BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Business Plan
2019/20

Prudential Regulation Authority

Business Plan 2019/20

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Foreword by the Chief Executive

Prudential regulation in the UK is leaving one phase and entering another. Brexit inevitably brings some uncertainties but the PRA will maintain high prudential standards

Looking back at last year's business plan and forward to this year's, I am struck that we in the PRA are moving out of the one phase and into another. This is happening in two ways, one more predictable than the other.

The more predictable shift is the move out of the post-crisis reform phase into more of a steady-state. The clearest example of this is in relation to ring-fencing: after many years of hard construction work the fence is up, and our activity switches from building to border patrol. We need to make sure that the fence does its job, and this will mean a range of new activities for our supervision teams, most obviously setting prudential requirements for the ring-fenced banks and making sure that they are operating in the way intended by Parliament.

But ring-fencing is only one example. Another important one is on the insurance side, where we have largely completed a set of refinements to our implementation of Solvency II and can get back to a stronger focus on the underlying elements of safety and soundness and policyholder protection. This will include ongoing scrutiny of life insurers' investments in illiquid assets and a variety of developments in general insurance markets.

Across both banking and insurance we will also push forward the next stage of our work on operational resilience. This will build on last year's discussion paper, through a proof-of-concept cyber stress test exploring the FPC's impact tolerance for payments, and through a consultation paper as we aim to establish a stronger regulatory framework in this area.

Another cross-cutting area where work is entering a new phase is competition. We will continue to implement the measures we have already brought in, such as the New Banks and New Insurers Start-up Units, to reduce barriers to entry. But we will also take a fresh look at barriers to growth. This is a difficult area because the very act of proportionality – in other words tougher standards for larger firms – creates a gradient of regulatory requirements for growing firms. But we will examine it in order to deepen our collective understanding of the issues.

Across all of this, we are putting more effort into our 'horizon-scanning' programme. This aims to prevent firms from risking up excessively or in ways that are not properly controlled or capitalised, and to identify and remove opportunities for regulatory arbitrage.

Finally, let me turn to the other main way in which we are moving out of one phase and into another – Brexit. At the time of writing, this remains rather less predictable than the change in regulatory phases described above. For that reason, over the past two years we put a huge amount of effort into activities designed to mitigate the impact of a cliff-edge, no-deal Brexit.

It is in the nature of our work that we spend time preparing for unlikely downside scenarios – this is, for instance, exactly what we do when stress testing both banks and insurance companies. Nonetheless, in the case of Brexit contingency planning this has been a particularly challenging task and has placed some strain on resourcing in the context of holding ourselves to a flat nominal budget. I therefore hope that in the course of this year we will enter a new phase in which more of our Brexit effort can be devoted to the future, and in particular to engaging with colleagues in Parliament, the Government, and industry about what sort of framework we want to have for financial services in the UK post-Brexit. It will not surprise you to hear that we see high prudential standards as a vital component of this!

A big thank you to all of the staff in the PRA for everything they have done over the last year. I hope this business plan provides a good guide to where we will be focusing our efforts as we enter the next phase of the PRA's work.

Overview of responsibilities and approach

The Prudential Regulation Authority (PRA), as part of the Bank of England (Bank), is responsible for the prudential regulation of deposit-takers, insurers and the largest investment firms in the UK.

The PRA was established in April 2013 as part of reforms to the regulation of financial services after the financial crisis. We were given two primary objectives: a general objective to promote the safety and soundness of the firms we regulate; and an objective specific to insurance firms, to contribute to ensuring that policyholders are appropriately protected. We also have a secondary objective to act in a way (so far as is reasonably possible) to facilitate effective competition in the markets for services provided by PRA-authorised firms.

We advance these objectives using two key tools: regulation and supervision. Through regulation, we set standards or policies that set out what we require and expect of firms. Through supervision, we assess whether firms are meeting our requirements and expectations, the risks that firms pose to our objectives and, where necessary, we take action to reduce those risks. Our approach to regulation and supervision is forward-looking, judgement-based, and focused on the issues and firms that pose the greatest risk to the stability of the UK financial system and policyholders, and is set out in the 'PRA approach documents'.[1]

We supervise around 1500 firms and groups.[2] This includes nearly 900 banks, building societies, credit unions[3] and designated investment firms (DIFs), and over 600 insurers of all types (general insurers, life insurers, friendly societies, mutuals, the London market and insurance special purpose vehicles (ISPVs)). As such, our focus is primarily at the individual firm and sector level (micro-prudential regulation) with the most important decisions taken by the Prudential Regulation Committee (PRC). The PRC works with other areas of the Bank and its committees, including the Financial Policy Committee (FPC) which has a view of the UK financial system as a whole (known as macro-prudential regulation). We also work closely with the regulator for conduct issues, the Financial Conduct Authority (FCA).

Chart 1: PRA-supervised deposit-takers and DIFs, as at 28 February 2019

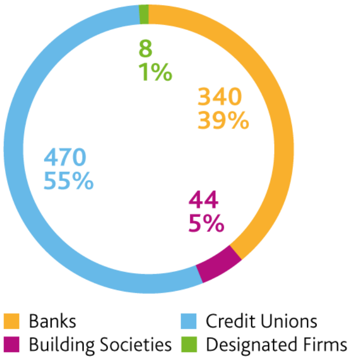
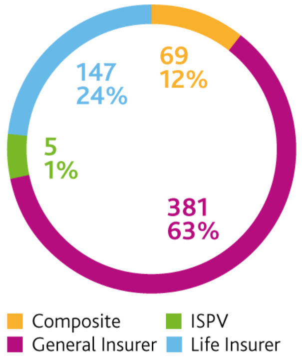


Chart 2: PRA-supervised insurers, as at 28 February 2019



1 Available on the Bank of England website at https://www.bankofengland.co.uk/prudential-regulation/publication/2018/pra-approach-documents-2018.

2 The exact number of PRA-authorised firms and groups changes as new firms enter, other firms close or vary their permission, and entities within groups restructure.

3 Banks, building societies and credit unions are collectively referred to as deposit-takers as they are the only UK financial institutions authorised and regulated to collect deposits from the general public.

The PRA's Strategy

The PRA's strategy is to deliver a resilient financial sector by seeking: an appropriate quantity and quality of capital and liquidity; effective risk management; robust business models; and sound governance including clear accountability of firms' management. This supports our pursuit of our primary safety and soundness, policyholder protection, and secondary competition statutory objectives.

