

## E-ALERT | Financial Services and Regulation

March 5, 2014

### PRA CONSULTS ON ITS APPROACH TO SUPERVISING INTERNATIONAL BANKS

On 26 February 2014, the United Kingdom (“UK”) Prudential Regulation Authority (“PRA”) published a consultation paper on its approach to supervising international banks and their branches in the UK. It will be of particular interest to those firms which are headquartered outside the European Economic Area (“EEA”) and which have branches in the UK. In specific cases, some firms will have to consider changing their business models and legal structures if they wish to continue operating in the UK. However, the proposals in the consultation are relevant to all existing and prospective PRA-supervised banks and designated investment firms which operate in the UK, via branches and subsidiaries, and which have their headquarters in another jurisdiction.

The consultation paper (“CP4/14”) adds further detail to the PRA’s approach to banking supervision, which it published in April 2013, when it took over prudential regulation in the UK from the Financial Services Authority (“FSA”). It contains both a draft supervisory statement on branches in the UK and draft rules, to be inserted into the PRA Handbook, relating to data collection and reporting criteria. However, the main focus of the document is on the draft supervisory statement, which explains how the PRA intends to authorise and supervise branches of non-UK banks in line with its statutory objectives of promoting safety and soundness, and ensuring the stability of the UK financial system. CP4/14 closes to responses on 27 May 2014.

#### THE DRAFT RULES

Under the new draft rules, EEA and non-EEA headquartered banks which operate in the UK through branches will be required to complete a new data collection return from 2015. This return will need to be completed twice yearly and is designed to enhance the PRA’s understanding of the potential impact which foreign branches could have on UK financial stability. It will provide the PRA with useful quantitative information on economic functions being performed by these bank branches in the UK. The PRA has also intimated in the consultation that it intends to ask a “sub-set” of branches to complete the return during 2014 in order to assess its practicability. The PRA will then review the data received from this sub-set and take into consideration any feedback received during the consultation, before rolling out the actual return in the following year.

The draft rules also propose that non-EEA banks will need to have proper resolution plans for their UK branches. This requirement should be read alongside the proposed “fundamental” rule on which the PRA consulted in January 2014, and which if it comes in, will require banks to prepare for resolution in a way which means that they can be resolved in an orderly manner, with the minimum disruption to critical services. The new rule in the consultation goes further and states that the plan must be adequate for the resolution of the UK branch. Any firm which is unable to comply with this new proposed rule is unlikely to satisfy the

Threshold Conditions set out in the PRA Handbook. Where this is found to be the case, the branch in question may have its licence withdrawn.

## THE DRAFT SUPERVISORY STATEMENT

By way of context, the consultation explains that there are currently 145 branches of international banks operating in the UK, which in aggregate account for 31 percent of the total assets of the UK banking system. The majority of the business conducted by these branches tends to be wholesale business, rather than retail, due to the City of London's role as a key global financial centre. Therefore, the PRA believes that close supervision of these branches is imperative. The draft supervisory statement considers the PRA's supervision of UK branches of both EEA banks ("EEA Branches") and non-EEA banks ("Non-EEA Branches").

## PRA APPROACH TO SUPERVISION OF NON-EEA BRANCHES

The PRA's approach to supervision of both new and existing Non-EEA Branches in the UK is based on an assessment by the PRA of the equivalence of the branch's home state's supervision of the entire firm, as well as the activities which the branch in the UK wishes to carry on and the level of assurance which the PRA receives from the home state supervisor ("HSS") regarding its resolution planning. Once the PRA is satisfied with the equivalence of the regime and has the required assurance, it will also wish to obtain a clear and agreed split of prudential supervisory responsibilities with the HSS. Where this is not forthcoming, it may refuse authorisation of a new branch or cancel an authorisation of an existing branch.

The PRA will look to establish a clear acceptance from the HSS of its prudential responsibilities for branches in the UK. It will require a firm-specific agreement covering the responsibilities for prudential supervision of the Non-EEA Branch and an appropriate level of information sharing. These agreements will vary depending on the branch's activities in the UK and the home jurisdiction, but the PRA will look to work with the HSS where possible. The PRA will focus its supervision on understanding the UK branch's activities, but it will consider this in the context of the whole firm. Where it discovers risks which might apply to the firm as a whole, it will raise these with the HSS. It will assess and address any UK-specific issues in consultation with the HSS. The PRA also explains briefly how it intends to cooperate with the HSS in relation to supervision of the firm's and branch's capital, systems and controls, governance and risk management.

