

Treasury Committee

Oral evidence: The work of the Prudential Regulation Authority, HC 1185

Tuesday 7 March 2023

Ordered by the House of Commons to be published on 7 March 2023.

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Members present: Harriett Baldwin (Chair); Anthony Browne; Emma Hardy; Danny Kruger; Andrea Leadsom; Siobhain McDonagh; Anne Marie Morris.

Questions 1 – 60

Witnesses

I: Sam Woods, Deputy Governor for Prudential Regulation, Bank of England, and Chief Executive Officer, Prudential Regulation Authority; Julia Black, External Member, Prudential Regulation Committee, Bank of England; Victoria Saporta, Executive Director, Prudential Policy, Prudential Regulation Authority.

Examination of witnesses

Witnesses: Sam Woods, Julia Black and Victoria Saporta.

Q1 Chair: Welcome to this session of the Treasury Select Committee, where we are going to cover the work of the Prudential Regulation Authority. Can I start by asking our witnesses to introduce themselves?

Sam Woods: I am Sam Woods, head of the PRA.

Julia Black: I am Julia Black, external member of the PRC.

Victoria Saporta: I am Vicky Saporta, executive director of prudential policy at the PRA.

Q2 Chair: Sam, just to note, we have just agreed to publish the letter you have kindly sent to us highlighting your temporary recusal for any work on pensions and liability-driven investing. We understand that, should those questions come up in today's session, Vicky will handle them. Is that correct?

Sam Woods: Yes, that is fine. I can do backward-looking questions, but maybe Vicky should make the first responses.

Q3 Chair: This week we received quite a strongly worded letter from the Governor elaborating on some of the points you raised when you were



last in front of us about the PRA's concern that the changes to Solvency II are going to increase the probability that an insurer fails in the way Equitable Life failed. You have put some numbers on that. Do you want to highlight why you have chosen to do that?

Sam Woods: Yes. We were responding to the direct question you put to us last time. The direction of the effect should not be a surprise to people. The Government's very clear and overwhelming objective of the Solvency UK reform, along with some other objectives, is to promote growth and investment. That is a sensible thing for a Government to want to do. They want the insurance sector to play a role in that. To me and my colleagues, it is not surprising—it is not surprising to the Government either—that it comes with some increase in risk.

You then come to the quantum of that. We are talking about tail risks. The team has had to do a heroic job to take a stab at answering the question that you put to us. In terms of the answer they come to, they have come at it in two ways, one using an options pricing model and one using credit ratings, and they have taken the average of those two results. That leads to what was in Andrew's letter to you, which is the move from a 0.5% probability of default in one year to a 0.6% probability.

How you feel about that probably depends on your perspective. From 0.5% to 0.6% is a 20% increase. You could also argue, if you wanted to argue it the other way, that it is a change from one relatively small number to another relatively small number, but we think it is relevant for the Committee to understand that. The Government, of course, understand that this is part of the effect of these reforms.

I just have one final point, if I might. Although the focus of the letter in response to your question was on that quite specific question, which is obviously a very important question, for me what is more important than that increase in the probability of default, which can only be very broadly estimated, is the thing we have discussed here before about the matching adjustment.

In effect, this is one of the foundations of the whole calculation. We have been trying to make that stronger. The Government have decided not to take that forward, and we have accepted that as the Government's position. For me, that is a larger issue than the move from 99.5% to 99.4%.

Q4 **Chair:** When you were in front of us last time, we asked, because these matters are still before Parliament, whether you wanted Parliament to vote against these changes. You did not give us a clear answer.

Sam Woods: I would not urge parliamentarians to do one thing or another. We have laid out the case in relation to this set of reforms. This is one part of it. It is worth saying in passing that there are a lot of other



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bits to this reform in relation to which we and the Government have been on exactly the same page throughout.

The Government have been clear that they are not persuaded by that case. That is a combination of perhaps not being persuaded that the risk is one they need to worry about as much as we think we need to worry about it and the balance the Government have to strike with their growth and investment objectives. The Government took the view that introducing the change we were looking for would reduce, in the Government's assessment, the growth and investment benefits of the package.

People can argue whether or not that is right, but that is broadly the judgment that was reached. It is fair enough for Governments to reach those judgments. Some of that will come to Parliament in due course in the form of statutory instruments during the Government's part of the review, if you like. Parliament can have its say at that point.

Q5 Chair: You are basically saying that, as the regulator responsible for the risk of these organisations, you feel this is wrong. I wonder whether you feel so strongly this is wrong that you are prepared to resign over it.

Sam Woods: No, I have no intention to resign and nor have I threatened to resign as part of this process. That would have been quite a strange thing to do.

Our job in this process, as I see it and as I think my colleagues agree, is to surface things we think are problems so they can be considered in the debate. In this particular set of reforms, it has been the case from the beginning that both we and the Government have our hands on the steering wheel because of the way these laws were imported.

It has always been the case that the changes that could be made—we were looking to make a change here—would only really be those that could be supported by both the Government and the regulator in this case. It is only in this particular part of the package, which is only one part of a much broader package, that that condition was not present.

Q6 Chair: You do not support it.

Sam Woods: The way I would put it is we have a different view on the substance of that. We would like to make these changes to the matching adjustment, but we accept that the Government have reached their final view and have not taken our advice.

There is also a practical point. We need to get on with this. We cannot go on debating forever. We do not have new points or evidence we are bringing forward. We have made all the points in public over the last year or two. As a practical matter, the teams are getting on with the implementation and preparation. All of this is subject, of course, to the views of Parliament.



Q7 Chair: Do you have any other powers you can use to mitigate what you see as being an unacceptable increase in risk here?

Sam Woods: One could debate the word “unacceptable”. In a sense we are accepting that the Government are going to take it forward in that shape.

The Government have committed—again, it will be subject to parliamentary approval—to give us some additional powers to help us manage risk in the insurance sector. The most relevant ones are the ability for us to require senior managers in firms—as an aside, this is quite a good example of how the senior managers regime get used by us—to attest that the level of matching adjustment benefit being taken is commensurate with the risks that are retained by the firm, or rather with the risks that are not retained by the firm, which is what we have been getting at.

Alongside that, the Government intend to give firms the ability to top up voluntarily. If you are a firm investing in an asset and you think the fundamental spread on it, which is the relevant part of the matching adjustment, is not high enough, you will have the ability to top that up. That is very relevant to this consideration. We will also be doing some stress testing with individual firm results.

We do not think we either should or can use those to achieve the same effect as we were looking for through the reform of the fundamental spread. I will stop there, but I am happy to expand on that if you want me to.

Q8 Chair: I just wanted to ask you, Julia, as an external member, where you stand on all of this.

Julia Black: Sam has put the point very well. From our perspective, it was very important that the Government and others should really understand our perspective. We have a statutory mandate and our primary objective is the protection of policyholders. We have secondary objectives, and we have new secondary objectives coming in as well.

Assessing risk is always a matter of judgment. How safe is safe enough? How much risk do you want to tolerate?

Q9 Chair: You are saying that you do not think it is safe enough. You agree with what Sam has said there.

Julia Black: Absolutely, yes.

Q10 Chair: We are going to be a lot less safe. That is what you are saying.

Julia Black: I would go back to the point that the system is strong. As Sam said, we are talking about a move from a small percentage of risk to another relatively small percentage of risk. We are still moving up.



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The Government, as they are absolutely entitled to do, and Parliament might consider there are benefits to taking on that risk. In this case, the anticipated benefits are wider investment in infrastructure assets in particular, given their profile. That is absolutely a judgment for the Government to make.