Our regulatory regime involves both setting standards and holding firms to those standards through our supervision. We do not seek to operate a regulatory regime in which firms can never fail. When failure does occur, this should be with limited disruption to the provision of core financial services, without spillovers to the wider financial sector that could threaten financial stability, and should not expose the public sector to loss.

The strategic goals set out our workplan and priorities for the coming year. The context in which these goals have been formed continues to be one of significant change in the regulatory landscape.

This strategy will be achieved in close co-operation with other parts of the Bank, the Financial Conduct Authority (FCA), European and international counterparts. The continued excellent engagement of our staff will be integral to ensuring the successful delivery of our goals.

Shaping the PRA's strategy

Each year the PRA is required by law to review, and if necessary revise, its strategy and to publish a revised strategy in relation to our statutory objectives:

- to promote the safety and soundness of PRA-authorised firms;
- specifically for insurers, to contribute to the securing of an appropriate degree of protection for those who are or may become policyholders; and
- a secondary objective to act, so far as is reasonably possible, in a way which facilitates effective competition in the markets for services provided by PRA-authorised persons in carrying on regulated activities.

In addition to the statutory objectives, our strategy is shaped by other responsibilities such as the requirement to implement domestic and international legislation. This will include ensuring we have a fully functional legal and regulatory framework for financial services after the UK's withdrawal from the EU. Furthermore, as part of the Bank, we contribute to the delivery of the Bank's wider financial stability and monetary policy objectives.

We maintain the flexibility to respond to changes in markets, developments in the economy and other risks which can affect our statutory objectives and priorities, and reprioritise activities as needed. For 2019/20 such changes include the UK's withdrawal from the EU and developments in technology.

Strategic goals for 2019/20

The PRA's strategy outlines our intentions over the medium-to long-term. It was set by the Prudential Regulation Committee (PRC), in consultation with the Bank's Court of Directors. In order to progress the strategy, our strategic goals for 2019/20 are to:

- have in place robust prudential standards comprising the post-crisis regulatory regime, and hold regulated firms, and those who run them, accountable for meeting these standards ('robust prudential standards and supervision');
- continue to adapt to changes in the markets in which we are involved and pre-empt and mitigate risks to our objectives ('adapt to market changes and horizon scanning');
- ensure that firms are adequately capitalised, and have sufficient liquidity, for the risks they are running or planning to take ('financial resilience');
- ensure that operational resilience is established in our prudential framework and through time becomes as embedded in our supervisory approach as financial resilience is today ('operational resilience');
- ensure that banks and insurers have credible plans and capabilities in place to enable them to recover from financial stress events, and that we support the Bank as resolution authority to have a credible strategy to manage a firm's failure in an orderly manner ('recovery and resolution');
- facilitate effective competition by actively considering the proportionality of our approach as it contributes to the safety and soundness of the UK financial system ('competition');
- deliver a smooth transition to a sustainable and resilient UK financial regulatory framework following the UK's exit from the EU ('EU withdrawal'); and
- operate effectively and efficiently by ensuring that resources are allocated to work that best advances our strategy and reduces the greatest risks to the delivery of our statutory objectives ('efficiency and effectiveness').

PRA Business Plan 2019/20

This section sets out the workplan to deliver our strategic goals over the coming year

Robust prudential standards and supervision

We will maintain our commitment to robust prudential regulation. In 2019/20 the focus of work will pivot from developing and implementing new policies to embedding and evaluating them. We aim to safeguard the post-crisis gains in financial resilience, reforms such as those related to recovery and resolution (see pages 13-14), and ensure regulations are working as intended, while addressing more recent challenges including those associated with EU withdrawal and operational resilience. We will continue to support the Financial Policy Committee (FPC) to ensure that our regime is also delivering on the FPC's macroprudential objectives.

Structural reform – post-implementation monitoring and embedding

On Tuesday 1 January 2019, the largest UK banking groups[4] were required to implement the 'ring-fencing' of their UK retail business from their international and investment banking operations. This means that the core banking services on which retail and small business customers depend are ring-fenced from firms' wider activities in wholesale financial markets and the global economy.

Our supervisory focus now turns to ensuring that the ring-fences that have been established are effective in practice, and remain so.[5] Ring-fencing both broadens the range of regulatory requirements, and increases the intensity of supervision for the groups in scope. In October 2018, we updated our approach documents, including in respect of ring-fenced banks.[6]

In 2019/20 we will begin a review of proprietary trading by banks and designated investment firms in scope.[7] The review will consider whether the trading of these firms gives rise to any risks to their safety and soundness, what we have done to mitigate the risks and whether the powers of the PRA are sufficient to tackle such risks. In the PRA Annual Report 2018/19, due to be published later this year, we will include the first report to Parliament on the steps banks have taken to implement ring-fencing and firms' level of compliance.[8] We will also begin assessing the extent to which the new regime is meeting its objectives.

Solvency II – making improvements without eroding prudential standards

We finalised the majority of a series of improvements to our implementation of Solvency II in 2018.[9] The main remaining area of focus is the Solvency II risk margin, which we continue to consider too sensitive to interest rates and therefore too large in the current low rate environment, particularly for long-dated annuity business. The current design is leading UK insurers to reinsure the majority of new longevity exposure offshore. Over the coming year we will keep the implementation of the risk margin under review, as set out in the letter from Sam Woods to the Treasury Select Committee,[10] as our

4 Those with more than £25 billion of retail deposits. The requirement for large UK banks to ring-fence their core UK retail services and activities by 2019 is set out in amendments to FSMA under the Financial Services (Banking Reform) Act 2013 (the 2013 Act).
5 See 'From construction to maintenance: patrolling the ring-fence', speech by James Proudman, November 2018: https://www.bankofengland.co.uk/speech/2018/james-proudman-speech-at-cass-business-school-london.
6 'The PRA's approach to banking supervision', October 2018: https://www.bankofengland.co.uk/prudential-regulation/publication/2018/pra-approach-documents-2018.
7 As required under the Financial Services (Banking Reform) Act 2013 Part 1.
8 As required by Schedule 1ZB, paragraph 19(1A) of the Financial Services and Markets Act 2000 (FSMA).
9 https://www.bankofengland.co.uk/news/2017/october/pra-launches-series-of-improvements-to-the-implementation-of-solvency-ii.
10 'Solvency II Risk Margin', June 2018: https://www.bankofengland.co.uk/prudential-regulation/letter/2018/solvency-2-risk-margin.

future relationship with the EU in relation to financial services becomes clearer. We will also continue to explore possibilities to simplify implementation of the transitional measure on technical provisions, and expect to consult on a revision to our supervisory statement[11] in the first half of 2019.