The PRA will only allow Non-EEA Branches to undertake retail banking activities beyond a very minimal level where it has obtained a high level of assurance from their HSS with regard to a bank's resolution planning. In addition, Non-EEA Branches will also be required to focus on wholesale banking at a level which is not critical to the UK economy. In other words, if there were to be an interruption to a service which the Non-EEA Branch provides, this should not lead to financial instability in the UK. The consultation states that this is driven by two factors; first, the need for continuity of access to transactional accounts, such as current accounts for depositors; and second, the PRA's wish to subject those non-EEA firms which are covered by the UK's Financial Services Compensation Scheme ("FSCS"), and could cause a liability to the FSCS in the event of failure, to a higher level of supervision.

Where a Non-EEA Branch has already been established in the UK, the PRA will focus its supervision on whether the branch undertakes critical economic functions ("CEFs"), and on obtaining close cooperation from the HSS in relation to how these functions could be resolved were the bank as a whole to fail. The PRA will raise any issues with the HSS as a first step, and will then proceed to use its own powers over the branch to address its

concerns, where it is not happy with the HSS's response. If the issues identified are serious enough, the PRA may revoke the branch's authorisation to operate in the UK.

CEFs include:

- Retail banking;
- Corporate banking;
- payments, clearing and settlement;
- custody;
- intra-financial system borrowing and lending; and/or
- investment banking.

These listed activities will be considered CEFs where they are deemed material by the PRA. The PRA also states that, with regard to wholesale banks, CEFs are likely to be carried on globally and must therefore also be reviewed in such terms.

## PRA APPROACH TO SUPERVISION OF EEA BRANCHES

The PRA approach to supervision for EEA Branches will remain fully compatible with the recast Capital Requirements Directive ("CRD IV"). The HSS of the branch in the UK will be responsible for the prudential supervision of the whole firm including the branch. However, the Financial Conduct Authority ("FCA") will be responsible for supervising the EEA Branch's conduct under its Conduct of Business rules in the FCA Handbook. As part of its remit, the PRA will look to ascertain whether the branch carries on any CEFs in the UK. If so, the PRA will liaise with the HSS regarding the branch's resolution strategy, and aim to work with it on prudential supervision matters. If the PRA feels that the HSS is not addressing its concerns, it may refer the issue to the European Banking Authority ("EBA"). The PRA is also able to take more drastic measures in relation to the EEA Branch if required under the circumstances, so as to protect against financial instability within the UK. This is in accordance with measures set out in CRD IV.

## SUBSIDIARIES

UK subsidiaries of international banks are incorporated in the UK. Therefore, the PRA largely has the same legal and supervisory powers in relation to them as it would for a UK firm. However, given the international context, the PRA will also look to have a close and continuous dialogue with the group's HSS. It will look to review the position of the UK subsidiary within the wider consolidated group and monitor its links within the group, as well as look at the group's recovery and resolution plans. If required, the PRA will aim to limit the links between the UK subsidiary and the rest of the group. The PRA will be part of the supervisory college and attend the Crisis Management Group for the consolidated group where the UK subsidiary is of a significant size.

In cases where international groups establish both a subsidiary and a branch in the UK, the PRA will assess whether there is appropriate governance to oversee and manage the links between the two entities.

## WHAT NEXT?

Whilst this consultation paper is of interest to all international banks with subsidiaries and branches in the UK, it is of particular importance for non-EEA banks with branches in the UK. In the event the consultation is implemented without amendment, the PRA has made it

extremely clear that it will be prepared to refuse, alter or remove licences for those branches where its proposed supervision criteria are not met. Where branches are carrying on activities which will be considered CEFs, the PRA is even more likely to act.

Non-EEA Branches may, therefore, wish to consider whether continuing operations via a UK subsidiary would be a better option in future if they are unable to meet the new criteria, or wish to continue with retail banking operations over *de minimis* levels in particular. This is likely to be a time-consuming and complex legal and regulatory undertaking, but it may be the only option available in certain cases. Firms which think they might be in this position should look at the detail of the consultation closely and consider opening a dialogue with the PRA sooner rather than later in order to achieve a smooth transition and continuity of service.

## HOW WE CAN HELP

We have in-depth knowledge of the PRA's rules and supervision regime in the UK and are able to assist clients in many ways. We can:

- offer practical guidance and expertise in relation to the proposals set out within CP4/14, and how best to prepare your firm for the proposed regime;
- provide guidance on how to comply with all aspects of the current PRA supervisory regime, including on-site visits and preparatory interviews for senior management and key staff;
- advise on compliance with the Financial Conduct Authority's Conduct of Business rules, applicable to all bank subsidiaries and branches in the UK;
- assist with obtaining authorisation for a new branch or subsidiary from the PRA and FCA;
- advise on passporting services for firms under EU Directives;
- provide bespoke in-house training on any aspect of the UK regulatory regime; and
- assist with the drafting and preparation of both internal facing and client facing banking documentation which is compliant with UK regulation.

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If you have any questions concerning the material discussed in this client alert, please contact the following members of our executive compensation practice group:

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