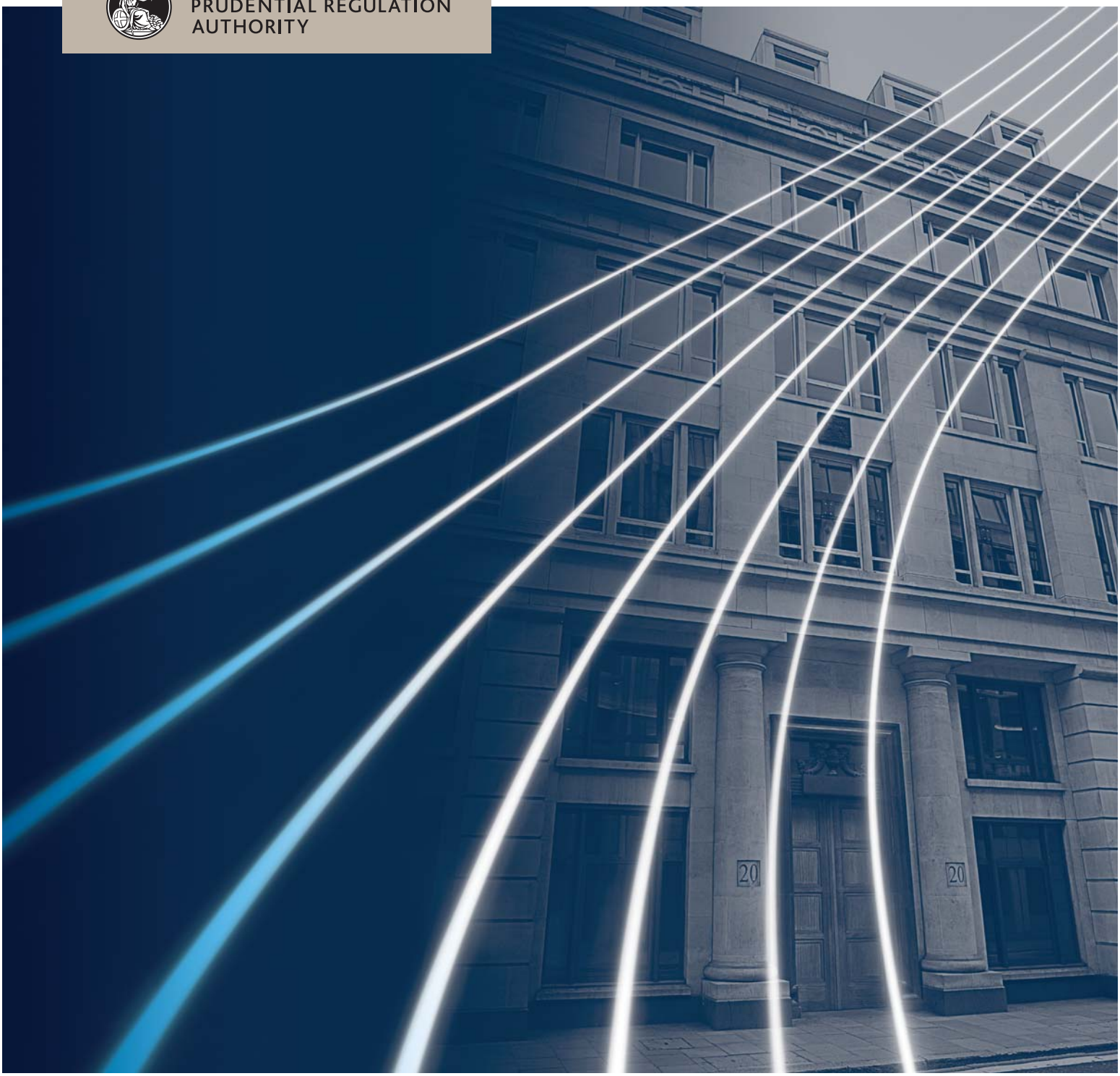
Statement of Policy

The power of direction over qualifying parent undertakings

April 2013



1. In December 2012, the Financial Services Authority (FSA) and Bank of England consulted, on behalf of the Prudential Regulation Authority (PRA), on the draft statement of policy on the power of direction. This power was established by the Financial Services (FS) Act 2012 which, in amending the Financial Services and Markets Act 2000 (FSMA), provides a new framework for financial regulation in the United Kingdom.

2. This document includes feedback on queries raised in consultation responses and publishes the final statement of policy on the PRA's use of the power to direct qualifying parent undertakings. No material changes were made following consultation.