Contribution to financial stability

We contribute to financial stability through policy development and implementation. This will include domestic evaluations of the capital framework and housing tools for the FPC, and developing and evaluating the macroprudential toolkit, including undertaking our own research, so that tools can be calibrated and implemented as the FPC identifies new or emerging risks.

Accountability – embedding and evaluating the governance regime for banks and insurers

As part of implementing the recommendations in the final report of the Parliamentary Commission on Banking Standards,[12] in 2016 the PRA and FCA implemented the Senior Managers and Certification Regime (SM&CR) to deliver clearer individual accountability at banks. We also delivered a proportionate regime for insurers – the Senior Insurance Managers Regime (SIMR) – that sat alongside the requirements of the Solvency II Directive and also applied to non-Directive firms. In December 2018, the SM&CR was extended to insurers – with the Certification Regime coming into effect in December 2019. This fully aligns the regimes for banking and insurance, while continuing to respect the different business models in the two sectors.

In 2019/20 we will begin an evaluation of the effectiveness of the SM&CR and remuneration policies for banks and insurers, as well as continue to review firms' governance arrangements in areas such as remuneration practices, diversity, and corporate governance at board level.

We will also continue our international work in these areas, including through engagement in international committees and with other jurisdictions developing their own accountability regimes.

Adapt to market changes and horizon scanning

The prudential regulatory framework must be responsive to changes in behaviour and the structure of the financial system, as well as risks arising from wider issues such as climate change and geopolitics. Over the coming year we will continue to seek to identify aspects of regulation that can lead to unintended behaviour or outcomes and will work with other areas of the Bank to aid and inform our monitoring of firms and the financial environment so that the appropriate responses can be put into place. For example, we will help to ensure that the microprudential, macroprudential and resolution frameworks are coherent and consistent with one another. Where issues are identified, and good practice is available to share, we will communicate to firms at individual or sector level, as appropriate, using channels including letters, speeches, briefings, and publications.[13] The following areas continue to be of particular interest to us as regulated firms adapt their practices and business models:

- The UK's withdrawal from the EU. Depending on the future relationship with the EU in relation to financial services, we will be monitoring any changes in firms' business structures, models and practices. We and firms will need to continue to monitor whether Threshold Conditions are met so that firms are permitted to carry on the regulated activities in which they engage.

11 SS6/16 'Maintenance of the transitional measure on technical provisions' under Solvency II, April 2017: https://www.bankofengland.co.uk/prudential-regulation/publication/2016/maintenance-of-the-transitional-measure-on-technical-provisions-under-solvency2-ss.
12 See 'Banking Commission publishes report on changing banking for good', 19 June 2013: http://www.parliament.uk/business/committees/committees-a-z/joint-select/professional-standards-in-the-banking-industry/news/changing-banking-for-good-report/.
13 All published materials are available from the PRA section of the Bank's website: https://www.bankofengland.co.uk/prudential-regulation.

- Financial risks arising from climate change. Following our research and recommendations on the possible effects of climate change on the banking and insurance sectors, we have set up the Climate Financial Risk Forum (CFRF), together with the Bank and FCA, to share good practice and provide intellectual leadership. We have considered responses to our proposed expectations on enhancing banks' and insurers' approaches to managing the financial risks from climate change,[14] and plan to publish final policy in the first half of 2019 and integrate these risks into our supervisory approach.

- New firms seeking authorisation to operate in the UK. Some new firms may be created from the restructuring of existing firms and groups, for instance as a result of the UK's withdrawal from the EU. Others may seek authorisation as they take advantage of digital technologies to deliver their services, or improvements to the regulatory processes through the joint PRA/FCA 'New Bank Start-up Unit' and 'New Insurer Start-up Unit'.[15] In the next three years, we expect this activity to continue to lead to an increase in the number of new banks and insurers.

- Monitoring the opportunities and risks from developments in technology. The financial sector continues to evolve, with technology driving significant change in a number of areas. We have begun to see the impact of Open Banking with the implementation of Payment Services Directive 2, and a number of large technology companies have continued to grow their financial services offerings. We will continue to monitor firms' operational resilience, focusing on issues such as cyber resilience, crypto-assets and the use of financial technologies (FinTech) by banks, insurers and their service providers. We will also continue to engage with firms and other industry participants (including other regulators) to consider whether and when any reassessment of prudential regulation is required. Moreover, we continue to remain alert to the broader challenges and opportunities arising from the use of regulatory technology, including how we could use it to collect, store and analyse data.[16]

- Firms' response to regulation. We will monitor firms' response to regulation to identify behaviours that lower regulatory requirements without a commensurate reduction in the underlying risk exposure. Domestically, we continue to monitor areas such as secured financing transactions and leveraged lending. Internationally, our work supports the Basel Committee's evaluation and monitoring work, for example in the work on the treatment of settled-to-market derivative transactions under the Liquidity Coverage Ratio and Net Stable Funding Ratio.

- Consolidation of defined benefit (DB) pension schemes. In 2018 the Department for Work and Pensions (DWP) consulted on proposals to create a regulatory regime for profit-seeking consolidators of closed DB pension schemes. We have a close interest in the regulation of such entities, as they offer financial services that are economically similar to annuities provided by PRA-regulated life insurers. Competition between insurers and consolidators, or direct involvement in consolidation by insurance groups, could affect delivery of the PRA's objectives. The PRA responded to the DWP consultation[17] and will continue to work with DWP and other stakeholders to help to deliver a regime that delivers the government's objectives in a way that is consistent with our own objectives.

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14 The banking and insurance sector reports, as well as CP23/18 'Enhancing banks' and insurers' approaches to managing the financial risks from climate change' are available at: https://www.bankofengland.co.uk/climate-change.

15 Information about the New Bank Start-up Unit and related materials are available on the Bank of England website at http://www.bankofengland.co.uk/prudential-regulation/new-bank-start-up-unit. Information and related materials for the New Insurers Start-up Unit are available at: https://www.bankofengland.co.uk/prudential-regulation/new-insurer-start-up-unit.

