BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

Annual Report

Annual Report

1 March 2020–28 February 2021

Prudential Regulation Authority
Annual Report[1]
1 March 2020 to 28 February 2021

Presented to Parliament pursuant to paragraph 19(4) of Schedule 1ZB of the Financial Services and Markets Act 2000 as amended by the Financial Services Act 2012, and the Bank of England and Financial Services Act 2016.

1 Including the PRA Annual Competition Report, and the annual report of the Prudential Regulation Committee to the Chancellor of the Exchequer on the adequacy of PRA resources and the independence of PRA functions.

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This report is made by the Prudential Regulation Authority (PRA) under the Financial Services and Markets Act 2000 (FSMA) as amended by the Financial Services Act 2012 and the Bank of England and Financial Services Act 2016. It is made to the Chancellor of the Exchequer and covers the year ended 28 February 2021.

The report covers the requirements of paragraph 19 of schedule 1ZB of FSMA.

The Bank of England Annual Report and Accounts for the year ending 28 February 2021 is available on the Bank of England's (the Bank's) website. The PRA's audited accounts for the reporting year ending 28 February 2021 are set out on pages 164–172 of the Bank of England Annual Report and Accounts. HM Treasury has issued an accounts direction; disclosures relating to this can be found on pages 168–169 of the Bank of England Annual Report and Accounts.

Additional material can be found on the Bank's website at www.bankofengland.co.uk/prudential-regulation.

Any enquiries related to this publication should be sent to us at praannualreport@bankofengland.co.uk.

Consultation

Members of the public are invited to make representations to the PRA on the:

- PRA Annual Report;

- way in which the PRA has discharged, or failed to discharge, its functions during the period to which the report relates; and

- extent to which, in their opinion, the PRA's objectives have been advanced and the PRA has considered the regulatory principles to which it must have regard when carrying out certain of its functions (contained in section 3B of FSMA), and facilitated effective competition in the markets for services provided by PRA-authorised firms in carrying on regulated activities in accordance with section 2H of FSMA.

Please address any comments or enquiries to praannualreport@bankofengland.co.uk or by post to:

PRA Communications
Prudential Regulation Authority
20 Moorgate
London EC2R 6DA

The consultation closes on Tuesday 14 September 2021.

Privacy and limitation of confidentiality notice

By providing representation to the PRA on this Annual Report, you provide personal data to the Bank of England. This may include your name, contact details (including, if provided, details of the organisation you work for), and opinions or details offered in the representations.

The representations will be assessed to inform our further work as a regulator. We may use your details to contact you to clarify any aspects of your response.

Your personal data will be retained in accordance with the Bank's records management schedule. To find out more about how we deal with your personal data, your rights, or to get in touch please visit www.bankofengland.co.uk/privacy.

Information provided in response to this report, including personal information, may be subject to publication or disclosure to other parties in accordance with access to information regimes including under the Freedom of Information Act 2000 or data protection legislation, or as otherwise required by law or in discharge of the Bank's functions.

Please indicate if you regard all, or some of, the information you provide as confidential. If the Bank of England receives a request for disclosure of this information, we will take your indication(s) into account, but cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system on emails will not, of itself, be regarded as binding on the Bank of England.

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Foreword by the Chair

Andrew Bailey
Governor,
Chair of the Prudential Regulation Committee

As Sam rightly says in his foreword, the financial system has played a key role in supporting the UK economy through the turmoil of the pandemic. This outcome could not have been achieved without public and market confidence in UK banks, building societies, credit unions and insurers. That confidence is supported by the PRA's oversight of the safety and soundness of these firms.

Like all organisations, Covid-19 led us to make many changes to our plans for 2020/21. We did not, therefore, achieve everything we had originally intended to. But that is not a criticism. Rather, PRA colleagues quickly adapted their supervision plans to make space for new priorities, including work to assess emerging risks and running novel reverse stress tests. We also made adjustments to a variety of policies to allow firms headroom to serve their customers. And in some cases we postponed and even cancelled planned work while ensuring that we continued to deliver on our mandate as the circumstances changed.

Our response to Covid-19 has again shown the benefit of the PRA being a regulator within the central bank. Close working between PRA colleagues and other teams within the Bank of England has meant that the Financial Policy Committee and Monetary Policy Committee have benefited from incisive and timely analysis from supervisors, including on stress test results, Libor transition, and the implications of negative interest rates on the financial sector and the economy.

Joint working across the Bank also mitigated financial stability risks that might have resulted from the UK's exit from the EU, with UK legislation coming in to force in January. We have already begun the process of developing the UK's future financial regulations, jointly with the FCA and HM Treasury. This will be a major priority for the PRA for the coming years.

I give my sincere thanks to all PRA staff and fellow members of the PRC, whose hard work and personal resilience has been instrumental in achieving these outcomes.

20 May 2021

Report by the Chief Executive

Sam Woods
Deputy Governor, Prudential Regulation,
Chief Executive of the PRA

I said in my foreword to last year's Annual Report that we are moving from implementing the reforms following the last great crisis, to defending our framework and looking out for new risks and opportunities. Over the past year, those new risks have crystallised in the form of the crisis caused by the Covid-19 pandemic. The reforms have played a vital role in ensuring the financial system was able to cope with this new crisis, and our key role has been to help support the economy through this period. The measures we put in place to respond to the economic shock of Covid-19 were therefore a major focus for us in 2020/21. However, as you will see from this report, we have also been able to continue making progress on our other strategic priorities, including – and perhaps most significantly – delivering a smooth transition to a sustainable and resilient UK financial regulatory framework following the UK's exit from the EU.

Few sectors have avoided the effects of the disruption brought about by Covid-19. In the world of prudential regulation, we have been focused on managing its impacts on the sectors we regulate, in order to help build a bridge to enable the economy get to the other side of the crisis safely. The most important bits of bridge-building for this crisis have been done by the Treasury – in particular, the furlough scheme and various loan schemes. But we have been busy too. For instance: to retain capital in the system we requested large banks to suspend dividend payments for 2020 and cancel any outstanding 2019 dividends payments; to take pressure off firms we paused section 166 reviews; and to aid the functioning of monetary policy we asked firms to ensure operational readiness for negative rates. As I write, the outlook looks better than we might have expected a year ago, but there is still considerable uncertainty.

The last year has also thrown into sharp relief the importance of firms' operational resilience, with an unprecedented number of staff across the financial sector working from their homes rather than offices. Operational resilience of firms and financial market infrastructures (FMIs) is a key priority for the PRA, and this year we finalised our co-ordinated Policy Statements with the Bank and FCA, following extensive consultation and engagement with industry. The policy makes it clear that firms and FMIs are expected to take ownership of their operational resilience and to prioritise plans and investment choices based on their impacts on the public interest. We also focused this year on firms' cyber resilience and on other key areas including the increasing use of third-party services, adoption of cloud services, and the governance and delivery of significant IT and operational changes.

Another recent milestone was of course the UK's exit from the EU. To support a smooth transition, we took a number of actions: preparing to retain and convert EU legislation into operable UK legislation; commencing the Temporary Permissions Regime (TPR) at the end of the transition period; and providing technical support to the UK Government, including in relation to the agreement by HM Treasury and the European Commission on a Memorandum of Understanding on Financial Services Regulatory Cooperation. These measures, among others, allowed us to fulfil our objective of reducing cliff-edge risks and minimising any disruption that could have occurred in the event that the transition period ended without the EU and UK agreeing the terms of a trade and cooperation agreement.

Now that we are on the other side of the transition period, our focus has moved to exploring the opportunities available to us as the UK now that there is greater scope to tailor regulation for our market. I should emphasise that in all of this work, we have no interest in lowering standards – but we can become more dynamic in response to features of the UK market and changes in the world around us. Our first step in this direction, following a lot of work in the year covered by this Annual Report, was in April 2021 when we published a Discussion Paper on developing a new 'strong and simple' prudential framework for non-systemic banks and building societies. The Paper sets out our current thinking about ways in which the framework could be simplified for small and growing firms while, of course, maintaining resilience.

We have worked closely with HM Treasury on preparing the Call for Evidence for its review of the Solvency II regime. The Call for Evidence set out the specific areas being considered for review, with a view to tailoring the regime to fit the UK market better. We have supported HM Treasury in its analysis and preparation of its response to the Call for Evidence.

Also high on our list of priorities over the last year has been ensuring PRA-authorised firms continue to improve their resilience to the risks from climate change, and supporting the transition to a net-zero economy. We engaged with firms to build their understanding of our expectations on what they should do to mitigate climate risks, including through a joint PRA/FCA Climate Financial Risk Forum (CFRF), followed by a guide containing practical tools and case studies on climate risk management and scenario analysis. We also announced further detail on our 2021 biennial exploratory scenario (BES) exercise, a system-wide climate test including banks and insurers that will assess resilience against physical and transition risks using three different climate scenarios.

We have also made progress in managing the transition from Libor to alternative interest rate benchmarks. This has been a major effort by the banking sector in particular, but on the insurance side of our work in January 2021 we also consulted on a proposed approach to deep, liquid and transparent assessments and the transition of the GBP risk-free rate and associated Solvency II technical information from Libor to SONIA. Our intention is to provide clarity for insurers about the technical information in order to facilitate a smooth transition.

There have also been other key pieces of work in 2020/21 that we have managed to progress despite the pressures caused by Covid-19. 2020 marked the first year when all elements of the Senior Managers and Certification Regime (SM&CR) were fully in place across all PRA-authorised firms, strengthening governance and promoting better prudential outcomes. We have also finalised our reform of capital requirements for credit unions, putting in place a new system which will make it easier for successful unions to grow by removing cliff-edge effects which were present in the previous regime.

Overall, 2020/21 has been a year of intense focus on ensuring the safety and soundness of the financial system through the Covid-19 crisis. Particularly in the first half of 2020, this meant some truly admirable efforts on the part of PRA staff to implement complex measures at very short notice while keeping the rest of the PRA's priority areas afloat. While we are not free and clear from uncertainty yet, as I write this things seem to be looking up and we are looking forward to some exciting challenges and opportunities in the year ahead.

20 May 2021

Prudential Regulation Committee

Members and responsibilities

The Prudential Regulation Committee (PRC) is the body within the Bank responsible for exercising the Bank's functions as the Prudential Regulation Authority (PRA), as set out in the Bank of England Act 1998 and the Financial Services and Markets Act 2000 (FSMA). The PRC is on the same statutory footing as the Monetary Policy Committee and the Financial Policy Committee.

The PRC's terms of reference provide for 12 members. Five members are Bank of England staff: the Governor, and four Deputy Governors. The Committee also includes the Chief Executive of the Financial Conduct Authority (FCA), and at least six members appointed by the Chancellor of the Exchequer.

- The PRC is independent in all its decision-making functions, including making rules and the PRA's most important supervisory and policy decisions.
- The PRA's functions are exercised by the Bank and are funded by PRA fees, with the PRC responsible for consulting on and setting the level of those fees.
- The PRC is required to report annually to the Chancellor of the Exchequer on the adequacy of resources allocated to the PRA functions and the extent to which the exercise of those functions is independent of the exercise of the Bank's other functions.[2]

Members as at 26 May 2021[1]

Top row, left to right

Andrew Bailey
Governor, Chair of the PRC

Julia Black
External member
Term: 30 November 2018 – 29 November 2024

Ben Broadbent
Deputy Governor, Monetary Policy
Term: 1 March 2017 – 28 February 2023

Norval Bryson
External member
Term: 1 September 2015 – 31 August 2021

Middle row, left to right

Sir Jon Cunliffe
Deputy Governor, Financial Stability

Antony Jenkins
External member
Term: 5 April 2021 – 4 April 2024

Jill May
External member
Term: 23 July 2018 – 22 July 2024

Sir Dave Ramsden
Deputy Governor, Markets and Banking

Bottom row, left to right

Nikhil Rathi
Chief Executive of the FCA
Term: 1 October 2020 – 30 September 2025

John Taylor
External member
Term: 14 January 2021 – 13 January 2024

Sam Woods
Deputy Governor, Prudential Regulation and Chief Executive of the PRA

1 The Bank of England Act 1998 provides for one member to be appointed by the Governor with the approval of the Chancellor. The Governor appointed Ben Broadbent. Ben Broadbent's PRC term differs to his Deputy Governor term. David Belsham was an external member of the PRC until 30 April 2021. Mark Yallop was an external member until 30 November 2020. Christopher Woolard was an interim member until 30 September 2020, in his capacity as interim CEO of the FCA. Tanya Castel has been appointed as an external member from 1 September 2021.

2 Available on pages 8–9 in this report.

- Since February 2016, the Bank has indemnified members of the PRC against personal civil liability on the same terms as the members of Court.[1]

The PRA's statutory objectives, which underpin its forward-looking, judgement-based approach to supervision are:

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

On 23 March 2021, HM Treasury issued 'Recommendations for the Prudential Regulation Committee'.[2]

This sets out 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 in FSMA.

1 See pages 7 and 13 of the Bank of England's Annual Report and Accounts 2020/21.
2 Available at: www.bankofengland.co.uk/about/people/prudential-regulation-committee.

Annual report of the PRC to the Chancellor of the Exchequer

The adequacy of resources allocated to the performance of PRA functions and the extent to which the exercise of PRA functions is independent of other Bank functions.

This is the annual report by the Prudential Regulation Committee (PRC) to the Chancellor of the Exchequer under paragraph 19 of Schedule 6A to the Bank of England Act 1998 (as amended). It relates to the period of 1 March 2020 to 28 February 2021. The Prudential Regulation Authority (PRA) publishes this report as part of its commitment to transparency.

Background

Since 1 March 2017, the PRA has been part of the legal entity of the Bank of England (Bank). The PRC is a statutory committee of the Bank and is responsible for the exercise of the Bank's functions as the PRA. The PRC is on the same statutory footing as the Bank's Monetary Policy Committee (MPC) and the Financial Policy Committee (FPC). The PRA Annual Report summarises the PRC's responsibilities and the statutory framework under which the PRA operates. Under this statutory framework, the PRC is responsible for strategy, policy and rule making, and the adoption (with the approval of the Bank's Court of Directors) of the budget for the PRA. These functions cannot be delegated.

The performance of PRA functions

The PRA has published two approach documents setting out how it advances its statutory objectives: the PRA's approach to banking supervision and the PRA's approach to insurance supervision.[1] The PRA does not seek to operate a zero-failure regime. This is a key principle underlying the PRA's approach to supervision. Each year the PRC sets the PRA strategy and business plan, and adopts the PRA's budget. These are based on the PRA's approach to supervision, the PRA's operating model, and its risk tolerance, all agreed by the PRC.

The adequacy of resources

The PRA is fully funded by fees paid by regulated firms. The PRA consults each year on the allocation of fees among firms and has the ability, after consultation, to raise additional funds during the year for material changes. The PRA received five responses to its fees consultation proposals in 2020/21,[2] which did not result in changes to the proposals.

The PRC seeks to ensure that the PRA's financial and non-financial resources are appropriately allocated to the work that best advances its objectives. In making judgements on the allocation of resources, the PRC takes into account a wide range of relevant considerations. These include the wider legislative and policy framework under which the PRA operates, including the duty to have regard to certain factors under the Financial Services and Markets Act 2000 (FSMA), and the Legislative and Regulatory Reform Act. The PRC also takes into account HM Treasury's recommendation letter,[3] which contains recommendations about aspects of the Government's economic policy which the PRC should have regard to when considering how to advance the PRA's objectives, and when considering the application of the regulatory principles set out in FSMA. In addition, the PRA plans its resources to deliver multi-year programmes of work (such as climate change or operational resilience), and responds to changes to the external environment and risk profile of its regulated firms.

The PRC receives and reviews regular updates on the PRA's performance and on how the PRA's financial and non-financial resources are allocated and monitored, as well as how any resource risks are being mitigated through: performance and assurance reporting; discussions of PRC papers; and PRC members' regular interaction with the PRA, including meetings with senior management and other staff.

1 Available at: www.bankofengland.co.uk/prudential-regulation/publication/pras-approach-to-supervision-of-the-banking-and-insurance-sectors.
2 CP4/20 'Regulated fees and levies: Rates proposals 2020/21', April 2020: www.bankofengland.co.uk/prudential-regulation/publication/2020/regulated-fees-and-levies-rates-proposals-2020-21.
3 Available at: www.bankofengland.co.uk/about/people/prudential-regulation-committee.

In particular, the regular reporting to PRC covers: progress against strategic aims; budget and headcount position; staff turnover; technology availability; and the PRA's risk profile. The reports and other evidence provided to the PRC during the year indicate whether the PRA has used its financial and non-financial resources to deliver its functions, in line with its business plan.

The Bank's internal control functions also apply to the PRA. This includes the Bank's risk management framework, Compliance function, Internal Audit function and the Audit and Risk Committee of Court. In addition, PRC members have the benefit of their own engagement with industry through meetings and events across the year.

In 2020/21, the PRA underspent by £7.6 million, principally due to expensed project and travel costs being lower than assumed. In line with the rest of the Bank, this reflects the continued prioritisation of activities, particularly in light of the impact of Covid-19. Due to additional income received in the year, predominantly in the form of model fees, alongside retained financial penalties, the PRA will return £11.9 million to firms (4% of the PRA's total budget), as explained within the 2021/22 fee rates consultation.[1]

The extent to which the exercise of PRA functions is independent of other Bank functions

The PRA has a number of safeguards in place to ensure it retains sufficient operational independence, including the independence of the PRC and the funding and reporting arrangements set out in FSMA and the Bank of England Act 1998.

The PRC is independent in all its decision-making functions, which include making rules and the PRA's most important supervisory and policy decisions. The PRC also maintains its independence by ensuring that actual and potential conflicts of interest across its members are identified and managed on a continual basis, and by having its own internal infrastructure and processes. PRC members' remuneration is determined by the Bank's Remuneration Committee.

The PRA is located within the Bank, which facilitates interaction with all areas of the Bank and ensures that there is effective policymaking on financial stability. This is done in a way which maintains the distinct roles and responsibilities of the Bank and the PRA and is in line with the Basel Core Principles. For example, in accordance with the relevant legislation, the Bank has arrangements in place to ensure that its functions as the UK's resolution authority and its supervisory functions (which are exercised in its capacity as the PRA) are operationally independent from one another and has issued a statement setting out these arrangements.[2]

The PRC is structurally separate from the FPC and MPC by having different external membership. The PRC and FPC hold all meetings separately, except those to discuss matters of mutual interest (for example, the annual concurrent stress test). The FPC sometimes takes decisions that constrain the decisions that can subsequently be taken by the PRC. The FPC also has specific powers of direction over prescribed macroprudential measures and can make recommendations to anyone with the purpose of reducing risks to financial stability, including the PRA.

