Prudential supervision

LEARNING OBJECTIVES

In Topic 18, the main focus was on how firms and individuals are regulated and supervised, to protect consumers from bad conduct and to make sure the market operates efficiently. In this topic we will explore the regulations that are designed to ensure firms, large and small, are run prudently, are financially sustainable and do not expose their customers to undue risk.

By the end of this topic, you should have an understanding of:

- the international regulators that set prudential standards;
- the key concepts of capital adequacy, liquidity and operational risk;
- the requirements of the Basel Accords;
- the Capital Requirements Directive;
- Solvency II;
- the FCA and PRA prudential sourcebooks.

This topic covers Unit 2 syllabus learning outcomes U1.2.

THINK ...

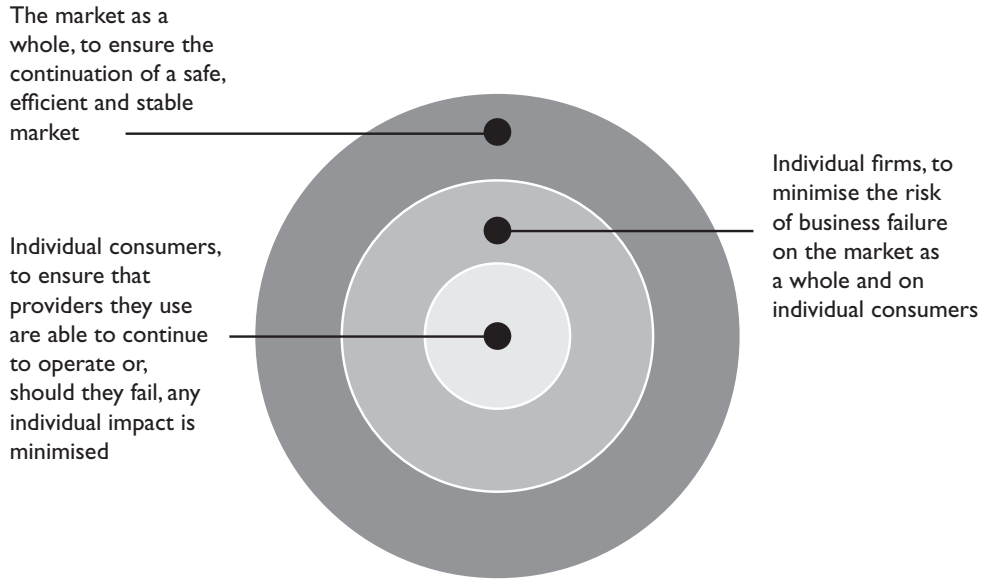
This area of financial services may well be new and unfamiliar to you. To give you a sense of the need for effective prudential regulation, search for information on the events of the 2007–09 financial crisis. During that period, weaknesses in prudential regulation saw the failure of financial institutions and the global financial system brought close to collapse. The following article, for example, gives you a sense of the enormity of the crisis:

Mathiason, N. (2008) Three weeks that changed the world. *The Guardian* [online], 28 December 2008. Available at: www.theguardian.com/business/2008/dec/28/markets-credit-crunch-banking-2008.

19.1 What is prudential management?

A vital element of the work of the industry regulators is to ensure that firms have adequate risk management systems in place, particularly in relation to financial risks. This is referred to as prudential management. Prudential standards operate at various levels, as indicated in Figure 19.1.

FIGURE 19.1 LEVELS OF OPERATION OF PRUDENTIAL STANDARDS



The majority of the prudential rules are the remit of the PRA; it is responsible for the prudential regulation of all deposit-takers, insurers and significant investment firms. The FCA is responsible for the prudential regulation of firms for which it is the sole regulator, typically smaller businesses.

The FCA's general approach to prudential supervision is to manage failure when it happens, rather than focusing valuable resources on reducing its probability. Remember that, in respect of prudential regulation, the FCA regulates smaller firms. Therefore the FCA's approach has to be seen in context, that the failure of a smaller firm would generally not present a risk to the integrity of the whole financial system. There are exceptions, and where failure of a particular firm is likely to have a wider impact, the FCA will focus on reducing the impact on customers and the integrity of the financial system.

