

Treasury Committee

Oral evidence: The work of the Prudential Regulation Authority, HC 222

Wednesday 7 February 2024

Ordered by the House of Commons to be published on 7 February 2024.

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Members present: Harriett Baldwin (Chair); Mr John Baron; Dr Thérèse Coffey; Dame Angela Eagle; Stephen Hammond; Drew Hendry; Danny Kruger, Keir Mather.

Questions 61 - 158

Witnesses

I: Sam Woods, Deputy Governor for Prudential Regulation and Chief Executive Officer, Prudential Regulation Authority; Tanya Castell, External Member, Prudential Regulation Committee, Bank of England; Gareth Truran, Director, Prudential Policy Directorate, Bank of England; Phil Evans, Director, Prudential Policy Directorate, Bank of England.

Examination of witnesses

Witnesses: Tanya Castell, Phil Evans, Gareth Truran and Sam Woods.

Q61 **Chair:** Welcome to this afternoon's session of scrutiny on the work of the Prudential Regulation Authority. Can I start by inviting you all to introduce yourselves?

Sam Woods: I am Sam Woods, chief executive of the PRA.

Gareth Truran: I am Gareth Truran. I am a director of policy at the PRA.

Phil Evans: I am Phil Evans. I am also a director of prudential policy at the Bank of England.

Tanya Castell: I am Tanya Castell. I am an external member on the Prudential Regulation Committee.

Q62 **Chair:** Welcome, everybody. We are not expecting any votes during this session, although it is not impossible. Let us hope that we are able to complete our full scrutiny before that happens. Sam, I wondered whether you had read our report about the Edinburgh reforms, which we published on the first anniversary of the Chancellor's speech in



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Edinburgh.

Sam Woods: Yes, I have seen that and took an interest in it and in the various comments that the Committee made.

Q63 **Chair:** Am I right in thinking that there are four main Edinburgh reforms where the PRA is directly involved: the senior managers regime review, ringfencing, securitisation and removal of capital deductions for non-performing loans? Do you recognise those as the four that you are progressing?

Sam Woods: Yes, I do, but I would put Solvency II in as a sidebar, which is in or out of the Edinburgh reforms. Those are the four within the main list, yes.

Q64 **Chair:** We will be talking about Solvency II in a moment. Do you feel that you are pushing as fast as you can to implement those reforms?

Sam Woods: Yes, we are. We have done the capital deduction for non-performing loans. We have removed that. We have closed the securities regulation piece. We will come on to that. We have closed the ringfencing piece. When I say "closed", I mean that we have closed the consultation and are coming to the rulemaking. On senior managers, we have published the discussion paper and the next piece is to come this year.

Q65 **Chair:** I wondered if you could tell people today when they are likely to see the changes that were foreshadowed by the Edinburgh reform speech for the senior managers regime, for example?

Sam Woods: Senior managers is a process led by the Treasury and we have a supporting role for our bit of it. That I think will be this year, in terms of changes to come forward. The Government have committed to come forward, I think in the first half of this year, with some changes on that. Those will then, of course, have to be consulted on.

Q66 **Chair:** We have not had the consultation on that yet then.

Sam Woods: We have had our discussion paper and the Treasury's call for evidence. We have had a lot of responses to that. Perhaps I will bring in Gareth as well, if I may, on policy.

Gareth Truran: Yes, this is on my side of policy. The senior managers regime is partly in legislation and partly in PRA rules, so we have to work very closely with the Treasury on this. The Treasury published a call for evidence and we published a discussion paper in March last year on our respective parts of the regime. We have had feedback to that. As Sam says, the Treasury will, I think, shortly be announcing its response to that call for evidence from its side. In parallel to that, we have been preparing proposals in the light of the feedback we have had on how the regime is working operationally. We are ready to consult on those in the first half of this year.



Q67 Chair: It is just that it challenges people in the private sector, who make changes faster than this, or even someone such as me, who has worked in both areas, to understand why it takes so long to review something such as this and why we are still waiting for these changes.

Sam Woods: Maybe I can give you a flavour of that. One point is that the feedback on that particular part of the regime has not been an enormous demand for massive changes. People want it basically to be made more efficient and to work better, without undermining the main purpose of the regime.

The overwhelming piece of feedback was an operational thing, not really a policy thing, which you have also taken us to task on previously, which is about getting quicker at doing the senior managers approvals. We have retrieved that position. As we sit here, 98% for the last quarter were done within the three-month deadline that we like to set. That has been sorted, just to reassure on that point.

Industry also needs time, first to be consulted and then to implement. We will come on to Solvency II later, but just as an aside, because I think it is relevant to this point, one of the main points of feedback on our most recent consultation has been a concern from industry that the amount of time between the end of the consultation and when we plan to bring in the rules is too short. I think that we will stick with it.

Q68 Chair: This is on senior managers specifically.

Sam Woods: This is on Solvency II, just as an aside, but there is a demand for these things. We recognise that there is a demand to move forward. We want to move forward and we will do so on the timeline that Gareth just set out.

Q69 Chair: We have also heard that feedback about the slowness of the process. You are saying that you have sorted that out and people are not experiencing any delays anymore.

Sam Woods: That is sorted. That was an operational issue. Essentially, when the regime was widened that created a huge bow wave for the FCA. As the FCA got on top of that issue, that created a further ripple on to us and we got behind. At both ends it is now sorted. You should never expect it to be 100% within a three-month deadline, because there will be some cases, but we think that 98% is high enough.

Q70 Chair: You are not aiming for perfection.

Sam Woods: It depends on how you define perfection. 100% would tell you that, regardless of the complexity of the case or the issues that we need to think about in terms of safety and soundness, we were determined to get it through within three months. That would actually be a bad sign. You should look for us to be north of, say, 97%. If we slip down into the lower 90s, or indeed much further down where we had been coming out of Covid, you should raise that again with us.



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Q71 **Chair:** To go back to the senior managers regime, where you are being told in your consultation that people do not want to see much in the way of change, I do not understand why it takes so long. Why do these things take so long?

Sam Woods: It is partly a question of all the things we are doing at the same time. We are going to talk about a number of things in this session and we will come on to some of the other files later. The scale of those within the context of the PRA staffing is extremely large. Also, of course, we are fitting in with the Government's timetable. As Gareth says, we will be out there alongside the Government. It makes sense for industry to see the full package together, so whatever the Government want to put forward with what we want to put forward, so they are not getting half of the picture. It is a combination of those things that dictates the timetable.