The fee income generated from regulated firms can only be used for the functions covered by the statutory framework under which the PRA operates. The PRA's budget covers the PRA's direct costs as well as indirect costs charged by the Bank, including centralised functions such as Technology, Finance, and Human Resources. The Bank's external auditors review the allocation of indirect costs charged by the Bank and provide external assurance that costs have been allocated appropriately.

1 CP8/21 'Regulated fees and levies: Rates proposals 2021/22', April 2021: www.bankofengland.co.uk/prudential-regulation/publication/2021/april/regulated-fees-and-levies-rates-proposals-2021-22.
2 Available at: www.bankofengland.co.uk/-/media/boe/files/about/legislation/statement-structural-separation.

Senior leadership team
as at 26 May 2021

Sam Woods
Deputy Governor
Prudential Regulation
and CEO of the PRA
(FPC, PRC)

Vicky Saporta*
Executive Director
Prudential Policy

Lyndon Nelson
Deputy CEO and
Executive Director
Supervisory Risk
Specialists and
Regulatory
Operations

Phil Evans
Director
Financial Prudential
Policy

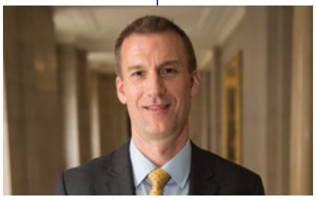
Gareth Truran
Director
Cross-cutting and
Insurance Policy

Duncan Mackinnon
Director
Supervisory Risk
Specialists

* Also reports to Deputy Governor, Financial Stability.

Anna Sweeney
Executive Director
Insurance Supervision

Charlotte Gerken
Executive Director
Insurance Supervision



David Bailey
Executive Director
International Banks
Supervision

Sarah Breeden
Executive Director
UK Deposit-Takers
Supervision

Rebecca Jackson
Director
International Banks
Supervision

Melanie Beaman
Director
UK Deposit-Takers
Supervision

Find out more online
www.bankofengland.co.uk/about/people/prudential-regulation-committee

Review of 2020/21

The PRA's activities in 2020/21 were directed by the PRA's Business Plan 2020/21.[1]

This section of the Annual Report outlines the work completed in pursuit of our 2020/21 strategic goals and in support of our statutory objectives. Readers may also find it helpful to refer to the 'PRA Business Plan 2021/22', which sets out the PRA's strategy and workplan for the coming year,[2] and the PRA's approach documents.[3]

Box A: Examples of how the PRA delivered its 2020/21 strategic goals

1. 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

- We managed the EU withdrawal transition, including implementation of Capital Requirements Directive V, smoothly and with minimal disruption.
- We implemented a number of updates and temporary measures to our prudential policies in response to Covid-19.
- We engaged with firms on actions and expectations to manage the transition from the London interbank offered rate (Libor) to alternative interest rate benchmarks.
- We continued to refine our implementation of Solvency II and worked with HM Treasury to launch a review of the regime.

2. Continue to adapt to changes in the external market and to hold regulated firms, and those who run them, accountable for meeting our standards

- We continued to work with PRA-authorised firms towards improving their resilience against the risks from climate change and to support the transition to a net-zero carbon economy.
- We wrote to the CEOs of banks and insurers in July 2020 to provide detailed guidance on our supervisory expectations related to climate change that were published in April 2019. This included sector-wide feedback on progress to date, and an end-2021 target for firms to have fully embedded plans to hold sufficient capital to withstand material climate-related losses.
- We have actively engaged with firms to build their understanding of our expectations on climate change, including through a joint PRA and FCA Climate Financial Risk Forum (CFRF), followed by a guide containing practical tools and case studies on climate risk management and scenario analysis.
- We announced further detail on our 2021 biennial exploratory scenario (BES) exercise system-wide climate test. This includes banks and insurers, and will assess resilience against the physical and transition risks using three different climate scenarios.
- We used our statutory powers to conduct investigations and initiate enforcement action where needed to tackle threats to safety and soundness in PRA-authorised firms.

1 April 2020: www.bankofengland.co.uk/prudential-regulation/publication/2020/pra-business-plan-2020-21.
2 May 2021: www.bankofengland.co.uk/prudential-regulation/publication/2021/may/pra-business-plan-2021-22.
3 'The PRA's approach to banking supervision' and 'The PRA's approach to insurance supervision', available at: www.bankofengland.co.uk/prudential-regulation/publication/pras-approach-to-supervision-of-the-banking-and-insurance-sectors.

3. Ensure that firms are adequately capitalised, and have sufficient liquidity, for the risks they are running or planning to take

- We contributed to the Bank's desktop stress test of the resilience of the UK banking sector, which included a reverse stress test scenario that would deplete regulatory capital buffers by around 5 percentage points.
- We continued to assess the financial resilience of firms through our supervision at firm and sector level.
- We contributed to the work of the Basel Committee on Banking Supervision (BCBS) as it finalised revisions to the market risk framework.
- We ensured that insurers maintain capital for balance sheet risks arising from complex products and asset exposures, such as illiquid unrated assets, and also that they reflect reduced loss absorbency of own fund items where appropriate.
- In July 2020, we published our updated policy on Pillar 2A (reconciling capital requirements and macroprudential buffers).

4. Develop our supervision of operational resilience in order to mitigate the risk of disruption to the provision of critical economic functions

- We published co-ordinated Policy Statements with the Bank and the FCA, as the culmination of a major workstream initiated through the 2018 operational resilience Discussion Paper.
- We published our Policy Statement aimed at modernising the regulatory framework on outsourcing and third-party risk management.
- We assessed the effectiveness of the operational risk management frameworks at firms, including service availability and business continuity management.
- We used the Cyber Questionnaire, completed by over 100 firms, as a key tool to assess firms' cyber resilience.
- We explored how Covid-19 was affecting the resilience of firms' IT arrangements, including the resilience of remote working technologies, the impact on IT change programs, the strength of IT control environments, and business continuity plans for critical operations.

5. 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 resolution strategy to manage a firm's failure in an orderly manner

- We extended the dates for the major UK banks and building societies to submit their first reports on their preparations for resolution, to reduce operational burdens on PRA-regulated firms in response to Covid-19.
- We published a consultation in October 2020 with proposals to revise the operational continuity in resolution (OCIR) policy. The final Policy Statement will be issued in the first half of 2021.

6. Facilitate effective competition by actively considering the proportionality of our approach as it contributes to the safety and soundness of the UK financial system

- We consulted on a set of proposed clarifications to our approach to the supervision of banks and building societies that have typically been in existence for less than five years after receiving authorisation without restrictions.
- We also proposed to introduce new expectations to address inappropriately low UK internal ratings based (IRB) mortgage risk weights and reduce unwarranted risk weight differences between standardised approach (SA) and IRB mortgage risk weights for current UK mortgages.
- The Annual Competition Report, on pages 53–61, sets out our work over 2020/21 to support the delivery of our secondary competition objective.

7. Deliver a smooth transition to a sustainable and resilient UK financial regulatory framework following the UK's exit from the EU

- We carried out work to minimise disruption that could have occurred in the event that the UK and EU ended the transition period on 31 December 2020 without agreeing the terms of a trade and co-operation agreement.
- We made preparations to retain and convert EU legislation into operable UK legislation (known as 'nationalising the acquis').
- The Temporary Permissions Regime (TPR) commenced at the end of the transition period, providing continuity for UK users serviced by EEA firms while those firms seek permanent status in the UK.
- We worked on deepening our relationships with supervisors and regulatory authorities around the world to advance our supervisory and regulatory objectives. This included the signing of Memoranda of Understanding (MoUs) with the European Central Bank (ECB), the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA), and 27 National Competent Authorities. A remaining three MoUs have been agreed in principle and are awaiting signature. Splits of Responsibility agreements for supervision of branches have been agreed with the ECB and 11 National Competent Authorities, covering 72 out of 75 incoming branches. Discussions continue with three National Competent Authorities covering three remaining branches, two of which are yet to fully establish operations in the UK.
- We consulted on our approach to the supervision of international banks operating in the UK, proposing expectations for receiving information concerning the risks in the wider group, and for co-operation with regulated entities and their supervisors.
- We provided technical support to the UK Government, including in relation to the agreement by HM Treasury and the European Commission on an MoU on Financial Services Regulatory Cooperation.

8. Operate effectively 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

- We reassessed our business critical needs and moved to virtual working in March 2020. We have balanced the demands associated with supervising in a fast-changing environment with the capacity of our staff using regular prioritisation reviews.
- We experimented with a number of proofs of concept in order to advance our RegTech and Data Strategy.
- Building on our previous work in the application of artificial intelligence (AI) across our operations, the PRA Data Innovation team introduced the first AI search engine to all colleagues in the PRA to help them search for information received from regulated firms.
- Feedback from firms gave us assurance on the effectiveness and quality of our supervisory framework and approach.

1. 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

Contribution to financial stability

We have contributed to the Bank's objective of maintaining financial stability through our policy development and implementation. This includes changes and temporary measures made to our prudential policies in response to the economic shock from Covid-19. For example:

- We adjusted a number of our prudential policies, where necessary and within our powers to do so. This included interim measures in response to the Government's emergency financial relief initiatives.

- We have provided data and analysis to support the FPC's December 2020 commitment to review the calibration of its mortgage market recommendations. Following the FPC's review of the structural level and balance of capital requirements for the UK banking system, in July 2020 the PRA also published its final policy to reduce minimum capital requirements in a way that leaves overall levels of loss-absorbing capacity in the banking system broadly unchanged.[1]

- We took a decision to maintain firms' systemic risk buffer (SRB) rates at the rate set in December 2019, and will reassess them in December 2021.

- We implemented Capital Requirements Directive V, while the UK was subject to European law, and in the transition period, updating the rules to ensure that the regime was operable in a UK-only context.[2]

- On 12 February 2021, we published a consultation proposing to implement some of the set of international Basel III standards that remain to be implemented in the UK.[3]

- Reflecting the extensive preparations made by authorities and the private sector over a number of years, 'EU withdrawal': the EU withdrawal transition period ended on 31 December 2020 without any material disruption to the provision of financial services. Working with the FPC, we will continue to monitor financial stability risks which could arise from disruption to the provision of financial services in the future. For more information on our work on EU withdrawal, please see page 36.

- We wrote to the CEOs of life and general insurance firms with the results of our desktop stress testing in relation to Covid-19. Our analysis showed that the sector was robust against downside stresses, with the highest uncertainty centred on certain general insurers' liabilities – particularly those arising from business interruption claims. We highlighted our expectation for firms to maintain close monitoring of the additional risks presented by Covid-19, and update their risk and capital assessments as the situation evolves. We also published the results of the biennial insurance stress test conducted in 2019.[4]

1 PS15/20 'Pillar 2A: Reconciling capital requirements and macroprudential buffers', July 2020: www.bankofengland.co.uk/prudential-regulation/publication/2020/pillar-2a-reconciling-capital-requirements-and-macroprudential-buffers.
2 PS29/20 'Capital Requirements Directive V (CRD V): Final policy', December 2020: www.bankofengland.co.uk/prudential-regulation/publication/2020/capital-requirements-directive-v-further-implementation.
3 CP5/21 'Implementation of Basel standards', February 2021: www.bankofengland.co.uk/prudential-regulation/publication/2021/february/implementation-of-basel-standards.
4 www.bankofengland.co.uk/prudential-regulation/letter/2019/insurance-stress-test-2019.

Accountability: Embedding and evaluating the governance regime for banks and insurers

In 2020, we marked the first year when all elements of the Senior Managers and Certification Regime (SM&CR) were fully in place across all PRA-authorised firms, providing a common platform directed at enhancing individual accountability. The SM&CR strengthens governance within firms and also provides us with a flexible tool that promotes better prudential outcomes across a range of areas (eg capital, liquidity, credit, and operational risk) by ensuring that supervisors can, where appropriate, link risk mitigation actions to responsible individuals. We have also continued to reaffirm the link between accountability and incentive-setting, and the need to ensure that the variable remuneration of Senior Managers reflects their performance against their objectives and areas of responsibility.

To assess whether the SM&CR is achieving its aims, over the past year we conducted an evaluation of the regime's effectiveness. The final report, which drew on input from a range of external and internal stakeholders, was published in December 2020.[1] This found that the SM&CR has succeeded in providing firms and supervisors with a tool for promoting individual accountability and has improved behaviours. As we explore how we can further embed the regime, we will take into consideration the feedback provided during the evaluation and in response to the report.

Alongside the SM&CR, our remuneration regime has worked to ensure that firms adopt remuneration policies that are consistent with, and promote, sound risk management and do not encourage excessive risk-taking. We also worked on the evaluation of the effectiveness of our remuneration rules, taking account of linkages to the SM&CR, and provided input into the Financial Stability Board's peer review of the UK's approach to remuneration, published in April 2021.[2]

Libor

The PRA resumed full supervisory engagement on Libor on 1 June 2020, after suspending transition data reporting and some firm meetings at the end of Q1 due to Covid-19. We reclassified firms for Libor supervision in June 2020 to ensure that the frequency of supervisory engagement was aligned to the scale and complexity of firms' exposures to Libor. Supervisors have continued to monitor firms' progress against the targets of the Working Group on Sterling Risk-Free Reference Rates, and their management of the risks associated with transition through regular review meetings and collection of firm exposure data.

In January 2021, we consulted on a proposed approach to deep, liquid and transparent assessments and the transition of the GBP risk-free rate and associated Solvency II technical information from Libor to SONIA.[3] The intention is to provide clarity for insurers about the technical information in order to facilitate a smooth transition.

Solvency II

The Government announced in June that it would undertake a review of Solvency II with the aim of tailoring the regime to better fit the UK market. We worked closely with HM Treasury in the preparation of its Call for Evidence,[4] which set out the specific areas being considered for review. These included, among other things, the risk margin, matching adjustment, transitional measure on technical provisions, reporting requirements, and calculation of the Solvency Capital Requirement (SCR). We have continued analysis and development of policy options, and supported HM Treasury in its analysis of responses and preparation of its response to the Call for Evidence.

1 Evaluation of the Senior Managers and Certification Regime (SM&CR), December 2020: www.bankofengland.co.uk/prudential-regulation/publication/2020/evaluation-of-the-senior-managers-and-certification-regime.
2 www.fsb.org/2021/04/peer-review-of-the-united-kingdom/.
3 CP1/21 'Deep, liquid and transparent assessments, and GBP transition to SONIA': www.bankofengland.co.uk/prudential-regulation/publication/2021/january/solvency-ii-deep-liquid-and-transparent-assessments-gbp-transition-to-sonia.
4 www.gov.uk/government/publications/solvency-ii-review-call-for-evidence.

Box B: Enforcement: Tackling threats to safety and soundness and strengthening accountability in PRA-authorised firms

At the start of 2020/21, we had 12 separate open cases, comprising investigations into eight PRA-authorised groups and 16 individuals, and one matter previously referred to the Upper Tribunal.

In the 2020/21 financial year we:

- opened one new case involving a PRA-authorised group;
- concluded five investigations;
- imposed our largest ever financial penalty (£48,308,400) as part of a co-ordinated global settlement with Goldman Sachs Group (GSG) in relation to its involvement in the 1MDB scandal (see '1MDB' below for further details); and
- used our statutory powers to address failures in whistleblowing systems controls within a PRA-authorised group (see 'Tokio Marine Kiln' below for further details).

As at 28 February 2021, in addition to the one matter previously referred to the Upper Tribunal, we had 11 separate open investigations, focused on eight PRA-authorised groups and 13 individuals. These cover the full spectrum of PRA-authorised firms, from Categories 1 to 5, across a range of industry sectors including banks, insurers, and credit unions. The issues and themes encountered in our existing portfolio of cases cut across a number of PRA strategic priorities, including operational resilience and outsourcing, prudential management and risk controls, regulatory reporting, and disclosure to the PRA.

1MDB

In October 2020, the PRA and FCA imposed financial penalties on Goldman Sachs International (GSI) for risk management failures connected to 1Malaysia Development Berhad (1MDB) and its role in three fundraising transactions for 1MDB. 1MDB is a Malaysian state-owned development company which was at the centre of billion-dollar embezzlement allegations. GSI underwrote, purchased, and arranged three fundraising bond transactions, booked to GSI, which were approved by global GSG committees in which GSI participated. The transactions involved clients and counterparties in jurisdictions with higher financial crime risk, in addition to a third party that GSI had serious concerns about. GSI failed to assess and manage risk to the required standard, given the high risk profile of the transactions, and failed to assess risk on a sufficiently holistic basis. In addition, it failed to address bribery allegations in 2013 and to manage misconduct allegations related to 1MDB in 2015.

The PRA imposed a financial penalty of £48,308,400 and the FCA imposed a financial penalty of £48,308,400. These penalties were part of a US$2.9 billion globally co-ordinated resolution reached with the GSG and its subsidiaries.

Tokio Marine Kiln

On 21 December 2020, the PRA and FCA jointly imposed voluntary requirements on Tokio Marine Kiln Insurance Limited and Tokio Marine Kiln Syndicates Limited (collectively TMK), focusing on whistleblowing systems and controls. This followed on from extensive whistleblower allegations during 2019, in response to which TMK appointed an external firm to investigate. That investigation raised serious concerns, and on 20 December 2019 TMK made disclosures to the PRA and FCA about potential shortcomings in the operation of its whistleblowing systems and controls and other matters. TMK voluntarily agreed to take further steps to demonstrate the effectiveness of improvements to its systems and controls in this area, including providing a written report and an attestation to the PRA and FCA.

2. Continue to adapt to changes in the external market and to hold regulated firms, and those who run them, accountable for meeting our standards

The prudential regulatory framework must be responsive to changes in behaviours and the structure of the financial system, as well as to risks arising from wider issues such as climate change and geopolitics.[1] Over the past year, we continued to seek to identify aspects of regulation that can lead to unintended behaviours or outcomes, and have worked with other areas of the Bank to aid and inform our monitoring of firms and the financial environment so that the appropriate responses could be put into place. During 2020/21, we communicated where issues have been identified and good practice is available to share, using channels including letters, speeches, and publications.[2]

In the banking and insurance sectors, we continued to facilitate market entry through the joint PRA/FCA New Bank Start-up Unit (NBSU) and the New Insurer Start-up Unit (NISU).[3] Following the launch of NISU in 2018, there has been an increase in firms reaching out to regulators about setting up new insurers in the UK. Overall, however, interest in new insurers remains significantly lower than for new banks.

In light of this, we are continuing to consider how a pipeline of new insurers can be further facilitated, including assessing the appropriateness of a 'mobilisation' (authorisation with restriction) phase for insurers, as is available for new banks. We had hoped to see a greater number of approaches to us regarding digital insurance technology and innovation – more commonly known as InsurTech. This could have been due to the Covid-19 pandemic, and interest may pick up again in the coming year. Mobilisation remains a focus for us, particularly as HM Treasury has recently sought views on this as part of the call for evidence in respect of their review of Solvency II.