19.1.1 International prudential regulation

It is important to understand that the UK's regulators do not operate in isolation; their work is driven by regulatory requirements at an international level. Trade is conducted on a worldwide basis, and the economies of many different countries are highly interconnected: problems in one economy or with a single large financial services provider can cause problems across the world. Such problems were seen following the collapse of Lehman Brothers

in the United States in 2008, an event widely believed to have triggered the ensuing financial crisis. The Basel Committee on Banking Supervision sets standards for the prudential regulation of banks globally. The EU sets out detailed requirements for banks, building societies and investment firms within the member states. We will look at standards set by the Basel Committee in section 19.5 and the EU requirements in section 19.6.

WHAT IS THE BASEL COMMITTEE ON BANKING SUPERVISION?

The Basel Committee is a multinational body acting under the auspices of the Bank for International Settlements, and is based in Basel, Switzerland. Its role is to strengthen the regulation, supervision and activities of banks to enhance financial stability; many of the people who work for it are on secondment from central banks and national regulatory bodies. It first established an international framework for deposit-takers (ie principally banks) in 1988. This framework, which – among other things – set out minimum capital requirements for banks, was known as the Basel Accord. It was superseded by the expanded Basel II, itself superseded by Basel III in 2010.

19.2 What is capital adequacy?

One of the key areas of prudential control for financial institutions relates to their capital adequacy. There are different rules for deposit-takers (such as banks and building societies), investment firms and life assurance companies.

Regulations about capital adequacy broadly state that, should a business run into difficulties, the business must have sufficient capital to make it very unlikely that deposits will be placed at risk. Capital in this context is often referred to as the own funds of a business, ie those obtained from shareholders and related sources, as distinct from funds deposited by customers. The business aims to make a profit for its shareholders, and it is the shareholders who are expected to bear the risks in pursuit of the financial reward. Thus although a bank's lending is generally financed by deposits, any losses made (for instance if a loan is written off because the borrower does not repay it) should be borne by shareholders rather than by depositors. Minimum requirements for capital adequacy are set to protect a bank's depositors so that they do not lose money.

The minimum capital that a business must hold is expressed in the form of a solvency ratio: that is, capital as a proportion of the value of the bank's assets (ie mainly its loans). The solvency ratio takes account of the fact that some

assets represent more of a risk to the bank than others, because the level of capital that must be held reflects the perceived risk level of the different assets.

KEY TERMS

CAPITAL ADEQUACY

Ensuring that a business holds sufficient reserves of capital to ensure it is sustainable.

SOLVENCY

The extent to which a business's assets exceed its liabilities. An example from the financial services industry would be mortgage lenders whose assets are the loans made to consumers; liabilities are the funds borrowed to facilitate those loans, from deposit-taking or from the money markets.

SOLVENCY RATIO

Capital as a percentage of the risk-adjusted value of assets.

19.3 What is liquidity?

Liquidity can be defined as the ease and speed with which an asset can be converted into cash – and thus into real goods and services – without significant loss of capital value. It must not be confused with solvency, or with capital adequacy, which are different issues. In relation to banks, the definition of liquidity is a measure of a bank's ability to acquire funds immediately at a reasonable price in order to meet demand for cash outflows.

The regulators define liquidity risk as the risk that a firm, though solvent, does not have sufficient financial resources available to enable it to meet its obligations as they fall due. Problems could, for example, arise when a bank that has committed a large volume of its assets to long-term mortgage advances is faced with an unexpectedly high number of its savings account holders wanting to withdraw funds; the bank may have the assets to enable the withdrawals but the mortgage loans are too illiquid. In assessing liquidity risks that they may face, banks need to consider the timing of both their assets and their liabilities, and endeavour to match them as far as possible.

LIQUIDITY

The ease and speed at which an asset can be converted to cash.