Q72 **Chair:** Lack of resources is slowing you down on delivering these reports.

Sam Woods: There is a practical constraint, but I do not think that it is biting in a way that is causing great difficulty. We have put a very strong emphasis on getting the Solvency II package through at the pace that this Committee has taken an interest in previously. We have also got, on Phil's side of the house, a very large Basel package, which we will come on to as well. We cannot expand our troops in a never-ending way to accommodate all of that and do it all at maximum speed, but we are going at a good pace. As I say, of the three files we are touching on today, we have closed the consultation on three of them and in one of those cases it has been done.

Q73 **Chair:** When do we expect ringfencing to be finished?

Sam Woods: It is Phil; I have to remember which side of the house it is. That will be Q2. We have closed our piece of that consultation. I am happy to come on to the substance if you want to. The Government have committed to coming out in Q2. We are ready to go with that.

Q74 **Chair:** In terms of the external committee, Tanya, I wondered whether you are concerned about the pace at which the PRA is able to cope with all these changes and reforms.

Tanya Castell: As Sam outlined, there is a lot at this current point in time. It is trying to manage that effectively. Some of it, such as some of the Basel piece and on Solvency II is very complicated. From the perspective of making sure that industry is consulted and, as Sam says, sometimes saying, "Do not go quite so fast", they are getting the balance right. It is tricky, but they are trying to do an awful lot. It is something we obviously watch to make sure that things are progressing appropriately.

Q75 **Chair:** Do you have scorecards? How do you go about watching?

Tanya Castell: We can see the timeline and know what is due to come when. We also get advance notice of what papers are going to hit us at



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what times, so we can see how things are progressing. We also get regular updates from the different directorates on how things are progressing there, particularly from the policy department.

Q76 Chair: On securitisation specifically, why did that move up to be one of the quicker ones to do, if you can call it quick?

Sam Woods: That one has gone reasonably quickly. That is an important market for banks in terms of shifting their exposures around and also, of course, for people who want to invest in the types of securities that banks may offload. The Government chose to make that a priority. We were happy to fall in line with that. For us, the two big priorities are the CRR, which are the banking rules that are coming in tranche 2 of the smarter regulatory framework schedule, and Solvency II. We were happy to work on the securitisation regulation as part of tranche 1, which is what the Government chose to do.

Q77 Chair: You had to be told by the Treasury to do it.

Sam Woods: I do not want to create a sense that there was a tension in this. There is a collaborative exercise where we, FCA and Treasury get together, but the Government, quite rightly, have the whip hand in terms of the decisions on timing, because it is about importing law into rules. Also, they have to adjudicate between the two regulators as to which ones go first.

Q78 Chair: I think that it is fair to say that, when the Committee looked at your consultation on securitisation, we felt that there was a bit of a missed opportunity there. You are sticking very closely to what was there before, whereas the US seems to be the much more vibrant securitisation market. Was that a conscious policy choice?

Sam Woods: It was conscious but reasoned, in the sense that there is a big difference between the US market and ours, of course, which is that we do not have Fannie Mae and Freddie Mac. The whole securitisation market over there is, as you say, a much bigger feature. The assessment that the Government made, and we agreed with it, was that the regulation itself seemed to be broadly working, but there were some targeted areas where reform would be helpful. The two that fell to us are the two that are in the CP. One is about the due diligence standards and one is this quite specific thing about non-performing exposures. We can go into that if you would like to.

Chair: Yes, do go into that.

Sam Woods: I will bring in Phil as well. Essentially, the problem that people were complaining about was that, for reasons that are probably obvious, when you securitise a non-performing exposure, it tends to go into the securitisation at a lower value than its nominal value, for the reason that it is non-performing. The risk retention requirements—in other words, how much of the securitisation the bank or the manufacturer has to hold on to—were defined originally in relation to the



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nominal value. It is creating an outsize requirement for those types of securitisation, which was not intended, and we basically proposed to fix that. Phil, do you want to come in as well?

Phil Evans: You explained it.

Q79 **Chair:** That has been implemented, has it, Phil?

Phil Evans: No. We have put out a consultation paper. That consultation period is closed and now we are working through it. You explained it very clearly. There is nothing to add on that.

One thing I would get across on securitisation is that it is a very large piece of rulebook across a number of different places. Some is in the securitisation regulation, some is in the CRR and they all interrelate. If you want to do something that is coherent and holistic, one thing you have to do is get it all in the same place so that people can understand it. Then we can look at it much more in the round. A key part of what we are doing, as Sam said, is transferring it piece by piece so that, when we have our arms around the whole thing, we can look at it much more holistically and take a more rounded view on it.

Q80 **Chair:** For the Committee's benefit, we have heard that the senior managers regime will be completed this year. We heard that ringfencing will be completed in Q2.

Sam Woods: Yes.

Q81 **Chair:** When will securitisation be completed?

Sam Woods: I think that it will be the first half, will it not, Phil?

Phil Evans: The non-performing exposures, which is the part that Sam mentioned, is done completely.

Chair: You have said that that is done, yes.

Sam Woods: I just have a point of clarity, Chair. This is the slightly confusing thing. The issue within the securitisation regulation is about non-performing exposures. Quite separately, we have consulted on removing a separate capital reduction for non-performing exposures. That is done.

Q82 **Chair:** Yes, understood. Yes, we counted those as four things altogether.

Sam Woods: On the senior managers regime, to be absolutely clear, I am expecting us to be consulting with the Government this year on the changes. I would not want to guarantee whether that means that they are all in by the end of this calendar year. We will go as fast as we can, but I am not 100% sure that that will be the case.

Q83 **Chair:** I think that we are sufficiently jaded on this Committee not to take these things as guarantees, I have to say, but I appreciate you clarifying that. I have one final point. In terms of the EU files, which are



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the other strategic priorities, or do you just not have any bandwidth to look at anything else at the moment?

Sam Woods: The big things for us are CRR and Solvency II. They will be coming through to us this year. Those are the main ones.

Q84 **Drew Hendry:** Good afternoon. Gareth, can you explain what your rationale is behind your critical third parties consultation?