3. Going forward, the PRA will keep the scope and use of its powers over qualifying parent undertakings under review.

Consultation responses

4. Eight responses were received: four from trade bodies (covering banks, building societies, insurers and other wholesale financial market participants), three from entities within the insurance industry; and there was one response from a law firm.

5. All responses to the draft statement of policy focused on the use of the power of direction and sought further clarification on aspects of the proposed use of this power. The following is the PRA's response to the queries received in response to the consultation.

6. All of the respondents commented on this being representative of an extension of the PRA's powers beyond those held by the FSA. They highlighted that the PRA would already have substantial powers under FSMA and sought to understand what to expect of the PRA in its exercise of this extension to its powers.

7. In October 2012, draft 'Approach' documents, one for banks and investment firms, and the other for insurers were published. These documents set out how the PRA intends to exercise it functions in order to advance its objectives. These Approach documents provide general guidance on the PRA's approach in relation to the exercise of its functions, including the use of this power of direction.

Does the PRA intend to use the power of direction as a 'last resort'?

8. There is no requirement that the power of direction must be used only as a last resort and in some instances, the exploration of other regulatory measures may be impracticable or inappropriate. However, in order to satisfy the general condition set out at s192C of FSMA, the PRA must issue directions only in order to advance its objectives. In deciding whether to issue a direction, the PRA is required to have regard for the desirability of using its powers over the group's regulated entities rather than the holding company and the proportion of benefit to burden which is likely to result from the use of the power of direction.

How is the PRA qualified to issue directions to unregulated holding companies and will decisions be subject to an internal decision-making process?

9. The power of direction is to be applied where the general condition or alternatively the consolidated supervision condition is met as set out in FSMA. With regard to internal decision-making, the PRA is required to apply the regulatory principles set out at s3C of FSMA (as amended by the FS Act 2012) in its decision-making.

Is there an entitlement to make representations to the PRA and appeals to the Tribunal?

10. Respondents expressed concern that it was not clear that entities would be in a position to appeal against the use of the power of direction. Sections 192E ss(5)(d) to (12) and s192G of FSMA (as amended by the FS Act 2012), set out requirements relating to representations to the PRA and references to the Tribunal with which the PRA must comply when it uses its power of direction. In particular, a person who objects to the PRA's use of the power of direction may refer the matter to the Tribunal. In addition, a direction made by the PRA must set out a period for the addressee to make representations and include details of the right to refer the matter to the Tribunal.

What about regulatory arbitrage through manipulation of the group structure or relocation of the holding company?

11. The PRA expects that groups and their parent companies will seek to comply with the regulatory measures in place. The PRA considers it unlikely that a group would undergo a significant restructure or relocate its parent company simply because the PRA is able to exercise a power of direction over the holding company. In any event, if the PRA became concerned that actions were being taken for the purpose of regulatory arbitrage, it is empowered to act to counter this.

What consistency may dual-regulated firms expect from the regulators?

12. The PRA will exercise the power only in order to advance one or more of its objectives, as set out in s192C of FSMA. For dual-regulated firms, the FCA will also exercise the power in order to advance its operational objectives.

Section 192F of FSMA requires cross consultation between the PRA and the FCA prior to notice of the issue of a direction being given to the subject of the direction. This will provide an opportunity for consistency which is particular to the exercise of the power of direction, over and above the more general requirements for the regulators to consult with each other.

Statement of policy on the use of the power to direct qualifying parent undertakings

Background

1. This statement sets out the Prudential Regulation Authority's (PRA's) policy on the use of its power to direct a qualifying parent undertaking under section 192C of the Financial Services and Markets Act 2000 (as amended by the Financial Services Act 2012) (FSMA), as required by section 192H FSMA.

Conditions for the exercise of the power of direction

2. The statutory provisions relating to the power of direction are set out in sections 192A to 192I FSMA. In order for the PRA to be able to exercise the power of direction:

(a) the parent undertaking must be a 'qualifying parent undertaking' of a 'qualifying authorised person'; and

(b) either the 'general condition' or the 'consolidated supervision condition' must be satisfied.

Parent undertaking must be a 'qualifying parent undertaking' of a 'qualifying authorised person'

3. A parent undertaking is a 'qualifying parent undertaking' of a 'qualifying authorised person' under section 192B FSMA, if:

(a) it is the parent undertaking of a 'qualifying authorised person' (a 'qualifying authorised person' being a UK-incorporated body corporate that is an authorised person, and is either a PRA-authorised firm or an investment firm);

(b) it is incorporated in the United Kingdom or has a place of business in the United Kingdom;

(c) it is not itself an authorised person, recognised investment exchange or recognised clearing house; and

(d) it is a financial institution of a kind prescribed by the Treasury by Order.