16 See 'Cyborg supervision – the application of advanced analytics in prudential supervision', speech by James Proudman: https://www.bankofengland.co.uk/speech/2018/james-proudman-cyborg-supervision.

17 February 2019: https://www.bankofengland.co.uk/prudential-regulation/publication/2019/pra-response-to-dwp-consultation-paper-defined-benefit-pension-scheme-consolidation.

Financial resilience

Our objective to promote the safety and soundness of PRA-authorised firms is delivered in part through ensuring that firms have adequate financial resources for the risks they are running or planning to take. We assess the financial resilience of firms through our supervision at firm and sector level, and use stress testing to examine how firms cope with extreme scenarios.

In the coming year, we will assess the adequacy of capital and liquidity resources of firms in the banking sector through a range of measures. We will continue to assess credit risk and asset quality, and to consider the level and drivers of risk-weighted assets. System-wide stress testing, thematic cross-firm reviews, continuous assessment meetings, scrutiny of regulatory returns and other data, and an assessment of where 'Pillar 1' capital requirements do not adequately capture risk will remain core parts of our work to ensure firms are adequately capitalised and have sufficient liquidity. Supervisory work will also take into account firms' implementation of policies related to financial resilience, such as the final Pillar 2 liquidity reporting requirements[18] (implemented from 1 July 2019). In carrying out this work, we will continue to draw on capabilities from across the Bank wherever possible to ensure the best possible outcomes.

We will continue to be involved in negotiating and implementing policy in international forums, including the Basel Committee on Banking Supervision (BCBS) and the Financial Stability Board (FSB), and – depending on the status of EU withdrawal – at the European level, for example as part of finalising the negotiations on the Capital Requirements Directive and Regulation (CRD V/CRR II). The Basel III reform package was endorsed in December 2017[19] and while the package has an implementation date of 2022 for most reforms, we will be monitoring how and when the new standards will be implemented in the UK.

For insurers, we continue to focus on balance sheet risks arising from complex products and asset exposures, and will assess whether insurers are setting appropriate risk appetites for Solvency Capital Requirement (SCR) coverage. We will continue to ensure robust and adequately calibrated Solvency II internal models, guarding against model drift.

For life insurers we will continue our programme of asset reviews (including of illiquid assets – see the asset quality section below), implement our updated supervisory statement on equity release mortgages,[20] and renew our focus on the adequacy of life insurance reserving.

For general insurers we will focus on business plan optimism, reserving and underwriting oversight for specialist general insurer business models. Following strong support from market participants to a letter we sent to CEOs of general insurers in May 2018,[21] in the coming year insurers with poor recent underwriting results will be asked to provide us with a copy of their 2019 business plan, and a justification of why their plans are appropriate. We will also extend our review of firms' exposure management, engaging with claims functions, and consider the effectiveness of reinsurance arrangements.

At the international level, we will work within the International Association of Insurance Supervisions (IAIS) to develop the Insurance Capital Standard (ICS) version 2.0. The design of ICS version 2.0 is

18 As set out in Appendix 4 of PS2/18 'Pillar 2 liquidity', February 2018: https://www.bankofengland.co.uk/prudential-regulation/publication/2016/pillar-2-liquidity.

19 https://www.bis.org/press/p171207.htm.

20 The latest version of SS3/17 'Solvency II: Matching adjustment – illiquid unrated assets and equity release mortgages', as well as PS31/18 'Solvency II: Equity release mortgages', December 2018, is available at: https://www.bankofengland.co.uk/prudential-regulation/publication/2018/solvency-ii-equity-release-mortgages.

21 See the letter, and our overall impression of the market's reaction to our letter is available at: https://www.bankofengland.co.uk/prudential-regulation/letter/2018/market-conditions-facing-specialist-general-insurers-feedback-from-recent-pra-review-work.

expected to be adopted by the IAIS in 2019, ahead of a five-year monitoring period beginning from 2020. We will also contribute to the finalisation of the IAIS' holistic framework for the mitigation of systemic risk in the insurance sector, which will be presented to the FSB in late 2019 ahead of its planned implementation from 2020 onwards. Subject to EU withdrawal, our engagement in Europe will also continue, eg with the European Insurance and Occupational Pensions Authority (EIOPA), and we will monitor the development and implementation of International Financial Reporting Standards (IFRS) 17 which will replace IFRS 4 on accounting for insurance contracts from 1 January 2021.

Stress testing

Stress testing of firms is one of the key tools used by us and other areas of the Bank to support our microprudential and macroprudential objectives.[22]

Banking stress tests examine the potential impact of a hypothetical adverse scenario on the individual institutions that make up the banking system, and on the system as a whole. We run two types of banking stress test. First, the annual cyclical scenario (ACS) is used by the FPC and PRC to assess banks' resilience to a severe stress informed by these committees' judgements about prevailing risks. The results are used as a guide to setting capital buffers for banks so that they have enough capital to withstand shocks while continuing to support the economy. As risks build in the financial system, and so the risk of severe negative macroeconomic and financial markets shocks rise, the ACS is designed to reflect these increasing risks.

Second, every other year we also run the biennial exploratory scenario (BES). The BES allows us to explore risks to the banking system not covered in the ACS, and which do not necessarily relate to the capital adequacy of banks. The first BES in 2017 focused on the potential impact on banks' business models of persistently low interest rates and the increased use of FinTech. In 2019 the Bank will launch both an ACS and its second exploratory scenario.

Insurance firms use stress and scenario testing to consider the potential impact of certain adverse circumstances on their business. It is an important element in firms' planning and risk management processes, helping them to identify, analyse and manage risks.[23] To complement EIOPA's 2018 exercise and firms' own assessments, in the second half of 2019 we plan to run a stress test exercise for larger insurers, covering around 85% of the general insurance sector and 95% of the life insurance sector by assets. The aim of the exercise will be to understand sector-wide and individual insurer resilience to a number of scenarios, including natural and man-made catastrophes for general insurers and credit and longevity stresses for life insurers.

Asset quality

Taking a risk-based approach, we will review firms' asset quality and management of investment risk. Where we find weaknesses, we will address them appropriately through supervisory action and setting regulatory expectations and/or requirements.