1 For all information on our work in response to Covid-19 see the dedicated PRA webpage: www.bankofengland.co.uk/coronavirus/information-for-firms.
2 Examples are available from the Prudential Regulation homepage under 'PRA publications': www.bankofengland.co.uk/prudential-regulation.
3 See the dedicated webpages for the NBSU and NISU: www.bankofengland.co.uk/prudential-regulation/new-bank-start-up-unit and www.bankofengland.co.uk/prudential-regulation/new-insurer-start-up-unit.

International engagement

The UK is a global centre for the activities of banks and insurers. As the host regulator for internationally headquartered global systemically important banks (G-SIBs) and internationally active insurers, we have an essential role in global consolidated supervision. Given the international nature of the largest wholesale firms operating here as both branches and subsidiaries, we need to understand the nature and extent of the risks facing these firms and their wider groups, and need an open, transparent, and proactive exchange of information and views with the home state regulators. We have well-established co-operative relationships with home state regulators and group parent companies to support us in delivering supervisory priorities efficiently and effectively. Our supervisory engagements include regular calls, information sharing, thematic reviews, and joint on-site supervisory reviews. Over the past year, we have increased our bilateral engagement with regulators from around the world, including with the US, the EU, China, Switzerland, Japan, Canada, and India. In particular, engagement around risks to firms as a result of Covid-19 has been positive in terms of frequency and depth across all jurisdictions. More broadly, we have continued to actively participate in global supervisory colleges, albeit remotely.

We have continued to make progress in our assessments of a large number of third-country branch applications for EEA-based banks and insurers. We will continue to work closely with firms and their home state regulators on these applications and the supervision of cross-border firms. Following publication of a consultation paper setting out our approach to the supervision of international banks operating in the UK,[1] we prioritised our engagement with the largest international regulators to explain our proposed approach, and will continue to engage with all jurisdictions in the lead up and after publication of the final Supervisory Statement. Furthermore, the Bank (including the PRA) has signed a number of MoUs to facilitate continued supervisory co-operation and information sharing with European and other authorities.

The PRA, working jointly with the Bank, engaged with the BCBS to agree a delay to the implementation of Basel 3.1 in order to alleviate the immediate burden on firms during the Covid-19 pandemic.

1 CP2/21 'International banks: The PRA's approach to branch and subsidiary supervision', January 2021: www.bankofengland.co.uk/prudential-regulation/publication/2021/january/international-banks-branch-and-subsidiary-supervision.

Box C: Climate change

Climate change, and society's response to it, creates financial risks that are directly relevant to our objectives. Our work on the financial risks from climate change forms part of the Bank's broader climate strategy to play a leading role, through our policies and operations, in ensuring that the financial system, the macroeconomy, and the Bank are resilient to the risks from climate change and supportive of the transition to a net-zero economy. To achieve this, we are working to ensure PRA-authorised firms effectively manage the risks that climate change presents to the safety and soundness of their operations and to broader financial stability.

Over the last year, our domestic and international work programme in this area has grown significantly.

In July 2020, Sam Woods wrote to the CEOs of PRA-regulated banks and insurers to provide more detailed guidance for firms[1] on the supervisory expectations that were published in April 2019.[2] These recommended how banks and insurers should develop their approach to the financial risks from climate change and embed it into their governance and risk management frameworks, scenario analysis, and disclosure. The July 2020 letter also gave sector-wide feedback on progress against the supervisory expectations, and in light of this, set a deadline of year-end 2021 for firms to have fully embedded the PRA's supervisory expectations on climate. The letter also noted that firms must demonstrate to the PRA how they have gained comfort that they are holding sufficient capital to withstand material climate-related losses.

Since the launch of its supervisory expectations, the PRA has actively engaged with financial firms to build an understanding of its expectations on climate change and support firms' efforts to develop an appropriate response. The PRA and FCA co-convened the Climate Financial Risk Forum (CFRF) in March 2019 to build intellectual capacity and share best practice. In June 2020, the CFRF published a guide for the financial sector containing practical tools, information, and case studies on climate risk management, scenario analysis, disclosure, and innovation.[3]

In June 2020, we published the Bank's first climate-related financial disclosure, setting out the Bank's approach to managing the risks from climate change across its entire operations, including the steps taken to improve its understanding of these risks in future years.[4] This will be an annual exercise from now.

In November 2020, the Government-Regulator TCFD Taskforce, set up to examine the most effective way to approach climate related financial disclosures, including exploring the appropriateness of mandatory reporting, published an interim report and roadmap setting out an indicative path towards mandatory climate-related disclosures across the UK economy by no later than 2025.[5] The Bank is one of seven members of the TCFD Taskforce, chaired by HM Treasury with representation from the FCA, Financial Reporting Council, The Pensions Regulator, Department of Work and Pensions, and Department for Business, Energy and Industrial Strategy. As set out in the Taskforce's interim report, the PRA will perform a review of firms' published disclosures in 2022, which it will use to inform its decision whether to introduce further measures through targeted use of its general rule making power to require PRA firms to make TCFD disclosures to improve the quantity, quality or consistency of disclosure. If such measures are required, the PRA would expect to consult.

1 www.bankofengland.co.uk/prudential-regulation/letter/2020/managing-the-financial-risks-from-climate-change.
2 SS3/19 'Enhancing banks' and insurers' approaches to managing the financial risks from climate change', April 2019: www.bankofengland.co.uk/prudential-regulation/publication/2019/enhancing-banks-and-insurers-approaches-to-managing-the-financial-risks-from-climate-change-ss.
3 www.bankofengland.co.uk/news/2020/june/the-cfrf-publishes-guide-to-help-financial-industry-address-climate-related-financial-risks.
4 www.bankofengland.co.uk/prudential-regulation/publication/2020/climate-related-financial-disclosure-2019-20.
5 www.gov.uk/government/publications/uk-joint-regulator-and-government-tcfd-taskforce-interim-report-and-roadmap.

In December 2020, the Bank published a comment letter responding to the consultation paper on sustainability reporting issued by the International Financial Reporting Standards (IFRS) Foundation.[1] This comment letter followed the joint statement issued by the Government-Regulator TCFD Taskforce, and reiterated the Bank's support for the IFRS Foundation's proposal to establish a new sustainability reporting standard setting body.

In November 2020, the Bank announced further detail on its 2021 biennial exploratory scenario (BES) exercise – a bottom-up system-wide climate stress test including both banks and insurers. The detail included timelines, participants, and a planned programme of engagement.[2] The Climate BES will be launched in June 2021, and its objective is to test the resilience of the largest banks and insurers, as well as the financial system, to the physical and transition risks associated with three different possible climate scenarios, looking ahead over many decades.

Internationally, we are members of the central banks and supervisors' Network for Greening the Financial System (NGFS). Alongside a number of other publications, in June 2020 the NGFS published a set of scenarios for use by central banks and supervisors carrying out climate-risk analysis, as well as a guide to scenario analysis.[3] This work was led by the macrofinancial workstream of the NGFS, chaired by Sarah Breeden (Executive Director for UK Deposit-takers Supervision at the PRA and sponsor for the Bank's work on climate change). In December 2020, Anna Sweeney (Executive Director for Insurance Supervision) was appointed Chair of the Sustainable Insurance Forum (SIF).

Over the course of 2020/21, we have been active in our engagement, and led or participated in many climate-related meetings, speaking events, and workshops with industry, investors, academics, regulators, government, and other authorities, to share knowledge and build expertise. In November 2020, we hosted our first course on climate within the Bank's Centre for Central Banking Studies, with participants from over 50 different central banks. Collectively, this approach is helping to embed climate risk into our supervisory approach and into the approach taken by PRA-regulated firms regarding the financial risks generated by climate change.

1 www.bankofengland.co.uk/news/2020/november/boes-joint-statement-in-support-of-ifrs-consultation.
2 www.bankofengland.co.uk/news/2020/november/the-boe-is-restarting-the-climate-biennial-exploratory-scenario.
3 www.ngfs.net/sites/default/files/medias/documents/820184_ngfs_scenarios_final_version_v6.pdf.

3. Ensure that firms are adequately capitalised, and have sufficient liquidity, for the risks they are running or planning to take

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 severe economic scenarios.

Banking

A key area of supervisory focus through 2020/21 was to ensure that firms were financially and operationally resilient to deal with the consequences of the pandemic, and to support the real economy through the crisis too.

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 fully capture risk, supported this focus and remained core parts of our work to ensure firms are adequately capitalised and have sufficient liquidity.

The submission of complete, timely, and accurate regulatory returns, including accurate reporting of capital and liquidity, is the foundation for effective supervision and the PRA's ability to assess the financial resilience of firms. Following the October 2019 letter to CEOs of all PRA regulated banks and building societies,[1] a number of Skilled Persons reviews (section 166 of FSMA) of the accuracy of, and governance and controls surrounding, regulatory returns were commissioned in the 2019/20 period. Following delays in response to Covid-19, Skilled Persons continued to progress these reviews during the period covered by this report. The letter also set out the PRA's expectation that firms take action as necessary to ensure the integrity of their returns. During 2020/21, we followed up with a range of firms to understand the actions taken to ensure the integrity of returns.

Throughout the year, we focused on a number of areas to ensure firms have sufficient liquidity and are adequately capitalised:

- Our supervisory responses for Covid-19 included the cancellation of the 2020 stress test for the eight major UK banks and building societies in order to help lenders focus on meeting the needs of UK households and businesses via the continuing provision of credit. This was in line with the 11 March 2020 measures, which included a decision by the FPC to reduce the UK countercyclical buffer (CCyB) rate to 0% of banks' exposures to UK borrowers with immediate effect, and to maintain the SRB at December 2019 rates.[2]

- The Bank, the FPC, and the PRA reiterated that all elements of the substantial capital and liquidity buffers that banks have built up exist to be used as necessary to support the economy during this period of Covid-19-related stress.

- The PRA engaged closely with deposit-takers during market dislocations associated with the early phases of Covid-19 and the UK lockdowns. This included working with firms in the spring on liquidity and funding pressures arising from short-term disruptions to funding markets, and on capital pressures arising from market risk during volatile markets.

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

2 www.bankofengland.co.uk/financial-stability#ccyb.

- Following a 2019 review of the structural level and balance of capital requirements for the UK banking system, in July 2020 we published our updated policy on Pillar 2A.[1] This takes into account the increase, from 1% to 2%, in the UK CCyB rate that the FPC expects to set in a standard risk environment. In light of the Covid-19 pandemic, and high uncertainty surrounding the extent of the stress, the PRA temporarily increased the PRA buffer for all firms that receive a Pillar 2A reduction. The PRA buffer will increase by 56% of a firm's total Pillar 2A reduction – ie the minimum amount of Common Equity Tier 1 (CET1) the PRA requires for firms to meet Pillar 2A requirements – until the UK CCyB rate begins to increase towards 2%. Using the PRA buffer does not trigger any automatic distribution restrictions. The point at which the automatic distribution restrictions apply, which are required by onshored European legislation (the Capital Requirements Directive IV (CRD IV)), will decrease for firms receiving a Pillar 2A reduction.

Distributions

At the end of March 2020, the PRA welcomed the decisions of the boards of the large UK banks to suspend dividends and buybacks on ordinary shares until the end of 2020. At the PRA's request, they also cancelled payments of any outstanding 2019 dividends and restricted cash bonus payments to senior staff. This exceptional request reflected the unprecedented levels of economic uncertainty facing the global economy at that time due to the onset of the Covid-19 pandemic.

In December 2020, the PRA updated its approach and announced a temporary approach to shareholder distributions for 2020.[2] Bank boards were able to determine the appropriate level of distributions within a set of guardrails outlined by the PRA. The guardrails were designed to ensure that any distributions would be prudent and ensure that banks were able to continue to support households and businesses through the continuing economic disruption. This framework was also consistent with the PRA's view that distributions are an important and necessary part of the functioning of the banking system.

The PRA intends to transition back to its standard approach to capital-setting and shareholder distributions through 2021, and aims to provide a further update ahead of the 2021 half-year results of large UK banks.

Negative interest rates

In October 2020, Sam Woods sent an information request to a selection of firms to help the Bank and PRA understand the operational implications of implementing a negative or zero Bank Rate.[3] The responses to this request showed that firms were already able to deal with near-zero rates (down to at least two decimal places), while the majority of firms would require time to make some changes to systems and processes in order to implement a negative Bank Rate. On the basis of firms' responses to this exercise, and consistent with the PRA's primary statutory objective to promote the safety and soundness of individual firms along with its insurance policyholder protection objective and secondary competition objective, in February 2021 Sam Woods wrote to firms announcing that the PRA would begin engagement with PRA-authorised firms on their development of solutions.[4] The aim is for firms to be in a position to be able to implement a negative Bank Rate at any point after six months.

1 PS15/20 'Pillar 2A: Reconciling capital requirements and macroprudential buffers', July 2020: www.bankofengland.co.uk/prudential-regulation/publication/2020/pillar-2a-reconciling-capital-requirements-and-macroprudential-buffers.
2 www.bankofengland.co.uk/prudential-regulation/publication/2020/pra-statement-on-capital-distribution-by-large-uk-banks.
3 www.bankofengland.co.uk/prudential-regulation/letter/2020/info-request-operational-readiness-policy-rates.
4 www.bankofengland.co.uk/prudential-regulation/letter/2021/february/letter-from-sam-woods-4-feb-21.

Insurance

In March 2020, we introduced an expectation that firms would reflect potential reductions of loss absorbency due to tax impacts, when calculating their solvency cover. This ensured that they were not in danger of overstating their capital strength.[1]

In April, we published our expectations as to when sub-debt and preference shares issued other than from the Solvency II holding company could be considered to be available for risks throughout the Solvency II group, thus ensuring that firms did not recognise non-available own funds when calculating coverage at a group level.[2]

Throughout Q2 and Q3, in response to Covid-19, we published several announcements clarifying our requirements on aspects of the prudential framework, including the application of the matching adjustment, treatment of loans, and distribution of profits.[3]

We continued our focus on ensuring firms hold adequate capital for balance sheet risks arising from complex products and asset exposures. Supervisory teams continue to challenge management to ensure they are setting appropriate risk appetites for SCR coverage, and we reinforced our expectations around how senior management and boards should engage with a firm's Solvency II internal model (IM).[4] We closely monitored firms to ensure Solvency II IMs were robust and adequately calibrated. We remain vigilant against potential model drift, observing divergence between the aggregated SCR of IM firms versus firms using the Solvency II standard formula, and setting expectations for firms' modelling.[5]

For general insurers, we focused on business plan optimism, reserving, and underwriting oversight for specialist general insurer business models. In November 2019, following our first two letters to Chief Actuaries in 2018,[6] we wrote to firms' Chief Actuaries and CEOs to share insights from our further reviews of firms' reserving during 2019.[7] This included work on casualty lines for London Market firms, reserving in the UK motor market, and a thematic review of case (outstanding claims) reserves in the retail and wholesale markets. Our conclusions were also informed by wider supervisory interactions with firms and other stakeholders, such as Chief Actuaries, Lloyd's, and signing actuaries. Some of the key issues to emerge from this included: bias in reserve assessment; weakening of case reserving basis; inadequate claims inflation allowance; attritional loss deterioration; and transparency over key judgements and assumptions in management information. We asked firms to make explicit reference to how they have considered the findings in their 2019 year-end reserving exercises and associated actuarial reports.

1 PS7/20 'Solvency II: Adjusting for the reduction of loss absorbency where own fund instruments are taxed on conversion', March 2020: www.bankofengland.co.uk/prudential-regulation/publication/2019/sii-adjusting-for-reduction-of-loss-absorbency-where-own-fund-instruments-are-taxed-on-conversion.

2 PS10/20 'Solvency II: Group availability of subordinated liabilities and preference shares', April 2020: www.bankofengland.co.uk/prudential-regulation/publication/2019/solvency-ii-group-availability-of-subordinated-liabilities-and-preference-shares.

3 Statement clarifying the PRA's approach to the application of the matching adjustment during Covid-19. Follow-up note to insurers on the letter from Sam Woods 'Covid-19: IFRS 9, capital requirements and loan covenants': www.bankofengland.co.uk/prudential-regulation/letter/2020/covid-19-ifrs-9-capital-requirements-and-loan-covenants. Letter from Sam Woods to insurers on distribution of profits: www.bankofengland.co.uk/prudential-regulation/letter/2020/letter-from-sam-woods-to-insurers-on-distribution-of-profits.

4 See David Rule's speech 'Model use and misuse', 14 May 2020: www.bankofengland.co.uk/speech/2019/david-rule-british-insurers-prudential-regulation-seminar.

5 See two letters from Sid Malik – to Chief Actuaries: www.bankofengland.co.uk/prudential-regulation/letter/2019/observations-from-recent-regulatory-reviews and to Chief Risk Officers: www.bankofengland.co.uk/prudential-regulation/letter/2019/proxy-modelling-survey-best-observed-practice.

6 www.bankofengland.co.uk/prudential-regulation/letter/2018/review-of-actuarial-function-reports-in-general-insurance-firms; and www.bankofengland.co.uk/prudential-regulation/letter/2018/joining-the-dots-the-actuarial-function-underwriting-capital-and-reserving.

7 www.bankofengland.co.uk/prudential-regulation/letter/2019/letter-from-gareth-truran-pra-current-areas-of-focus-for-general-insurance-firms; and www.bankofengland.co.uk/prudential-regulation/letter/2019/letter-from-james-orr-feedback-from-recent-pra-reserving-reviews.

We also continued to support the development of international regulatory standards. We furthered our domestic implementation of the tools making up the International Association of Insurance Supervisors' (IAIS's) Holistic Framework for systemic risk in insurance, including participation in the Global Monitoring Exercise. Despite the operational challenges of 2020, the first year of the Global Insurance Capital Standard (ICS) monitoring has been effective, with strong participation from UK Internationally Active Insurance Groups (IAIGs), which has allowed for meaningful feedback and analysis to support discussions on ICS performance. The ICS aims to provide a globally comparable risk-based measure of capital adequacy of IAIGs, and a common language to facilitate effective supervisory discussions of group solvency. We engaged with a number of the IAIS committees and working groups involved in developing this framework, and provided leadership and active engagement across all the work streams.

Investments

In response to the uncertainty over the impact of Covid-19 on firms' portfolios, we heightened our monitoring of their asset quality and management of investment risk. We built on the analytics used for the 2019 stress tests for qualitative and quantitative analysis of the potential impact of credit downgrades and investment losses.

In April 2020, we published an update on our expectations in respect of firms investing in illiquid, unrated assets within their Solvency II matching adjustment (MA) portfolios. The PRA's view is that the Credit Quality Step (CQS), to which an internal credit assessment maps, remains within the plausible range of CQSs that could have resulted from an issue rating given by an external credit assessment institution (ECAI).

We continued to review firms' risk management and governance of illiquid and other assets, including their internal ratings. In addition to the use of section 166 of FSMA powers, we are encouraging firms to obtain opinions from an ECAI as part of their own internal rating validation process.