A firm's assets can provide liquidity in three main ways: by being sold for cash, by reaching their maturity date, and by providing security for borrowing. Asset concentrations, where a large number of receipts from assets are likely to occur around the same time, should be avoided. Similarly, banks try to avoid

liability concentrations, where a single factor or a single decision could result in a sudden significant claim. A wide spread of maturity dates is one obvious way to achieve this.

LIQUIDITY RISK

The situation of the UK bank Northern Rock in 2007 illustrates liquidity problems that can arise.

The bank had a business plan that involved borrowing money short term on the money markets on a regular basis to fund a proportion of its (much longer-term) mortgage lending. The success of the plan depended on the continuing availability of short-term interbank lending. When this dried up as a result of escalating economic problems in the USA, the bank's liquidity quickly disappeared. It was forced to approach the Bank of England for assistance.

At that point, a different aspect of liquidity risk appeared. When concerns about the stability of the bank became widely known, large numbers of depositors sought to withdraw their savings (a so-called 'run on the bank'). Banks do not retain all the funds deposited with them in a readily accessible form – as we have already learned, most of their deposits are lent to customers who wish to borrow. Only a small proportion is kept in cash or assets convertible into cash. If a run on the bank occurs, its liquidity can quickly be used up. In the case of Northern Rock, the government stepped in to guarantee deposits, which halted the bank run.

CHECK YOUR UNDERSTANDING 1

It's quite a while since you studied the role of the Bank of England in the UK financial system. Can you recall its key functions and explain the main reason why Northern Rock approached the Bank for assistance?

19.4 What is operational risk?

The way in which a business is run and managed is another area in which prudential risk can arise. Operational risk is the risk of loss as a result of failed or inadequate internal processes, people and systems (eg staff fraud, or a computer failure), or as a result of external events, such as a natural disaster.

Capital requirements for operational risk were included for the first time in Basel II (see section 19.5.1). The basic approach to calculating the capital required is to multiply the institution's gross annual income (averaged over the past three years) by 0.15. Insurance held against the events happening cannot be offset against this. For large institutions with different business lines, a more sophisticated system (called the standardised approach) can be applied, using different multiplying factors for each line.

19.5 What are the Basel Accords?

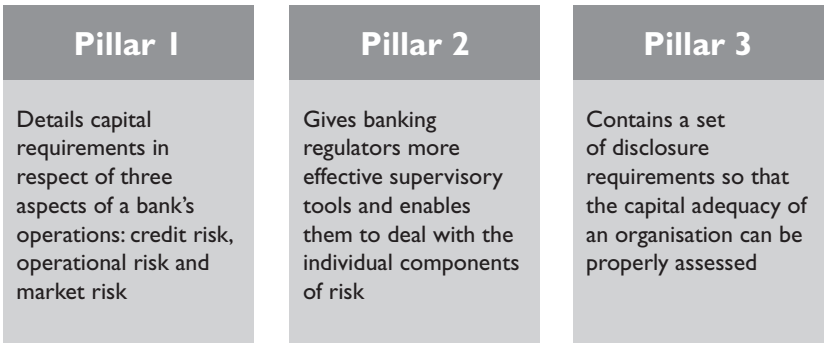
The Basel Committee on Banking Supervision first issued minimum capital requirements for banks in 1988. The rules set out in the Basel Accord were adopted by the G10 group of countries, including the UK.

19.5.1 Basel II

Basel II was published in 2004 and superseded the original Basel Accord. It requires banks to hold levels of capital appropriate to the risk presented by their lending and investment practices: as risk increases, so do the associated capital requirements.

Basel II consists of three 'pillars', as shown in Figure 19.2.

FIGURE 19.2 THE THREE PILLARS OF BASEL II



In relation to supervision and disclosure, Basel II introduced a requirement for banks to carry out 'stress tests', ie the use of computer simulations to understand the effect of particular events on the firm. Stress tests ascertain the extent to which a firm would have sufficient capital in certain adverse economic conditions.

These supervisory processes are backed by a set of disclosure requirements to ensure that banks publish sufficient information to enable market participants to assess a bank's risk profile and the extent of its capitalisation (ie its capital assets and reserves in relation to its risks and commitments). The disclosure requirements enable a distinction to be made between those banks that are managing their risks in a prudent manner and those that are not.

