Please note: This letter has been prepared for the website. Square brackets show where this letter may differ slightly, along with formatting from those versions sent directly to firms.

Bank of England

Prudential Regulation Authority

David Bailey
Executive Director, UK Deposit Takers

Charles Woods
Director, UK Deposit Takers
10 January 2023

Dear [Chief Executive Officer,]

UK Deposit Takers Supervision: 2023 priorities

We are writing to update you on the Prudential Regulation Authority's (PRA) 2023 priorities for UK deposit takers. These priorities are intended to complement our ongoing supervision and the feedback you will have received following the most recent Periodic Summary Meeting (PSM) for your firm. These are sent to the wide and diverse range of UK-based deposit takers that we supervise; therefore, this list is not exhaustive, but is intended to provide a helpful overview of our priorities for 2023.

Credit Risk

The operating environment for firms remains challenging. The impact of increasing interest rates, inflation and high cost of living, geo-political uncertainty, and supply chain disruptions is expected to pose challenges to firms' credit portfolios. Firms need to be ready for a prolonged period of stress.

In recent years, including through events like the Covid-19 pandemic, firms have tightened underwriting standards, enhanced forbearance tools, and increased operational preparedness for collections. However, these enhancements are untested under the current combination of risk factors. Therefore, it is important that firms ensure their credit risk management practices are robust, portfolios are closely monitored, customer support and collections arrangements are appropriately scaled, and expected credit loss provisions[1] are recognised in a timely manner.

Our assessment of firms' credit risk management will include a focus on traditionally higher risk areas including retail credit card portfolios, unsecured personal loans, leveraged lending, commercial real estate, buy-to-let, and lending to Small- and Medium-sized Enterprises (SMEs). We will also look at firms' early warning indicator frameworks given many credit risk metrics are backward looking. Firms should expect increased engagement with us, including targeted requests for enhanced data and analysis.

Financial resilience

Given the challenging operating environment, it is paramount that firms manage their financial resources to ensure that the financial sector can continue to support businesses and households. We will continue to focus on financial resilience, through ongoing assessment of individual firm's capital and liquidity positions as well as how these may evolve in light of potential headwinds. Areas of focus will include the impact of evolving retail and wholesale funding conditions, as well as scheduled maturities of drawings from the Term Funding Scheme with additional incentives for Small - and Medium-sized Enterprises (TFSME) in the coming years.

We expect firms to take proactive steps to assess the implications of the evolving economic outlook on the sustainability of their business models. This should include consideration of broader structural changes to the banking sector such as the evolution of new financial technology and competition. The Bank of England's ('Bank') Annual Cyclical Scenario stress test, the results of which will be published in Q3 2023, remains a core tool for the PRA to explore the financial resilience of major UK banks and building societies. Supervisors will continue to work with firms as they seek to enhance their own testing and scenario development capabilities in response to the current environment.

Risk management and governance

Last year, we highlighted the deficiencies in banks' risk management and governance frameworks brought to light by the default of Archegos Capital Management. We specifically asked firms to consider concentrated and leveraged exposures and to improve counterparty risk management. During 2022, the market reaction to Russia's invasion of Ukraine, and volatility in the nickel and long dated Gilt markets, reinforced the importance of a robust risk culture and sound risk management practices at firms.

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1 https://www.bankofengland.co.uk/prudential-regulation/letter/2022/october/thematic-feedback-2021-2022-written-auditor-reporting.

However, despite regular messaging from the PRA on the subject, these events demonstrated that firms continue to unintentionally accrue large and concentrated exposures to single counterparties, without fully understanding the risks that could arise. In 2023, firms must ensure that those lessons from past crises are definitively learned in full, and thoroughly embedded across the first and second lines of defence.

We will continue to assess firms' risk management and control frameworks through individual and cross-firm thematic reviews. We will focus on firms' ability to monitor and manage counterparty exposures, particularly to non-bank financial institutions. Given the global nature of market events, we will continue to work closely with our regulatory counterparts on these topics.

Operational risk and resilience

We continue to maintain our focus on operational risk and resilience, including through the assessment of firms against the PRA's operational resilience rules as set out in Supervisory Statement (SS) 1/21 – 'Operational resilience: Impact tolerances for important business services'.[2] By now, firms are expected to have identified and mapped their Important Business Services (IBS), set impact tolerances for these, and commenced a programme of scenario testing. We have been reviewing firm self-assessments and engaging with individual firms and the sector more generally on our findings.[3]

Our focus for the coming year will be on using this framework, and the testing that firms are conducting, to assess whether they can remain within their impact tolerance for each IBS in the event of a severe but plausible disruption to their operations.

More broadly, in response to increasing digitisation, changes in payment systems and the need to address legacy IT systems, many firms are executing large and complex programmes of IT change. We expect these changes to be well managed with the associated transition and execution risks appropriately mitigated.