Gareth Truran: Yes, certainly. Critical third parties was one of the areas of new powers and responsibilities that came through in the Financial Services and Markets Act last year. The issue there is one that I think this Committee back in 2019 identified. It has certainly been a topic on the Financial Policy Committee agenda and in our work too.

Clearly, there is a growing trend over time for financial services firms to look to outsource certain types of business to third parties. We recognise that that is a perfectly legitimate thing for them to look to do. It can improve efficiency and effectiveness and so on, but there is also the potential that, over time, there are a very small number, and we expect it to be a small number, of providers that end up having so much of a share of business outsourced from across the financial services sector that they become, in effect, a critical dependency for the ability of the financial sector as a whole to operate.

Q85 **Drew Hendry:** Is there a specific new risk that you have now identified that did not exist in the past?

Gareth Truran: It is growing in concentration.

Q86 **Drew Hendry:** I was going to ask whether it is a new risk or whether this is an old problem that has simply transferred to third parties when it used to sit with the firms that you are already regulating.

Gareth Truran: It is a reflection that outsourcing has become a much more common practice. Whether it is in technology or other parts of firms' operations, there are now more of those services that are outsourced to specialist providers. It is a risk that has grown over time as that trend has continued. The Government have recognised that. As I said, this Committee has recognised that risk.

The legislation provides for us to be able to apply some particular oversight of the services that those providers provide to the financial sector, but the bar for it is very high. It is about whether the providers are so material, in terms of the activities they provide for the financial sector as a whole, that a disruption in that service or the failure of that provider could pose a material risk to financial stability. It is a very high test.

Q87 **Drew Hendry:** You centred on outsourcing there. The largest providers of cloud computing, for example, for the banks are the likes of Amazon Web Service, Microsoft and Google. If these companies do not comply with the proposals in your consultation, what will you do? What sanctions



can you use, given that they are not UK-based?

Gareth Truran: I should make clear that decisions on which companies end up being designated will be ones that the Treasury will make. We will provide advice and recommendation into that process, but the Treasury will need to decide which companies end up being in the services. The ones you mention are obvious examples of the ones that we might look at.

The legislation includes a number of powers and things that we can do in terms of our oversight of third parties, including powers to gather information, commission external reports and so on. Ultimately, it includes a number of what in the rest of our world we might think of as being enforcement-type powers, so the ability to censure a firm or to impose conditions or limitations on the services it provides to the financial sector. Those are the powers that Parliament has given us.

Q88 **Drew Hendry:** To push you again, how would that work if they are non-UK-based?

Gareth Truran: The legislation is framed in terms of the services these firms would provide, not the actual entity. If there were cases where firms were based overseas, and indeed there may be good reasons why services might be provided from overseas, the ability that we would have is in the powers that you have given us. We have the ability to require them to undertake certain corrective measures or to impose conditions on the ability of financial services firms in the UK to deal with them.

Sam Woods: Maybe I could add one point, Mr Hendry. It is nice to meet you. The one power that Parliament has not given us is the power to fine them. That is a difference, for instance, against the EU approach. I feel moderately confident—this is a new area—that the combination of the ability to censure in public what is likely to be a major technology company for failing to do what it should do and going to put in conditions on what they can provide, ultimately either to say “You cannot provide anymore” or “You cannot provide any”, are quite good sticks. I am glad that you have given us that ladder. I think that, if you had only given us the ability to ban them, that would not be terribly effective. I am not sure how credible it would be for us to turn around and say, “You cannot supply at all”. I am hoping that that will work, but it is a new field for us and we will find out in operation.

Q89 **Drew Hendry:** Where do we start from just now? Is there a level regulatory playing field for UK-based cloud computing providers at the moment?

Sam Woods: Do you mean within the UK or the UK versus other jurisdictions?

Drew Hendry: I mean the UK versus other jurisdictions within what you are proposing.



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Sam Woods: Yes, in a qualified way. The word that people use around this is “interoperability”, which is a slightly slippery kind of word. It means that the way our regulation works can dock reasonably effectively with what the Europeans are doing through something called DORA. The Americans have had a version of this for a long time. I think that it is called the Bank Service Company Act. Imagine if you are a bank operating in all those jurisdictions and buying a service from a cloud provider in all those jurisdictions. We think that it will be manageable for that bank to have this kind of a framework around it.

Q90 **Drew Hendry:** Would you consider banning a UK bank from using a specific cloud computing provider if they were not complying with your directions?

Sam Woods: That is the limiting power that you have given us. We would be banning the provider. It is very important that, you having given us that power, we have a willingness to use it. As I say, that is probably the end of a chain of escalation. You can think about the Uber example in a different space. A complete ban of Uber was a very difficult thing for another regulator to do and so it is good that you have given us that escalation.

Q91 **Drew Hendry:** To follow through from that and get a full understanding, you talked about that banning, that ultimate sanction. In between that, do you have any regulatory powers at present to compel these third-party computing companies to do anything at all?

Sam Woods: As we speak, we are in a halfway house between you having passed the law and—

Q92 **Drew Hendry:** The answer is no really.

Sam Woods: We have powers, but, because we have not yet made the rules, they will be more limited. We will, once we have them, have quite a few. Gareth mentioned one that is important, which is this information gathering power, which may not sound important to you. That is a very powerful thing: that we have the ability to appoint a skilled person to go into one of these providers and check up on how they are doing. That will be useful, but also quite a powerful mechanism to get them to do what we want.

Q93 **Drew Hendry:** On the subject of going in to check how they are doing, cloud computing can take place across multiple servers located anywhere in the world and thus are not potentially prone to a single point of failure that could occur for UK banks as they attempt to run their own IT. Should we therefore be trying to encourage third-party cloud computing from a financial stability point of view?

Sam Woods: It is two-sided. To give you a sense of this, we received in the PRA last year 200 what are called material outsourcing notifications, where a bank or insurance company said to us, “We are going to ship something out”. A chunk of those would have been to do with the cloud.



Oftentimes, when those come to us, you look at it and you think, “The guts of this institution will in fact be safer hosted in a cloud environment from things such as cyber”. On the other hand, you create that kind of concentration risk. That is really what these new powers are about.

We take an interest in things like whether the cloud provider in question would be able to move the services from one what they call an availability zone to another. How easy would it be for the bank or insurer to move to another cloud provider? Those are kinds of questions that we ask. We are using the cloud providers as an example here and they are the most obvious candidates to be designated. We will see what the Treasury makes of that. In addition to all those things that we can require banks and insurance companies to try to negotiate, there are these extra powers you have given us to reach over and say, “If you want to be a provider”, as Gareth was saying, “of a material kind to UK financial services, you need to play ball”.