As a regulator, it is very important that we surface and we give our technical advice. That is our role. It is a democratic system and it is for Parliament and Government to decide. Whatever you decide, we will implement.

Q11 Chair: Just very quickly moving on to the new competitiveness and growth objective, Sam, how are you going to change the way the PRA operates as a result of that secondary objective, should Parliament agree that legislation?

Sam Woods: It is a very big change for us. I will bring in Vicky in a moment, if I might. Part of the change is a managerial change in Vicky's area, where we are staffing up and changing the shape of what her directorate does.

There are many things we have in train—these are actual things we are doing—to support that objective, if you approve it. If you do not approve it, we will have to change tack with those things. The entire rest of the Solvency UK package is in that space, by the way.

Maybe I can give you one example because it brings it to light. Under the existing regime there are 200 tests and standards that have to be met if a firm applies to us for an internal model to set their capital requirements. In effect, those are boxes that need to be ticked. We intend to remove 70% of those. The point of doing that is not to reduce the robustness and stringency of the process. It is just that, now we are out of the EU, we do not think we need to be so bureaucratic about it. There are many things of that kind. That is just one example.

There is one other point here, which is more of a cultural or mindset point. If, as we are expecting, you agree to give us that new secondary objective—by the way, we support it—it is very important that all of our staff understand that Parliament has changed something about what we are meant to do and that we embrace that and take it forward in a positive way.

We are very conscious of that. We are doing a lot of that internally in terms of how we talk about it and the enthusiasm we have for taking forward that part of our remit. That sounds a bit soft but it is quite important. Could I possibly bring in Vicky on the management side?

Victoria Saporta: On the management side of it, it is important to understand that before the reforms we also used to undertake rulemaking in areas not covered by the EU. For example, the senior



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managers regime was done through our own rulemaking, because the EU does not have something similar.

In very important areas of financial requirements, such as capital and liquidity for banks and insurers, we used to take the EU regulations. Over time, once the Government transfer it through statutory instruments after the Bill gets enacted, all of that will come to us. That requires us to propose rules and then write them.

In terms of how we are going to do that and how we are doing this at the moment in the areas where we have the power to do so, we will go through and look at the objectives Parliament has set us. If Parliament enacts the secondary objective on competitiveness and growth and maintains the primary objective of safety and soundness, for example, we will look at the measures that keep our banks and insurers safe and we will choose the measures that facilitate competitiveness and growth.

We will show that in our consultation papers, in our proposals and in the way we do our cost-benefit analyses, and we will write about it in a transparent way. As Sam says, that has changed the way we need to approach all of this. We have reorganised the directorate. We have had to expand it.

Q12 **Chair:** You are hiring extra people to do that.

Victoria Saporta: We are hiring extra people. We hired 40 extra people last year. We are now up to 256 from 215. It was 41. We are going to hire another 30 this year to be able to do that.

Q13 **Anthony Browne:** I want to ask a few questions about Basel 3.1 and ring-fencing. You have made your proposals on Basel 3.1. We have had some evidence and we also had a session with the CEOs of some of the banks that are concerned about the impact it would have on economic growth and in particular on SME lending, when you introduce the new scaling factor for SMEs. Do you accept that criticism? Is it going to be more expensive for banks to lend to small businesses as a result of this?

Sam Woods: Thanks for the question, Mr Browne. We are currently receiving evidence of that from the banks. We need to keep an open mind until it comes in. It is possible that it will be true because the scaling factor you referred to under Basel, which is a new preferential risk weight for SMEs, is a smaller reduction than the one we have currently inherited from the EU.

The actual evidence on this that is already available is from a couple of studies, one by Banque de France and another by the European Banking Authority. Those studies were about the effect of the SME discount factor on the availability and cost of finance for SMEs. Banque de France concluded that it had some effect. The European Banking Authority, which covers the whole of the EU, of course, concluded that any such effect was immaterial amongst the various other factors there were.



That is what we have at the moment. We will have more that comes in. It is worth mentioning that the main point of the reforms is to make sure we are capturing risk correctly. The reason to do that is, if you do not, that chicken comes home to roost when you have a downturn, and that is precisely when you want lending to be available. If banks are short on capital at that point, you will have a problem.

The particular problem we have—this is the collective “we” globally—is that we have allowed banks to model too much of their exposures in areas where the data is not that reliable. You get these ridiculous results. If you put the same set of assets into different banks’ models, there can be a difference of 13 times in the capital requirement that comes out. That has to be dealt with.

Q14 Anthony Browne: This would bring us out of alignment with the EU. We have Brexit freedoms; we can do that. Is there a competitiveness issue around that?

Sam Woods: There absolutely is a competitiveness issue. Whether it is positive or negative is the question. The choice we have in implementing this is between being global and being European. We have had a very close look around the rest of the world. We have published this, by the way.

Hong Kong, Switzerland, Singapore, Australia, Canada and, I confidently expect, the US, though they have not said so yet, will implement very fully. They will aim for full compliance with Basel. In our assessment, the EU is more of an outlier and is going to be non-compliant. It is already materially non-compliant, and we think it may move into the lowest grade on the basis of these deviations.

The competitiveness issue cuts in two directions. This is what we are going to have to consider based on the evidence that comes in. On the one hand, it is part of our licence to operate a massive global centre. Part of what attracts business to London is that people think we are a reliable regulator that plays by the global rules. That is attractive to firms because they can come here and rely on the fact that the people they are dealing with are properly regulated. That is on one side of the ledger.

On the other side of the ledger, if we have a slightly stricter interpretation than the EU but one that is not stricter than the rest of the world, will that give EU firms a competitive advantage against our firms? This is what we are going to have to weigh as we go through the process.

Q15 Anthony Browne: In America, unless it is changing, this will apply to internationally active banks. We will presumably carry on with what we inherited from the EU in applying it even to UK-only banks. Vicky is shaking her head. Is that not the case? A lot of lenders to SMEs are UK-only banks and small business banks.

Sam Woods: Let me bring in Vicky, if she is shaking her head.



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Anthony Browne: America only applies Basel to international banks. It does not apply Basel to US-only banks.

Victoria Saporta: Yes, we want to move there.

Q16 **Anthony Browne:** You want to move to the American system.

Victoria Saporta: Yes.

Sam Woods: To be clear, there is a cut-off for small banks. We are moving to the model in the sense that we are going to take our small banks out of the full Basel regime. Quite where you make the cut-off may well differ across jurisdictions.

Victoria Saporta: Yes. This is something we want to do now we are outside the EU. I can tell you this is the case because I have been a member of the Basel Committee, which sets these international standards, for many years. These standards are really set for global and internationally active banks. They are not really set for smaller banks. That is why we have the so-called "strong and simple" initiative. We published a consultation paper.

At the moment, as Sam says, this is for domestic banks with full balance sheets below £20 billion. We are giving them the option to opt out of the Basel regime.

Q17 **Anthony Browne:** The challenger banks that lend to small businesses would have the option of opting out of Basel 3.1.

Sam Woods: It depends on which challenger you mean. It depends on whether they are within the limit or not.

Anthony Browne: Yes, the ones below the threshold.

Victoria Saporta: Yes.