We have also observed a material increase in services being outsourced, particularly to cloud providers, and we expect firms to manage the risk arising from this accordingly. In doing so, firms should meet the expectations on outsourcing and third party risk management set out in SS2/21 – 'Outsourcing and third party risk management'. [4]

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2 https://www.bankofengland.co.uk/prudential-regulation/publication/2021/march/operational-resilience-impact-tolerances-for-important-business-services-ss.

3 https://www.bankofengland.co.uk/speech/2022/april/david-bailey-speaker-at-uk-finance-event-operational-resilience-beyond-2022.

4 https://www.bankofengland.co.uk/prudential-regulation/publication/2021/march/outsourcing-and-third-party-risk-management-ss.

Firms should ensure IBS can remain within impact tolerances even when they rely on outsourcing or third party providers. We welcome the feedback provided to Discussion Paper (DP) 3/22 – 'Operational resilience: Critical third parties to the UK financial sector',[5] and we encourage your continued engagement as we work with other UK authorities to develop our thinking and policy further in this area.

The number of firms offering crypto products continues to grow, presenting new challenges for risk management. We will continue to monitor firms' use of new technologies, and advancements in asset tokenisation. We expect firms to have fully understood the impact of offering crypto products on their operational resilience, and to have materially met our supervisory expectations as set out in SS1/21 before engaging with these opportunities in any material way.

Real Time Gross Settlement (RTGS)

The Bank is introducing the delivery of ISO 20022 messaging[6] in CHAPS on Monday 19 June 2023 as part of the RTGS Renewal programme. We expect firms to be ready for this change, ensuring cut-over to the new messaging standard without interruption to customer payments or liquidity management. This includes completing all necessary testing and participating in dress rehearsals and go-live events in full.

A number of similar ISO migrations are happening in parallel, and firms should be clear on the dependencies between them in their own systems, including in the event of further changes to the timelines for one or more of these events. As preparations for the move to the renewed RTGS system in 2024 continue, firms should be ready to complete testing and training during 2023, adapting systems and processes as needed to be able to access and use the new system.

Model risk

Given the central role that models play in supporting firms' risk assessment and management, and the weaknesses that we highlighted in our 2022 priorities letter, Model risk management (MRM) remains a priority. To support the strengthening of MRM practices in firms, we published Consultation Paper (CP) 6/22 – 'Model risk management principles for banks',[7] and expect to publish finalised MRM principles for banks in H1 2023. We will expect firms to review these and make any changes to their MRM approach that are necessary to ensure they comply with the principles.

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5 https://www.bankofengland.co.uk/prudential-regulation/publication/2022/july/operational-resilience-critical-third-parties-uk-financial-sector.

6 https://www.bankofengland.co.uk/payment-and-settlement/rtgs-renewal-programme/consultation-on-a-new-messaging-standard-for-uk-payments-iso20022.

7 https://www.bankofengland.co.uk/prudential-regulation/publication/2022/june/model-risk-management-principles-for-banks.

In 2023, for Internal Ratings Based models (IRB), we will continue to focus on three key workstreams: the implementation of IRB Hybrid mortgage models; the IRB Roadmap for non-mortgage portfolios; and IRB aspirant firm model applications. We will also increase our focus on new Fundamental Review of Trading Book (FRTB) models and firms' intended methodologies following the publication of our consultation on the implementation of Basel 3.1 standards.[8]

Data

Data remains an area of focus for the PRA as the submission of complete, timely, and accurate regulatory returns remains the foundation of effective supervision.[9] We continue to invest in delivering our own Regulatory Technology (RegTech) and data strategy, for which accurate firm submissions of data and information are critical. Over recent years, we have commissioned a programme of skilled persons reviews which have repeatedly identified deficiencies in the controls over data, governance, systems, and production controls related to regulatory reporting. We expect firms to consider the thematic findings set out in our communications on regulatory reporting[10] to inform how best to improve their submissions going forward. We will continue to use skilled persons reviews in this area in 2023.

Additionally, we will be engaging with firms in 2023 on which data we collect as part of the Banking Data Review,[11] and will continue to consult firms on the long-term reforms to the way we collect data as part of the Transforming Data Collection Programme.[12]

Financial risks arising from climate change

Climate change presents an increasingly material risk to firms and the financial system.[13] In 2022, we started actively supervising firms against our supervisory expectations.[14] Our recently published letter to Chief Executives[15] highlighted the

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8 https://www.bankofengland.co.uk/prudential-regulation/publication/2022/november/implementation-of-the-basel-3-1-standards.

9 https://www.bankofengland.co.uk/prudential-regulation/letter/2019/reliability-of-regulatory-returns.