Q94 Drew Hendry: In the earlier part of the answer that you gave me there, are you saying that there is potentially a risk that, looking at these third-party contractors more closely, you may harm what appears to be a well-functioning infrastructure that is already there? Would that be fair to summarise?

Sam Woods: There is always a risk when you bring in a new regulation, as we are doing here, taking the powers you have and turning them into rules, that you have an unintended effect. However, the costs, which is often what it comes down to, from a commercial point of view that we have are pretty small when we think about the sorts of companies that we are talking about. The estimate we have put in the CBA is between £650,000 and £950,000 upfront cost and £500,000 a year. That is a lot of money in one sense, but if you think about it in the context of one of those very large cloud providers and what they are doing in UK financial services—

Q95 Drew Hendry: It begs the question of whether it is enough.

Sam Woods: That is what we are going to find out. If I had to worry about whether it is enough or too weak, I would probably be on the “Is it too weak?” side, but it is a good place to start. I would also say that those companies that seem to feel that it is likely that they will be designated, such as the cloud providers, have actually been engaging in quite a positive way, obviously in their own interest. I think that they recognise that what they do is important enough that something is going to need to be done in this space.

Drew Hendry: We will watch closely.

Q96 Dr Coffey: One of your new duties is about increasing growth or helping to do that. My colleague is going to look at that in more detail. Perhaps one of the most famous elements of that is reform of Solvency II. The impression I have had in the past is that the PRA was a bit more sceptical



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about it, but of course you are being diligent and getting on with this new regime. How many firms have applied to make use of the changes to the matching adjustment so far?

Sam Woods: I think currently it will be zero because the changes are not yet in place, but I am checking with Gareth. He is nodding. My guess would be that all of the current providers will apply.

Q97 **Dr Coffey:** I guess that that was proving my point. When are you going to be able to make the changes? The reforms were announced a while ago, so how long is it going to take before people can take advantage of this?

Sam Woods: We expect the first two sets of rules to drop during this month, so to publish them by the end of February. We plan to publish the matching adjustment-related rules in June.

Gareth Truran: That is right. I should also make clear that some of the reforms were introduced at the end of last year. The Government cut part of the Solvency II regime called the risk margin. That has freed up £14 billion of capital from the life insurance sector based on our previous estimates to this Committee, which are already in force. In some of the reforms we consulted on last year, some of the feedback from firms was on whether we could bring some of them in earlier. We have accelerated a number of those.

Some of the reforms are in force already. As Sam says, the final policy for most of the others will follow in February and then June. It will be June for the investment proposals and everything else will be done through the course of this year. The final policy will be published by the end of February. There are then various other technical changes we need to make alongside the Treasury to give these effect legally, because these parts of the regime are currently locked into legislation. The Treasury also needs to lay some statutory instruments throughout this year. Those will be done by the end of the year. That is completely in line with the timetable that we and the Treasury set out last June.

Sam Woods: To be extra clear, the Treasury's intention is that it does its part of the statutory instrument part of this for the matching adjustment bit that you were just asking about by June. That is the intention when we do our rules as well, so that is all effective from the end of June.

Q98 **Dr Coffey:** From that perspective, what is your estimated timeline of when you will be making your first decisions? I am trying to get a sense of pace. I am trying to understand—it is my lack of understanding—the letter that you sent to the Committee last month. I am trying to get an understanding of where this 18 months comes into all of this.

Sam Woods: It is a tricky area. The topic of my letter was about the approval of IRB models, which set capital requirements for banks. That is a much more complicated process than approving matching adjustment applications from firms to put particular assets into matching adjustment



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portfolios. On that, the average time it has taken to date has been three and a half months. We have proposed various ways in which we think that the process could be streamlined, both for us and for firms. If you took that as a guide, you can roll that forward from when firms start to apply after the end of June.

Gareth Truran: As part of the process of consultation over the last few months, we have already been discussing examples with firms of the sorts of things they would like to include in the matching adjustment portfolios. We think that our reforms will enable them to do that. We think that we are heading in the right direction.

Q99 **Dr Coffey:** Could you share some of that? A lot of it has largely been about things such as infrastructure, whether it is housing or other elements.

Gareth Truran: That is right. The changes to the matching adjustment are about what types of cash flows can benefit from the matching adjustment treatment, which is a generous treatment. At the moment, the type of assets that insurers can include are ones that have fixed cash flows because they are designed to meet pension obligations that the insurers have to pay out to their policyholders. The reforms that the Government are introducing will enable those criteria to be slightly widened to include assets with what is being called highly predictable cashflows. They still have to be pretty certain as to whether they will happen, but it will be slightly wider.

An example might be construction assets, where there is a phase in the construction and points in that project where the nature of the cashflows change, and so those sorts of assets. We have seen some examples of student accommodation or other types of assets. I should make clear that the reforms are not necessarily limited to that, so it will be for insurers to decide what sort of assets they seek to include.

Q100 **Dr Coffey:** The figure that has been well advertised is £100 billion. Do you think that that is viable and over what timescale would that be?

Sam Woods: You are right. That is an industry figure that the Government have also adopted. The industry has characterised it as a 10-year investment in certain types of assets. I think that is a plausible number. I know that the ABI, through its investment delivery forum, confirmed its commitment to it again as recently as November. From my interactions with the Government, I know that Ministers are very focused on holding the insurers to that commitment. I think that they would be wise to meet it.

Q101 **Dr Coffey:** There have been some concerns expressed about whether this could just end up in dividends or being used outside of the UK. What is your assessment of that?

Sam Woods: The Government should keep a close eye on making sure that the insurers deliver their half of the bargain, if you like, that was



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made. We need to be careful not to overreach our role. Our role is to set the tramlines: here are the capital requirements. Above those, there are decisions for boards about "What do we do with our money? Do we want to invest more? Do we want to pay out more in terms of dividends?" When they are making those choices, they would be wise to have an eye to very public commitments made to the Government. Those are things that need to sit with boards, not with us.

Q102 Dr Coffey: In terms of the development of some of your assessment of agreeing, because firms have to apply, what sort of risk profile are you already modelling, in terms of size of company, so small companies versus perhaps larger ones?