Q18 **Anthony Browne:** I have some questions about the ring-fence regime. We had the Skeoch review into this, which made various proposals. We had Keith Skeoch and John Vickers, the authors of the review, in front of us a few weeks ago. One of the things they both said was that we are not close—those were the words used by Keith Skeoch—to knowing when a bank is fully resolvable without recourse to the taxpayer. This was in the light of questioning about whether, if we do proper recovery and resolution for the banks, we would still need a ring-fencing regime. Do you agree that banks are not resolvable yet without recourse to the taxpayer?

Sam Woods: It was a very interesting session. I was particularly impressed by John Vickers's grasp of Solvency II, which struck me as beyond the call of duty in his case. He seemed to understand it very well.

We have said that we consider we should be able to resolve large banks at the moment, but not without risk. It would be a crazy thing for any



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central bank or regulator to say they knew with 100% confidence that, if a big bank blew up, they were going to be able to take care of it without any collateral damage. We would never say such a thing.

We have said we think that, with the combination of things we have in place, including ring-fencing but also bail-in arrangements, higher capital and things of that kind, we should be able to resolve a bank in a way that does not create a very large amount of disorder. Of course, you will not know until you get there.

Q19 Anthony Browne: Yes, that is the point I was making. Do you accept the argument that, if you are very confident you can resolve banks without recourse to the taxpayer, you do not need the ring-fencing regime, or will you always need the ring-fencing regime?

Sam Woods: I do not agree with that. By the way, there are many sensible changes we could make to the regime, including those Keith Skeoch recommended.

In this zone, he suggested—this is sensible—that we look at that question and see how the two regimes of ring-fencing and resolution fit together. That is a fair challenge to us. The Government have issued a call for evidence on that; it is now out there. He left the idea further out that it could possibly lead to that. That is how I took what he said.

I am sceptical about that for two reasons. First—Andrew mentioned this in the letter the Chair was referring to—these two things are complements, not substitutes. Our assessment of the resolvability of firms within the ring-fence depends in part on the ring-fence, which we think could be very useful for us in a resolution situation. Particularly if a big cross-border bank went bust, you can imagine that it might be extremely important to be able to do something different with the UK part of it, for instance.

The second reason is that the point of ring-fencing is not all about the death of a bank. It is also about the going concern, in the sense that the Independent Commission on Banking said—the Government and Parliament at the time agreed with this—there is a particular thing the banks do, which is holding all of our day-to-day deposits and those of small firms, that is very sensitive and therefore we should have the ability to have a bit of extra resilience around that piece.

What does that mean? It means a bit more capital around that part of banks' businesses. As a practical matter, you cannot do that if you do not have a separate entity. That part of the debate is unaffected by the resolution part.

Q20 Anthony Browne: What are the most important reforms you could make to the ring-fencing regime without compromising that ability to help resolvability?



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Sam Woods: We can do everything that Keith Skeoch recommended. There was a series of things in there. Some of them are very sensible adjustments. I can give you a good example. At the moment, the definition of a relevant financial institution—that is, one to which a ring-fenced bank cannot lend—includes high street IFAs. There may be issues with high street IFAs, and this Committee has taken interest in them, but them bringing down the banking sector is not one of them. That has just landed on the wrong side of the line.

Another one is the ability to hedge mortality risk. That is fair enough. If banks want to provide equity-release mortgages, we do not want them to hold mortality risk. They should be able to hedge that. It will happen on the insurance side mostly.

There is one that requires a little bit of thought but is absolutely right in principle. His panel recommended that banks that do not do any investment banking activity at all, or that only do a tiny bit, could be released from the regime. In principle, that is okay.

Anthony Browne: That is if it is less than 1%.

Sam Woods: Yes, but the devil is in the detail. How much is okay? There is also a measurement issue. It would not make any sense at all if you had a bank that only did retail in the UK but was internationally a bank with a lot of investment banking activity. It would be crazy to say, “They do not do it in the UK so they can use UK deposits to support the activity”. Then you would have an unlevel playing field. Those just need to be navigated. The principle of the thing is right.

Q21 **Anthony Browne:** I have one final question. You said that the Skeoch reforms are a good idea. There was a reform proposed by the Government to increase the asset threshold from £25 billion to £35 billion, which would bring certain banks out of the ring-fence. Do you agree with the Government or with Keith Skeoch?

Sam Woods: We do not think there is a financial stability or safety and soundness problem. I was involved in the original work on the £25 billion. It has been flat since, and it is reasonable for it to go up a bit.

You would not want it to go too high, first, because of the safety and soundness aspect—£35 billion is a lot of money—and, secondly, because of the competitive aspect. This was what was weighing on the Skeoch panel’s mind in particular. If you bring it up too high, you create an unlevel playing field between those banks that have more deposits than that and have to have them in the ring-fence and others that just come in for a chunk. I do not want to speak for Keith, but I think that was what they were thinking about.

Q22 **Chair:** Will you use that same line, wherever it ends up being drawn, for the changes to 3.1 as well?

Sam Woods: Do you mean in terms of the cut-off?



Chair: Yes. Would it not make sense to use the same cut-off?

Sam Woods: That is a good point. We want to align things as much as possible. At the moment, we think £20 billion is the right place to draw that line. We do have two different lines there.

On “strong and simple”, I should just say that we have not yet set out what we are planning to do on capital. People should not assume there is no Basel in there at all, but we do intend that the regime will not be the full Basel regime, including all the buffers.

Q23 **Andrea Leadsom:** Good morning. I was very interested in your comments on the ring-fencing. Just to be clear, Sam, you are saying that ring-fencing should stay because it is an integral part of making a bank resolvable. Is that correct?

Sam Woods: Yes, for that reason and for the resilience of those day-to-day banking activities. May I add one more?

Andrea Leadsom: Yes.

Sam Woods: It is a brief one. I admit this is slightly more contentious, but I happen to believe it. Ring-fencing is good for competitiveness. Why do I say that? Many people would disagree. If you want to host a giant financial centre, you have to be very open. We are one of the most open jurisdictions in the world in terms of our regulatory approach. In fact, the IMF says we are in a class of our own. We have £6.3 trillion of assets and 150 bank branches. There are lots of ways of describing that phenomenon.

You have to be very open, much more open than it actually makes sense to be for your day-to-day banking activity. If we were as open about that set of activity as we are about what goes on on the wholesale side, I would imagine this Committee would find it quite difficult, given the sorts of things we have swishing in and out across the border.

If your industrial strategy is to have a giant trading centre in a medium-sized economy, you need to create that distinction, partly to have safety and soundness here but also so you can be really very open on the wholesale side.

Q24 **Andrea Leadsom:** Yes, I completely agree with that. That is exactly right. That is the balance. It plays into the secondary objective of competitiveness too, does it not?

Going to the top level, is leaving the EU an opportunity for UK financial services as a global centre? Could I ask each of you for a “yes” or “no”, with perhaps just a little bit of explanation?

Julia Black: We are demonstrating that, yes, it is creating opportunities. After the crisis, the EU moved to a different model of financial regulation. It moved from a model of directives that could be implemented at member state level in the most appropriate way to a model with a much



greater focus on using regulations and maximum harmonisation. That is what you need to do when you are trying to regulate 27 or 28 member states: you need to make sure you set a bar below which nobody can fall. We also know that across the 27 different member states everybody has a very different model for their financial system, which includes their savings products and all sorts of different things.

There were certain elements we argued for at European level that we were not able to do, though we needed to do them, for those other wider reasons because we were regulating that wider market. Those considerations fall away for the UK. We have the opportunity to tailor those rules as appropriate for the UK economy and the wider UK financial markets. We are demonstrating that we are very open to doing that.