In May 2020, we issued our final policy[1] on the Prudent Person Principle (PPP) and applied those principles in our investment and governance supervisory reviews that were based on evidence of PPP implementation by firms. We provided feedback to individual firms which demonstrated an interpretation and implementation of PPP that fell short of PRA's expectations.

We also undertook detailed investment analysis and deep-dive reviews on investment strategies, asset allocation, asset exposures, and asset valuations of our firms, including a specific focus on the quality of their internal credit rating frameworks.

Liquidity

The conditions for availability of liquidity to insurers were benign during the year. Our supervisory reviews therefore focused on the liquidity risk management frameworks of firms and their alignment with our published policy on liquidity risk management.[2]

1 SS1/20 'Solvency II: Prudent Person Principle', May 2020: www.bankofengland.co.uk/prudential-regulation/publication/2020/solvency-ii-prudent-person-principle-ss.
2 SS5/19 'Liquidity risk management for insurers', September 2019: www.bankofengland.co.uk/prudential-regulation/publication/2019/liquidity-risk-management-for-insurers-ss.

Stress testing

For the banking sector, in 2020 we contributed to the Bank's desktop analysis of the resilience of the UK banking sector to the unfolding stress, including a 'reverse stress test' exercise which estimated how severe the economic paths for the UK and global economies would need to be in order to deplete regulatory capital buffers by around 5 percentage points – a similar amount to the 2019 annual cyclical scenario (ACS) test. This showed that UK banks, in aggregate, had capital buffers that allowed them to lend in, and remain resilient to, a wide range of possible outcomes for the UK and global economies.[1]

Over the past year, we assessed the resilience and vulnerabilities of non-systemic firms under a range of scenarios and internal capital adequacy assessment processes (ICAAPs), and paused the mid-tier enhanced ICAAP project for one year. The large number of non-systemic UK deposit-takers that the PRA supervises have a wide range of business models at different stages of development maturity, and will therefore be affected by Covid-19 in different ways. They are held to robust capital standards and typically capitalised to maintain adequate capital resources through idiosyncratic scenarios of equivalent severity to the 2019 stress test – but they are not required to hold capital to ensure they can maintain credit supply through stress scenarios. Non-systemic firms hold an aggregate CET1 ratio of around 17% (as at February 2021), and an aggregate liquidity coverage ratio of over 200%.

We also supported the biennial exploratory scenario (BES) exercises. The 2019 BES was designed to explore the implications of a severe and broad-based liquidity stress affecting major UK banks simultaneously, and to consider how banks' and authorities' reactions to the stress would shape its impact on the broader financial system and the UK economy. Insights from the exercise helped to shape aspects of the Bank's response to the impact of Covid-19, and these insights will continue to help inform several strands of the Bank's work in future.[2]

For the insurance sector, concurrent stress testing also continues to be a valuable tool for the PRA in pursuing a forward-looking, proportionate, and judgement-based approach to support insurance supervision. Insurance stress tests (ISTs) are run on a biennial basis for the largest insurance firms. These exercises test the resilience of the insurance sector to a number of hypothetical scenarios, and help the PRA to assess the adequacy of firms' risk management.

In June 2019, we launched our third biennial IST, asking the largest regulated life and general insurers to provide information about the impact of a range of stress tests on their business. On the general insurance side, the exercise suggested the industry is resilient to natural catastrophe risks. On the life insurance side, the exercise highlighted areas around the design and specification of our scenarios, which will be developed ahead of the next stress test exercise.

In addition, IST 2019 included an exploratory exercise in relation to cyber underwriting and climate change. The set of climate scenarios explored the impacts to both firms' liabilities and investments stemming from physical and transition risks.

The next insurance stress test will be launched in 2022.

1 www.bankofengland.co.uk/report/2020/monetary-policy-report-financial-stability-report-august-2020.
2 Further details are set out in the March 2021 Financial Policy Summary and Record: www.bankofengland.co.uk/financial-policy-summary-and-record/2021/march-2021.

Asset quality and liquidity

Insurance

Since the introduction of Solvency II, we have observed inconsistencies in the way the PPP is understood and applied by different firms. In May 2020, we published SS1/20, which set out our expectations of firms regarding the PPP.[1] When applied to a particular firm's circumstances, the standards set by the PPP are likely to allow for a range of reasonable investment strategies, but a firm should also consider more than just whether it has prudently invested its portfolio. We made clear that we would exercise our independent judgement and expect insurers to take action where we judge that the PPP's standards are not being met.

In April 2020, we published our expectations in respect of firms' modelling of income producing real estate (IPRE) loans within their Solvency II internal models, and in respect of the use of internal credit assessments for assigning fundamental spreads for illiquid, unrated assets.

We reviewed insurance firms' internal rating frameworks and asked for the reviews of such frameworks by independent experts appointed under section 166 or by the firms.

We published final policy on insurers' approaches to managing liquidity risk. We drew on recent engagements with stakeholders in the insurance sector and our regulatory experience, including through reviews of Own Risk and Solvency Assessment (ORSA) reports and liquidity risk reviews of PRA-authorised firms, to identify some key issues for insurers to consider when managing liquidity risk, and to which we pay close attention in the conduct of our supervision.

We also continued our work in respect of insurers investing in equity release mortgage portfolios. In particular, we have developed guidance on how the Effective Value Test diagnostic tool can be used to monitor compliance with Solvency II requirements as economic conditions change, and how firms should allow for this when setting capital requirements for these investments.

Banking

Asset quality

Covid-19 has heightened PRA-authorised firms' credit risks, and it remains a dominant focus for us across the banking sector. Over 2020/21, we increased our monitoring of firms' credit risk management and asset quality, predominantly using existing supervisory tools, but supported by increased data collection and analysis, and greater intensity and focus in firm meetings. This included close monitoring of UK firms' support and lending to the real economy, particularly with regard to the roll out of government support schemes such as the Coronavirus Business Interruption Loan Scheme, Bounce Back Loans for corporate and small and medium-sized enterprise (SME) borrowers, and payment deferrals for retail borrowers. We used:

- supervisory tools such as firm meetings, data analysis on a firm-specific and cross-firm basis (bespoke Covid-19 returns and regulatory returns data reviews), written auditor reports, and interactions with auditors;
- PRA specialist-led reviews, including assessments of firms' credit risk management, provision coverage, and asset quality;

1 SS1/20 'Solvency II: Prudent Person Principle', May 2020: www.bankofengland.co.uk/prudential-regulation/publication/2020/solvency-ii-prudent-person-principle-ss.

- thematic reviews, combining financial stability and risk specialist resources, to provide both micro- and macro-impact assessments for particular asset classes and sectors;
- desktop stress testing exercises; and
- reviews of firms' ICAAPs.

In 2020, we continued to review firms' asset quality and management of credit risk by taking a risk-based approach. Our approach aimed at having greater systematic coverage and intensive horizon-scanning in responding to the Covid-19 crisis. Thematic and asset quality reviews were targeted to key vulnerable sectors and asset classes across commercial and retail activities. We increased the number of meetings with firms and data collections to help monitor the credit risks and the Covid-19 government support schemes. We have also continued to assess firms' asset quality in various cross-firm exercises such as desktop stress testing and IFRS 9 provisions (see the stress testing and IFRS 9 sections).

For corporate assets, we have performed thematic and firm-specific reviews on Covid-19 vulnerable sectors (eg aviation, hospitality and leisure, retail) and firms' exposure to SMEs. Alongside this, we continued to undertake the annual UK commercial real estate underwriting survey, which captures loans written by major bank and insurance participants. In addition, we have undertaken a data collection for leveraged lending and highly leveraged corporates to help inform our understanding of the risks these activities pose to firms.

For retail assets, we monitored and reviewed payment deferrals portfolios, including a cross-firm thematic review of the quality of some firms' initial payment deferral portfolios. Furthermore, we reviewed firms' collection capacities across retail secured and unsecured products.

For non-systemic firms, we completed an assessment of resilience and vulnerabilities using a range of scenarios and ICAAPs, firm-specific asset quality reviews on commercial activities, and thematic reviews of IFRS 9 provisions for retail exposures. The findings from the thematic review of fast-growing firms in 2019 led to us requesting the Internal Audit function of a sample of selected non-systemic banks and building societies to undertake a review of the credit collections functions. The deadline for submissions was delayed due to Covid-19. The review has now been completed, with a letter summarising the findings due to be published in 2021 Q2. In addition to the reviews, our CEO and chairs conferences for non-systemic firms are used to share our thematic findings, provide learnings, and share good industry practice.

Traded risk

We have continued to maintain our dialogue with firms on the new market risk capital requirements, the Fundamental Review of the Trading Book (FRTB). FRTB is significant for banks, particularly those that calculate requirements using their own models (subject to regulatory approval).

The PRA took action to limit excessive procyclicality in risk-weighted assets during the Covid-19 market stress. Temporary approaches announced in March and April 2020 were subsequently replaced by more permanent changes to our published policy on market risk, limiting the impact from a sharp increase in the number of value-at-risk (VAR) back-testing exceptions during 'exceptional circumstances' (such as the Covid-19 market stress), and permitting firms not to consider the most recent 12 months when selecting the period to be used for stressed VAR calculations (to prevent a double-count with VAR).

International Financial Reporting Standard (IFRS) 9

We continue to work closely with firms and their auditors to understand their approaches to expected credit loss (ECL) and the implications of those approaches for banks' capital ratios, and to encourage greater consistency of outcomes and high-quality disclosures about ECL. New transitional arrangements for the capital impact of IFRS 9 were implemented through the Capital Requirements Regulation.[1] The PRA also issued five statements and letters regarding the approach to IFRS 9 that banks, building societies, and investment firms should take.[2] The purpose of providing the guidance was to help firms implement existing regulatory and accounting requirements in a robust, well-balanced, and consistent way, notwithstanding the unique challenges created by Covid-19-related events.

In October 2020, following a review of written auditor reports[3] received earlier in the year, we wrote to firms to give thematic feedback for the 2019/20 reporting period, which centred on ECL.[4] We had previously emphasised the importance of ECL being implemented well and in ways that achieve as much consistency of outcomes as is practicable.[5] We were pleased to see that significant progress had been made by firms to enhance the controls and governance around their ECL models and data, but said that further progress is needed. We set out thematic findings around model risk and economic scenarios, including matters that arose as a result of the uncertainty associated with Covid-19.

We, the FCA, and the Financial Reporting Council are sponsoring the work of the Taskforce on Disclosures about Expected Credit Loss. It involves preparers and market participants working together to try to reach a consensus on what good ECL disclosure looks like. The Taskforce's second report was published in December 2019.[6] It focuses mainly on: disclosures that help users understand the types and the extent of credit risk exposure a bank has and how that risk has evolved; the forward-looking information about macroeconomic conditions used in estimating ECL; and the sensitivity of ECL provisions to different macroeconomic conditions.

1 June 2020: www.bankofengland.co.uk/prudential-regulation/publication/2020/statement-on-crr-quick-fix.
2 Statements and letters on IFRS 9 and Covid-19:
www.bankofengland.co.uk/news/2020/march/boe-announces-supervisory-and-prudential-policy-measures-to-address-the-challenges-of-covid-19.
www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/publication/2020/joint-statement-on-covid-19.pdf.
www.bankofengland.co.uk/prudential-regulation/letter/2020/covid-19-ifrs-9-capital-requirements-and-loan-covenants.
www.bankofengland.co.uk/prudential-regulation/publication/2020/statement-on-application-regulatory-capital-ifrs9.
www.bankofengland.co.uk/prudential-regulation/letter/2020/covid-19-ifrs-9-capital-requirements-further-guidance.
3 Written auditor reporting involves the PRA developing a set of questions each year that external auditors of major UK banks answer in writing at the end of their audit. Our questions give auditors insights into regulatory concerns that may be relevant to their audit work. Auditors' responses help us to make more effective use of the work auditors do in areas that are of interest to supervisors.
4 Letter from Victoria Saporta, 'Written auditor reporting – update and main thematic findings', October 2020: www.bankofengland.co.uk/prudential-regulation/letter/2020/written-auditor-reporting-thematic-feedback-from-the-2019-2020-reporting-period.
5 Letter from Sam Woods, 'Implementation of IFRS 9 Financial Instruments', November 2016: www.bankofengland.co.uk/prudential-regulation/letter/2016/letter-from-sam-woods-implementation-of-ifrs-9-financial-instruments; and letter from Sam Woods, 'IFRS 9 Financial Instruments', August 2017: www.bankofengland.co.uk/prudential-regulation/letter/2017/letter-from-sam-woods-ifrs-9-financial-instruments.
6 www.frc.org.uk/news/december-2019-(1)/taskforce-on-disclosures-about-expected-credit-los.

4. Develop our supervision of operational resilience in order to mitigate the risk of disruption to the provision of important economic functions

A key priority for the Bank, PRA, and FCA is to continue building a stronger regulatory framework to improve the resilience to operational disruptions of firms and financial market infrastructures (FMIs). Given firms' increased reliance on technology and third-party providers, it is vital that they prepare to recover from disruptions and invest where needed to ensure continued provision of important business services.

In 2020/21, we continued to embed operational resilience in our supervisory approach, consulted on new policy setting our expectations for the operational resilience of firms' important business services, and enhanced our monitoring of firms' capabilities to react, recover, and learn from operational disruptions.

Operational resilience has been particularly important throughout the pandemic, as firms had to adjust their operating models to allow the majority of staff to work from home. As part of our monitoring of operational resilience throughout 2020, we carried out reviews to assess changes to IT arrangements, the effectiveness of firms' business continuity plans for this type of operational disruption, and the effectiveness of the changes to the risk management framework and controls firms had to make to adapt to the Covid-19 operating model. Cyber risk, third-party risk, and internal fraud risk remain the biggest operational risks.

Defining and shaping policy

Just after the close of the reporting period for this Annual Report (in March 2021), but reflecting a major programme of work which took place during the year, we published co-ordinated policy statements with the Bank and the FCA. These followed extensive consultation and engagement initiated through the operational resilience discussion paper that we jointly published in 2018, and addresses many of the proposed policy changes based on the responses we received. The policy proposals make it clear that firms (banks, building societies, PRA-designated investment firms, UK Solvency II firms, and the Society of Lloyd's and its managing agents) and FMIs are expected to take ownership of their operational resilience and to prioritise plans and investment choices based on their impacts on the public interest. If disruption occurs, firms are expected to communicate clearly by, for example, being able to provide services through alternative channels where they experience disruption.

The new policy expects firms and FMIs to:

- identify their important business services that if disrupted could cause harm to consumers or market integrity, threaten the viability of firms, or cause instability in the financial system;
- set impact tolerances for each important business service, which quantify the maximum level of disruption they could tolerate;
- identify and document the people, processes, technology, facilities, and information that support their important business services; and
- take actions to be able to remain within their impact tolerances through a range of severe but plausible disruption scenarios.

For the PRA, the policy aims to address risks to operational resilience, including those arising from the interconnectedness of the financial system, and the complex and dynamic environment in which firms operate.

The policy provides a proportionate minimum standard of operational resilience that incentivises firms to prepare for disruptions and to invest where it is needed.

Outsourcing and third-party risk management

Alongside the operational resilience policy, we also published our policy for modernising the regulatory framework on outsourcing and third-party risk management. This policy complements the operational resilience policy and will facilitate adoption of the cloud and other new technologies, as set out in the Bank's response to the 'Future of Finance' report.[1] The policy also aligns our supervisory approach with that of the European Banking Authority (EBA) and EIOPA.

The policy aims to improve regulatory certainty in a number of areas of increasing importance to our objectives. For instance, it addresses how firms should:

- assess the materiality and risks of outsourcing arrangements and perform vendor due diligence;
- manage intra-group outsourcing arrangements;
- protect data outsourced to/shared with third parties such as cloud service providers; and
- develop, document, and test business continuity plans and exit strategies for their most important outsourcing arrangements to improve their ability to withstand and recover from a failure or major disruption at a service provider, including assessing the resilience requirements of material cloud outsourcing arrangements.

The policy also set out our expectations on governance, including under the SM&CR, and record keeping.

CBEST and operational resilience reviews

CBEST is a joint PRA and FCA framework for assessing the cyber resilience of firms' critical business functions through threat intelligence-led penetration testing. The PRA conducts assessments on a three-year cycle. For the cycle beginning in 2018/19, we have completed 15 CBEST assessments and initiated a further seven. We have actively worked with non-UK financial services regulators on a number of cross-jurisdictional CBEST assessments and threat-led penetration tests.

As a result of Covid-19, the planned SIMEX20 sector-wide exercise was cancelled to allow responders to focus on live response issues. However, collectively building capability across the industry continued as planned, delivering the following outcomes, which had been identified as desirable by previous exercises and the Covid-19 response:

- Common incident lexicon: provides a consistent and clear methodology for firms to communicate the severity of an incident outside of their individual organisation. It encompasses communications to other firms, clients, customers, regulators, and other relevant third parties. The incident lexicon is due to be published in Summer 2021.
- Sector response framework (SRF): reflecting lessons learned from Covid-19, the SRF has been developed via engagement with response groups across industry, authorities, and government. It has been documented as a guide to support firms, FMIs, and industry groups to co-ordinate, share information, and ensure the sector can respond effectively to incidents. It facilitates collaborative engagement between the sector and financial authorities to maintain financial stability, market integrity, and consumer confidence.

1 www.bankofengland.co.uk/report/2019/future-of-finance.

- Settlement contingencies: in response to the risk of staff absences due to Covid-19, the Bank and UK Finance engaged industry to support further development of two contingency tools: amended settlement hours, and a voluntary sterling settlement postponement. This work included developing a set of operational support documents for industry to use in either circumstance if needed, and further legal analysis is being undertaken to ensure these contingencies can be deployed as effectively as possible.

- Patching guidance: provides a collective industry view of good practice technology vulnerability patching. It includes consideration of the associated challenges and risks of operational application. The guidance for the financial sector was published in February 2021.

- System integrity reconnection framework: provides good practice guidance to aid the process of resuming business and safely reconnecting an organisation that has been technically quarantined after suffering a material cyber incident. The guidance for the financial sector was published in February 2021 and will be tested alongside the US equivalent during an industry desktop exercise later this year.

Cyber stress testing

In June 2017, FPC set out the elements of the framework of regulation to strengthen the UK financial system's resilience against cyber risk, including: (i) clear baseline expectations for firms' resilience that reflected the importance of firms and the services they provide for the financial system; (ii) regular testing by firms and supervisors to ensure that resilience kept pace with the evolving nature of the risk; (iii) identification of firms that were outside the financial regulatory perimeter, but which might be important for regulated firms; and (iv) clear and tested arrangements to respond to cyber incidents when they occurred. The June 2018 Financial Stability Report stated that the Bank would use regular cyber stress tests to test firms' ability to meet these impact tolerances in severe but plausible scenarios.[1] Firms would be invited to participate based on the significance of their contribution to the operations of the UK financial system's vital functions.