4. In relation to (d) above, the Treasury has made an Order[1] prescribing what is a 'qualifying parent undertaking'. The Order provides that the following are prescribed as 'qualifying parent undertakings':

(a) insurance holding companies — broadly, companies whose main business is to acquire and hold subsidiary companies which are exclusively or mainly insurance or reinsurance companies;

(b) financial holding companies — broadly, companies whose principal activities are to acquire subsidiary companies which are either exclusively or mainly credit institutions, investment firms or financial institutions; and

(c) mixed financial holding companies — companies which have at least one subsidiary which is a credit institution, an insurance undertaking or an investment firm and which, together with their subsidiaries, constitute a financial conglomerate for the purposes of the Financial Conglomerates Directive.

5. In prescribing these categories of firms as 'qualifying parent undertakings', the Treasury has sought to bring within the scope of the power of direction those entities which are within the scope of consolidated (or supplementary) supervision under EU law.

6. The definition of 'qualifying parent undertaking' includes any UK-incorporated parent undertaking (or parent undertaking with a place of business in the United Kingdom) in an ownership chain which meets the definitions contained in the Order, even if the undertaking is not itself the ultimate parent undertaking. In general, the PRA would consider action to be most effective when taken in relation to the ultimate parent undertaking at the head of the ownership chain, as that is usually where most of the power to direct and control the group resides.

7. However, where the ultimate parent undertaking is not a 'qualifying parent undertaking' (for example if the group is headed by a non-UK entity or a non-financial entity) then the PRA will not have the power to direct that ultimate parent undertaking. In such circumstances, the PRA may consider that use of the power of direction over another qualifying parent undertaking in the ownership chain is appropriate.

8. The PRA may also consider taking action in relation to an intermediate qualifying parent undertaking in other cases, for example, if there are restrictions on the powers of the ultimate parent undertaking in its constitution, if the ultimate parent undertaking fails to act, or if action is to be taken in relation to the immediate parent of a firm (particularly in cases where there are distinct subgroups within wider groups).

The 'general condition' and the 'consolidated supervision condition'

9. The PRA can only use the power of direction if either the general condition or the consolidated supervision condition is satisfied:

General condition — the general condition is that the PRA considers that it is desirable to give the direction in order to advance, in the case of the PRA, any of its objectives.

(1) The Financial Services and Markets Act 2000 (Prescribed Financial Institutions) Order 2013.

10. The ultimate parent undertaking of an authorised firm can be the centre of power in a group. In that situation, it will usually decide overall group strategy and organisation, including group risk management policies, group recovery plans and intra-group flows of capital and liquidity. The ultimate parent undertaking can be the primary listed entity in the group and may have the primary capital and debt raising ability for the group. A parent undertaking is also usually the only entity that can alter the group structure above and around an authorised firm or remove some barriers to effective resolution (both to ensure an authorised firm is resolvable and if an authorised firm is in resolution).

11. The PRA's general objective is to promote the safety and soundness of PRA authorised firms. FSMA requires the PRA to advance this objective primarily by seeking to:

(a) ensure that the business of PRA-authorised firms is carried on in a way which avoids any adverse effect on the stability of the UK financial system; and

(b) minimise the adverse effect that the failure of a PRA-authorised firm could be expected to have on the stability of the UK financial system.

12. The PRA's insurance objective is: contributing to the securing of an appropriate degree of protection for those who are or may become policyholders.

13. The PRA considers that these objectives will be advanced by having suitable requirements (for example, prudential standards or systems of governance and controls) enforced directly at group level. Where action to advance PRA objectives taken at the authorised firm level is considered to be, or likely to be, less effective than action taken at the qualifying parent undertaking level then the PRA will consider using its power of direction over the qualifying parent undertaking.

Consolidated supervision condition — The consolidated supervision condition is that: (i) the PRA is the competent authority for the purpose of consolidated supervision that is required, in relation to some or all of the members of the group of a qualifying authorised person, in pursuance of any of the relevant EU directives; and (ii) the PRA considers that the giving of the direction is desirable for the purpose of the effective consolidated supervision of the group.