- Q25 **Andrea Leadsom:** Yes, I agree. Taking that a step further, in UK financial services there is this argument that being seen as safe is a competitive advantage. Does the materiality of UK financial services, as Sam says, to a medium-sized economy mean that, because we have such a huge financial services sector, we can take advantage of being strong and stable, to coin a phrase, in a global environment? Can that be a competitive advantage in itself?

Julia Black: Absolutely, yes. There is research on this that has been done by looking at spreads in equity markets. Those spreads are much narrower if there is trust in the market, if there is a belief that it is fair and that there is market integrity. The same goes in relation to credit ratings for banks. We want people to believe that it is a trustworthy place to do business, with high standards, and that everybody is going to be held to the same standards. That is really important. That is absolutely key to our competitiveness and making us attractive as a global financial centre. Having strong regulation is absolutely fundamental to that.

- Q26 **Andrea Leadsom:** Having been very much burned in the UK—people were burned across the world, but very much so in the UK—by the financial crisis, it certainly seems to me that it is an advantage to be able to regulate ourselves and not to join the club, going in the same direction as the herd towards retrenchment, shutting things down and overregulation. We can be flexible and lift off the brakes when things are going well. Is that also an advantage? Perhaps, Sam, you could address that.

Sam Woods: Yes, it is. We can take away stuff we never thought had any point anyway. For instance, we have taken away something called intermediate parent undertaking. We were always against it; we have taken it away. The bonus cap is perhaps not a very popular one, but we think it is a pointless regulation and we propose to take it away. There are various things of that kind.

We can then navigate on our own in a way that works better for our market, exactly in the way you just described. We need to do it intelligently. To take the Basel 3.1 example, the strategic issue there—



the Committee should have this in its mind—is whether we want to be compliant with Basel. There are basically four buckets when Basel assesses you: you can be compliant, largely compliant, materially non-compliant or non-compliant.

Our argument is not that we have to be in the top bucket and perfectly compliant. Many others will be there. We think we can do some tailoring for our market based on the evidence we have. We need to be in that second bucket. That is just to illustrate the way we are doing it. You could take the notion that strength is good for competitiveness to a ridiculous degree, but at some point it might tip over. That is how we think about it.

Q27 Andrea Leadsom: Can I just change the topic slightly and come on to competitiveness amongst banks? Sam, can you expand a bit on internal modelling versus the standardised approach? It has always seemed to me that there is a real advantage to some banks that have managed to do internal modelling. You just gave a statistic of how much capital they are not having to provide because they are working it out for themselves. Are banks now turning to less risky assets or are they underestimating their risk? Is there a problem building up there?

Sam Woods: You are right: this is a very important competition topic. For some time, we have been troubled by the size of the gap between model risk weights, particularly for UK mortgages, and standardised risk weights, from the point of view of both competition and safety and soundness.

I am going to bring in Vicky, if I may. Through a combination of some things we are doing ourselves and the implementation of Basel, we are bringing down the higher of those, the standardised risk weights. We argued for that in Basel and we got it agreed; we think it is safe to do that. We are also taking steps, in terms of some flaws in the move to hybrid models, to bring up the other. We published some research just last week, alongside a speech Vicky gave, which has in it some of the data.

Victoria Saporta: You have captured it. In terms of capital requirements, as Sam said, the biggest issue between big banks and smaller banks was that big banks, particularly for low loan-to-value mortgages, had to hold considerably less capital than smaller banks.

That was not particularly good for competition, for obvious reasons. Indeed, it was called out by the Competition and Markets Authority. It was also not particularly good for safety and soundness because it pushed the smaller banks towards the riskier end of the mortgage curve. Of course, those banks tend to be more concentrated and less diversified. We wanted to change that.

Going back to your question about EU opportunities, when the Competition and Markets Authority report came out, we were part of the



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EU. The capital requirements in the minimum standard for Pillar 1 were what is known as maximum harmonised. We could not change them, even to bring them up, for the bigger banks that were part of the internal model.

We went to the Basel Committee and we negotiated some international standards changes with a view to the EU implementing them or, if the referendum turned out as it did, us implementing them. That meant, first, standardised risk weights for low loan-to-value mortgages went down to something closer to what was produced for internal models. We also introduced this output floor, with floors across the books of the big banks that have internal models in terms of the amount of capital that can go down below it, which brought the internal model firms up. That reduced the gap.

On top of that, we have done some other reforms. For example, the banks that used internal models produced vastly different results when we stressed the mortgage book. That depended on whether they used a point-in-time model or a through-the-cycle model. That did not seem right.

We introduced a change for these banks some time ago, which is being implemented right now, so that all of them produce hybrid models that are somewhere between the two. You want to reflect the risks that are current and also take a longer view. That is also reducing the gap. As a result, we think that is going to be good for safety and soundness and good for competition.

Q28 **Andrea Leadsom:** Without wanting to put words into your mouth, would it be fair to say that leaving the EU has been good for competition and for the safety of the UK financial services sector?

Victoria Saporta: Leaving the EU produces opportunities for us to manage our financial system in a way that is appropriate while also maintaining the global alignment that is also important for having the open system we have now. As you said, Dame Andrea, that comes from both sides of the coin. It means we can tailor things to UK circumstances to facilitate competitiveness, but, given that we have a massive financial system in a medium-size economy, it also means, on the other side, we can be macroprudentially flexible when we see risks arising and that we are not constrained by a maximum harmonised system.

Q29 **Siobhain McDonagh:** Could you think of a single policy you might be involved in that would be less popular with the general public than removing bankers' bonuses?

Sam Woods: No, I cannot. It is probably the single most unpopular thing we have proposed.

Q30 **Siobhain McDonagh:** How would you square the comments of the Governor of the Bank of England on curbing wages in order not to impact inflation at the same time as wanting to remove bankers' bonuses?



Sam Woods: Our proposal to remove bankers' bonuses is based on the evidence we have, which is quite convincing, that the only effect of that cap has been to increase the fixed pay of bankers. We thought it would have that effect. We thought it would have no effect on constraining bankers' pay.

Our team has done some research on this. To give you a flavour on this, what we tend to see is that, as bankers come close to the cap—it is either 100% or 200% of their pay; these are very large bonuses—what happens is that in the following year their base pay gets an extra boost of about 15%. It is very unhelpful from that point of view. It actually raises their salaries.

It also means that less of what these bankers get paid is deferred and spread out over time. Why do we care about that? The system we had before the financial crisis in many of our banks was that these bonuses were 100% cash at year-end. That is a completely crazy system. Even quite reasonable people may do some quite strange things when they are presented with that way of being paid.

The idea of holding some of it back is that, if it then turns out that whatever was done was not as good as it appeared, if that risk comes home to roost, you can then cancel it. We think that is a much better way to go. The bonus cap works against that.

Q31 Siobhain McDonagh: Can you understand the public's scepticism at the ability of the PRA or the Bank of England to do anything about this group of people? Their risk-taking was seen to wreck the UK economy and the average taxpayer had to bail the banks out. People now find themselves with collapsing standards of living and falling wages for this year and next year, through no fault of their own.

Sam Woods: I understand the scepticism. I was very closely involved in those events at the time. As a Treasury official, I was painfully aware of the cost for households.

The way people should think about this is that two things were done in response to that, on pay in particular. One, which we led the way on and which is very important, is the thing I was just talking about, which is making sure people cannot take all of these bonuses at year-end, which is really a very dangerous system. We are absolutely going to stick with that.