Since the introduction of Solvency II, UK life insurers have increased their holdings of illiquid assets such as infrastructure, commercial real estate (CRE) and equity release mortgages to back annuity liabilities. These can be a good match for long-term annuity liabilities, but they can also be complex and may lack observable market prices as well as external credit ratings, making it difficult to assess the investment risk firms are taking. Last year we updated our supervisory statement on assessing the appropriateness of the matching adjustment benefit claimed by firms in respect of equity release mortgages. We will

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22 Further information on our stress tests can be found: https://www.bankofengland.co.uk/stress-testing.

23 The 'Stress testing for insurers' section on the Bank's stress testing web page sets out the PRA's expectations of firms, and includes information about how stress testing is incorporated in the Solvency II Own Risk and Solvency Assessment, see https://www.bankofengland.co.uk/stress-testing.

follow this up with a consultation in 2019 on outstanding issues, including the ongoing assessment of the Effective Value Test, and how best to address excessive interest rate sensitivity that may arise over time. Other work on illiquid assets will include examining how risks associated with CRE lending are incorporated into internal models. We will continue to review firms' risk management and governance of illiquid and other assets, including their internal ratings. Where we have concerns about particular internal ratings, we may commission an opinion from an External Credit Assessment Institution (ECAI) using our powers under Section 166 of FSMA. We will target our reviews at firms with large and/or complex exposures.

The Prudent Person Principle in Solvency II is an important safeguard against concentration risk. It requires insurers to invest only in assets where they can properly identify, measure, monitor, manage, control and report the risks. In 2019, we plan to consult on a supervisory statement on our expectations of firms' implementation of the Prudent Person Principle.

A number of recent changes in financial markets have increased insurers' exposure to liquidity risk. In 2019, we also plan to issue a supervisory statement outlining good practices for insurers to identify, monitor and manage liquidity risks, following the consultation published in March 2019.[24]

Credit risk remains a dominant risk carried by the banking sector. Over 2019 we will continue to assess credit risk and asset quality in PRA-regulated banks using:

- supervisory tools such as continuous assessment (meetings and regulatory returns data reviews), written auditor reports (WARs), and interactions with auditors;
- specialist-led reviews including assessments of firms' credit risk management, provision coverage and asset quality;
- thematic reviews, combining financial stability and risk specialist resources to provide both micro- and macro-impact assessments for particular asset classes and sectors;
- annual stress testing, under the new IFRS 9 accounting standard for expected credit losses; and
- reviews of firms' Internal Capital Adequacy Assessment Processes (ICAAPs).

We will further embed the approach adopted in 2018 where we broadened the scope of reviews to improve the systematic coverage of the full credit risk lifecycle: market conditions and strategy; asset origination and underwriting standards; asset quality; monitoring and control; problem debt management and IFRS 9 provisions; and capital adequacy. This work will be focused on key risk areas aligned to supervisory priorities and credit conditions. We will continue to undertake the annual UK CRE underwriting survey, which captures loans written by major bank and insurance participants. In addition, for 2019 we will undertake a similar exercise for leveraged lending and highly leveraged corporates to hep inform our understanding of the risks these activities pose to our firms.

Alongside our work to improve the systematic coverage of the full credit risk lifecycle we will continue to undertake selected detailed asset quality reviews on potentially higher risk portfolios, products and segments across both commercial and retail activities as determined through our horizon-scanning activities. Our asset quality reviews will focus on areas of risk impacted by a variety of factors including, but not limited to, changes in the external market, firms' business models, and firms' risk profiles. We will also continue to assess firms' asset quality in various cross-firm exercises such as stress testing (see the stress testing section on page 10).

24 CP4/19 'Liquidity risk management for insurers': https://www.bankofengland.co.uk/prudential-regulation/publication/2019/liquidity-risk-management-for-insurers.

International Financial Reporting Standard (IFRS) 9

For the banking sector, we continue to progress work on how firms are implementing IFRS 9. While it is not for us to set, interpret or enforce accounting standards, we have issued – and will continue to issue – communications to firms where the application of the accounting standards has an impact on our statutory objectives.[25] Supervisors will continue to work closely with firms to monitor implementation and any impact on capital. We are also working with the largest UK banks and building societies to identify and begin addressing material sources of modelling and other inconsistency between firms. We also continue to encourage good disclosures about IFRS 9. We, the FCA, and Financial Reporting Council are sponsoring the work of the UK Taskforce on Disclosures about Expected Credit Losses (DECL Taskforce), a partnership of preparers and users of annual reports that is making a series of recommendations designed to encourage firms to provide comprehensive and comparable high-quality year-end disclosures about expected credit losses.

We will also continue to contribute to the work being carried out internationally and domestically to ensure that any implications for the regulatory capital regime are identified and addressed. Working with colleagues in the Financial Stability Directorate of the Bank, we will use the results from the 2018 stress test to assess how best to avoid the interaction of IFRS 9 and the stress test leading to an unwarranted increase in capital requirements as transitional arrangements are phased out. Continuing engagement with trade bodies, auditors and global accounting and auditing standards setters will also help to identify any guidance needed for an orderly, prudent and consistent approach to implementation.

Operational resilience

Operational disruption can impact financial stability, threaten the viability of individual firms and Financial Market Intermediaries, or cause harm to consumers, policyholders and other market participants in the financial system. Operational resilience therefore continues to be a high microprudential and macroprudential priority for us and other areas of the Bank, as well as the FCA.

From a microprudential perspective, our priority is continuing the development of our supervisory approach, tools and firm engagement, building on our joint discussion paper with the Bank and FCA, published in July 2018.[26] Having received feedback on the discussion paper we will continue to work with the Bank and FCA to develop a framework that provides a common understanding of, and approach to, the supervision of operational resilience, while acknowledging the different responsibilities of the separate regulatory authorities. We plan to publish a consultation paper in the second half of 2019 setting out our proposed policy, with a view to establishing operational resilience in our prudential framework by end-2020, and through time embedding operational resilience into our supervisory approach as much as financial resilience is today. For life insurers, we will work with the FCA to review outsourcing arrangements. We will also continue to assess the use of cloud infrastructure by PRA-regulated firms. Other operational resilience supervisory work will continue this year, and will contribute to and help to inform our microprudential agenda.

Our assessment of firms' operational resilience will continue and develop this year, again closely aligned with the Bank and FCA. As planned, we will focus on developing and improving response capabilities as identified by the 2018 market-wide cyber incident exercise. We will also prepare for the next cycle of response exercises both internationally and domestically scheduled for 2019 and 2020. We will also support enhancement of the financial sector's collective cyber incident response tools, threat

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25 Letters to firms setting out the PRA's expectations and other communications are available on the Bank's website at: https://www.bankofengland.co.uk/prudential-regulation/letter/2017/transition-disclosures-for-ifrs9-financial-instruments.