14. The PRA's obligation to conduct consolidated supervision arises from the relevant EU Directives (eg the Banking Consolidation Directive,[1] the Insurance Groups Directive[2] and the Financial Conglomerates Directive)[3] which in turn implement the relevant international standards on consolidated supervision (in particular the standards on consolidated supervision set by the Basel Committee on Banking Supervision in its Core Principles for Effective Banking Supervision,[4] the International Association of Insurance Supervisors' Insurance Core Principles[5] and the Joint Forum Principles for the Supervision of Financial Conglomerates).[6]

15. The PRA considers that the purpose of consolidated supervision is to enable supervisors to take necessary action to protect authorised firms from the adverse effects of being part of a group. These adverse effects may include: financial contagion (losses in a group entity impacting on a firm through financial linkages); reputational contagion (an event in one entity impacting adversely on another entity in the group through reputation damage); multiple gearing (ie use of the same capital resources more than once in the same group); upgrading the quality of capital within a group (ie by using funds borrowed by the parent undertaking to create core equity Tier 1 capital within the authorised firm, giving a false appearance of the quality of capital within a firm); barriers to effective resolution (eg complex group structures or intra-group arrangements); and the impact of intra-group relationships on authorised firms (exposures, contingent liabilities etc).

16. The application of rules on prudential standards and systems of governance and control on a consolidated basis aims to address many of the risks above. Therefore, where the effectiveness of consolidated supervision would be greater if action was taken by the qualifying parent undertaking then the PRA will consider using its power of direction. For example, a particularly strong case for using the power of direction would be made where any act or omission of a qualifying parent undertaking leads, or could lead, directly or indirectly, to an authorised firm being unable to ensure compliance with rules applied at the consolidated level required by the relevant European legislation. In determining whether there is compliance, the PRA will also take into account the purpose of the rule and its intended effect.

17. A direction placed on a qualifying parent undertaking regarding consolidated supervision will generally support the authorised firms in complying with their obligation to ensure that their consolidation group complies with consolidated requirements, but it will not absolve them of this obligation. In such circumstances action can be taken at both the qualifying parent undertaking and authorised firm level if necessary.

(1) Directive 2006/48/EC.
(2) Directive 98/78/EC.
(3) Directive 2002/87/EC.
(4) Basel Committee on Banking Supervision — Core Principles for Effective Banking Supervision (September 2012) (www.bis.org/publ/bcbs230.pdf).
(5) International Association of Insurance Supervisors — Insurance Core Principles, Standards, Guidance and Assessment Methodology (1 October 2011, and amended 12 October 2012) (www.iaisweb.org/view/element_href.cfm?src=1/16689.pdf).
(6) Joint Forum — Principles for the Supervision of Financial Conglomerates (September 2012) (www.bis.org/publ/joint29.pdf).

18. There may be occasions when desirability of exercise of the power may be based not solely on a single material concern. Where there have been several causes for concern over a period of time, with each specific issue being insufficient on its own to trigger the use of the power of direction, the cumulative effect of these will be included in the consideration of whether to use the power of direction.

19. Annex 1 to this statement of policy contains a non-exhaustive list of possible scenarios in which the PRA may consider exercising the power of direction.

Matters to which the PRA must have regard when deciding whether to use the power of direction

20. Section 192C(5) FSMA provides that, in deciding whether to give a direction, the PRA must have regard to:

(a) the desirability where practicable of exercising its powers in relation to authorised persons rather than its powers under this section, and

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

21. Whilst the PRA will consider using its powers over authorised firms to try to achieve its objectives in the first instance, there are some circumstances where the PRA would usually consider use of the power of direction over the qualifying parent undertaking to be more appropriate, for example:

(a) where action against the authorised firm fails to remedy the concerns;

(b) where the PRA considers that action against the authorised firm is likely to fail to remedy the concerns;

(c) where the authorised firm fails to comply;

(d) where the PRA considers the authorised firm is likely to fail to comply;

(e) where the authorised firm does not itself have the ability to effect the desired change;

(f) where the issue can only be resolved effectively by the qualifying parent undertaking; and

(g) in cases of urgency.

22. In stressed circumstances, the potential conflicts between a parent undertaking and an authorised firm can become heightened. In this case, the likelihood that actions taken in relation to authorised firms alone would be insufficient is increased and the need for the power of direction may be more acute. The power of direction would also be considered as a key tool for use in stressed circumstances where time may be critical.

Content of the direction

23. Section 192D(1) FSMA provides that a direction made under the power of direction may require the parent undertaking either: (a) to take specified action; or (b) to refrain from taking specified action. Section 192D(2) goes on to provide that a requirement may be imposed by reference to the parent undertaking's relationship with: (a) its group; or (b) other members of its group. The requirement would normally be imposed either in relation to whichever relationship(s) are causing the concern, including relationships between sister companies, or by reference to the group generally if the concern relates to group-wide issues.