The other thing that was done at EU level was this bonus cap. As I say, this has precisely the opposite effect. It is very unhelpful. The extent to which bankers are exposed to the problems they create is going to be greater if we remove that bonus cap. It is a very difficult point to get across, but the evidence really does show that very clearly. That is why we are taking that forward. We are aware that it is something that appears, on first blush, to be something that would lead to an increase in bankers' pay, but we do not think it will have that effect.



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- Q32 **Siobhain McDonagh:** Does the proposal to remove the cap not just suggest to people that there is no way these people's incomes can be controlled? The system you use does not matter. The cap on bonuses actually is not a cap. Most of us would be amazed to get a bonus of 100%, let alone 200%, of our annual income.

Sam Woods: I agree.

- Q33 **Siobhain McDonagh:** The cap does not work, so people's annual salary increases. We get rid of the control of the cap, but people's annual income will not decrease either. There is no form of control either that can be applied or that there is a will to apply.

Sam Woods: Of course I have sympathy with a lot of that. I understand how people feel about people who are very highly paid, including bankers.

- Q34 **Siobhain McDonagh:** They are people who take no responsibility for the risk they take with other people's money. I do not wish to suggest that this is just green envy. We take the responsibility for their actions; they get the bonus.

Sam Woods: We do take responsibility for trying to make sure the incentives they have are directed towards managing those risks in the right way. That is part of our job. It is not part of our job to set absolute pay levels for bankers. That is negotiated in the private sector between shareholders and employees. We take an interest in it because bankers being paid too much can mean there is not enough capital, which can lead to a problem for us.

Our strong belief, which is quite thoroughly backed up by the evidence, is that the right way to do that is through deferral, the ability to cancel bonuses, the ability to claw back and all of those things. This bonus cap has a completely perverse effect—we said it would, and the evidence shows it has had this effect—of boosting base pay for bankers and making them less sensitive to risk. The bonus cap cuts against everything you are saying people worry about.

- Q35 **Siobhain McDonagh:** It is hard to imagine being less sensitive to risk than what we went through during the financial crisis.

Sam Woods: I agree, but you can run the following thought experiment. The system you had before the crisis in many of our largest institutions was that bankers earn these bonuses and they were all paid out in cash at year-end. That is the same as it being paid in salary, though it is not monthly; it is paid at the end of the year.

The effect of the bonus cap, perversely—though we expected this—has been to push more of the pay in that direction, which in our view is nuts. We always thought this was a bad idea. It has proved to be a bad idea. That is why we are getting rid of it. These arguments are a little bit nuanced. I understand that it is not the easiest thing to explain to



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members of the public why this is a good thing for the safety of our system.

- Q36 Siobhain McDonagh:** I always think members of the public are a lot brighter than politicians or most people in positions of authority think they are. Their feeling is one of injustice. There are two sets of rules going on here. You either get your money by having an excessive bonus or you get your money by having your annual salary increased. Whatever measure it is, they still come off the best and the taxpayer still carries the risk.

Would you look at using a whole-company pay policy to determine the salaries of senior managers in the banking sector? That would mean the board could not just look at how their highest members of staff get paid, what bonus they get and all the rest of it, without having to consider what the young woman on the reception gets paid, what the lady who is cleaning their office gets paid and what the fairest way of dealing with the whole company would be.

Sam Woods: Yes, and we do take an interest in companies' remuneration policies. The objective you have given us is safety and soundness. We focus on that in our review. That goes to the issue about the structure of how people are paid.

There is another tension that is provided by the market, by shareholders. Shareholders also do not like bankers to be paid more than they have to be paid. You see quite convincing evidence in terms of share price reactions to announcement by banks about their cost base. That is the other pressure there. We do absolutely take interest in banks' policies for those reasons.

- Q37 Danny Kruger:** I want to ask some questions about the new responsibilities you have. Vicky, this goes back to some of the points you made earlier about the recruitment of staff for these new functions. I would be interested in your reflections about the challenges you have had. You said you have recruited 40 new people. A while ago Sam was talking about the need for 100 staff and saying that you are taking more on soon. Are you now confident that you are going to be okay resource-wise? Secondly, can you talk us through the challenges you have had? Why is there such difficulty in recruiting for the regulator in this space?

Victoria Saporta: Just to clarify—I am in Sam's hands here—the PRA as a whole has recruited 100, of which 40¹ are in my particular directorate. The need to hire some of the other staff was initially related to our exit from the EU. For example, we have to do authorisations for branches that used to passport. There are also some new risks, such as operational resilience and cyber resilience. The 100 number is correct; 40 of those are in these new functions.

¹ Following the hearing the Bank of England informed the Treasury Committee that the precise number was 41 as stated earlier in the hearing at Q12.



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Relative to our expectations, we have been quite successful in the recruitment we have had over the past year. We did throw a lot into it in terms of reaching out as much as we could and making the process as efficient as possible.

Q38 Danny Kruger: Do they come mostly from within the regulatory sector or are you getting people from the banks?

Victoria Saporta: It depends on the function. Some of them come from the regulatory sector and the Civil Service, but some of them come from consultancy firms. The big six are a big source of recruitment, particularly for actuaries. That is an area where we did have some issues.

Q39 Danny Kruger: You are competing with some pretty big salaries.

Victoria Saporta: We are competing with some big salaries, yes, particularly for actuarial staff in my area. In some other areas, cyber specialism is also very competitive.

Q40 Danny Kruger: I understand the challenges there. Maybe we need to offer big bonuses—do not answer that.

Sam Woods: I think not!

Danny Kruger: Have you needed to deprioritise any particular areas of the regulator's work in order to take on these new responsibilities?

Sam Woods: The picture to have in your mind is that we have gone up by pretty much precisely 100 heads this year, the financial year which has just come to an end. During that, we have not had to deprioritise very significantly.

We are proposing a much tighter budget settlement for this coming year, in view of the pressures there are on everyone at the moment. We will be broadly flat on heads for the next year. As Vicky mentioned earlier, her area still needs to go up a bit more. We have had to rearrange some things internally. We have mainly looked for areas where we have put out enough guidance for firms to be pushing on a bit more without having us all over them.

There are a couple of areas. One is operational resilience. Another is climate, which we are still very interested in, but we think firms have some progress to make before we come back again. We have focused some of our work. For instance, we are doing some work on critical third parties. We need to do that.

Over this last year, the answer is no. In the coming year, because we want to hold ourselves flat, we are going to have to do a bit more of that.

Q41 Danny Kruger: That is interesting. It will be interesting to see how that develops. On the cost-benefit analysis requirement that you now have, I was struck by an article in the *FT* by Helen Thomas in January. She recognises the value of cost-benefit analysis, but she says, "The danger is that analysis that is something of an art becomes held up as a



pseudoscience, or a way of getting at The Right Answer. The battle over the merits of regulation itself becomes a battle over the inputs and workings in weighing costs and benefits”.

Do you recognise the danger of trying to be over-precise? This new obligation puts a requirement on you to get very precise about something that fundamentally is impossible to be precise about.

Sam Woods: Yes, I do. Julia, do you want to come in?

Julia Black: Yes, I am very happy to take this. I do recognise that danger. There is an absolute value to cost-benefit analysis. One needs to calibrate regulation appropriately. We cannot have excess burdens, et cetera. Often, the benefits are quite long-term and quite difficult to determine.