10 https://www.bankofengland.co.uk/prudential-regulation/letter/2021/september/thematic-findings-on-the-reliability-of-regulatory-returns.

11 https://www.bankofengland.co.uk/paper/2020/transforming-data-collection-from-the-uk-financial-sector.

12 https://www.bankofengland.co.uk/paper/2021/transforming-data-collection-from-the-uk-financial-sector-a-plan-for-2021-and-beyond.

13 https://www.bankofengland.co.uk/speech/2022/july/nathanael-benjamin-speech-at-uk-finance-new-tides.

14 https://www.bankofengland.co.uk/prudential-regulation/publication/2018/enhancing-banks-and-insurers-approaches-to-managing-the-financial-risks-from-climate-change.

15 https://www.bankofengland.co.uk/prudential-regulation/letter/2022/october/managing-climate-related-financial-risks.

progress made by firms since the publication of SS3/19 – 'Enhancing banks' and insurers' approaches to managing the financial risks from climate change', and provided feedback on the Bank of England's Climate Biennial Exploratory Scenario exercise (CBES) which was run in 2021.[16] Overall, we have observed that firms have taken tangible and positive steps to implement our expectations. However, the level of embeddedness varies from firm to firm and further progress is needed by all firms within scope of SS3/19. We expect firms to take a proactive approach to addressing risks in this area with the letter providing some specific examples of areas where, by now, firms would be expected to demonstrate capabilities in meeting supervisory expectations. It also reiterates that approaches should be proportionate to the nature of the firm's business, scale of the risks, and the complexity of its operations.

Other areas of supervisory focus

Diversity, Equity, and Inclusion

Diversity, Equity, and Inclusion (DEI) remains an important focus and a topic we expect firms to continue to embed in their cultures. Building upon our joint Discussion Paper (DP) 2/21 – 'Diversity and inclusion in the financial sector – working together to drive change' published in July 2021[17] and the voluntary pilot survey,[18] we plan to issue a consultation paper in 2023 setting out proposals to introduce a new regulatory framework on DEI in the financial sector.

Resolution

The Bank, as resolution authority, and the PRA, continue to prioritise resolution as this is an important component of ensuring that the UK has a resilient, efficient, and competitive banking system. The Resolvability Assessment Framework (RAF)[19] applies to firms where the preferred resolution strategy is bail-in or partial-transfer. These firms should continue to work to ensure that they achieve, and can continue to maintain, the resolvability outcomes of the RAF, and ensure that they are transparent in their disclosures about their preparations for resolution.

16 https://www.bankofengland.co.uk/stress-testing/2022/results-of-the-2021-climate-biennial-exploratory-scenario.

17 https://www.bankofengland.co.uk/prudential-regulation/publication/2021/july/diversity-and-inclusion-in-the-financial-sector.

18 https://www.bankofengland.co.uk/prudential-regulation/publication/2021/july/diversity-and-inclusion-in-the-financial-sector.

19 https://www.bankofengland.co.uk/paper/2019/the-boes-approach-to-assessing-resolvability.

Supervisory Approach

As set out in the PRA's 2022/23 Business Plan,[20] we continue to strengthen our supervisory approach. As part of this and with effect from January 2023, we have updated our approach to categorising the 'potential impact'[21] of firms, reducing the number of categories from five to four. We have also refined our risk assessment framework and our core assurance work. Where this results in any changes to the supervisory workplan for any individual firm, we will communicate this directly to the firm in due course. Until they are informed otherwise, firms should continue to work with the workplan communicated to them following their last PSM. We will also update our published supervisory approach documents[22] during the first half of 2023.

The Financial Services and Markets Bill, which is currently being considered by Parliament will – if passed into law – introduce a new secondary competitiveness and growth objective for the PRA. The new objective would require the PRA to act in a way which, subject to aligning with relevant international standards, facilitates the international competitiveness of the UK economy and its growth in the medium to long-term. If appropriate, the PRA's supervisory approach will be updated to reflect changes that are made to its statutory objectives.

This letter in conjunction with your firm's PSM letter, should convey a sense of our planned work for 2023. We look forward to working with you over the coming year.

Yours sincerely,

David Bailey
Executive Director
UK Deposit Takers

Charles Woods
Director
UK Deposit Takers

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[20] https://www.bankofengland.co.uk/prudential-regulation/publication/2022/april/pra-business-plan-2022-23.

[21] A core part of the risk assessment framework is the potential impact assessment. We assess the significance of a firm to the stability of the UK financial system. This 'potential impact' reflects a firm's potential to affect adversely the stability of the system by failing, coming under operational or financial stress, or because of the way in which it carries out its business.

[22] https://www.bankofengland.co.uk/prudential-regulation/publication/pras-approach-to-supervision-of-the-banking-and-insurance-sectors.