24. Where desired actions are reserved to the shareholders of the parent undertaking the relevant direction cannot address the shareholders directly. In such cases the direction would instruct the parent undertaking to facilitate the decision of the shareholders, for example by calling a general meeting and proposing the motion required to achieve the desired action.

25. Section 192D(3) provides that a requirement may refer to the past conduct of a parent undertaking (for example, by requiring the parent undertaking to review or take remedial action in respect of past conduct).

26. Additionally, a requirement imposed by the direction may be expressed to expire at the end of a specified period, but this does not affect the power to give a further direction imposing a new requirement. Equally, a requirement imposed by the direction may have no specified end date. The direction may be revoked by the PRA by written notice to the parent undertaking to which it is given, and/or ceases to be in force if the undertaking to which it is given ceases to be a qualifying parent undertaking.

27. Annex 2 contains a non-exhaustive list of possible directions which the PRA may consider making.

Annex 1
Non-exhaustive list of possible scenarios in which the PRA may consider exercising the power of direction

Examples of scenarios in which the PRA may consider the exercise of its power of direction include, but are not limited to:

- Insufficient quality or quantity of own funds or liquid assets or other assets that are made available to the authorised firms to meet their solo requirements.
- Intra-group transactions and allocation of risks and financial resources (including large exposures, booking practices, other channels of contagion and arrangements for the mitigation of risk such as by reinsurance) which do not meet the standards expected by the PRA.
- Group-wide recovery plans which do not meet the standards expected by the PRA.
- Where there are barriers to the resolution of a firm or group that are most appropriate to mitigate or remove at the level of the parent undertaking.
- Where action at the level of the parent undertaking is required to improve resolvability.
- Group-wide remuneration policies which do not meet the standards expected by the PRA.
- A proposed acquisition by the parent undertaking which may affect compliance with consolidated or group requirements or the solo requirements of any authorised firm in the group.
- Where the actions of the parent undertaking in a recovery or resolution scenario may increase the chance of disorderly failure or the use of taxpayer funds.
- Scenarios where the parent undertaking moves, or may move, impaired, sub-standard or high-risk assets into an authorised firm with a view to allowing that firm to fail or be taken into resolution whilst the rest of the group carries on as a going concern, potentially leaving the failed firm in the group to be supported by taxpayers.
- Where only the actions of a parent undertaking in relation to one of its unauthorised subsidiaries may maintain the stability of the authorised firms, particularly in stressed circumstances (eg where an authorised firm is reliant on services provided by an unauthorised sister company).
- Where risks generated in an unauthorised part of the group could affect the stability of either the authorised firms or the group as a whole.
- Insufficient quality or quantity of own funds or liquid assets or other assets being available to meet consolidated group requirements.
- Insufficient transferability of a group's own funds or liquid assets to support the group's regulated activities.
- Complex or opaque group structures which hinder the authorised firm's and/or the PRA's ability to assess and manage the risks generated by the authorised firm's membership of its group.
- Group-wide risk management or governance arrangements, including those relating to directors, that do not meet the PRA and/or internationally agreed standards.
- Systems and controls to manage group risks which do not meet the standards expected by the PRA.

Annex 2
Non-exhaustive list of possible directions which the PRA may consider making

Directions which may be made by the PRA may include, but are not limited to:

- A requirement to meet specific prudential rules applied at the consolidated level.
- A requirement to improve the system of governance or controls at group level and/or in relation to subsidiary undertakings (including non-UK subsidiaries) where this is necessary for effective consolidated supervision.
- A restriction on dividend payments, or other payments regarding capital instruments, in order to retain capital in the group.
- A requirement to move funds or assets around the group to more appropriately address risks.
- A requirement for the group to be restructured in order to make it more supervisable.
- A requirement to stop or impose restrictions on an acquisition or divesture (taking account of any potential conflict with takeover rules).
- A requirement to ensure the continuity of service is provided between relevant group entities.
- A requirement to include entities (including shadow banking entities, where appropriate) in consolidated calculations.
- A requirement to raise new capital.
- A requirement to take steps to facilitate the removal from office of directors of the parent undertaking who do not meet the PRA's expectations as regards being fit and proper to direct a holding company.
- A requirement to remove barriers to resolution.
- A requirement to issue debt suitable for bail-in.