The FPC agreed that as part of establishing clear baseline expectations for firms' resilience, it would set tolerances for how quickly critical financial companies must be able to restore vital financial services following a severe but plausible cyber incident, and the Bank would use regular cyber stress tests to test firms' ability to meet these 'impact tolerances' in severe but plausible scenarios. The FPC launched a pilot cyber stress test in 2019 and we have been supporting this work.

Supervision of operational risk and resilience

Our approach to the supervision of banks' operational risk and resilience continued to assess the effectiveness of the operational risk management framework, including service availability and business continuity management. Over 2020/21, we focused on firms' cyber resilience and on key areas of change, including the increasing use of third-party services, the adoption of cloud services, and the governance and delivery of significant IT and operational changes in firms.

More specifically, supervision work on operational risk and resilience included:

- The Cyber Questionnaire CQUEST, which has been used with over 100 firms during the period and continues to be a key tool to assess firms' cyber resilience.

1 www.bankofengland.co.uk/financial-stability-report/2018/june-2018.

- Assessing compliance with the EBA's Guidelines on Information and Communication Technology Risk Assessment under the supervisory review and evaluation process (ICT SREP).
- Engaging in the BCBS's work to enhance banks' operational resilience, including a review of existing BCBS documents, with a view to publishing an updated set of guidance/standards.
- Fostering engagement with the financial sector on operational resilience through roundtable discussions with representatives of the financial services industry, advisory and legal firms, and industry bodies.
- Given the financial sector's increasing adoption of cloud services, we have reviewed a number of cloud outsourcing notifications from firms, and continue to monitor developments across the industry and with cloud providers. This also involves oversight of multi-year transformation and digitisation programs, to enhance understanding of idiosyncratic and collective risks.
- Engaging with firms through continuous assessment meetings to identify operational risks as well as firms' abilities to prevent, recover, and learn from operational disruptions. This includes assessment on the topics of governance, strategy, risk management, change, third-party dependencies, business continuity plans, and how firms adapted to Covid-19-related changes in the operating model. Our supervisory approach included: reviewing the governance and execution of IT change, including the greater reliance on remote working technologies and the impact on IT change programs and the IT control environment, and assessing the changes in top risks and controls that firms made due to the new operating model.
- The global and interconnected nature of large financial firms reinforces the importance of international co-operation on this topic. We have been in close dialogue with our supervisory counterparts regarding operational resilience, and on 3 December 2020, we made a statement jointly with the ECB and Federal Reserve Bank, which reflects our collective thoughts on operational resilience and the areas in which we think further progress is needed.

5. 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 resolution strategy to manage a firm's failure in an orderly manner

The UK established a framework for resolution (known as the 'resolution regime') in the Banking Act 2009. The PRA works closely with the Bank to ensure firms are safe and sound.

The Resolvability Assessment Framework (RAF) sets out how the Bank, as resolution authority, will assess resolvability.[1] It also requires, through the Resolution Assessment Part of the PRA Rulebook, that the major UK banks and building societies formally assess their preparations for resolution, submit a report of that assessment, and publish a summary of their report (public disclosure).

In May 2020, the Bank and PRA announced changes to resolution measures aimed at alleviating operational burdens on PRA-regulated firms in response to the Covid-19 outbreak.[2] These measures extended deadlines, by a year, for the major UK banks and building societies to submit their first reports on their preparations for resolution and publicly disclose a summary of these reports. Firms will now be required to submit their first reports to the PRA by October 2021 and make public disclosures by June 2022. The Bank will also make its first public statement on these firms' resolvability by June 2022.

The PRA published a consultation in October 2020 with proposals to revise its operational continuity in resolution (OCIR) policy.[3] The proposals aim to improve firms' resolvability and support the Bank of England's approach to resolution. The PRA published its final policy relating to OCIR in the first half of 2021.

1 www.bankofengland.co.uk/paper/2019/the-boes-approach-to-assessing-resolvability.
2 www.bankofengland.co.uk/news/2020/may/statement-by-the-bank-of-england-and-pra-on-resolution-measures-and-covid-19.
3 CP20/20 'Operational continuity in resolution: Updates to the policy', October 2020: www.bankofengland.co.uk/prudential-regulation/publication/2020/operational-continuity-in-resolution.

6. Facilitate effective competition by actively considering the proportionality of our approach as it contributes to the safety and soundness of the UK financial system

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 facilitates effective competition in the markets for services provided by PRA authorised persons in carrying on regulated activities'.[1]

In July 2020, we consulted on a set of proposed clarifications to our approach to the supervision of banks and building societies that have typically been in existence for less than five years after receiving authorisation without restrictions.[2] Improved clarity regarding our supervisory expectations facilitates effective competition by reducing the uncertainty faced by new and growing firms. These proposals were finalised in April 2021.[3]

In September 2020, we also proposed to introduce new expectations on the internal ratings based (IRB) approach to UK mortgage risk weights.[4] The purpose of these proposals was to address the prudential risk stemming from inappropriately low IRB UK mortgage risk weights. These proposals would also reduce unwarranted risk weight difference and facilitate effective competition by reducing the difference between SA and IRB mortgage risk weights for current UK mortgages.

For more information on how we are meeting our objective to facilitate effective competition, please read the Annual Competition Report (pages 53–61).

1 Section 2H of FSMA.
2 CP9/20 'Non-systemic UK banks: The Prudential Regulation Authority's approach to new and growing banks', July 2020: www.bankofengland.co.uk/prudential-regulation/publication/2020/new-and-growing-banks.
3 PS8/21 'Non-systemic UK banks: The Prudential Regulation Authority's approach to new and growing banks', April 2021: www.bankofengland.co.uk/prudential-regulation/publication/2020/new-and-growing-banks.
4 CP14/20 'Internal Ratings Based UK mortgage risk weights: Managing deficiencies in model risk capture', September 2020: www.bankofengland.co.uk/prudential-regulation/publication/2020/internal-ratings-based-uk-mortgage-risk-weights-managing-deficiencies-in-model-risk-capture.

7. Deliver a smooth transition to a sustainable and resilient UK financial regulatory framework following the UK's exit from the EU

The UK's withdrawal from the EU had significant implications for the way we discharge our responsibilities, and it continued to be a significant focus of our work over the past year. The UK left the EU on 31 January 2020 and entered a transition period set out in the UK-EU Withdrawal Agreement, during which time EU law continued to apply in the UK. A core priority was to reduce risks and minimise the disruption that could have occurred in the event that the UK and EU ended the transition period on 31 December 2020 without agreeing the terms of a trade and co-operation agreement. We made preparations to nationalise the acquis (retain and convert EU legislation into operable UK legislation) so that the UK has a functioning regulatory framework once EU law no longer applies. We also put in place temporary regimes so that EEA firms that were operating in the UK using the EU passport can continue to do so for a period after the end of the transition period. We published a consultation paper setting out our approach to the supervision of international banks operating in the UK.[1] Responses to this consultation have been received and the final policy is expected to be published in Summer 2021. We also finalised MoUs with the ECB, EBA, EIOPA, and 27 National Competent Authorities. A remaining three MoUs have been agreed in principle and are awaiting signature. Splits of Responsibility agreements for supervision of branches have been agreed with the ECB and 11 National Competent Authorities, covering 72 out of 75 incoming branches. Discussions continue with three National Competent Authorities, covering three remaining branches, two of which are yet to fully establish operations in the UK.

Monitoring and mitigating risks

We supported the FPC in identifying, monitoring, and mitigating financial stability risks arising from the UK's withdrawal from the EU. Ahead of the end of the transition period between the UK and EU, the FPC had regularly published a checklist of actions to avoid disruption to the provision of financial services. Reflecting the extensive preparations made by authorities over a number of years, the transition period ended without any material disruption to the provision of financial services. We will continue to support the FPC in monitoring financial stability risks that could arise from disruption to the provision of financial services in the future.

Regulatory framework: Nationalising the Acquis of EU law

We worked closely with HM Treasury and other regulatory authorities (including the FCA) to ensure that the domestic regulatory framework for PRA-authorised and regulated firms was fully functional at the point at which EU law ceased to apply in the UK. This has included working with HM Treasury to develop appropriate amendments to retained EU legislation, which resulted in 68 statutory instruments being made. The PRA made the remaining EU Exit Instruments to amend rules and retained Binding Technical Standards in its remit. We made a temporary transitional direction to delay the impact of the majority of changes, with key exceptions, for 15 months after the end of the transition period, until 31 March 2022.

Authorisations

The Temporary Permissions Regime (TPR) commenced at the end of the transition period. The TPR provides continuity for UK users serviced by EEA firms while those firms seek permanent status in the UK.

1 CP2/21 'International banks: The PRA's approach to branch and subsidiary supervision', January 2021: www.bankofengland.co.uk/prudential-regulation/publication/2021/january/international-banks-branch-and-subsidiary-supervision.

Supervisory co-operation

We have continued to deepen our relationships with supervisors and regulatory authorities around the world to advance our supervisory and regulatory objectives. We have ensured our supervisory approach can continue to be applied, including through numerous Memoranda of Understanding and other co-operation agreements the PRA has signed to facilitate continued co-operation and information.

Financial services relationship

In the context of the UK's new relationship with the EU, the Bank continued to provide technical support to the UK Government as requested over the 2020/21 period. This was in accordance with the Bank's and PRA's statutory objectives. We supported the technical agreement between HM Treasury and the European Commission on a Memorandum of Understanding on Financial Services Regulatory Cooperation.

Regulatory Initiatives Forum

The Financial Services Regulatory Initiatives Forum is co-chaired by the PRA and FCA CEOs, who convened its inaugural meeting in April 2020. The Forum exists to enhance co-ordination between its members with a view to better managing the operational impact of their initiatives on the financial services industry, including its consumers. After meeting, the Forum publishes a consolidated view of the regulatory workplan: the Regulatory Initiatives Grid. This publication helps stakeholders to understand – and plan for – the timing of regulatory initiatives. The PRA is a major contributor to the Grid and believes our stakeholders have valued its introduction. The Forum published the first two editions of the Grid during the reporting period, in May and September 2020. The most recent iteration was published on 7 May 2021.

8. Operate effectively by ensuring that resources are allocated to work that best advances our strategy and reduces the greatest risks to the delivery of our strategic objectives

Embedding the plan for PRA technology

The onset of the Covid-19 pandemic resulted in a significant increase in the amount of data firms share with us to support the monitoring of emerging risks. This has resulted in a substantial demand for new data analytical and visualisation tools to enable supervisors to make timely decisions in a quickly changing environment. For example, the PRA Data Innovation team has developed a number of tools to equip supervisors with the capability to monitor the Bounce Back Loan Scheme, and the Coronavirus Business Interruption Loan Scheme, as well as a spike in other *ad hoc* Covid-19-related reporting.

In line with the Bank's response to the Future of Finance report, the PRA has experimented with a number of proof of concepts (POCs) to meet the commitments made with regards to delivering our RegTech and Data Strategy. These include the development of tools integrating multiple data sources for market monitoring. For example, we developed two POCs providing supervisors with the capability to monitor Twitter sentiment data, as well as news media headlines.

Building on our previous work in the application of artificial intelligence (AI) across our operations, the PRA Data Innovation team introduced the first AI search engine to all colleagues in the PRA. This tool provides a greatly improved search experience across all the unstructured information received from regulated firms.

Throughout the year, the PRA has been a leader in the area of international collaboration on the subjects of RegTech and SupTech, working alongside other international central banks and regulators. This included the co-leading, with the Monetary Authority of Singapore, of the FSB G20 Fin SupTech and RegTech report, published in October 2020. This was delivered and presented entirely virtually, with input from 22 other member countries.

The Systems, Change and Banking Data team has driven forward work on the 'banking sector monitoring' renewal programme through provision of business ownership, product ownership, and SME support, and continued to develop the Aperture tool used mainly by PRA banking supervisors and other areas of the Bank. The Aperture development project has been focusing on product sales data, taxonomy 2.9 analytics, and updating the calculations. The team has also redesigned their training delivery on banking data systems and tools, which will be launched in the second half of 2021.

The PRA published its largest ever set of rule instruments on 31 December 2020, which included the EU Exit instruments and those implementing CRD V. A new and improved PRA Rulebook platform will be implemented in 2023. This will be a vital step towards achieving a single, coherent rulebook post-EU withdrawal. The new Rulebook will allow for easier navigation of content, and will benefit from the latest digital developments, including making content more accessible, where possible, in machine-readable format.

In parallel, we embarked upon a digital skills strategy to provide colleagues in the PRA with enhanced digital skills, to continue to meet challenges of the technology era.

Risks to the delivery of the PRA Business Plan, unforeseen events, and execution risk

Covid-19 clearly had an impact on our activities across the year, as it did for the firms we regulate, and required us to reprioritise and change our plans for a number of the activities previously set out in our Business Plan. However, we continued to focus on our strategic goals and core objectives, as well as supporting government initiatives. The need to support the wellbeing of our staff was also a priority, as this was an important part of ensuring that the pandemic's disruption of our business was minimised.

Building on the developments in our own internal risk model, we have further developed the risk assessment framework that we use to supervise firms, to help us make better choices about how we prioritise our time when disruptive events arise.

During 2021/22, we also undertook a strategic review of our activities. This exercise is due to complete in Summer 2021 and we intend to set out further details in next year's Annual Report.

Internal factors

Given the Covid-19 pandemic, the PRA's operations and ongoing pursuit of operational effectiveness came under significant pressure in 2020/21. The PRA, along with the rest of the Bank and many other organisations, moved to virtual working in mid-March 2020. At this point, each PRA directorate assessed their business critical processes to determine whether these could be carried out effectively remotely, or if workarounds could be put in place. This led to PRA staff working entirely virtually during each of the national lockdowns. Like other organisations, the PRA had to quickly adapt its processes and business priorities to the new virtual working environment, and keep them under continual review, to account for unavoidable reductions in productivity, collaboration, and staff wellbeing in the face of the pandemic. A cross-Bank scheme to temporarily divert resources ensured that new or ongoing work that directly supported the strategic objectives, or response to the pandemic, could continue at an appropriate pace in the event of staff sickness or other absence.

Alongside these pressures on operations, the PRA maintained a focus on budgets to ensure it supported the Bank in meeting its budget targets. Before the pandemic, the PRA's senior management team conducted prioritisation exercises to work out how best to allocate resources to ensure delivery against our strategic goals while meeting the budget constraints. This prioritisation continued throughout 2020/21. In addition, budget savings were made due to the cessation of travel during the pandemic.

Measuring progress

In 2020/21, we continued to draw on a variety of information to monitor the progress of delivery against our statutory objectives, strategy, and business plan on an ongoing basis.

The PRC and the Supervisory Risk and Policy Committee regularly received information on both quantitative and qualitative measures and indicators, to make an assessment of delivery against the PRA's strategy, business plan, statutory objectives, and risk tolerance. This enabled the PRC to report to the Chancellor of the Exchequer on the adequacy of resources and provide sufficient information on supervisory processes and outcomes (see pages 8–9).

FCA: Effective regular co-ordination

We have continued to co-ordinate well with the FCA across a wide range of policy, authorisations, and supervisory matters. We assess our performance every quarter against the statutory MoU. In particular, the PRA and the FCA worked collaboratively on the Regulatory Initiatives Grid and Forum to ensure it has broad membership and covers all relevant information.

There has been positive engagement and co-ordination with the FCA on a number of other supervisory and policy matters of joint interest, notably: the Climate Risk Forum, the use of shared IT systems, joint engagement with the European Supervisory Authorities, and HM Treasury's consultation on the Future Regulatory Framework.

The relationship between the PRA and FCA supervision teams continues to be a collaborative one, which both regulators consider to be working well. Across all areas of the PRA and FCA, information is proactively shared where appropriate.

Authorisations has historically been an area of close collaboration, and in 2020/21 this continued to be the case. Both regulators worked closely together to implement process improvements to help lessen the impact of an abnormally high volume of cases due to Brexit.

The PRA and FCA enforcement areas had several joint investigations in the 2020/21 period, and they shared best practice and feedback relating to cases.

We continued to engage with the relevant teams at the FCA to share the outcomes of respective firm feedback surveys.

Firm feedback

We regularly seek input from firms on the effectiveness and quality of our supervisory framework and approach. One of the ways we do this is through the annual firm feedback survey. The team that oversees this process is independent of frontline supervision.

The survey gives PRA-authorised firms the chance to comment on a number of topics, including:

- our understanding of firms;
- the firm's understanding of the PRA's regulatory objectives and expectations;
- the PRA's level of challenge to firms;
- the effectiveness of firms' relationships with us;
- our co-ordination with other regulators and data requests; and
- our approach to new technology (from 2020).

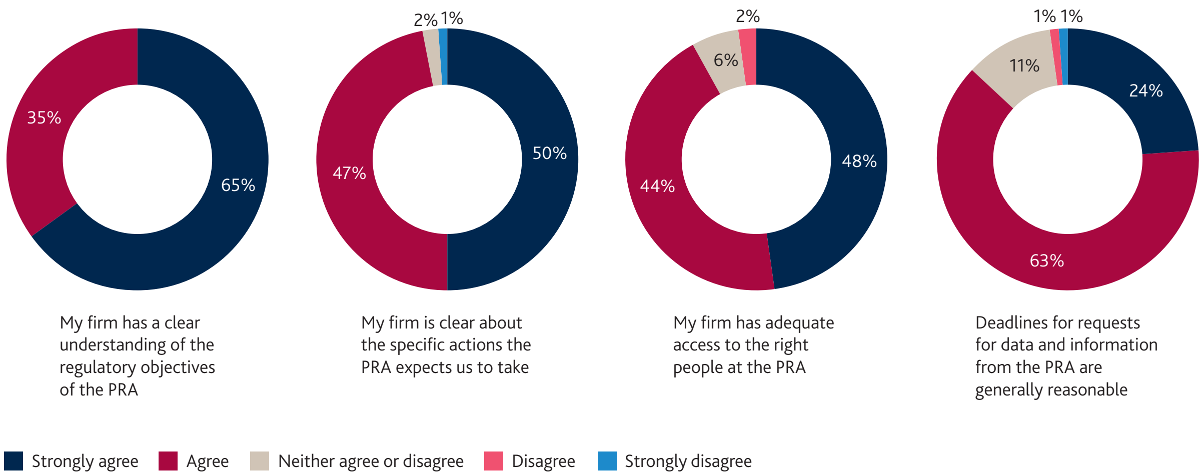
We ask firms questions about topical issues in the industry, and request that they suggest three improvements that the PRA could make. Firms are also welcome to make additional comments.

We appreciate firms' participation in the survey. It is important that we continue to understand, as the PRA evolves, both what firms think works well, and what we might do differently.

The survey was completed by 189 firms in 2020. Due to the additional pressure Covid-19 put on firms, we suspended follow-up meetings and only held seven meetings with large firms before March. For similar reasons, we did not hold roundtable discussions with small firms, which we had first introduced early in 2020.