26 DP1/18 'Building the UK financial sector's operational resilience': https://www.bankofengland.co.uk/prudential-regulation/publication/2018/building-the-uk-financial-sectors-operational-resilience-discussion-paper.

information sharing, and risk management by working with external partners and industry bodies to establish the Financial Sector Cyber Coordination Centre.

We will continue to support the FPC with its cyber agenda, including the planned stress test, and setting impact tolerances. We will continue to engage bilaterally with firms and this engagement will help to inform the FPC's view of its systemic risk appetite.

Across this work we will maintain and develop the required network to enable the Bank's operational resilience strategy to access specialist support. This includes continuing to work with HM Treasury, FCA, National Cyber Security Centre, Information Commissioner's Office, and National Crime Agency. International engagement also remains key, since firms operate internationally and operations span across borders. We will work with a range of international forums such as the Basel Committee and the G7, and will continue to push for increased international co-ordination.

Recovery and resolution

As part of our supervisory approach, we recognise that firms can face periods of financial stress. To ensure an efficient, competitive banking system that supports growth, firms should be allowed to fail; this means accepting that we do not operate a zero-failure regime.

During the financial crisis, governments were forced to bail out failing banks, some of which were too big to be allowed to fail. As part of addressing the 'too big to fail' problem, firms are required to draw up recovery plans, so that they are ready for periods of financial stress, can stabilise their financial position, and recover from financial losses. Recovery planning is an important component of the regulatory reform agenda and addresses the risk that the management of firms concentrate disproportionately on growth opportunities at the expense of managing downside risk. We expect firms to undertake recovery planning, with final elements of our policy coming into effect on 30 June 2019.[27]

However, if a firm does fail, the Bank, as the UK's resolution authority, must ensure that it does so in an orderly manner, reducing risks to depositors, the financial system and public finances – a process known as resolution.

The final major piece in the UK's resolution regime for banks was reached with the publication of Bank (as resolution authority) and PRA (as prudential regulator) proposals related to the Resolvability Assessment Framework (RAF).[28] The RAF is designed to ensure banks are accountable for their own resolvability. It does this by setting rules to demonstrate how firms have prepared for resolution and requiring UK banks with at least £50 billion in retail deposits to disclose publicly their own assessment of their resolvability. These banks would be required to submit assessments of their preparation for resolution to the PRA and publicly disclose a summary of that assessment on a two-year cycle beginning in 2020.

Our existing policy on structural reform and operational continuity in resolution, in effect from 1 January 2019, also contributes to this strategic goal. Firms will continue to develop capabilities in other areas of the reforms, including valuations,[29] and continuity of access to financial market infrastructures.

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27 See Supervisory Statement 9/17 'Recovery planning', December 2017: https://www.bankofengland.co.uk/prudential-regulation/publication/2017/recovery-planning-ss.

28 See the joint Bank of England and PRA 'Introduction to the Resolvability Assessment Framework' at: https://www.bankofengland.co.uk/paper/2018/introduction-to-the-resolvability-assessment-framework.

29 See 'The Bank of England's policy on valuation capabilities to support resolvability', June 2018: https://www.bankofengland.co.uk/paper/2018/the-boes-policy-on-valuation-capabilities-to-support-resolvability.

We will also continue our work with the Bank's Resolution Directorate to ensure firms develop capabilities to wind down their trading and derivatives businesses in an orderly manner, and collaborate with international regulators to ensure a coordinated and effective approach. In the coming year we will continue to progress solvent wind down work with UK banks and international investment firms that have material trading and derivative books, with a view to developing policy for the approach to be taken in the PRA Rulebook.

For insurers, we will continue to contribute to the FSB's resolvability assessment process for the two global systemically important insurers (G-SIIs) for which we are the host supervisor.

Competition

Our secondary competition objective states that 'when discharging its general functions in a way that advances its objectives, the PRA must so far as is reasonably possible act in a way which, as a secondary objective, facilitates effective competition in the markets for services provided by PRA-authorised persons in carrying on regulated activities'.

In March 2017, the Government sent the PRC its first recommendation letter about aspects of the Government's economic policy to which the PRC should have regard when considering how to advance its objectives and when considering the application of the regulatory principles set out in FSMA.[30] The letter indicated that the Government is keen to see more competition in all sectors of the financial services industry, particularly retail banking. This includes minimising barriers to entry and ensuring a diversity of business models, and recognising differences in the nature and objectives of business models and ensuring burdens are proportionate.

In the coming year, we will continue to deliver against our secondary competition objective by:

- assessing the competition implications of our policies and checking for any unintended distortions to competition;
- continuing to implement policies to facilitate internal-rating based model applications from smaller banks,[31] and refining the Pillar 2A capital framework;[32]
- further refining the framework to facilitate the issuance of Insurance Linked Securities (ILS) through ISPVs in the UK with a planned consultation in H1 that will take account of our experience of operating the new supervisory regime since the end of 2017;[33]
- completing new bank authorisations where relevant,[34] and ensuring the application of a proportionate approach within the UK banking sector;
- continuing to support the New Bank Start-up Unit, and the New Insurer Start-up Unit;[35]
- developing in a proportionate manner our approach to operational resilience in our prudential framework; and

30 Information about the PRC and HM Treasury's letter are available on the Bank's website at https://www.bankofengland.co.uk/about/people/prudential-regulation-committee.

31 Policy Statement 23/17 'Internal Ratings Based (IRB) approach: clarifying PRA expectations', October 2017: https://www.bankofengland.co.uk/prudential-regulation/publication/2017/internal-ratings-based-approach-clarifying-pra-expectations.

32 Policy Statement 22/17 'Refining the PRA's Pillar 2A capital framework', October 2017: https://www.bankofengland.co.uk/prudential-regulation/publication/2017/refining-the-pra-pillar-2a-capital-framework.

33 Information on the framework for ISPVs is available at: https://www.bankofengland.co.uk/prudential-regulation/authorisations/insurance-special-purpose-vehicles.

34 See the dedicated web page for more information and materials at: http://www.bankofengland.co.uk/prudential-regulation/new-bank-start-up-unit.