Sam Woods: Do you mean in terms of which insurance companies will use this?

Q103 Dr Coffey: Yes.

Sam Woods: I would be really very surprised if every company in the annuity business does not apply for these benefits in one way or another. They have, as Gareth said, all already taken the cut to the risk margin. There is a range of firms there, but I think that they will all use it.

Q104 Dr Coffey: There is an assumption that there will be extra risk, but clearly the balance there is likelihood of exposure, as it were. As I say, the PRA initially seemed to come across as somewhat sceptical, but what sort of measures are you looking at to help with that?

Sam Woods: To speak to that and the point about scepticism, we had a very public and quite difficult debate with the industry—the Committee took a close interest—around whether we should reform the matching adjustment in a more fundamental way, but that argument is done. We did not persuade the Government to take that forward. We have moved on from that and are very much focused on the whole rest of this package.

In terms of the impact on risk, our assessment of that has not moved since the letter that Andrew Bailey sent to the Committee. We think that that 0.5 to 0.6 is still the right number. If you take the decision to allow in some of these predictable cash flows rather than fixed cash flows, a lot of the things in the consultation paper are about, "If that is going to happen, how do we ensure that there is appropriate oversight of that within firms? How do we make sure that it is not too much?"

Of those things, to highlight one, this attestation thing is a good common-sense measure: that we require a senior person within a firm that is doing this to say that they have high confidence that the matching adjustment will be earned by the firm. I think that that will focus minds in a helpful way.

Q105 Dr Coffey: I will take one final step back on timeline. You have already done something last year. You are publishing stuff in February. The final



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bit that you need to do is in June.

Sam Woods: It is June, yes.

Gareth Truran: It is June for the matching adjustment, yes.

Q106 **Dr Coffey:** Then Treasury has to lay some SIs. I seem to think you said something about end of year. Can you clarify about that?

Gareth Truran: The things that came into force at the end of last year are done. Those are in force. There is nothing more to do on those. The final package that we will publish at the end of February will allow firms to see exactly what our final policy will be. Those will come into force at the end of the year. The reason for that is there is some proprietary work that the firms will need to do to change systems and so on and to allow the Treasury to lay the necessary SIs to enable them to come into force in our rules. The investment proposals are the ones that we will publish in June and they will come into force in June.

Q107 **Dr Coffey:** People will be able to apply from, say, July onwards, as long as the SIs are done.

Gareth Truran: That is correct.

Q108 **Dame Angela Eagle:** I want to ask about identification and management of step-in risk, the shadow banking sector and groups of connected clients. Before I get into detail there, there has been this big shift away from the regulated banking sector since the 2008 crisis into much more presence in the unregulated shadow banking area. To what extent do you think that that poses systemic risks?

Sam Woods: It is to quite a significant extent. Since the financial crisis, the banking sector has grown but the non-bank sector has grown more. For the PRA, that manifests as a risk to the safety and soundness of those still within the perimeter. The best single example is this family office called Archegos, which we touched on once before. It was a \$10 billion hit coming out of a single family office into the core banking system. That illustrates the risk quite nicely.

The Financial Policy Committee has that broader remit and spends a lot of time on those issues. There has been very good progress on LDI and in some other areas, such as money market funds. It is hard going to get meaningful reform outside that perimeter because of the international nature of it and the many different stakeholders involved, including different regulators with different objectives. To be honest, I found that quite frustrating as a line of work, but we are making some progress.

Q109 **Dame Angela Eagle:** There is not really an agreed international way of dealing with it. There might be some people who say that, if it quacks like a duck and walks like a duck, you should regulate it like a duck, whether it pretends to be a shadow duck or is an actual duck.



Sam Woods: I do not want to pursue the duck analogy too far, but the Financial Stability Board is where these issues come together internationally. There is a lot of work and effort going on. If I look at it relative to what we have been able to achieve within the banking sector since the financial crisis, it is less, but perhaps that is not surprising. Although we have had some quite significant and repeated blow-ups, we have not had something quite like that. In the one area where we have had something quite dramatic, LDIs, we have actually made a lot of progress pretty quickly.

Q110 **Dame Angela Eagle:** I wanted to ask about step-in risk and to ask whether you could give us examples of firms that face step-in risk in the event of a shadow entity that they may be associated with failing, and how much data and information you have about these things. Perhaps while you are answering that you could explain as you go along, for those who are watching, what a step-in risk is, because lots of people watch and we can get very technical about what we are talking about and not really communicate with people.

Sam Woods: I take caution from what you say. I will try to explain it as simply as I can. I may also bring in Phil. Step-in risk is the risk that a bank has other entities that are connected to it but are not actually part of it. If they got into trouble, in effect, the bank would have to bail them out. It could be an IT provider, going back to our conversation with Mr Hendry. It is more usually other types of financial entity that do something closely related to what the bank does.

I will give you a concrete example and then may bring in Phil. If you think back to the financial crisis—I think it was November 2007—HSBC had to, in effect, take over and bring back on to its balance sheet two financial entities. This is in the public domain. I think that one was called Cullinan and one was called Asscher. Those added \$45 billion to the size of the bank, effectively overnight. Our regulation is about making sure the banks are scanning their perimeter and saying, “Where might that happen and do we have it covered?” Phil, do you want to come in as well?

Phil Evans: You are right to say that there was a lot of this during the financial crisis.

Q111 **Dame Angela Eagle:** There is less now, I suspect, but that may not be true.

Phil Evans: There is some that we are still worried about, but it is probably different. Sam mentioned the IT firm-type example. There is also anything where there is reputational risk if you do not step in because there is a connection. It could be contractual, but it does not have to be contractual. It is just a reputation risk so that, if you do not step in, your brand gets sullied. That can happen anywhere.



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You are right to point out the link to the financial crisis. Basel, the international area that comes up with these rules, basically determined an approach back in 2017. This is our implementation of that. As far as we can tell, other countries have not yet done anything in this area, so, believe it or not, we are a little bit ahead of the curve. The thing we are doing is relatively light touch. You asked about how we know. The thing we are asking for is that firms come and tell us where they have these risks and then discuss with the supervisors what kinds of mitigation things they are doing.

Q112 **Dame Angela Eagle:** It is really asking companies, "Tell us what these off-balance sheet things that you are dealing with are where you think that there might be a risk that you would have to step in", what the size of them is and what the likelihood that it may crystallise is.