Chart 1 shows a selection of the survey results, reflecting the types of issues for which the PRA sought an opinion. The full quantitative results will be available on the Bank's website.

Chart 1: Excerpt from firm feedback survey results 2020



Overall, 2020 scores show firms have maintained their positive views about the PRA, notwithstanding the pressures arising from Covid-19, and the resulting need for more intrusive supervision. Firms gave the most positive scores for their understanding of the PRA's objectives and relationships with the PRA.

The least positive scores concern the PRA's co-ordination with the FCA (75% favourable) and other regulators (67% favourable for relevant firms). Although the scores are relatively lower than for other questions, comments recognised the improved co-ordination and the efforts made at the start of the pandemic. When we have previously explored firms' responses to co-ordination with the FCA, they said this is just a reflection of the different functions of the two organisations, and not a criticism of their respective behaviours.

We have sought to act on the feedback from previous surveys:

- as in previous years, firms commented that timescales for SM&CR approvals were in some cases too long. Firms also indicated that, on occasion, the time limit was exceeded. The FCA had a large increase in applications, which contributed to the delays, and has now increased resourcing to resolve this. The PRA is also considering ways of helping firms improve the quality of their applications, such as engaging with larger firms and trade bodies;

- in response to feedback about information requests, given the increased demand for data during the pandemic, we have taken steps to increase notice and reduce volume where possible. We are also actively seeking to develop more consistent data to be used in times of stress, so that firms can be better placed to respond. Longer term, we are looking to invest in better data capability to reduce the burden on firms; and

- we have enhanced the search function on the Bank's website and used reference numbers for papers to generate more streamlined results. We are also planning to introduce a 'mega-menu' to aid navigation.

Zelmer review

The Zelmer report on the prudential supervision of the Co-operative Bank recommended that the PRC, and the executive management of the PRA, should continue to play a leading role in ensuring that supervisory strategies for individual firms proactively take account of emerging regulatory developments.[1] In response, the PRA agreed to document and standardise existing good practice on emerging regulatory developments, so that supervisors have ready access to the information.

The PRA has now completed this work to document good practice, which was agreed by PRC in February 2021, and it is now available to supervisors and the PRA's policymaking functions. The documentation will assist with the standardisation of practices where appropriate. The PRA strategic review will continue this work by addressing the operation of the PRA's policymaking function following the UK's withdrawal from the EU, and includes the operating relationship with Supervision.

The Zelmer report also asked the PRA to develop further material to convey key principles for supervisors to apply, when supervising significant firm transactions that may pose higher risks to the PRA's objectives. The PRA has consolidated existing guidance, and developed further principles, which are available to our supervisors.

1 The Zelmer report is available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/789802/38336_U_BoE_Independent_Review_Hi_Res.pdf.

Box D: Parliamentary accountability

Our objectives are set by Parliament. We take our duties to Parliament very seriously, and representatives of the PRA aim to account for our decisions as transparently and clearly as possible. The senior staff of the PRA and PRC members appear in front of parliamentary committees frequently. Sam Woods, Antony Jenkins, John Taylor, Sarah Breeden, and Vicky Saporta appeared before the Treasury Select Committee (TSC), the Environmental Audit Committee (EAC), and the Financial Services Bill Public Bill Committee (PBC) seven times between 1 March 2020 and 28 February 2021:

- Appointment of Antony Jenkins to the Prudential Regulation Committee, 13 January 2021 (TSC).[1]
- Appointment of John Taylor to the Prudential Regulation Committee, 13 January 2021 (TSC).[2]
- Financial Stability Report, 6 January 2021 (TSC).[3]
- Financial Services Bill Committee Stage, 17 November 2020 (PBC).[4]
- Decarbonisation and Green Finance, 30 September 2020 (TSC). [5]
- Greening the Post-Covid-19 Recovery, 24 September 2020 (EAC). [6]
- Economic impact of Coronavirus, 15 April 2020 (TSC).[7]

The PRA has also made formal submissions to parliamentary committees in writing, including:

- Written evidence to the Future of Financial Services inquiry, March 2021.[8]
- Written evidence to the Financial Services after Brexit inquiry, November 2020.[9]
- Letter from Executive Director Sarah Breeden to TSC Chair on embedding climate risk in the Senior Managers Regime, 19 October 2020.[10]
- Letter from the Governor to TSC Chair on insurance stress tests, 29 June 2020.[11]

1 https://committees.parliament.uk/oralevidence/1516/pdf/.
2 https://committees.parliament.uk/oralevidence/1517/pdf/.
3 https://committees.parliament.uk/oralevidence/1473/pdf/.
4 https://hansard.parliament.uk/pdf/commons/2020-11-17/aa198216-87c9-45e0-8958-94cdfa1c96f3.
5 https://committees.parliament.uk/oralevidence/972/pdf/.
6 https://committees.parliament.uk/oralevidence/942/pdf/.
7 https://committees.parliament.uk/oralevidence/285/pdf/.
8 https://committees.parliament.uk/writtenevidence/23354/pdf/.
9 https://committees.parliament.uk/writtenevidence/16654/pdf/.
10 https://committees.parliament.uk/publications/3293/documents/31063/default/.
11 https://committees.parliament.uk/publications/2106/documents/19843/default/.

PRA executives have also engaged with parliamentarians outside of parliamentary committees, including through evidence to All-Party Parliamentary Group inquiries and briefings with parliamentarians on PRA policy. We are committed to carrying out our policymaking role in a transparent way, which helps facilitate scrutiny by Parliament. The UK Government has proposed that the PRA takes on more responsibilities for policy development as a result of the UK's departure from the EU, and if Parliament agrees to these proposals, it will then hold us to account for achieving any objectives it sets for the PRA. This is crucial for the democratic legitimacy of the PRA's development of financial services rules. We are committed to providing whatever information or other assistance is needed to help Parliament fulfil this role.

Box E: Communications: Supporting the PRA's objectives

Our industry-wide communications forms a vital part of the delivery of the PRA's statutory objectives and supervisory approach. This includes publications, briefings, speeches, and letters to firms and industry participants on both policy and supervisory activity. In 2020/21 we:

- provided communications to support the ending of the EU withdrawal transitional period, including a policy statement to 'nationalise the acquis', converting EU legislation into functional UK legislation. We also issued updates to our adoption of CRD V and the Bank Recovery and Resolution Directive II;
- issued a large number of statements and updates to industry, in response to the rapidly changing economic environment. These outlined interim measures and capital treatments following government financial relief initiatives, temporary loans and repayment holidays, and changes to Financial Services Compensation Scheme (FSCS) coverage;
- continued to deliver improvements to our implementation of Solvency II, including a policy statement on Solvency II technical information and insurance approaches for matching adjustments;
- continued to support the development of a microprudential framework for supervising operational resilience, with policy statements on outsourcing and third-party risk management, and the development of impact tolerances for important business services;
- delivered a number of statements and events on climate change and the move towards a net-zero carbon economy;
- continued to issue the monthly PRA Regulatory Digest, which remains one of our most downloaded publications; and
- worked in conjunction with HM Treasury and the FCA to issue our first Regulatory Initiatives Forum grid and a subsequent second grid, providing industry with our joint forward view of key regulatory publications and initiatives. The most recent iteration of the grid was published on 7 May 2021.

2020/21 policy publications[1] and other publications

- 25 consultation papers
- 27 policy statements
- 31 supervisory statements
- 5 statements of policy
- 47 statements
- 24 letters

1 www.bankofengland.co.uk/prudential-regulation/policy.

Complying with FSMA

This section covers a number of issues that we take into account when carrying out our duties or other areas that we report on.

These include:

- complying with FSMA;
- complying with the regulators' code and principles;
- our complaints scheme;
- details of how we have used the provisions of section 166 of FSMA; and
- sections 339A and 339B of FSMA relating to firms' auditors.

Complying with FSMA

In carrying out our functions during the reporting period, we were required to, so far as was reasonably possible: (i) act in a way which advances our general objective to promote the safety and soundness of PRA-authorised persons; and (ii) specifically for insurers, act in a way which contributes to the securing of an appropriate degree of protection for those who are or may become policyholders (sections 2B and 2C of FSMA). This report sets out how we have discharged our functions and the extent to which, in our opinion, the objectives have been advanced. Section 3B of FSMA sets out a number of regulatory principles to which the PRA must have regard (under section 2H(2) of FSMA) in discharging its general functions. These are the:

(a) need to use resources in discharging our general functions in the most efficient and economic way;

(b) principle that a burden or restriction which is imposed on a person, or on the carrying on of an activity, should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction;

(c) desirability of sustainable growth in the economy of the UK in the medium or long term;

(d) general principle that consumers should take responsibility for their decisions;

(e) responsibilities of the senior management of persons subject to requirements imposed by or under FSMA, including those affecting consumers, in relation to compliance with those requirements;

(f) desirability where appropriate of exercising our functions in a way that recognises differences in the nature of, and objectives of, businesses carried on by different persons (including different kinds of persons such as mutual societies and other kinds of business organisations) subject to requirements imposed by or under FSMA;

(g) desirability in appropriate cases of publishing information relating to persons on whom requirements are imposed by or under FSMA, or requiring such persons to publish information, as a means of contributing to the advancement by the PRA of its objectives; and

(h) principle that the PRA should exercise its functions as transparently as possible.

We take these principles into consideration when carrying out our functions, including when making policy.

Furthermore, in carrying out our functions during the reporting period, we were required to, so far as was reasonably possible, act in a way which facilitated effective competition in the markets for services provided by PRA-authorised persons in carrying on regulated activities (section 2H(1) of FSMA). There are several examples of how meeting this requirement was achieved in the PRA Annual Competition Report on pages 53–61.

Details of how we have met our general duty to consult (under section 2L of FSMA) and considered any representations made (under section 2N of FSMA) can be found on page 45, which also explains how the PRA engages with firms more generally. These arrangements include the establishment and maintenance of the PRA Practitioner Panel under section 2M of FSMA. The Panel is an independent body representing the interests of practitioners in the financial services industry. It plays an important role in PRA policymaking by providing appropriate challenge and scrutiny. As well as PRA policies, the Panel also considers items from other directorates within the Bank of England that have policies with potential prudential impact.

In 2020/21, the Panel met four times and provided the PRC and senior management from across the PRA and the Bank with feedback on topics such as the actions taken by the PRA in response to Covid-19, liquidity coverage ratios and use of capital buffers in times of stress, and the appropriate regulatory response to the use of artificial intelligence and machine learning. The Panel continued to provide input into policy at different stages of development – from practical insights to implementation, to proposals under consultation, to early stage policy development. The Insurance Sub-committee met twice during the 2020/21 reporting period. It provided input on insurance-focused topics such as HM Treasury's Review of Solvency II, the development of the Regulatory Initiatives Forum grid, and the PRA's consultation on operational resilience and insurance supervision.

The PRA and FCA have a duty to ensure a co-ordinated exercise of functions and to maintain an MoU describing how they intend to comply with that duty (under sections 3D and 3E of FSMA respectively). Details of how this has been managed effectively are covered on pages 39 and 40.

We have the power to require the FCA to refrain from taking certain actions, specified under section 3I of FSMA, or to give a direction to the FCA in relation to with-profits policies (section 3J of FSMA). We did not exercise this power during 2020/21.

Section 354B of FSMA outlines our duty to co-operate with other persons (whether in the UK or elsewhere) who have functions similar to ours, or have functions relevant to financial stability. Details of how we have complied with this duty are throughout this report and in particular on pages 36 and 37.

Regulators' code and principles

In accordance with sections 21 and 22 of the Legislative and Regulatory Reform Act 2006 and the Legislative and Regulatory Reform (Regulatory Functions) Order 2007, the PRA, when exercising its functions, is required to have regard to the following Regulators' Principles and Code.

Regulators' principles

- Regulatory activities should be carried out in a way that is transparent, accountable, proportionate, and consistent.
- Regulatory activities should be targeted only at cases in which action is needed.

Regulators' Code

- Regulators should carry out their activities in a way that supports those they regulate to comply and grow.
- Regulators should provide simple and straightforward ways to engage with those they regulate and hear their views.
- Regulators should base their regulatory activities on risk.
- Regulators should share information about compliance and risk.
- Regulators should ensure clear information, guidance, and advice is available to help those they regulate meet their responsibilities to comply.
- Regulators should ensure that their approach to their regulatory activities is transparent – including publishing, on a regular basis, details of their performance against their service standards, including feedback received from those they regulate and data relating to complaints about them. Details of firm feedback are set out on pages 41 and 42; details of complaints are set out below; and the PRA's statutory performance report is published on our website.

PRA's complaint scheme

As part of the statutory Complaints Scheme (under Part 6 of the Financial Services Act 2012), we are responsible for ensuring formal complaints against us are dealt with quickly. During the reporting period, we received 23 formal complaints, 21 of which related to PRA action taken in relation to the payment of dividends by the largest UK banks during 2020, which we did not uphold. All investigations were concluded during the reporting period. Of the 21 dividend complaints, four were referred to the Financial Regulators Complaints Commissioner, who was still considering these at the end of the period.[1] Two complaints, one against the PRA and one against the Bank of England, were excluded under the scheme as the subject matter was not within the scope of the scheme. Of the complaints excluded under the scheme, one was assessed by the Financial Regulators Complaints Commissioner, who found that the complaint could not be considered under the scheme. The Commissioner also completed reviews of four complaints from the previous reporting period that were referred. Details of the final decisions are/will be available on the Commissioner's website.[2]

Section 166 reports by skilled persons[3]

Section 166 (s166) of FSMA provides a regulatory tool which gives us powers to obtain an independent expert review of aspects of a regulated firm's activities. Such reviews can be undertaken where we seek additional information, further analysis, expert advice and recommendations, or assurance around a particular subject.

In 2020/21, we commissioned 17 reviews by skilled persons (2019/20: 29 reviews), including two (2019/20: six) where we contracted directly with the skilled person.

1 Subsequently, two of the dividend complaints were not upheld by the Complaints Commissioner and two were partially upheld.
2 https://frccommissioner.org.uk/final-reports/pra-the-prudential-regulation-authority/.
3 Including s166a reports by skilled persons.

The reviews fell within the areas shown in **Table A**. In 2019/20 there were nine reviews of firms' regulatory reporting under Lot F, of which the majority were commissioned following the Dear CEO letter, dated 31 October 2019, on the reliability of regulatory returns. Following the onset of Covid-19, the reviews commissioned in response to the Dear CEO letter were paused to alleviate the operational burdens on firms. While these reviews have subsequently recommenced, we commissioned no new reviews.

Table A: Section 166 reviews by areas of focus

Lot[(a)]	Total for 2019/20	Total for 2020/21
Lot B: Governance and individual accountability	1	4
Lot C: Controls and risk management frameworks	9	7
Lot F: Prudential – deposit-takers, recognised clearing houses and PRA-designated investment firms	12	3
Lot G: Prudential – Insurance	4	3
Lot J: Technology and information management	3	–
Total	**29**	**17**

(a) A detailed description of the services provided under each lot can be found on the PRA's website; PRA's approach to supervision: www.bankofengland.co.uk/prudential-regulation/supervision.

The total estimated cost of s166 reviews commissioned in 2020/21 was £4.6 million (2019/20: £23.4 million), of which the cost per review ranged from £62,000 to £0.9 million (2019/20: £86,000 to £4.2 million).[1] Of this total, the estimated cost of the two reviews where we contracted directly with the skilled persons was £1.2 million[2] (2019/20: six, at a cost of £1.3 million). The estimated cost of the reviews commissioned in 2019/20 on regulatory reporting was £13.1 million (2019/20: £7.7 million reported in the 2019/20 Annual Report).

Meeting with auditors

Under section 339A(2) of FSMA the PRA is required to issue and maintain a code of practice that includes arrangements on the: (i) sharing of information (that we are not prevented from disclosing) with auditors of PRA-authorised persons; and (ii) exchange of opinions with auditors of PRA-authorised persons. We published Legacy SS7/13 'The relationship between the external auditor and the supervisor: a code of practice' (the Code) in April 2013.[3] Section 339B(2) of FSMA states that we must make arrangements for meetings to take place at least once a year with the external auditor of any PRA-authorised person to which section 339C of FSMA applies. Thirty-five firms (2019/20: 33) fell within the scope of section 339B FSMA during the reporting period, and we conducted 62 meetings (2019/20: 44) with the auditors of these firms. At least one meeting with the auditor of each such firm was held during the reporting period. We look to auditors to contribute to effective supervision by directly engaging with us in a proactive and constructive way. We also report to the PRC annually on the quality of the relationship between auditors and supervisors. For the period ending 29 February 2020, we reported the

1 The costs disclosed include actual costs incurred by the firms, or an estimate where the review is ongoing and the actual costs are not yet available. The comparative figures have been revised to reflect the actual costs incurred for reviews commissioned in 2019/20 and completed in 2020/21. Two reviews commissioned in 2019/20 are ongoing, and the reported costs for these reviews remain as estimates.
2 Costs of directly-contracted s166 reviews include VAT.
3 www.bankofengland.co.uk/prudential-regulation/publication/2013/the-relationship-between-the-external-auditor-and-the-supervisor-a-code-of-practice-ss.

results of a survey of supervisors to the PRC. A significant majority of those surveyed were satisfied with their auditor-supervisor relationship. The PRA continues to focus on maintaining open and constructive relationships that add value.

Structural reform

Structural reform (also referred to as ring-fencing) has been in effect since 1 January 2019. Ring-fencing requires UK banking groups with more than £25 billion of core deposits to ensure the provision of core services (broadly, facilities for accepting core retail deposits, and payments and overdrafts relating to core retail deposit accounts) is separate from certain other activities within their groups, such as investment and international banking.[1] As at 1 January 2021, the following UK banking groups are in scope of ring-fencing and contain at least one ring-fenced body (RFB): Barclays, HSBC, Lloyds Banking Group, NatWest Group, Santander UK, TSB and Virgin Money.[2]

Our activity relating to ring-fencing advances our general safety and soundness objective. We are required to discharge our functions in a way that seeks (among other things) to:

(i) ensure that the business of RFBs is carried on in a way that avoids any adverse effect on the continuity of the provision in the UK of core services;

(ii) ensure that the business of RFBs is protected from risks (arising in the UK or elsewhere) that could adversely affect the continuity of the provision in the UK of core services; and

(iii) minimise the risk that the failure of an RFB, or of a member of an RFB's group, could affect the continuity of the provision in the UK of core services.

Paragraph 19 (1A) of Schedule 1ZB of FSMA requires us to report in our Annual Report, in general terms, on certain aspects of ring-fencing, including: the extent to which RFBs have complied with ring-fencing provisions in legislation and PRA rules; the steps taken by RFBs to comply with ring-fencing provisions; the steps we have taken to enforce ring-fencing provisions; the extent to which RFBs are undertaking activities that would be excluded or prohibited but for an exception in the legislation; and the extent to which RFBs appear to have acted in accordance with our guidance relating to ring-fencing provisions. Our Annual Report for the period 1 March 2018 to 28 February 2019 was the first to include this information.