35 The New Insurer Start-up Unit was launched in August 2018. See the dedicated web-page for more information and materials at https://www.bankofengland.co.uk/prudential-regulation/new-insurer-start-up-unit.

- conducting further analysis on barriers to growth for smaller firms, including by assessing the extent to which the overall regulatory burden is affected as firms grow organically in size and complexity.

EU withdrawal

Preparing for the UK's withdrawal from the EU has been a significant focus for us since 2016, and will continue to be in 2019/20. We have approached this work guided by our statutory objectives and by the Bank's wider objective of financial stability. EU withdrawal represents a potentially significant change in the operating environment for financial services institutions.

Monitoring and mitigating risks

The FPC has published its assessment of risks of disruption to financial services from EU withdrawal on a quarterly basis. These include risks relevant to the PRA, such as having an appropriate legal and regulatory framework in place and continuity of banking and insurance services. We have used the checklist as a way of monitoring key risks and tracking progress against them.

We have prepared for EU withdrawal in whatever form it takes. Throughout the year, we have been working with the firms we supervise to identify potential risks to their operations resulting from EU withdrawal. We will continue to work closely with the rest of the Bank, firms and other authorities to monitor and mitigate prudential risks arising from the UK's withdrawal from the EU, informing the FPC's work where necessary.

Regulatory and supervisory framework

We have been working closely with the Government to ensure that there is a clear legal and regulatory framework post-exit in order to ensure continuity for firms. Following consultations published in October and December 2018, we have set out our near-final changes to the PRA Rulebook, and onshored binding technical standards (BTS) alongside Policy Statement (PS) 5/19 'The Bank of England's amendments to financial services legislation under the European Union (Withdrawal) Act 2018', published on Thursday 28 February 2019.[36] The PS sets out our feedback on responses to the two consultations and our near-final policy in relation to changes to the onshored legislation and use of temporary transitional powers. In particular, we intend to use the temporary transitional powers so that firms and financial market infrastructures (FMIs) providing services within the Bank's and PRA's regulatory remits do not in most cases need to take any new action ahead of exit-day.

We will also work closely with the Government to implement the Financial Services (Implementation of Legislation) Bill. We will work with firms to provide clarity and guidance.

In the October consultation, we set out how, in the event the UK withdraws from the EU without an implementation period, the PRA would adopt some of the roles and responsibilities carried out by EU authorities. These have been set out in more detail as part of the communications on 28 February.[37]

Authorisations

A major part of our work to prepare for EU withdrawal over the last few years has been the authorisation of firms using their EEA passport to operate in the UK. Under the new temporary permissions regime (TPR), EEA firms that have been passporting into the UK can continue to operate for a period after withdrawal while they seek authorisation. We have been in close contact with firms and

36 https://www.bankofengland.co.uk/paper/2019/the-boes-amendments-to-financial-services-legislation-under-the-eu-withdrawal-act-2018.
37 More information is available at: https://www.bankofengland.co.uk/eu-withdrawal/transfer-of-roles-and-responsibilities-to-the-bank.

home supervisors through the year, and have been strongly encouraging firms to discuss their plans with their usual supervisory contact, to understand any risks to the safety and soundness of firms and to the financial sector as a whole. We will continue to work closely with firms on their applications during the Implementation Period, and also remain in close contact with their home supervisor.

Supervisory co-operation

Regardless of the UK's future relationship with the EU, we believe that supervisory co-operation is essential for effectively managing cross-border risks and activities. We have therefore worked closely with EU authorities (and the FCA and HM Treasury, as appropriate) to develop an appropriate supervisory co-operation framework. UK and EU authorities have made good progress on their discussions, and we have now signed Memorandums of Understanding with our main counterparts. The focus going forward will be on making these arrangements operational.

Future of financial regulation

The Treasury Select Committee (TSC) has announced an inquiry into the future of the UK's financial services sector. It will examine what the Government's priorities should be when it negotiates the UK's future trading relationship with the EU and third countries, how the financial services industry can take advantage of the UK's new trading environment, and whether the UK should maintain the current regulatory barriers that apply to third countries. We expect to provide evidence to the TSC to inform its work.

Efficiency and effectiveness

As part of the Bank's commitment to improve the way we work,[38] we will continue to drive effective prioritisation and to make our structures more fluid. We will provide targeted training and development to build expertise in our people, and will bring together people with different areas of expertise, skills and outlook to achieve our statutory objectives.

Embedding the plan for PRA technology

We will continue to develop our existing capability to provide improved management information to support the assessment of firms. This will be underpinned by continued incremental improvements to data storage and analytics. As part of our commitment to developing regulatory technology, we will continue to develop our Supervisory Desktop solution, and will also undertake the first phase of a project to implement new machine learning techniques to improve further the efficiency of our operating procedures in front-line supervision. In parallel we will continue to investigate other ways machine learning techniques may assist other areas of our business. More widely, in the course of 2019/20 we will have a fresh look at what opportunities may exist to improve ways in which our staff can access and analyse data.

Keeping pace with technological innovation will require significant effort. All of the work on regulatory technology will depend on close collaboration with our colleagues in the data, technology, legal, policy and procurement areas of the Bank. In the coming year we plan to build on the 'Best Use of RegTech' achievement recognised at the Banking Technology Awards 2018.[39]

38 For more information, see the Bank's Strategic Plan section (page 15) of the Bank's Annual Report and Accounts – 2018: https://www.bankofengland.co.uk/annual-report/2018.
39 For more information, see: https://awards.bankingtech.com/.

Risks to the delivery of the PRA Business Plan

Operating in a complex and fast-moving environment inevitably gives rise to risks to the delivery of the PRA Business Plan. These risks are monitored, actively mitigated (where possible), managed and reported to the PRC and Supervisory Risk and Policy Committee (SRPC) on a regular basis.

Unforeseen events

The nature of our environment means that we deal with unforeseen events that may arise internationally and domestically and which require a swift regulatory response. Depending on the scale and nature of these events, they can lead to significant re-prioritisation of Business Plan deliverables. Any crystallisation of risks within firms, adverse change in the economic environment, or other changes within or outside the UK, may impact the safety or soundness of firms. While recovery and resolution planning and stress testing will reduce the impact of firm failure on financial stability, a large and wide-ranging shock that impacts financial stability remains a risk and would have a significant impact on the Business Plan.