19.5.2 Basel III

Even before Basel II had been fully implemented, the events of the 2007–09 financial crisis highlighted the need for additional regulation. Basel III was agreed by members of the Basel Committee in 2010–11 and implementation was phased in up to 31 March 2019.

Basel III covers two main areas:

- regulatory capital;
- asset and liability management.

Regulatory capital

Basel III requires banks to reach a minimum solvency ratio of 10.5 per cent. Regulatory capital is the amount of capital that a bank is required to hold in order to meet regulatory requirements. There are precise definitions as to what can be counted as regulatory capital and there are two broad classes of capital:

- **Tier 1** capital, which includes share capital and disclosed reserves (ie profits retained in the business rather than being paid as dividends);
- **Tier 2** capital, which is known as supplementary capital.

The value of a bank's assets is adjusted to take account of the risk that those assets present. So, for example, loans to governments (such as a bank holding UK government gilts) have a risk weighting of zero as they are considered to be very secure; personal loans, conversely, are unsecured lending so carry a risk weighting of 100 per cent. A general theme is that the higher the risk presented by the business a bank is carrying out, the higher the level of capital it is required to hold. In practice, institutions normally keep more than the minimum solvency ratio required by Basel III.

Basel III also introduced a minimum leverage ratio, which is a bank's Tier 1 capital divided by its average total consolidated assets. Banks are expected to maintain a leverage ratio in excess of 3 per cent.

Asset and liability management

Basel III introduced two new ratios that banks must comply with in respect of asset and liability management:

- liquidity coverage ratio (LCR);
- net stable funding ratio (NSFR).

The LCR requires that high-quality liquid assets available to the bank exceed the net cash outflows expected over the next 30 days. In assessing a bank's ability to meet the LCR, different weightings are attached to different types of asset according to their liquidity. The LCR was phased in between January 2015 and January 2019.

While the LCR is aimed at ensuring a bank's short-term liquidity, the NSFR aims to protect its longer-term position. The NSFR requires that long-term financial resources exceed long-term commitments; long term in this context is taken as being more than one year. NSFR requirements had to be met from 2018.

FACTFIND

For further information on the phasing in of Basel III, check:

www.bis.org/bcbs/basel3.htm

19.6 What is the Capital Requirements Directive?

In the EU the requirements of Basel I, II and III are implemented by the Capital Requirements Directives (CRDs). CRD IV, which implements Basel III, came into effect on 1 January 2014, with the capital requirements being phased in over a number of years. The CRDs establish a supervisory framework that aims to minimise the effects of a firm failing. They do this by ensuring that firms hold sufficient financial resources to cover the risks that their business activities present.

CRD IV builds on existing rules and introduces new prudential requirements. Notably, the quality of capital that firms are required to hold has been improved and new capital buffers have been introduced for some firms. CRD IV applies to banks, building societies and investment firms.

CRD V came into effect on 28 December 2020 and introduced new rules governing the remuneration of staff, including the basis for identifying so-called 'material risk takers' – staff who are subject to the strictest remuneration rules. The reforms to the rules governing remuneration in CRD V include changes to deferral periods for performance-related pay and proportionality thresholds above which the requirements apply. As CRD V came into effect just before the end of the Brexit transition period, under the terms of the UK's Withdrawal Agreement with the EU the UK was required to 'onshore' the CRD V rules.

19.6.1 Total loss-absorbing capacity (TLAC)

There are additional capital requirements for banks deemed systemically important or too big to fail. The Financial Stability Board (FSB), an international organisation consisting of national regulators and central banks, issued a minimum total loss-absorbing capacity (TLAC) standard on 9 November 2015 for 30 banks identified as global systemically important banks (G-Sibs) that the Basel Committee on Banking Supervision (BCBS) deems at risk from being too big to fail. The TLAC requirements aim to bolster G-Sibs' capital and leverage ratios, ensuring these banks are equipped to continue critical functions without threatening

financial market stability or requiring further taxpayer support. The minimum TLAC requirement is in addition to minimum regulatory capital requirements, but qualifying capital may count towards both requirements, subject to conditions.