The legislation specifies the activities that must be conducted by RFBs, as well as the activities RFBs are prohibited from undertaking. Any activities falling outside those two categories – for example taking deposits from large corporates, or mortgage and credit card lending – can be carried out from either side of the ring-fence ('permitted business'). Banking groups chose to structure their groups in different ways, reflecting their current operations and preferred business strategies. As a result, some groups placed almost all permitted business within the ring-fence, while some others chose to locate significant proportions of their permitted business outside of the ring-fence. Over the previous year, the structure of most firms' RFB sub-groups remained largely the same. Firms have generally complied with our group structure policy set out in SS8/16[3] and we have not identified any major concerns.

1 The requirement for large UK banking groups to ring-fence their core services by 2019 is set out in FSMA 2000 (as amended by the Financial Services (Banking Reform) Act 2013).
2 Key information and materials relating to ring-fencing, including the list of RFBs, is available on our dedicated webpage: www.bankofengland.co.uk/prudential-regulation/key-initiatives/structural-reform.
3 'Ring-fenced bodies (RFBs)', December 2017: www.bankofengland.co.uk/prudential-regulation/publication/2016/ring-fenced-bodies-ss.

Our focus in the 2020/21 reporting period has been on ensuring the ring-fencing arrangements that firms have established are effective and well-embedded, particularly in light of the additional pressures firms have faced as a result of the impacts of Covid-19. We have continued to assess the effectiveness of RFBs' governance structures and risk management arrangements, including in relation to ring-fencing provisions.

In September 2020, the PRA published a review of proprietary trading[1] by PRA-authorised deposit-takers and investment firms incorporated in the UK. This review is one of the statutory reviews related to ring-fencing introduced by the Financial Services (Banking Reform) Act 2013, which required the PRA to review the case for further restrictions on proprietary trading. The review considered the extent of proprietary trading engaged in by relevant authorised persons, and whether the constraints on this activity, and the PRA's powers, are sufficient. The report found that 'classic' proprietary trading – short-term own-account trading with the intent of profiting from market movements unconnected with client activity – is currently a small fraction of all proprietary trading activity by banks, both in terms of the numbers of transactions it generates and their risk. Consistent with the statutory restrictions on such activity, there is no evidence of it taking place in RFBs. The report also concluded that the PRA already has substantial supervisory powers which can be and are used to mitigate the risks created by proprietary trading, and does not need new powers to address these risks. In 2021, HM Treasury, as required under the Financial Services (Banking Reform) Act 2013, appointed an independent panel to undertake reviews of ring-fencing legislation and proprietary trading. The reviews are expected to conclude in early 2022.

Ring-fencing provisions are numerous, detailed, and wide-ranging, touching on many aspects of the operations of the banks subject to them. Over the past year, firms have continued to take measures to ensure ongoing compliance with ring-fencing provisions and guidance issued by the PRA. This has included internal reviews being undertaken, consideration of the ring-fencing implications of changes and initiatives (particularly in relation to changes in the structure of firms and interaction with other entities in their banking groups), and improvements to compliance monitoring. During this reporting period, RFBs for the most part complied with the individual ring-fencing provisions and associated guidance, but we have been notified of a limited number of further instances of non-compliance. These were mostly of low materiality, and none were classed as severe. In all such cases, the firms took steps to resolve breaches immediately or took other action, including putting remediation plans in place. We have not taken any enforcement action in respect of the ring-fencing provisions in the past year.[2] Where it was judged additional action would improve firms' compliance with ring-fencing provisions, we have taken non-statutory supervisory action, such as requesting some firms to review and attest to their compliance with ring-fencing provisions.

Use of exceptions

The activities of RFBs are restricted by our rules and ring-fencing legislation. For example, the legislation prohibits RFBs from carrying on 'excluded activities' and contains certain 'prohibitions', including:

- dealing in investments or commodities as principal;
- incurring exposures to relevant financial institutions (RFIs);
- accessing payment systems indirectly; and
- having branches or subsidiaries in a country outside the UK which is not an EEA Member State.

1 Proprietary Trading Review: www.bankofengland.co.uk/prudential-regulation/publication/2020/proprietary-trading-review.
2 For information on the use of the PRA's statutory powers see www.bankofengland.co.uk/prudential-regulation/pra-statutory-powers.

The legislation also sets out certain permitted exceptions to these 'excluded activities' and 'prohibitions' to allow RFBs to carry out activities which they would otherwise be prohibited from undertaking. These exceptions aim to allow RFBs to undertake activities typical for a retail and commercial bank, such as 'dealing in investments as principal' for risk management purposes, collateral management, selling simple derivatives to its account holders subject to conditions,[1] transactions with central banks, and managing pension liabilities.

Our rules require an RFB to have policies in place that specify in detail the circumstances in which it will make use of exceptions ('exceptions policies'). We assess RFBs' use of exceptions through ongoing supervisory engagement, regulatory reports, and by undertaking reviews of RFBs' exceptions policies. This informs us of the extent to which RFBs undertook activities that would be excluded or prohibited but for an exception in the legislation.

Overall, the information we reviewed suggests that firms' use of exceptions is consistent with the objectives of the ring-fencing regime, and that firms have not taken risk positions which exceed the risk limits set out in the legislation.

The legislation includes exceptions to permit RFBs to deal in investments as principal or to incur exposures to RFIs where the sole or main purpose of the associated transaction is to hedge risks. All firms used this exception. The vast majority (more than 90%) of the hedging exceptions that RFBs used were those relating to hedging changes in interest rates. The remainder of the hedging exceptions (less than 10%) were mainly used to hedge changes in exchange rates. The relatively higher use of the exception for interest rate hedging is in line with the PRA's expectations, as this type of hedging is a prominent risk management activity for many retail banks. Exposures to RFIs related to hedging were relatively small compared to firms' capital bases.

The exceptions not related to hedging, such as for customer derivatives, own securitisations and covered bonds, trade finance, conduit lending, infrastructure finance, and ancillary exposures, were used by most RFBs to varying degrees. The use of these exceptions was within any applicable limits and consistent with the RFBs' business models. For example, the exception permitting RFBs to sell simple derivatives to its account holders was used by four of the seven RFB sub-groups, with a relatively low value of related exposures, which were within the limits defined in ring-fencing legislation.

The exceptions related to other prohibitions were mainly used to a small extent. RFBs were also generally direct participants in the main UK payment systems that they used, and where those payment systems were accessed indirectly, this was often through another RFB in the same group.

All investments retained or sold by an RFB after 1 January 2019 using the transitional provision in the legislation[2] had to mature by 31 December 2020. As mentioned above, an independent panel appointed by HM Treasury, as required under the Financial Services (Banking Reform) Act 2013, is undertaking reviews of ring-fencing and proprietary trading.

1 The conditions are set out in Article 12 of the Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014/2080 (EAPO).
2 The transitional provision is set out in Article 21 of EAPO.

Annual Competition Report – June 2021

This is our sixth Annual Competition Report (ACR),[1] marking the seventh year since our secondary competition objective (SCO) came into force on 1 March 2014. We produce the ACR to meet the Government's request for an annual report setting out how we are delivering against our SCO.[2] The SCO, as set out in Financial Services and Markets Act 2000 (FSMA), 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'.

Part 1: Application of the secondary competition objective in our work

It has been an unprecedented year for the PRA given the Covid-19 pandemic. We have had to delay and slow supervision and policy initiatives to support the response to Covid-19 and allow us and firms to address issues as they arose. This section of the ACR provides an update on key policy and supervisory decisions taken to deliver against the SCO, as set out in the PRA's 2020/21 Business Plan. Some of our policy initiatives that particularly deliver against the SCO include:

- clarifying supervisory expectations with respect to new and growing firms;
- proposing expectations on the minimum level of IRB UK mortgage risk weights;
- updating how we authorise and supervise insurance special purpose vehicles (ISPVs);
- proposing a larger reduction in Pillar 2A capital requirements for small firms, to reconcile with the structural increase of the UK countercyclical capital buffer (CCyB);
- developing, in a proportionate manner, our approach to firms' operational resilience in our prudential framework;
- finalising the reform of capital requirements for credit unions;
- implementing reporting requirements on exposures subject to measures applied in response to the Covid-19 outbreak in a proportionate way; and
- simplifying obligations for recovery planning.

In addition, as signalled by Sam Woods in his Mansion House speech in November 2020,[3] the PRA is considering ways the prudential framework could be changed for those banks and building societies that are neither systemically important nor internationally active, to simplify prudential regulation for those firms (see Box F for more detail).

Regarding the insurance sector, the government's call for evidence on the review of Solvency II launched in October 2020, inviting responses on the prospect of a 'mobilisation' phase for insurers.[4] Under mobilisation, firms

1 The Annual Competition Report (ACR) has been produced in response to a request from the Government included in HM Treasury's 2015 Productivity Plan 'Fixing the foundations: creating a more prosperous nation', that the PRA should publish an annual report setting out how it is delivering against its secondary competition objective (SCO) and, in particular, 'the steps it is taking to drive more competition and innovation in financial services markets and to help ensure that the right incentives exist for new banks to enter the market'. All versions of the ACR are available on the Bank's website: www.bankofengland.co.uk/prudential-regulation/secondary-competition-objective.

2 The rationale for the SCO, how the PRA interprets it, and what the SCO means for the PRA's regulation of banks and insurers is set out in the Bank of England's Quarterly Bulletin article, 'The Prudential Regulation Authority's secondary competition objective', December 2015: www.bankofengland.co.uk/quarterly-bulletin/2015/q4/the-pra-secondary-competition-objective.

3 'Strong and simple – speech by Sam Woods', given at Mansion House, November 2020: www.bankofengland.co.uk/speech/2020/sam-woods-city-banquet.

4 HM Treasury, 'Review of Solvency II: Call for Evidence', October 2020: www.gov.uk/government/publications/solvency-ii-review-call-for-evidence.

may be authorised to conduct regulated activities at an earlier stage in their development than would normally be permitted, and can use the mobilisation stage to 'mobilise' capital, complete recruitment, and test their systems (eg IT) and assumptions, in exchange for some initial restrictions on their activities. HM Treasury and the PRA are further considering the matter and the issues raised in the call for evidence responses.

Clarifying supervisory expectations with respect to new and growing firms

In July 2020, we consulted on a set of proposed clarifications to our approach to the supervision of banks and building societies that have typically been in existence for less than five years after receiving authorisation without restrictions.[1] In particular, we clarified that in a competitive environment it is normal to see both the entry and exit of banks. To make sure that firms can exit in an orderly way, we proposed that new banks should have solvent wind down plans in place at the point of authorisation (or upon exit from mobilisation), and maintain these until they move onto a PRA buffer set on a stress test basis. This would take place at five years after authorisation, or when they reach profitability, whichever is sooner. In addition, we proposed that the calculation of the PRA buffer beforehand would be equivalent to six months' operating expenses. This is to allow such banks a reasonable amount of time to find alternative sources of capital or make business model adjustments, in the event of a loss of investor support. Improved clarity regarding our supervisory expectations facilitates effective competition by reducing the uncertainty faced by new and growing firms. The final policy based on these proposals was finalised in April 2021.[2]

Setting a risk-weight floor under IRB for residential mortgages

In September 2020, we proposed to introduce new expectations on the internal ratings based (IRB) approach to UK mortgage risk weights.[3] The average IRB UK mortgage risk weight is just under 10%, having fallen from around 13% in 2014. These are historically low average IRB UK risk weights. The purpose of these proposals was to address the prudential risk stemming from inappropriately low IRB UK mortgage risk weights. These proposals would also reduce unwarranted risk weight differences across firms and facilitate effective competition by: (i) reducing the difference between SA and IRB mortgage risk weights for current UK mortgages; (ii) placing a limit on future divergence, and; (iii) reducing the variability of mortgage risk weights between those firms on the IRB approach for given levels of mortgage loan-to-values.

We proposed to introduce two expectations on the level of IRB UK mortgage risk weights: a minimum risk weight for each individual UK residential mortgage exposure; and an exposure-weighted average risk weight. The policy is due to be published in Summer 2021.

Reviewing approach to authorisation and supervision of ISPVs

Since the launch of this supervisory framework and the related commencement of the UK insurance linked securities (ILS) regime at the end of 2017, seven ISPVs have been authorised. As a result of the experience gained by both the PRA and the users of the UK ILS regime, in May 2020 the supervisory framework has been refined to facilitate the issuance of ILS through ISPVs in the UK.[4] We took into account feedback from respondents to the previous consultation, and provide further clarity on the PRA's approach and expectations in relation to the authorisation and supervision of ISPVs.

In particular, we clarified our policy on the acceptance of draft documentation being submitted at the application stage; on 'repeat' transactions leveraging the work done in previous reviews; on the PRA's expectations regarding

1 CP9/20 ' Non-systemic UK banks: The Prudential Regulation Authority's approach to new and growing banks', July 2020: www.bankofengland.co.uk/prudential-regulation/publication/2020/new-and-growing-banks.
2 PS8/21 'Non-systemic UK banks: The Prudential Regulation Authority's approach to new and growing banks', April 2021: www.bankofengland.co.uk/prudential-regulation/publication/2020/new-and-growing-banks.
3 CP14/20 'Internal Ratings Based UK mortgage risk weights: Managing deficiencies in model risk capture', September 2020: www.bankofengland.co.uk/prudential-regulation/publication/2020/internal-ratings-based-uk-mortgage-risk-weights-managing-deficiencies-in-model-risk-capture.
4 PS13/20 ' Insurance special purpose vehicles: Updates to authorisation and supervision', May 2020: www.bankofengland.co.uk/prudential-regulation/publication/2019/ispvs-updates-to-authorisation-and-supervision.

independent third-party opinions (in particular legal opinions); on how a 'roll-over' mechanism may be structured within the confines of the fully funded requirement; and on the expectations on risk transfer requirements, specifically where a 'similar arrangement' is being contemplated. This aids the healthy development of the UK ILS market, and promotes effective competition, as participants can more readily understand the requirements and standards relevant to UK ISPVs.

Reducing capital requirements for small banks and building societies

In December 2019, the Financial Policy Committee (FPC) raised the level of the UK CCyB rate that it expects to set in a standard risk environment, from in the region of 1% to in the region of 2%. In response to this, in July 2020, we reduced firm-specific Pillar 2A capital requirements for banks and building societies to maintain their total regulatory loss-absorbing capacity at broadly constant.[1]

The PRA made an additional reduction in Pillar 2A of 50% of the firm-specific UK CCyB pass-through rate available to small firms deemed to have a low risk profile. This is double the reduction received by large firms with a minimum requirement for own funds and eligible liabilities (MREL) in excess of their total capital requirements. Firms receive the full benefit of this additional reduction up to a minimum floor of 1% for the firm's variable Pillar 2A capital requirement. The PRA considers that smaller firms would not have been at a material competitive disadvantage to larger firms if the PRA applied only a 50% reduction in Pillar 2A. However, in considering policy options, the PRA considers that it can actively facilitate competition while not prejudicing the promotion of the safety and soundness of the firms it regulates, by granting eligible smaller firms an additional downward Pillar 2A adjustment.

Developing in a proportionate manner our approach to operational resilience in our prudential framework

Operational resilience refers to the ability of firms and the financial sector as a whole to prevent, adapt, respond to, recover, and learn from operational disruptions from whatever cause, including cyber threats. In March 2021, we finalised our policy on operational resilience jointly with the FCA.[2] Alongside our policy on outsourcing and third-party risk management, the new policy requires firms to identify important business services, set impact tolerances for those important business services, and take action to deliver their important business services during severe but plausible disruptions. We consider that the most proportionate and effective approach is to adopt an outcomes-based approach. Firms are expected to meet these outcomes in ways most appropriate for their circumstances. In supervising under the policy, we expect firms to meet the outcomes of the policy proportionate to their size, scale, and complexity.

Finalising the reform of capital requirements for credit unions

In March 2020,[3] we finalised the reform of capital requirements that apply to credit unions, with the implementation of a 'graduated rate' approach for credit unions with more than £10 million in total assets. Specifically, this approach requires higher levels of capital to be held only against total assets that exceed the threshold. The aim is to remove barriers to growth for larger credit unions approaching the corresponding regulatory threshold, which is expected to facilitate effective competition in the markets in which credit unions operate.

1 PS15/20 'Pillar 2A: Reconciling capital requirements and macroprudential buffers', July 2020: www.bankofengland.co.uk/prudential-regulation/publication/2020/pillar-2a-reconciling-capital-requirements-and-macroprudential-buffers.
2 PS6/21 'Operational Resilience: Impact tolerances for important business services', March 2021: www.bankofengland.co.uk/prudential-regulation/publication/2018/building-the-uk-financial-sectors-operational-resilience-discussion-paper.
3 PS6/20 'Credit unions: Review of the capital regime', March 2020: www.bankofengland.co.uk/prudential-regulation/publication/2019/credit-unions-review-of-the-capital-regime.

Box F: 'Strong and simple' regime

In April 2021, following work largely conducted in the reporting year covered by this Annual Report, the PRA published a discussion paper on developing a strong and simple prudential framework for non-systemic banks and building societies.[1] The work builds on the simplification of credit union capital requirements referred to above and as covered in more detail in the previous Annual Competition Report, and a number of PRA initiatives such as the recently finalised approach to new and growing banks.[2]

The discussion paper explores the potential to develop a simplified prudential framework for domestic non-systemic banks and building societies that maintains resilience and, as far as possible, does not add to barriers to growth. The latter is an important consideration, because by simplifying prudential regulation in this way, small and large banks and building societies would face different prudential requirements. The costs of adjusting to a change in prudential requirements could potentially act against competition by deterring small firms from growing.

The discussion paper suggests that there may be scope over time to develop a strong and simple framework to cover all non-systemic banks and building societies, but for practical reasons the first step of the work could be to develop a materially simpler set of prudential rules for the smallest firms, ie those that find existing prudential regulation particularly complex. We envisage ultimately developing proposals for a framework in which prudential requirements step up in complexity in line with the scale and complexity of firms' own business models and activities, converging ultimately on the full set of requirements for large internationally active banks.

The paper sets out the PRA's current thinking about ways in which the prudential framework could be simplified for small firms while maintaining resilience, as well as possible criteria for determining which firms would be in scope of this simpler regime. The paper highlights the trade-offs that may be required, eg between narrowing the scope of the regime to enable the PRA to go further to make it simple, and therefore needing to exclude more firms from it; between developing a materially simpler regime, and creating larger barriers to growth for firms wishing to grow out of it; and between a very simple but conservatively calibrated regime, and a more streamlined version of the existing regime which is calibrated on a more risk-sensitive basis. In reviewing potential options for simplification, the paper considers all elements of the existing prudential regime where there may be scope to simplify.