Execution risk

We continue to manage an extensive landscape of regulatory and legislative change and this will place additional constraint on resource which may compromise our ability to carry out our obligations as planned. The most significant execution risks include: firms being unable to submit and/or we are unable to process the necessary regulatory transactions ahead of withdrawal from the EU; and that we lose supervisory visibility of risks posed by firms due to structural or business model changes.

Dependencies

While we are working with the Bank and FCA on a systems upgrade to decrease our reliance on FCA systems, we are still reliant on them for the provision of certain IT systems and any degradation of service will impact our ability to deliver our obligations. The FCA provides upgrades and fixes to ensure a maintained service.

Our policymaking is often dependent on overseas authorities that lead on timings and requirements for delivery of legislative and regulatory change. The outcome of international policy negotiation could also differ from current PRA and Bank objectives which, in certain circumstances, could weaken our current approach. Maintaining external policy relationships is key in ensuring that new policy requirements meet our statutory objectives.

Internal factors

The PRA's budget is set in the context of the Bank's overall framework of financial control, and the Bank's target to maintain a flat nominal budget for 2019/20. In this context, our senior management team has conducted an extensive exercise to consider how best to focus our resources during the coming year given our eight strategic goals. There are difficult choices to make to deliver within flat controllable costs and constrained headcount. As a result, we have carefully considered which work to de-prioritise and will enact options including streamlining, delaying work, and reducing the frequency and intensity of certain activities. We have also incorporated sufficient flexibility in our resource planning to adapt to changes. To ensure we are using our limited resources in the best way to advance our objectives in the longer term, we are also undertaking a review of our operating model.

Measuring progress

We draw on a variety of information to monitor, and provide assistance over, the progress of delivery against our statutory objectives, strategy and business plan on an ongoing basis.

For example, we assess the success of our supervisory approach through: i) self and peer reviews where staff assess their own performance and receive independent challenge at regular intervals, as well as reviews carried out by other bodies (such as the IMF); ii) regular reviews of how firm-specific risks are being managed; and iii) firm feedback, and independent and/or external reviews. In the coming year, we and the Bank will start delivering the actions set out in our joint response to the independent review of the Co-operative Bank.[40]

The PRC and SRPC receive information on a regular basis, both quantitative and qualitative measures and indicators, to enable an assessment of delivery against our strategy, business plan, statutory objectives, and risk tolerance. This enables the PRC to report to the Chancellor on the adequacy of resources and to provide sufficient information on supervisory processes and outcomes.[41]

40 Information about the independent review, and our response, is available in the Bank's news release 'Independent Review of the supervision of the Co-operative ('Co-op') Bank published', 27 March 2019: https://www.bankofengland.co.uk/news/2019/march/independent-review-of-the-supervision-of-the-co-op-bank-published.

41 The PRC letter to the Chancellor for 2017/18 is available on pages 8-9 of 'The PRA Annual Report 2018': https://www.bankofengland.co.uk/prudential-regulation/publication/2018/annual-report-2018.

PRA Budget 2019/20

The PRA's budget for 2019/20 is £273 million, including implementation, project and transaction fees of £16 million, which is a decrease of £1 million on the 2018/19 budget[42]

The costs of the PRA will remain broadly flat in nominal terms with a reduction in the costs relating to activity to support structural reform, reflecting the implementation of the regime on 1 January 2019, and the supervision of ring-fenced banks in business as usual, with costs retained for post-implementation monitoring; and continued reduction in resource allocated to lower risk supervisory activity. This is offset by increases in other investment activities and the priorities of operational resilience, resolvability assessment, and developments in technology.

We explain how the PRA proposes to fund its budget in CP9/19 'Regulated fees and levies: rates proposals 2019/20',[43] published alongside the Business Plan. This CP includes proposals for allocating the cost of the PRA's 2019/20 ongoing regulatory activities across PRA fee payers.

42 The PRA's budget published in the PRA Business Plan 2018/19 was stated as £275 million, but was revised to £274 million when the PRA's pension costs were available, as set out in PS13/18 'Regulated fees and levies: rates for 2018/19': https://www.bankofengland.co.uk/prudential-regulation/publication/2018/regulated-fees-and-levies-rates-proposals-2018-19. Similarly, the PRA's budget for 2019/20 is provisional and may need to be revised when final estimates for the PRA's pension costs are available.

43 April 2019: https://www.bankofengland.co.uk/prudential-regulation/publication/2019/regulated-fees-and-levies-rates-proposals-2019-20.

Abbreviations

ACS	Annual cyclical scenario
Bank	Bank of England
BCBS	Basel Committee on Banking Supervision
BES	Biennial exploratory scenario
CEO	Chief Executive Officer
CFRF	Climate Financial Risk Forum
CRD	Capital Requirements Directive
CRD IV	CRR and CRD collectively
CRR	Capital Requirements Regulation
DB	Defined benefit
DECL Taskforce	The UK Taskforce on Disclosures about Expected Credit Losses
DWP	Department for Work and Pensions
EIOPA	European Insurance and Occupational Pensions Authority
EU	European Union
FCA	Financial Conduct Authority
FinTech	Financial Technology
FPC	Financial Policy Committee
FSB	Financial Stability Board
FSMA	Financial Services and Markets Act 2000 (as amended)
G-SII	Global systemically important insurer
G7	Group of Seven
IAIS	International Association of Insurance Supervisors
ICS	Insurance Capital Standard
IFRS	International Financial Reporting Standard
ILS	Insurance Linked Securities
IMF	International Monetary Fund
ISPV	Insurance special purpose vehicle
NtA	Nationalising the Acquis
PRA	Prudential Regulation Authority
PRC	Prudential Regulation Committee
RAF	Resolvability Assessment Framework
SCR	Solvency Capital Requirement
SIMR	Senior Insurance Managers Regime
SM&CR	Senior Managers and Certification Regime
TPR	Temporary permissions regime
UK	United Kingdom

Contacting the Bank of England and PRA

Please send any enquiries related to this publication to PRA.Communications@bankofengland.co.uk.

Bank of England
Threadneedle Street
London EC2R 8AH

020 3461 4444
www.bankofengland.co.uk

Public Enquiries
020 3461 4878
enquiries@bankofengland.co.uk

Prudential Regulation Authority
20 Moorgate
London EC2R 6DA

020 3461 4444
www.bankofengland.co.uk/pra

Firm Enquiries
020 3461 7000
PRA.FirmEnquiries@bankofengland.co.uk

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