Phil Evans: Yes, and, "What are you doing about it?" Yes, exactly.

Q113 **Dame Angela Eagle:** There are these different kinds of risks. Some would be much riskier than others because they would be much closer to the heart of what a bank did, such as if you had a shadow entity that was actually investing, like we did in the financial crash. To what extent are you happy that what you are doing will actually give you that information? During the last financial crisis, these things were materialising almost out of the blue and very few people knew about them. Certainly the regulatory authorities did not really know about them until it became clear that they had to be rescued.

Phil Evans: The whole point here is that we made it a requirement for firms to come along and tell us. That was not previously the case. Then they have to walk through the mitigation with us.

Q114 **Dame Angela Eagle:** Do they have to do that now?

Phil Evans: No, they do not.

Q115 **Dame Angela Eagle:** When are they going to have to do that from?

Phil Evans: We have put the consultation out. We expect to make final rules a bit later this year. Our plan is that it would apply from 1 January 2026.

Q116 **Dame Angela Eagle:** That is two years away from now.

Phil Evans: Yes. One thing we have done is created a simple reporting way that firms can dock into the supervisor.

Q117 **Dame Angela Eagle:** That is 18 years after the financial crisis first erupted. Is that fast enough? Finance moves quite quickly, does it not?

Sam Woods: I would add that this is not something that we have been blind to in the meantime, but we think that time has come to put more structure around the approach. As Phil says we are a tiny bit constrained by the fact that we think we can be in front internationally, but there is a limit to quite how far you want to be in front. This is an important area. It



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is an area that we were all burnt by in the past. To answer your earlier question to Phil, we think that this will do the job for us. Can it guarantee that there would never be any shadow entity that emerges from the shadows at a bad moment? Of course not, but I think that it should give us a good shot.

Q118 Dame Angela Eagle: How close do you think an entity has to be before it is easier to require it to be consolidated on to the parent's books rather than be lurking in the shadow banking area?

Phil Evans: That is a good question and that is part of the conversation you would expect the supervisor to have with the firm. What we have not done is said that there is a rigorous formula. It is meant to be that the firm identifies it and the supervisor has a conversation. It is a proportionate thing. If it is very far away, okay. If it is closer, we will press them harder. One thing I should say is that the rules do not apply to the very smallest firms.

Q119 Dame Angela Eagle: That is on the assumption, presumably, that they are not going to have huge shadow entities lurking that are 50 times their size that would cause a systemic problem.

Phil Evans: Exactly, yes, but to make sure that they do not have to go through the reporting that I have just described and make sure we get the information. We have said that the proportionate thing to do is to completely carve out the small firms.

Q120 Dame Angela Eagle: What would happen if a regulated entity was not up front with you about the nature of some of these shadow entities that they may then have to step into? What punishments would you have to dole out to them?

Sam Woods: We will be in a much stronger position once we have made the rule, because then they would be in breach of a rule.

Q121 Dame Angela Eagle: What would that mean?

Sam Woods: It would depend on the nature of the case. Let us imagine that a hypothetical bank had deliberately taken steps to obscure from us a very significant entity, which clearly should have been captured by the rules, that would be at the more serious end. That would be an enforcement action. It would likely be a fine. Of course, depending on the individuals involved, it could be a prohibition.

Q122 Dame Angela Eagle: Having these kinds of entities can sometimes lead to rather nice profits if they are in the unregulated area, if all they are risking is a tedious little fine a few years down the line while they are coining in profits from not being up front with you.

Sam Woods: I hope that they will not think about it that way. My experience of firms in our enforcement areas is that they do not like being in there at all and individuals do not like being in there. Some of the entities could be securitisation vehicles, again going back to the



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discussion we were having earlier. That is serving a useful purpose for a bank. It is true that it is part of how they make money, but it is not a bad thing for them to be doing.

The other point to make here is that this is something that risk managers and risk committees within banks are aware of. I do not think that we are coming along with something that is a big surprise to them, but it is more about making it a bit more robust.

Q123 Dame Angela Eagle: Finally, you have quite rightly talked about how smaller banking entities are being exempted completely from this. The way that these kinds of things often develop is that, if something is not regulated, that is where a lot of the action goes, if I can put it that way. It is happening in the shadow banking area. To what extent might there be developments in the smaller banking areas with step-in risk if it is not regulated, simply because it is not regulated? You might then suddenly observe, if you were looking, bigger shadow entities attaching themselves to smaller banks because they are exempt from your regulations.

Sam Woods: That is a wise comment and one I agree with. I have personally been burnt very badly before in the case of one small bank that had effectively spent a lot of money on an IT system and managed to obscure that, whether deliberately or not, in a sister entity. These sorts of things can definitely happen. We will be keeping an eye on it through supervision, but it is just a proportionality. It is a risk call, if you like. We think that it is less likely to happen here, so we do not need the full weight of what we are proposing. Nonetheless, supervisors of those areas need to be aware of that and to be having a bit of a look around.

Q124 Mr Baron: Can I briefly put the spotlight, if I may, on the rationale behind the joint PRA-Treasury consultation on the resolution regime for small banks? I think that you knew this was coming. Last month, the Treasury published a consultation proposing a new mechanism through which to place small banks into resolution without—this is the key point—placing the bank into insolvency. This sounds like a substantial rewriting of PRA policy. Can you set out your initial thoughts on this proposal. It suggests, as I say, a slightly different approach.

Sam Woods: I should say, first of all, that I and we are strongly in favour of what the Treasury is consulting. I will explain why. As we have discussed here before, we are not in the business of running a zero-failure regime. We have had around 20 banks exit the PRA's regulation during the life of the PRA. That is excluding ones that left for normal business reasons. We have managed to get most of those, as we have discussed before when we were talking about ease of exit, which is another consultation we have done, out of the system without having to put them into either insolvency or another type of resolution procedure. Where we can do that, we should.

If we come to the crunch and have not managed to do that, or something happens very quickly, such as Silicon Valley Bank, the options that we



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currently have are the bank insolvency procedure, transfer, which is the one we used in that case, or bridge bank. The issue that this consultation is trying to address is that, in some cases—it may be in many cases but certainly in some cases—continuity of access to deposits will be very important. Continuity of access to deposits is not consistent with the bank insolvency procedure. It is consistent with transfer and the bridge bank. The problem with the bridge bank is that, if there is net cost to that, it falls back to the taxpayer.