It is sometimes quite easy to focus on short-term burdens such as compliance costs, for example, without really understanding the benefits, particularly when the costs are quite concentrated on industry, as they are, and the benefits are broadly distributed across the tax-paying public and the public purse. As we have just been talking about in relation to Solvency II, these things are a matter of judgment. How much risk do you want to take? There is a risk-benefit calculation as well as a cost-benefit calculation.

Danny Kruger: Yes, that is right.

Julia Black: Very much along the lines of Helen Thomas’s article, we need to do this work, but we need to do it sensibly and recognise that it is possibly better to be generally right than precisely wrong.

Q42 **Danny Kruger:** The implication of your point that the costs are more obvious than the benefits is that the bias in a cost-benefit analysis might therefore lead you to downgrade the need for particular regulations because you do not recognise the benefits thereof. Is that a danger?

Julia Black: It can be. You have to caution against that. You have to caution against the fact that the benefits might not always be calculable or they may appear some long time in the future, which is the issue we face in relation to climate, et cetera. It is something to be dealt with. With that said, there is also a good long history of dealing with cost-benefit analysis. Governments have been doing it for decades. We should be able to do this in a mature and sensible way and have a mature and sensible debate around it.

Q43 **Danny Kruger:** That is understood. Going forward, then, the challenge will be to determine how precise you can be and what burdens you can place both on yourselves and also on firms in terms of getting data to understand the costs and risks. How will you go about determining whether you are putting a proportionate burden on the firms you are regulating?



Sam Woods: Maybe I can bring in Vicky, who does a lot of work on this. You can see it in quite a lot of the things we do at the moment. We have been touching on Basel, which is currently a very live one, but we also have in the Bill, if you approve it, this proposal for an additional CBA panel, which will help us in our work. Vicky, did you want to say a bit more about that?

Victoria Saporta: Yes. In direct answer to Mr Kruger, we will need to ask firms for a little more data to be able to do our job appropriately. Sometimes when we have uncertainty or we do not have the data in-house, we will have to ask for a bit more.

We have a mechanism within the PRA that looks at the data burden across the different areas to particular firms and tries to ensure proportionality. I might ask for data from my area, but my colleague might be asking for data from another area. We need to make sure it is proportionate.

In terms of the cost-benefit analysis panel, this is one of the accountability measures under the Bill. We have already started the work to set it up. Before a proposal is live, the panel is going to look at it in terms of the cost-benefit analysis. It is going to be subject to materiality threshold.

Q44 **Danny Kruger:** That is helpful. There is one last question from me, which follows on from that. There is a new requirement to maintain a continuous review of your rules. Again, how do you operationalise that? How much of a burden is that going to put on you? How do you interpret that requirement?

Victoria Saporta: I should say that we already review some rules. Just to give you an example, we published an evaluation of the SMCR regime back in 2020. That was under our control; the review was done under our own rulemaking authority. This particular accountability measure has made us rethink what we are doing. We will have to publish our approach on reviewing our reforms.

We are going to be thinking about the appropriate time period between a reform being put in place and having the evidence to be able to say whether it works. We are going to be thinking about the burden on the firms. In order to do an evaluation, you need to have appropriate data, et cetera. On the other hand, as experience has shown, the underlying economic dynamics change and so it is good to review the reforms and feed back. We will be publishing an approach on that.

Q45 **Anne Marie Morris:** Can we turn to liability-driven investment funds or LDIs? I will focus my questions principally to Victoria, but, Sam, if you want to come in, please do. We appreciate that the PRA does not regulate the funds, the LDIs, and nor does it regulate the pension funds that invest in them. You do regulate the banks that were the counterparties. Vicky, at the time this became such a big issue last year, what was the



bank exposure to risky pensions and LDI funds? How has that changed?

Victoria Saporta: You are absolutely right that banks were exposed to LDI funds mainly through their provision of gilt repos to them. As I was not involved in the counterparty risk management—it was more an action for supervision—I do not have the precise figures in my head. Sam might have them. This is backward-looking, so it does not create an issue for him. He could give them to you.

What was striking to me, with my policy hat on and more generally as a member of Sam's executive team, was that it revealed weaknesses in banks' counterparty risk modelling and management, which was something we were already on to since the failure of Archegos, which was a private fund.

For example, the banks did not know how much of the counterparty credit risk was in relation to pension funds because gilt repos were considered quite a safe asset, as we know. From the banks' perspective, they were lending this asset to the pension funds and they did not actively counterparty-risk-manage it. That is something we are looking into, but for the figures I would have to refer to Sam.

Sam Woods: Yes, I can just add to that very briefly. The level of exposure the banks had was not of itself excessive. At no point through this process were we worried that we had a safety and soundness issue for the banks.

The problem we had was that, in our assessment, the banks did not have enough of an understanding of the risks to which their counterparties, these LDI funds, were exposed. Specifically, the LDI funds did not have anything like enough room to manoeuvre to cover a 140-basis point increase in 30-year yields, which is what we saw.

On the one hand, that was twice as big as anything we have seen before. That "twice as big" is compared to the dash for cash that happened in 2020 with Covid arriving, and it was three times bigger than any other stress. You can argue about whether it is unreasonable for them to have that level of cover. The last time I was able to check, which was at the end of January, the level of resilience in the LDI funds, the counterparty exposures, were much higher, around 300 basis points. That risk has come down quite considerably for the moment.

Q46 **Anne Marie Morris:** That is very helpful. Vicky, you say you are looking at this and taking steps. Going forward, one of the challenges is clearly around transparency. We need to set very clear guidance and criteria to ensure this sort of problem cannot happen again and, indeed, as the regulator, ensure you have visibility on this and how it is going wrong. When you say you are taking steps to ensure that banks' counterparty risk is not going forward in the way it was last year, what are the steps you are taking?



Victoria Saporta: It is a supervisory priority amongst my supervisory colleagues. Indeed, in the supervisory priority letter they issued in January, they set out counterparty risk management. They go into the banks—this is the way I think about it—that have material counterparty credit risk. Those tend to be, though not exclusively, the foreign banks that operate in the UK, the investment banks, effectively, and some of the UK banks that have material investment banking activities. These are the banks that take the most counterparty credit risk.

It is effectively going into these banks, looking at their risk management and, as you say, looking precisely at whether they have the data systems to be able to pull out their exposure to a particular counterparty across all the operations of the bank. Unfortunately, that is not something all of them had. This is a lesson we learned from Archegos. If they do not have that capability, we require them to have it through supervision. If supervision is not sufficient, this will be thrown back to me and we might need to make some rules.

Q47 **Anne Marie Morris:** There are quite a lot of banks to be supervised. Given that we are in the position that we are, albeit you have indicated that things are rather better now than they were, what assurance can you give the Committee that we are in a safe place? In what sort of timeframe will you have looked at all of the banks that potentially have these problems so you are then able to decide whether you need to put in place new regulation and new frameworks?

Victoria Saporta: We should be in a position to make that call by the end of the year. It is a priority for this particular year. Going back to Mr Kruger's question, although we are trying to streamline now we are outside the EU, in this particular field there might be a requirement for data reporting. We might need to require more to be able to analyse it. If we find that there are still weaknesses by the end of the year, we will have to put the pressure up and increase the requirements in a particular area.

Sam Woods: May I add one brief point? Again, I am staying on the right side of my recusal on this. There is a parallel effort, which is to get that higher standard of resilience into the LDI sector itself. That was there quite recently. That has all been done through supervisory persuasion and guidance from the various bodies involved. There is a question about how you make sure that is sustained. That is relevant to the question. If it somehow proves impossible to sustain it on that side of the barrier, you would have more of a question for bank supervisors: "Okay, this is not being taken care of on the other side. Therefore, what more do we need to do on the banking side?"