Since 1 January 2022, the minimum TLAC requirement for G-Sibs has been at least 18 per cent of the resolution group's risk-weighted assets (RWAs).

CHECK YOUR UNDERSTANDING 2

CRD IV consists of two pieces of legislation:

- the Capital Requirements Regulation (CRR);
- the Capital Requirements Directive (CRD).

There is a key difference in the way the CRR was implemented in the UK compared with the CRD. Can you explain what it is? Think back to your studies of the EU's role in regulation and legislation in Topic 2.

19.7 What is Solvency II?

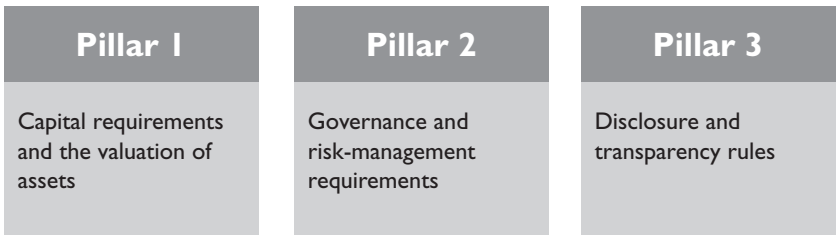
The failure of an insurance company presents a number of risks for consumers and, as with the banks, there are rules relating to the amount of capital a business must hold to mitigate the risk of insolvency. In the EU, a Directive that focused on the capital adequacy of insurers was introduced in the early 1970s; this is now referred to as Solvency I. A new Directive, Solvency II, came into effect on 1 January 2016. At an international level, the European Insurance and Occupational Pensions Authority (EIOPA) is responsible for its implementation. Within EU member states, national supervisory authorities will implement the requirements of the Directive.

The main aims of Solvency II are to:

- reduce the risk of an insurance company being unable to meet its claims;
- reduce losses suffered by policyholders should an insurer be unable to meet all claims in full;
- establish a system of information disclosure that makes regulators aware of potential problems at an early stage;
- promote confidence in the financial stability of the insurance sector.

Solvency II aims to harmonise regulation of the EU insurance industry and is primarily focused on the amount of capital an insurer must hold to reduce the risk of insolvency. It is based on three main 'pillars' (see Figure 19.3).

FIGURE 19.3 THE THREE MAIN PILLARS OF SOLVENCY II



The capital requirement is expressed in terms of a solvency capital requirement (SCR) which comprises a basic SCR, plus an allowance for operational risk, less an amount for adjustments. Insurers are required to complete and submit an Own Risk & Solvency Assessment (ORSA). The PRA has made changes to its Handbook to reflect the new requirements.

The regime applies to almost all EU insurance firms; some insurance firms are not subject to Solvency II requirements, depending on the amount of premiums they write, the value of technical provision or the type of business written.

FACTFIND

In time, Solvency UK will replace Solvency II. The PRA has established subject expert groups (SEGs) to gather a broad range of information on and options for the development of Solvency UK.

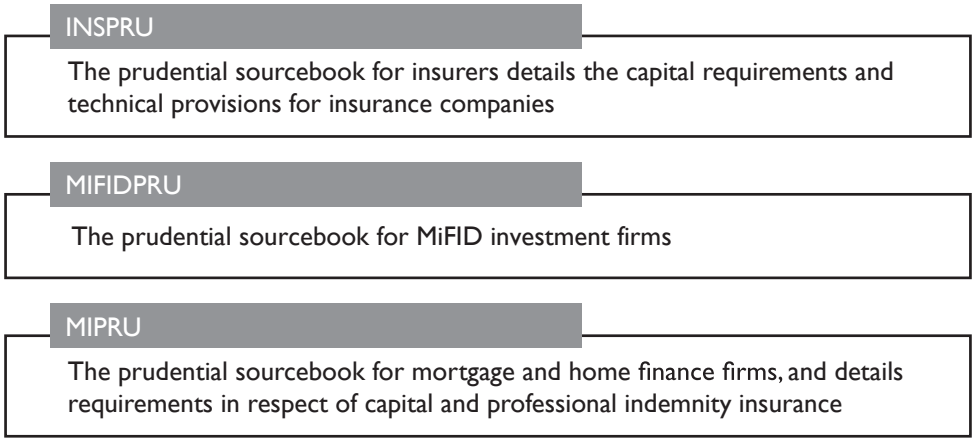
For the latest developments, you can visit:

www.bankofengland.co.uk/prudential-regulation/key-initiatives/solvency-ii/solvency-uk-pra-abi-insurer-engagement

19.8 What are the FCA/PRA prudential standards?

The FCA and PRA are responsible for establishing rules that translate EU legislation into practical standards that apply to regulated financial services providers. The FCA Handbook's 'Prudential Standards' section details prudential requirements. This section is made up of several subsections that detail requirements for different types of firm. The FCA has implemented a new prudential regime for investment firms, including the development of the Prudential Sourcebook for Investment Firms (MIFIDPRU).

FIGURE 19.4 OVERVIEW OF PRUDENTIAL STANDARDS SOURCEBOOKS



INVESTMENT FIRMS PRUDENTIAL REGIME (IFPR)

Most larger firms are now subject to the FCA's Investment Firms Prudential Regime (IFPR), whose rules can be found in the MIFIDPRU sourcebook. IFPR reflects the FCA's approach to capital requirements following Brexit. The regime came into force on 1 January 2022.

MIFIDPRU contains rules on own funds, concentration risk, basic liquid assets requirements, governance and risk management, and disclosure and reporting. The sourcebook also covers firms acting as clearing members and indirect clearing firms.

Further details can be found here: www.handbook.fca.org.uk/handbook/MIFIDPRU/

THINK AGAIN ...

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- describe the roles played by the PRA, the FCA and the Basel Committee on Banking Supervision in prudential management?
- explain what is meant by 'capital adequacy'?
- explain what is meant by 'liquidity risk'?
- describe what is addressed by each of the 'three pillars' of Basel II?
- explain what is meant by the 'liquidity coverage ratio'?
- outline the main aims of Solvency II?

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

Test your knowledge

Use these questions to assess your learning for Topic 19. Review the text if necessary.

Answers can be found at the end of this book.

1) Who is responsible for the prudential regulation of deposit-takers and insurers?

   a) Financial Conduct Authority (FCA).

   b) Prudential Regulation Authority (PRA).

   c) Monetary Policy Committee (MPC).

   d) Financial Policy Committee (FPC).

2) Why does the FCA concentrate on managing the failure of an individual firm if it happens rather than proactively seeking to prevent its failure in the first place?

3) Capital adequacy requirements are based on the principle that in the event of a firm making a loss:

   a) it can approach the Bank of England for additional funds.

   b) its depositors, not its shareholders, should bear the loss.

   c) the Basel Committee will determine whether the firm has sufficient capital to continue trading.

   d) its shareholders, not its depositors, should bear the loss.

4) What is a bank's solvency ratio?

5) How did Basel II seek to ensure that capital adequacy requirements more accurately reflected the risks represented by a firm's assets?

6) Under Basel III, banks must work towards a minimum solvency ratio of what level?

   a) 10.5 per cent.

   b) 8 per cent.

   c) 5 per cent.

   d) 4 per cent.

7) Basel III introduced new measures with regard to a bank's capital and asset liability management. Which of these measures is aimed at protecting the long-term financial stability of a bank?

   a) The liquidity coverage ratio.

   b) The net stable funding ratio.

   c) The Tier 1 capital measure.

   d) The Tier 2 capital measure.

8) What are the key aims of Solvency II?

9) Which of the following sections of the FCA Handbook contains details of the prudential requirements applying to MiFID investment firms?

   a) BIPRU.

   b) IFPRU.

   c) MIPRU.

   d) MIFIDPRU.