The PRA invites comments on the discussion paper from all interested parties, and plans to publish a summary of this. In developing the paper, the PRA has already engaged with a number of stakeholders at a working level, including the PRA Practitioner Panel and industry bodies. During the period for comments, the PRA plans to discuss the policy ideas set out in the discussion paper in more depth with stakeholders, to help us to develop proposals for future consultation papers. The PRA has also started to consider how a strong and simple framework would be implemented, in particular focusing on interactions with a number of other significant changes to prudential regulation due for implementation in the next few years (eg the Basel 3.1 changes).

1 DP1/21 'A strong and simple prudential framework for non-systemic banks and building societies', April 2021: www.bankofengland.co.uk/prudential-regulation/publication/2021/april/strong-and-simple-framework-banks.
2 PS8/21 'Non-systemic UK banks: The Prudential Regulation Authority's approach to new and growing banks', April 2021: www.bankofengland.co.uk/prudential-regulation/publication/2020/new-and-growing-banks.

Implementing new disclosure requirements proportionately

In July 2020, we clarified our expectations on how new disclosure requirements on loans subject to payment deferral under measures applied in response to the Covid-19 outbreak should be applied.[1] Specifically, the scope of implementation was limited to UK banks and building societies which: (i) are, or are controlled by, global or other systemically important institutions designated by the PRA in the most recent list; and (ii) have retail deposits equal to or greater than £50 billion on an individual or consolidated basis. In addition, we clarified that our expectation is for such firms to make these disclosures for the highest level of consolidation in the UK. The resulting lower regulatory burden for smaller firms facilitates effective competition.

Simplifying obligations for recovery planning and proportionate implementation of CRD V/Basel III standards

In December 2020, we finalised proposals to reduce supervisory expectations for small firms' recovery planning.[2] Specifically, eligible firms are notified that they can benefit from reduced recovery planning obligations in respect of scenario testing and consolidated recovery plan reporting.

In addition, eligible firms may benefit from a proportionate application of remuneration requirements under the implementation in the UK of CRD V.[3]

We recently proposed a proportionate application of disclosure, market risk reporting, capital requirements, and the net stable funding ratio requirements, as well as simpler counterparty credit risk and credit valuation adjustment risk methods, in a package to implement part of the set of international standards that remain to be implemented in the UK.[4]

Part 2: Implementing and embedding the secondary competition objective

This section of the ACR sets out how we have continued the process of embedding the SCO into our policy and supervisory decision-making. It also provides a summary of our engagement with external stakeholders and an update on our competition-focused research activities.

Embedding the SCO in our processes

As part of HM Treasury's consultation on the Financial Services Future Regulatory Framework Review, the Government reflected on the ongoing debate on whether the regulators should be given an objective to support the competitiveness of the UK financial sector, specifically aimed at supporting the economic viability of financial services and the ability of the sector to compete internationally.[5] However, the Government also presented the argument that one of the reasons for regulatory failure leading up to the 2007/08 financial crisis was an excessive concern for competitiveness which promoted the pursuit of a 'light-touch' approach to regulation and supervision. The Government sought views from stakeholders as part of the FRF consultation process, and will publish a second consultation, with final proposals, in 2021. The PRA is developing the analytical framework it uses to consider both competition and competitiveness, and the relationship between the two is discussed in Box G.

1 Available at www.bankofengland.co.uk/prudential-regulation/publication/2020/statement-on-eba-guidelines-reporting-data.
2 PS25/20 'Simplified Obligations for recovery planning', December 2020: www.bankofengland.co.uk/prudential-regulation/publication/2020/simplified-obligations-recovery-planning.
3 PS29/20 'Capital Requirements Directive V (CRD V): Final policy', December 2020: www.bankofengland.co.uk/prudential-regulation/publication/2020/capital-requirements-directive-v-further-implementation.
4 CP5/21 'Implementation of Basel standards', February 2021: www.bankofengland.co.uk/prudential-regulation/publication/2021/february/implementation-of-basel-standards.
5 HM Treasury, 'Financial Services Future Regulatory Framework Review', Phase II Consultation, October 2020: www.gov.uk/government/consultations/future-regulatory-framework-frf-review-consultation.

Box G: The interaction between competition and competitiveness

The SCO has at its centre the notion of effective competition. As articulated in our first ACR in 2016,[1] we believe that pursuing our general objectives of safety and soundness and policyholder protection by addressing the corresponding sources of market failures is instrumental to achieving effective competition. Accordingly, the PRA's general and secondary objectives are normally aligned.

Competitiveness is generally understood to entail a comparison of economic performance among peers not necessarily competing in the same market. From a general macroeconomic perspective, the comparison is usually made across country economies and is typically based on the level of productivity and its rate of growth. The most effective way of attaining long-run competitiveness is to pursue effective competition. The force of competition is indispensable to achieving a dynamic path of innovation. And it is innovation and the resulting productivity improvements that underpin competitiveness in the long run.[2]

Under this approach, competition and competitiveness are also normally aligned. The same can be argued with respect to the relationship between competitiveness and safety and soundness and financial stability, in that systemic financial crises can thwart productivity growth.[3] This is what we call 'sustainable competitiveness'.

Long-term and sustainable competitiveness can also encompass a renewed drive to make sure that prudential rules and supervisory expectations are proportionate, by removing 'overdetermined' regulation that can be unduly costly for firms to comply with.

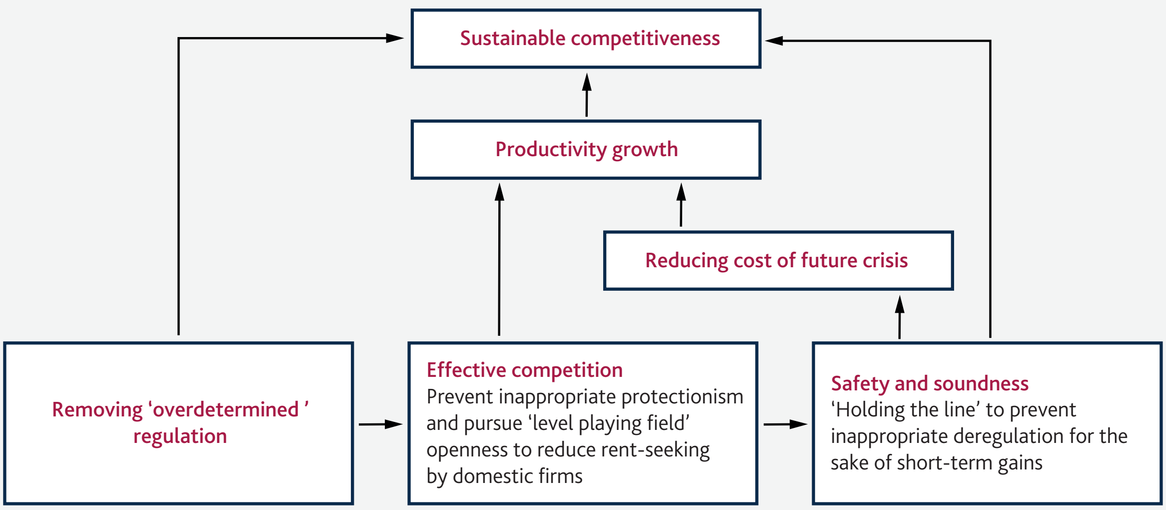
In contrast, an excessively short-term focus on competitiveness could be harmful in the long run, where it translates into actions which reduce the level of regulation below the level required by the public interest with the aim of boosting the profitability of domestic firms. In the long run, this would reduce competeveness because, respectively: (i) inappropriate deregulation increases the expected detrimental impact of future market failures; and (ii) protectionism reduces the contestability of the domestic market, which leads to less efficient outcomes.

The only sustainable approach is to promote productivity improvements across the economy, including the financial sector. In his recent Mansion House speech,[4] the Governor cautioned against 'the intention to water down [international standards], misguidedly because we think this would preserve some notion of our competitiveness as a nation. The UK could not be a global financial centre for long if we did'. Long-term competitiveness rests on a resilient financial sector that is able to prevent and mitigate the lasting damage to the economy that is typically caused by financial and economic crises.

1 PRA Annual Competition Report 2016: www.bankofengland.co.uk/prudential-regulation/publication/2016/pra-annual-competition-report.
2 For a recent overview on this debate see, for example, IMF (2020), 'Rising Corporate Market Power: Emerging Policy Issues', Staff Discussion Notes, March 2021: www.imf.org/en/Publications/Staff-Discussion-Notes/Issues/2021/03/10/Rising-Corporate-Market-Power-Emerging-Policy-Issues-48619.
3 As Andy Haldane has pointed out, the key enabler of sustainable growth is to prevent and mitigate the costs of economic recessions by setting up robust institutions, including financial regulation, to prevent financial crises: see, Andy Haldane, 'Ideas and institutions – A growth story, speech by Andy Haldane' given at the Oxford Guild Society, University of Oxford, May 2019: www.bankofengland.co.uk/speech/2018/andy-haldane-speech-given-at-the-oxford-guild-society.
4 'The case for an open financial system – speech by Andrew Bailey', given at the Financial and Professional Services Address, Mansion House, February 2021: www.bankofengland.co.uk/speech/2021/february/andrew-bailey-mansion-house.

Long-term competitiveness is also enhanced by a vibrant competitive financial sector, where firms are spurred to become more efficient and seek innovative ways to win customers' business, not only domestically, but also abroad. Effective competition can in turn propel export-led competitiveness and international attractiveness. This implies that we should embrace openness and accommodate change in the sector we oversee, while maintaining robust prudential standards, in order to pursue sustainable long-term competitiveness.

The diagram below summarises how the various concepts fit together. In particular, the primary objective of safety and soundness underpins sustainable competitiveness both directly and indirectly, respectively because: (i) foreign counterparties are more confident dealing with UK firms; and (ii) the expected cost of future crises is reduced. In addition, removing 'overdetermined' regulation can have a direct impact on sustainable competition to the extent that it improves the competitiveness of firms primarily active in international (non-domestic) markets.



Engagement with other regulators

We maintain effective working relationships with relevant UK regulators both as part of our legal requirements and where we have an interest in outcomes that may affect our objectives. We have had regular meetings with both the FCA and Competition and Markets Authority (CMA) for this purpose.

Since September 2020, one of our competition experts has been seconded on a part-time basis to the Financial Reporting Council to help with the preparatory work needed to embed and implement the new competition objective included in the Government's proposals to create a new regulator for the statutory audit market.[1] We want to support those reforms, given the important role that audit oversight, financial reporting, and good governance play in our work.

Co-operation with the Digital Markets Unit and within the Digital Regulation Cooperation Forum

A new area of interest is the design and implementation of the UK's new pro-competition regime for digital markets. The CMA-led Digital Markets Taskforce recommended establishing a Digital Markets Unit (DMU) and a regime based on identifying and regulating firms with 'strategic market status'.[2] This approach is intended to give consumers more choice and control over their data, help small businesses thrive, and ensure fair competition.

The DMU began operating in April 2021 and works closely with regulators, including the Information Commissioner's Office (ICO, the authority responsible for data protection and supervision of digital services providers, such as cloud providers, under the Security of Network and Information Systems Regulations) and Ofcom (the media regulator). The CMA, the ICO, and Ofcom formed the Digital Regulation Cooperation Forum (DRCF) in July 2020 to ensure a greater level of co-operation, given the unique challenges posed by regulation of online platforms. The FCA joined the DRCF as a full member in April 2021.

The PRA is in the process of establishing formal co-ordination arrangements with both the DMU and the DRCF, given our interest in operational resilience and financial stability, and the increasingly important presence of tech giants like Amazon, Microsoft, and Google. For example, the increasing reliance on outsourcing arrangements with a few dominant cloud service providers can create risk, especially when it is difficult to switch between them. As part of its current work-plan, the DRCF indicated its intention to establish appropriate mechanisms to co-operate effectively with the wider set of regulatory agencies, including the PRA, in specific areas of concern.[3] We are also in discussion with the DMU and the relevant government departments to explore possible co-ordination mechanisms with the DMU.

1 Department for Business, Energy & Industrial Strategy, 'Restoring trust in audit and corporate governance: proposals on reforms', March 2021: www.gov.uk/government/consultations/restoring-trust-in-audit-and-corporate-governance-proposals-on-reforms.

2 CMA advises government on new regulatory regime for tech giants, press release, December 2020: www.gov.uk/government/news/cma-advises-government-on-new-regulatory-regime-for-tech-giants.

3 Digital Regulation Cooperation Forum: Plan of work for 2021 to 2022, Policy Paper, March 2021: www.gov.uk/government/publications/digital-regulation-cooperation-forum-workplan-202122/digital-regulation-cooperation-forum-plan-of-work-for-2021-to-2022.

Update on competition-related research activities

As part of our efforts to improve awareness and understanding of the SCO among our internal and external stakeholders, we organised, jointly with the Bank for International Settlements (BIS) and the Centre for Economic Policy Research (CEPR), a conference on 'Financial innovation: implications for competition, regulation and monetary policy'.[1] The event was hosted virtually by BIS on 24 and 25 September 2020. This was the third in a series of conferences that the PRA launched in 2016 to promote research on the interaction between competition and financial regulation. Hyun Song Shin (BIS, Economic Adviser and Head of Research) gave a keynote speech entitled 'An early stablecoin? The Bank of Amsterdam and the governance of money'. Andy Haldane, Chief Economist of the Bank of England, participated in a policy panel on the policy implications of financial innovation.

Since the publication of last year's ACR, we have published further research on the impact of UK ring-fencing requirements in 2019,[2] requiring banking groups with more than £25 billion of retail deposits to split their retail and investment banking activities into legally separate subsidiaries: the ring-fenced bank, where retail deposits must be held, and the non-ring fenced bank, where investment banking must be housed. The authors found that banks to which ring-fencing rules apply rebalance towards the domestic retail market by reducing mortgage spreads, and hence gain mortgage market share.[3] As a result smaller banks out of scope of the reform respond to the increased competitive pressure by increasing the riskiness of their mortgage lending.

The research findings presented above are limited to the competition impact among banks and building societies that have adopted the IRB model approach. Therefore, they are not in contrast to the findings from another recently published piece of research on the impact of the refinements to the Pillar 2A capital framework targeted at small firms on the SA, which finds that eligible firms likely to receive capital relief invest more in low loan to value ratio mortgages.[4]

1 Draft legislation was published in October 2012, and became law in December 2013 as part of the Financial Services (Banking Reform) Act 2013. The law specified that the requirements would come into effect on 1 January 2019, and apply to banking groups with more than £25 billion of retail deposits. Building societies are exempt. In practice, five banking groups were required to restructure: Barclays, HSBC, Lloyds Banking Group, Royal Bank of Scotland, and Santander UK. These groups completed their restructuring in 2018, ahead of the January 2019 deadline.

2 Chavaz, M and Elliott, D (2020), 'Separating retail and investment banking: evidence from the UK', Bank Of England Staff Working Paper No. 892; www.bankofengland.co.uk/working-paper/2020/separating-retail-and-investment-banking-evidence-from-the-uk.

3 It is worth pointing out that the Financial Services (Banking Reform) Act 2013 requires the Treasury to appoint an independent panel to review the operation of the legislation relating to ring-fencing. Specifically, the recently appointed panel should assess the impact of the ring-fencing legislation on: (i) competition in the banking sector, examining both any benefits from ring-fencing and the extent to which it may have acted as a barrier to growth for smaller banks; and (ii) competition in the UK mortgage market, including considering the impact of ring-fencing on the price of mortgages and any risk-taking incentives the regime may have created for certain banks. For more information, see: HM Treasury, 'Independent reviews of ring-fencing and proprietary trading: Terms of Reference', February 2021: www.gov.uk/government/publications/members-of-the-ring-fencing-and-proprietary-trading-independent-review-panel-announced-and-terms-of-reference-for-the-review-published/independent-reviews-of-ring-fencing-and-proprietary-trading-terms-of-reference.

4 Arnould, G, Guin, B Ongena, S and Siciliani P (2020), '(When) do banks react to anticipated capital reliefs?', Bank of England Staff Working Paper No. 889; www.bankofengland.co.uk/working-paper/2020/when-do-banks-react-to-anticipated-capital-reliefs.

Financial review of 2020/21

The PRA incurred operating costs in 2020/21 of £278 million (2019/20: £271 million). Costs continued to include exceptional and non-recurring items such as the UK's withdrawal from the EU and special projects for firm restructuring. Where these exceptional costs are attributable to a particular segment of our authorised population, we will typically raise a Special Project Fee, otherwise they will fall to our fees in relation to ongoing regulatory activity.

Against our budget (£286 million), the PRA came in below by £8 million. This was predominantly due to the lower than assumed expensed project costs and reduced travel due to the ongoing Covid-19 pandemic. Due to additional income received in the year of £4 million, principally in the form of retained financial penalties and model fees, the return to firms for the next financial year is £12 million.

Under the Bank of England and Financial Services Act 2016, the Bank is required to present financial and other disclosures in respect of its activities as the PRA. These are available on pages 164–172 of the Bank's Annual Report and Accounts 2020/21.[1]

1 www.bankofengland.co.uk/annual-report/2021.

Abbreviations

ACR	Annual Competition Report
Bank	Bank of England
BCBS	Basel Committee on Banking Supervision
CEO	Chief Executive Officer
CET 1	Common Equity Tier 1
CMA	Competition and Markets Authority
Court	Bank's Court of Directors
CP	Consultation Paper
CRD	Capital Requirements Directive
CRD IV	CRR and CRD collectively
CRR	Capital Requirements Regulation
DP	Discussion Paper
EAC	Environmental Audit Committee
EBA	European Banking Authority
ECL	Expected credit loss
EEA	European Economic Area
EIOPA	European Insurance and Occupational Pensions Authority
ERM	Equity release mortgage
ESRB	European Systemic Risk Board
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)
IAIS	International Association of Insurance Supervisors
ICS	Insurance Capital Standard
IFRS	International Financial Reporting Standard
ILS	Insurance linked securities
IRB	Internal ratings based
ISPV	Insurance special purpose vehicle
MPC	Monetary Policy Committee
MoU	Memorandum of Understanding
MREL	Minimum requirement for own funds and eligible liabilities
NBSU	New Bank Start-up Unit
NISU	New Insurer Start-up Unit
OCIR	Operational continuity in resolution
PRA	Prudential Regulation Authority
PRC	Prudential Regulation Committee
PS	Policy Statement
RAF	Resolvability Assessment Framework
RegTech	Regulatory Technology
RFB	Ring-fenced body
RFI	Relevant financial institutions
SCO	Secondary competition objective
SMR	Senior Managers Regime
SM&CR	Senior Managers and Certification Regime
SRB	Systemic Risk Buffer
SS	Supervisory Statement
TPR	Temporary Permissions Regime
TSC	Treasury Select Committee

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