Q48 **Anne Marie Morris:** That is very helpful. Julia, I am now going to turn to you as the external member and look at this in a broader way. Clearly, there were regulatory failures. There were a lot of regulators involved in all of this. Most people identify the Pensions Regulator as the prime regulator that perhaps was found wanting. Clearly, you do not represent



them, but there does seem to me to be a question about whether the PRA was also, to some extent, asleep on the job.

In a sense, as regulators, you have to work together. While you must focus relentlessly on your particular mandate and remit, none the less there were things going on in other people's remits that will have an impact. We only have to look at the impact of interest rates being as low as they were for as long as they were, which impacted behaviour and caused the whole investment problem that led to leveraged LDIs, which were really what caused much of the problem.

What might or could the PRA have done differently? Given the big picture, what would you advise them now, as an external member, to do differently? Do you have any other comments on the regulatory system more broadly, looking at all the regulators that were involved in this?

Julia Black: You are right: it is a complicated patchwork of regulators. It is worth, however, drawing back a little bit. Back in 2018 before any of this hit the fan, as it were, the FPC, which is another piece of the regulatory architecture, identified LDIs as a potential source of risk. The FPC worked with the Pensions Regulator on the 80% of LDI funds that are segregated and not on the 15% or 20% that are pooled. It was the pooled LDI firms where the challenges came through.

As has been said, this was a tail risk or a black swan event, as some might call it, but for us as the PRA it does show how things that happen in non-bank financial institutions really blow back and reverberate in the banking system. These two incidents, plus the dash for cash in treasuries in the States in 2020, have really called attention to the different channels by which that can happen.

In particular, it can happen through the leveraged lending that is happening in the market. We have quite an interesting dynamic going on. One of the post-crisis reforms was to increase collateral requirements with regards to leveraged lending to make it safer. That is great; that is very good. In volatility, what happens is you have an increase in your margin requirements, which can happen really quickly. That means you have a massive problem with liquidity.

Those institutions had challenges getting liquidity, which happened in the pooled LDI funds partly because of their organisational structure and partly because of some operational issues with custodians and all the rest of it. That meant they had to sell assets into a falling market, et cetera. It is through that margining and liquidity risk. That is one way.

The second is through the collateral risks faced by your counterparties. The third is through correlations in asset values between your collateral that you posted and your collateralised securities. There is a whole channel there. That second one is about credit counterparties and how exposed you are across all the channels of your business as a bank to the same counterparty. Again, this is about that bit of join-up that is needed in the bank.



For me, the other thing for regulators to do is about that E. M. Forster saying, "Only connect". We need to do that joining up the dots. We need to do it internationally as well as nationally. One of the pieces of architecture Parliament did put in place post crisis was to have the FPC and the PRC, the macro and the micro together. That is a really good invention. It works really well in the UK. We are looked on by other overseas systems for the way that works quite well together. We get that marrying-up.

We do have to pull the regulators together. In the same way the banks need to pull together their knowledge of what they are doing, we need to pull together at an aggregate level what we can see happening at system level. Each of us can see a little bit of it, but it is only by coming together that we have a hope of seeing more of it. I am not sure we will ever see all of it, certainly not in real time. I hope that helps.

Anne Marie Morris: It absolutely helps. I hope those responsible across all the regulators were listening. If we can make that happen, we will be in a much better place.

Q49 **Emma Hardy:** Good morning, everyone. Last year you completed a climate stress test of the banking and insurance sectors. Are UK banks and insurers prepared for the climate change and net zero transitions?

Sam Woods: Thanks for the question, Ms Hardy. We are very glad this is coming up in this hearing because that was an important piece of work for us. The answer is that they are partially prepared. Why do I say that? If you look at the results of the various scenarios we ran, we concluded that in no individual scenario was there likely to be a threat to solvency or safety and soundness, but we also found that the potential headwind could reduce profitability by 10% to 15%, which is a very significant number. The difference between managing that effectively and not managing that effectively could be the difference between a firm being successful or not. It is a partial pass in that case.

The other way in which it is partial is a more specific point, which is quite important. In that test, we did not do a market stress. For example, we said, "To what extent will more of your mortgages go bust if no action is taken on climate change because there is more flooding?" We asked those kinds of questions.

Emma Hardy: I will question you on that in more detail in a moment.

Sam Woods: We will come back to that. We did not do a market stress. I always say the best way to think about this is to imagine the Palace of Westminster was flooded and therefore you suddenly had a much more aggressive policy response to climate change. This might be a good thing or a bad thing; it depends on your view on climate.

In that scenario, it is not unreasonable to think that a big policy shift could have a big effect in the financial markets. The reason I mention this



is, unlike the other types of exposures we are talking about, that is something that can hit very suddenly. We have not yet tested that. When we have time, we should. That is one that could occur more suddenly and would therefore be more threatening from a safety and soundness point of view.

Q50 Emma Hardy: Because you raised mortgages and flooding, I want to jump to that and then jump back, if I can. One of the risks from climate change is increased flooding. I believe flooding is inevitable; most people believe flooding is going to be inevitable. This could make houses with mortgages more difficult to sell. What impact could that have? What actions could the PRA take? Could you see yourselves stepping in with flooding-related capital requirements, if some banks fail to model the effects properly? Where do you see your role in this?

Sam Woods: We are doing a lot of work on this currently. We are shortly going to publish some more thoughts on that. Let me give you at least my perspective. Initially, when I thought about this question, my instinct was that there might be a question as to whether, in order to capture climate risks precisely—they tend not to manifest within the one-year window, which is what most of our capital requirements use—you might need a new slab of capital to deal with climate risks.

I have become more sceptical about that proposition through time. I have been quite considerably influenced by the results of our BES, the biennial exploratory scenario, although we are not using that set capital requirements. The evidence that provided—that this is something that is going to manifest over a long time and is more of a pay-as-you-go type of risk than a capitalise-upfront risk—had some importance.

Let me explain what will start to happen. We already see bits of this, by the way, but it will become increasingly demanding on this front. We will not have a whole extra wedge of capital. For instance, Vicky was talking earlier about modelling capital requirements, where firms model how much money they might lose on their mortgages. When they do that, they look at things like the probability of default and the loss given default and they use those as inputs in those models.

We expect—we are seeing a bit of it already and we expect to see more of it through time—people to be able to capture these climate effects in there in a very granular way. In the study, something like 45% of the losses came from 10% of the UK; it was something of that sort. If you are lending in those areas, have you taken account of it? What is going to happen here is that some firms will be better than others. We will be able to say, “Okay, this firm has really got on to that. This other firm has not. They need to come up to scratch on it”.

I think this is going to come into capital in that more granular way. That is my personal view; it is not a settled policy view.

Q51 Emma Hardy: How concerned should people with mortgages in flood-



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prone be at the moment? You are saying that you expect to see some businesses taking account of flooding. Are you therefore expecting to see that some banks move away from lending in certain areas of the country? Are they going to move away from lending in some places? What would your role be if they do?

Sam Woods: You are right to highlight that risk on the other side of this. Whatever the banks choose to do, it is our job to make sure they have the right amount of capital for what could happen to those particular exposures. This will build quite slowly through time. Some of this already occurs. Some lenders will not lend for, and indeed some insurers will not insure, homes with a certain exposure to flood risk. It is already with us to some extent.