Essentially, what the Government is consulting on is, “Let us add one more tool. Let us not get rid of these other ones, but let us add one more so that we have a continuity of access option for which the costs are not borne by the taxpayer”.

Q125 **Mr Baron:** I do not wish to just focus on you. That would be unfair, Sam, so anyone else can come in. Can I just push you on that a little bit, taking on board what you have said previously? It seems that this new resolution process is a tacit admission that even small banks are too big to fail. You gave in a speech in October. You said, “Fundamentally, a zero-failure regime is incompatible with having a private banking system. The magic of a capitalist economy lies in competition [...] but it is not much of a competition if the game is rigged so that nobody (except the taxpayer) ever loses”. There is a slight contradiction there, is there not?

Sam Woods: We are learning as we go along. My experience of these situations—I have now been in quite a few—is that it is all about having options. How many options do you have? Maybe Tanya might want to come in as well with a PRC view. If you think about the resolution work, you do a lot of work on, “What is the plan to take care of this bank if it blows up?” Credit Suisse would be a good example. In my experience, it is very rare that, when you come to the crunch, you do exactly that, but all of that work gives you options. Certainly in the Silicon Valley Bank case, we had those three options, but we would have been in a tough spot had we not been able to either transfer or bridge, but we could do both of those things.

Q126 **Mr Baron:** May I push you? I am happy to bring in Tanya. I would suggest that this is a policy going down the road of small banks being too big to fail. Where am I wrong?

Tanya Castell: In what is being proposed, the shareholders would lose out. The capital would be written off. The management would probably lose their jobs. It is not like there would not be a price for what had happened.

Q127 **Mr Baron:** That is the functioning of a capitalist society, is it not?

Tanya Castell: This would be part of that process. As Sam said, if it goes into insolvency you cannot protect that access to deposits. If you do this, there are still ramifications for the management and the organisation if they have mismanaged their risks, but you can enable those deposits to still be accessed.



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Q128 Mr Baron: You are saying that this resolution regime is a way by which depositors can get access to their deposit while, at the end of the day, allowing a bank to fail, if necessary.

Tanya Castell: It could be wound up or sold or whatever.

Sam Woods: I agree with what Tanya said. You should think of it as a ladder. If we can work it out quietly in going concern, we will do that. That is least costly for everyone, with the least noise and least bad for confidence. If you get to the point that you have to resolve the thing, I think it is very likely that, whenever you have a transfer available, you will probably take that option. We do not want to commit ourselves to that, but it seems likely to me, based on my experience, that we will go with that.

If you do not have that, you have the choice. Do you put it into an insolvency? There is a place for that regime, particularly where you have a bank that does not have a lot of transactional deposits. You could do it where there are transactional deposits but in the Silicon Valley case I would say that it is quite difficult to do so. Then you go to a bridge or you can use this other mechanism.

Tanya is making a vital point, which is that, in all of these, the shareholders have been wiped. I think that the sub-debt will have been wiped. The senior debt may well have been wiped. The management will have been tossed out of the bank. All of that has occurred and it is then just a question of what the best way to manage it from that point is.

Q129 Mr Baron: We have talked about depositors, shareholders and management. What about the UK economy? Is it always better to attempt to sell a failing bank to a larger bank, rather than let the bank go into insolvency?

Sam Woods: I do not think that it always will be, but it is quite likely that the least costly way of managing a failing bank may often be, if you have a willing buyer and no taxpayer sums are involved, to take that. As I say, we do not want to commit ourselves to that, but my experience suggests to me that, where that option exists, you would probably take it.

Q130 Mr Baron: Would you agree, Tanya?

Tanya Castell: Sam has worked through these things that would not generally be at the PRC level. I would tend to agree, yes.

Q131 Mr Baron: Would the PRA ever put a bank into insolvency if a willing buyer could be found easily? You have cited the SVB.

Sam Woods: It is possible, but I think it would be a hard thing to do if you had a willing buyer that was also fit and proper, for the reason that—the US has the best studies of this—on average, an insolvency process costs about 20% of assets. We run the banking system with about 5% of assets in terms of its capital, so that implies a lot of losses falling on



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other folks. We want to reserve the option to do that in that situation, but you would be thinking very carefully about, in the presence of this other option, how it is right to do that. There might be reasons, but, as I say, I think that you would have a natural tilt to the transfer.

Q132 Mr Baron: The proposals for the small bank resolution would involve, in essence, allowing the Bank of England to use funds, provided by the banking sector by the way, to help that smaller bank, for example, through that process. Do you think that that is fair or encourages competition in the banking sector? In effect, what you or the Bank is doing is taking money from the banking sector to keep a bank in existence, which later on will go and compete with those very same banks.

Sam Woods: That is a good question. You have to think about what the counterfactual is. The bank has already got to the point that we say it is being resolved. As I said, it is likely that, if you had a transfer option, you would take that rather than one of these other ones. Let us assume that you do not have a transfer.

Let us look at the difference between a bank insolvency procedure and this new mechanism proposed by the Treasury. In the bank insolvency procedure, any losses that would otherwise be borne by covered depositors already get cycled back to the industry, so that is likely to be quite costly. All you have to do to see the effect of that is look at the recent results of the US banks, which have all been brought down significantly by the recharge from the US bank changes.

You have that very costly insolvency process or this other option, which is that you recapitalise it. Existing shareholders are out and the cost of that falls on the banking sector. Quite often, it may be the case that this will actually be cheaper. If you thought it was going to be much more expensive, that would be one of the things you would be weighing about which option you should take.

Q133 Danny Kruger: I would like to talk a bit about the ringfenced banks regime and the changes that are under way there. The Vickers report originally suggested that ringfenced banks should not be setting up subsidiaries outside the UK. Can you talk us through the rationale, as you understand it, for that original rule? Why was that put in place, in your view, and what has changed now?

Sam Woods: I had better take that one as I was on the review at the time. I know that you had evidence from Sir John. It is true that when the Independent Commission on Banking originally recommended, we wanted to recommend a UK-only version, because that was the simplest. We were told in no uncertain terms that that was illegal while we were members of the EU, and that is why we had this EEA construct. Keith Skeoch and his panel, looking at it again, had some representations that this was unnecessarily restrictive and recommended opening it up.



