increasing risk of cyber threats, as set out in Supervisory Statement (SS) 1/21.[4] We encourage all firms, regardless of size, to test their resilience against such threats.

By Thursday 31 March 2022, firms must have identified and mapped their important business services; set impact tolerances for these; and initiated a programme of scenario testing. Impact tolerances provide a standard which boards and senior management should use for prioritising investment and making recovery and response arrangements. We will continue to review firms' programmes and their implementation.

We also introduced new expectations on outsourcing and third party risk management (as set out in SS2/21)[5] to strengthen our expectations on operational resilience, and to facilitate greater resilience of services provided by third parties, including the cloud and other technologies. We have observed a material increase in the services being outsourced, particularly to cloud providers, and we expect firms to manage the risk arising from this accordingly. Under SS2/21 firms should maintain an updated register of

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3 September 2021: 'Letter from Victoria Saporta Thematic feedback from the 2020/2021 round of written auditor reporting'. The letter reflects findings in relation to selected deposit-takers, but we think the feedback may also be useful to those firms applying IFRS 9 ECL that are not in scope of written auditor reporting. We suggest you read the letter and talk to your auditor about it.

4 March 2021: SS1/21 Operational resilience: Impact tolerances for important business services.

5 March 2021: SS2/21 Outsourcing and third party risk management.

their outsourcing arrangements. Firms should also ensure their important business services can remain within impact tolerances even when they rely on outsourcing or on third party providers.

## 4. Financial risks arising from climate change

Climate change presents a material and increasing financial risk to firms and to the financial system. Managing the risks to firms' safety and soundness from climate change requires action now, and remains a key PRA priority. Some firms have made good progress in embedding the PRA's supervisory expectations (as set out in SS3/19)[6], but progress has not been consistent across all firms, with further work required by many to meet those expectations. We have observed that most firms are focused on the business opportunities presented by climate change and remind firms that climate change also presents an increasing business risk that is foreseeable and requires action now.

We expect firms to take a forward-looking, strategic and ambitious approach to managing climate-related financial risks. This approach should be proportionate to the scale of the risks and the complexity of a firm's operations. From 2022, we will incorporate supervision of climate-related financial risks into our core supervisory approach. The assessment of a firm's management of climate-related financial risks will be included in all relevant elements of the supervisory cycle as outlined in our recently published Climate Change Adaptation Report.[7] As our collective understanding of climate-related risks, data, tools, and best practice evolves, we expect firms to refine and innovate to better integrate climate-related financial risk management across their organisation. The PRA will pay particular attention to how firms quantify climate-related risks and incorporate those risks into business strategies, decision-making, and risk-taking. Furthermore, we will keep a range of supervisory tools under review for use where we deem progress to be insufficient.

## 5. Regulatory reporting and data quality

Data is an increasing area of focus for both firms and the PRA. It is essential that we have accurate information and in line with this the submission of complete, timely and accurate regulatory returns continues to be the foundation of effective supervision.[8] Over 2020/2021 we asked firms to demonstrate how they deliver regulatory reporting of appropriate quality and commissioned a number of reports from skilled persons.[9] Overall we were disappointed to find significant deficiencies in a number of firms' processes for delivering accurate and reliable regulatory returns.[10]

We expect all firms to consider the thematic findings and any work they may need to do to improve their governance, controls, and data related to regulatory reporting. We expect the regulatory reporting process to receive no less care, diligence, and rigour than financial reporting. The PRA is expanding its programme of using skilled person's reviews[8] to verify the accuracy of regulatory returns, which will continue in 2022. Longer term, joint industry-Bank of England work on Transforming Data Collection,[11] creates the opportunity for better quality reporting at lower cost, and we encourage firms to engage with this initiative.

## 6. Diversity & Inclusion

Discussion Paper 2/21[12] set out our ambition to support the resilience of the financial services sector by encouraging diversity within firms. We see a clear link to our objectives: diversity helps bring a mix of views, perspectives and experiences within firms. An inclusive culture where staff can freely raise

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6 April 2019: Enhancing banks' and insurers' approaches to managing the financial risks from climate change.

7 October 2021: PRA Climate Change Adaptation Report 2021 - Climate-related financial risk management and the role of capital requirements

8 October 2019: Letter from Sarah Breeden and David Bailey 'Reliability of regulatory returns'.

9 Under Section 166 of the Financial Services and Markets Act 2000.

10 September 2021: Letter from David Bailey and Rebecca Jackson 'Thematic findings on the reliability of regulatory reporting'.

11 February 2021: Transforming data collection.

12 July 2021: DP2/21 – Diversity and inclusion in the financial sector – working together to drive change; and July 2021: DP21/2: Diversity and inclusion in the financial sector - working together to drive change.

concerns and participate appropriately in decision-making can reduce the risk of groupthink, encourage debate and innovation, and support the safety and soundness of firms.

We have received positive feedback from industry on the proposals in the Discussion Paper. While we recognise that change takes time, we expect firms to consider the themes set out in the Discussion Paper and challenge themselves to understand their gaps and consider where they can make progress.

**Other areas of supervisory focus**

Although a major milestone in the transition to risk-free rates was reached at the end of 2021, we expect firms to continue making best efforts to actively transition LIBOR referencing contracts wherever possible.[13] Together with the Financial Conduct Authority, we will be closely monitoring actions to remove any remaining dependencies on LIBOR, including synthetic LIBOR. We also expect firms to use the most robust alternative reference rates to LIBOR – any firm considering the use of credit-sensitive rates should assess the risks carefully and raise this with their supervisors before doing so.[14]

The Bank, as resolution authority, and the PRA, continue to prioritise resolution as this is an important component of ensuring that the UK has a resilient, efficient and competitive banking system. The Resolvability Assessment Framework (RAF)[15] applies to firms where the preferred resolution strategy is bail-in or partial-transfer, makes them accountable for their own resolvability, sets out how the Bank will assess this and introduces a public disclosure regime for the largest firms. These firms should continue to work to ensure that they achieve, and can continue to maintain, the resolvability outcomes, and ensure that they are transparent in their disclosures about their preparations for resolution.

This letter in conjunction with your firm's 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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[13] March 2021: Letter from David Bailey, Sarah Breeden and the FCA: 'Transition from LIBOR to Risk Free Rates'.

[14] July 2021: Financial Stability Report July 2021.

[15] July 2019: The Bank of England's approach to assessing resolvability.