If the effect of climate change or other things meant there were parts of the country that, as a matter of wider Government policy, we wanted to be inhabited but could not get funding from banks or could not get insured, that would be a question for the Government to look into.

We had a live example of this quite recently with cladding. As I think of it, cladding is an analogy of how this could go wrong. You could end up in a situation where a lot of people are trapped in a very difficult position. That will be a question for Government, not us, but we need to be conscious of our input into one part of that.

Q52 **Emma Hardy:** You mentioned that it will build slowly through time. Considering that mortgages are 20 or 25 years when they are taken out, can you define what sort of time period you are talking about? Is this over the life of one mortgage? How quickly are you expecting to see this? You have already said that some sectors are already starting to take action on this in some areas.

Sam Woods: It is hard to answer that with confidence. In a coming single-figure number of years, I hope we will be getting from banks a much better articulation of this set of risks, and we will get it from insurers as well. That will start to appear in capital requirements. For instance, firms do a thing called an ICAAP, where they tell us how much capital they think they will need. We are starting to see firms consider this in there. I would expect that to be more prominent in a few years' time.

Whether that means, within that timeframe, a big change in quantum I am not so sure because of the very long timeframe over which these risks will manifest. My assessment would be that people do not need to be worried in the short term about the problem you are identifying manifesting in a large way, but through time it is a big strategic issue.

Q53 **Emma Hardy:** Bearing in mind that you have said it is a big strategic issue and that it is going to manifest in time, are you concerned that the Prudential Regulation Committee remit letter from the Chancellor omitted the reference to climate change and net zero that was inserted in 2021?



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It says only that you should have regard to “the Government’s ambition for the provision of sustainable finance”. Is that a signal from the Government that they do not want the PRA in the business of advancing net zero?

Sam Woods: We did not read the letter in that way. It was clear that the letter is more focused in what it is asking us to take account of than the previous letter was. It is very much on growth and competitiveness. As you say, sustainability comes up underneath one of those. It is helpful to have that clarity from the Government.

For our part, we do attach weight to that change, but, as it happens and as I was explaining in response to Mr Kruger’s question earlier, we are at a point with the supervisory part of this, as opposed to the capital requirements-setting part of this, where there is a bit of a job for firms to do to progress their own capabilities. We are able to make a little bit of a resource trade-off in the coming year, but I imagine we will then be coming back in more heavily following that.

Q54 **Emma Hardy:** Given the seriousness of climate change and the impact it is going to have on specific economies around the country—I represent Hull, the second most flood-prone place in the whole country—are you surprised that the Government have taken away the specific regard to climate change? Is that going to impact any of your work going forward? Would you expect a future Government to be putting that future emphasis back in?

Sam Woods: I was not surprised by that. There is potentially some discussion in the Bill, because it is going through the House, about how this part of our work could be affected in the future. We will have very close regard to that because what gets put in law has a higher hierarchy in our system than the remit letter, although it is important.

I would have been surprised if the letter had come and told us not to do work on climate or net zero. That would have been quite strange, but that is not what happened. It was just a narrowing of the focus on what the Government really want us to pay attention to. As you say, sustainable finance is still one of the sub-bullets under one of the two main points.

At the margin, because we are at a point in supervision where we are having to make a few trade-offs for the next year and we think firms can make more progress based on what we have given them so far over this next year, the fact it was not highlighted in bright lights in the remit letter, as it was previously, perhaps conditioned our thinking about it. This is at the margin. It is an important part of what we do.

I do not want you to take this in the wrong way, but it has also become more business as usual. We have a set of supervision requirements; we have some thoughts about capital. It is a wing of what the PRA does rather than something completely new.



Q55 Emma Hardy: Finally and really quickly, because I have run out of time, have you discussed the removal of the reference to net zero and climate change with the Government? I do not know whether you are able to comment—if you cannot, do not worry—but are you keen to see it put back in? Are you having those conversations with the Government?

Sam Woods: I do not think I have had an explicit conversation about it with members of the Government. We take the remit letter on its own value. In answer to the last part of your question, the remit letter is the Government's chance to say, "Here is the part of our economic platform that we want you to be particularly interested in". That really is for them, and it would be cart-before-horse for us to be suggesting to them what was in it.

Q56 Chair: I have one final question before the bell. It is about the consultation on central bank digital currency. We heard from Sir Jon Cunliffe. He thinks there is a 70% chance the Bank of England will bring in its own digital currency. Is the PRA concerned that this could heighten the risks of a run on banks as people run into the central bank digital currency? I see you all nodding.

Sam Woods: Yes, you have put your finger on the central issue from the PRA's point of view. It is not so much the risk of individual bank runs. We have that today, and all of us can move money extremely quickly if we want to. It is more the risk of a systemic herding, in a stress, out of commercial bank deposits into a central bank digital currency. It is because of that concern, which is also an issue for the Financial Policy Committee, that in our publication we floated the idea that there would need to be some caps on this.

Q57 Chair: This is the £20,000 idea.

Sam Woods: Yes, we have put between £10,000 and £20,000 for individuals. In terms of the analysis we have looked at, some of which we published in a discussion paper in 2021, we make banks hold a lot of liquidity in order to be able to deal with runs. We think that could accommodate very significant herding of up to around 20% of deposits, which would be very large. That is not to say that will be an easy thing to accommodate, but we think the liquidity is there to deal with such a thing.

The £10,000 to £20,000 has only been floated at this point, but it comes from an observation we have made from a very strict thought experiment. Imagine that every single depositor, both corporate and individual, had a CBDC account. Assume they had no CBDC in those accounts at the beginning of the stress. Assume they moved the maximum, up to those limits, into those accounts all at the same time. That gets you to 20% to 30% of deposits moving.

It is reasonable to think that, with limits of that level, if that is what happened, the amount of outflow would be pushed down to within the amount of liquidity that is available. That is the thought there. It is early



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days, and the engagement will continue. That is the key point for us on the PRA side.

Q58 Danny Kruger: I just have a simple question. I appreciate this might not be a PRA question particularly. Sam, do you accept that a central bank digital currency would accelerate the decline of cash? Will it be neutral in its effect on how much cash we have in our economy?

Sam Woods: There is the amount of cash in the economy and then there is how much it is being used.

Danny Kruger: I mean the usage of cash.

Sam Woods: We have seen a pretty straight line reduction in the usage of cash for transactions since the introduction of being able to tap with your card. That is the thing that has been the real game changer, at least in my opinion. It is reasonable to think that trend will continue. We have said we will continue to provide cash and to make it available.

Q59 Danny Kruger: Will the provision of a digital pound accelerate the decline? I recognise it is declining anyway.

Sam Woods: It might do, but it is hard to know with confidence. If you have a trajectory like that already, it is hard to know whether the introduction of such a thing would push it up further.

The point Jon was putting to the Committee was that we want to move forward with the next stage of the work. In effect, we want to buy the option to be able to do this thing, if it seems it is going to be the right thing to do. The wider context for it is that money is becoming much more digital.

Q60 Chair: The PRA's view and input into the consultation, therefore, is that, provided there are these caps in terms of runs on the system, you are relaxed about the Bank of England bringing in its own central bank digital currency.

Sam Woods: There will be a lot more discussion before we get to that point, but that is the one point the committee has been particularly focused on so far.

Chair: Thanks. You have covered an extremely wide range of issues. It has been a very interesting session. Please continue to keep our financial sector safe and competitive. That brings us to the end of the Treasury Committee session on the PRA.