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Q134 **Danny Kruger:** That was post Brexit.

Sam Woods: Yes, exactly. Post Brexit, there was also the opportunity to do something a bit different. The Government accepted that and said, "We think that there probably is a way to remove this restriction without imperilling the regime or the safety and soundness of ringfenced banks", but that not imperilling relies on us to do some things. That is what our consultation is about.

Q135 **Danny Kruger:** Yes, indeed. It feels at first sight a very good thing that we are allowing these ringfenced banks to operate worldwide. Presumably that is your view.

Sam Woods: I have some sympathy with Sir John's view that he gave to you that maybe it is simplest and best if they are UK only. The question for us has more been whether they could they be opened up in that way. Might that have benefits, and could it be done without creating undue risks? Our answer to that question is yes, if we can take forward something like what we have in the consultation.

By the way, the motivation, I think, for the representations that Sir Keith and his team received was mainly about being able to raise some funding in the Channel Islands, so it is quite a specific issue. It was not, as far as I know, a desire for ringfenced banks to have enormous operations in all other parts of the world. That would be a very bad idea. The way we framed our consultation will allow the first while heading off the second.

Q136 **Danny Kruger:** I was going to ask you what problems the banks were facing with the regime as it was.

Sam Woods: I believe that it was that. It is perhaps worth bringing in Phil on what we are actually proposing.

Q137 **Danny Kruger:** It would be good to understand how you are going to ensure that the new regime is quite limited in its scope.

Phil Evans: We are consulting on having three safeguards. One is that the firm itself needs to come to us and explain how having a foreign operation, through either a branch or a subsidiary, is not a risk to the domestic ringfence. That is the first thing. The second thing is that the supervisory approach is sufficiently similar to the UK approach. The third thing is that there are no material barriers to resolution. We took the view that, if you had those three safeguards together, this thing would be okay.

Q138 **Danny Kruger:** I suppose it is the second one, is it, that would prevent them from establishing large-scale foreign subsidiaries? The regime would be so different.

Phil Evans: It is a combination.

Sam Woods: It is a combination of the first and second. This is not going to be in the rule but in the accompanying supervisory statement. We



have said that we will have regard to whether firms—they have to report to us—have more than 5% of their operations in foreign subsidiaries or branches. Secondly, we will have regard to whether they have any subsidiary or branch in a place that we do not have the right level of co-operation with or that has a really weak regime.

Q139 Danny Kruger: What is the volume of applications that you are anticipating? What capacity will you require in order to analyse the representations that they will be making?

Sam Woods: It will be quite small, because, as I say, there are not that many ringfenced banks in the first place. The motivation has mainly been around this Channel Islands point. I think it will be entirely manageable within the resources that we have. If it turns out to be a huge volume, we will have to have to reconsider.

Q140 Danny Kruger: It sounds like a deliberately limited change is under way here, but can you assure us that this is not the beginning of what might become an unravelling of the ringfencing regime? If you were to make further amendments in due course, perhaps in order to make use of new opportunities in global trade, etc, we might think that the regime is being steadily eroded.

Sam Woods: That is as much in your hands as it is in mine, given that a lot of this stuff is in law. The package that is being taken forward off the back of the Skeoch review, of which this is one piece, is fine and is a sensible way of making the regime more efficient and more proportionate without undoing its purpose. It is fine in that context.

If you take a much longer view, of course it could be the case that a series of evolutions through time would end up incrementally weakening the regime. If you look at Glass-Steagall in the US, you can see the thin remnants of it in their system today in something called Reg W. To be honest with you, that is true of all regulation. Perhaps that is the natural way of things.

Q141 Stephen Hammond: Good afternoon. I apologise because I have to go to a meeting with a Minister at 3.30 pm for a constituency case, so I will be rushing away.

In your speech in October 2022, you spoke about the fact that the PRA had a well-designed regulatory system. Some read that speech as meaning that having a well-designed regulatory system is already contributing to competitiveness and international growth. This was before the passage of the Financial Services and Markets Act. Would it be fair to say that you were cautious about the need for the secondary objective?

Sam Woods: Mr Hammond, it is very good to see you back on the Committee. I am glad you have asked that question because I also saw the evidence session that you had with the Treasury. A concern that had been reported to you by others was that the PRA was dragging its feet. I want to assure you that that is really not the case, in two ways. First, I



can describe what we are doing, if you want me to. I can come on to that.

Stephen Hammond: That was going to be my next question so you can roll it into this answer.

Sam Woods: One part of what we are doing is perhaps a bit boring but very important, which is the internal change. There is training for all staff; there is messaging from me to all staff, including town halls, explaining the new objective and how we are taking it on.

Our policy-making process, which both Phil and Gareth oversee, has had to be re-engineered so that people take account of the secondary objective in everything that we are doing. To give you a trivial but important example, when a policy paper comes up to the PRC, which Tony and I sit on, there is a box on the front of every single one that talks about the impact on the secondary objective.

All of that is very important internally, but, in terms of what we are doing, we have done the bonus cap. Members of the Committee have told me that was not very popular, but it is an important thing for competitiveness and growth. We have removed something called intermediate parent undertaking; we have removed some capital distribution restrictions that we did not like. We have done the things that we have talked about today in this Committee. There is a list of things that we have already done.

Then there are the really big bits. First, there is the Solvency II package. Aside from the thing that we had a big disagreement with the industry about, the rest of it is all about competitiveness and growth. On Phil's side of the house, the Basel package has a lot of competitiveness in it.

I wanted to make a second point, if I might. I am sorry; I am conscious of your time. There is also a thing here about the mindset of the regulator. All of us and our colleagues take pride in the fact we work for the public. How do we know we are working for the public? It is because we are doing what Parliament has asked us to do.

Regardless of the fact that I happen to think where Parliament landed was very sensible and makes a lot of sense for all kinds of reasons—if a function that has political oversight in an EU setting is pushed down to the regulator, of course it makes sense to adjust the objectives—we serve Parliament. If you change our objectives—it is the first time you have done it in the whole life of the PRA, and it is a big deal for us—we get on and do it. I would not want some of the debates before a change made by Parliament to be confused with how we implement after.

Q142 **Stephen Hammond:** I will just pick up two points from what you said there. First, you have run through a list of the things that have been already implemented. Is there anything left to implement? You talked about Basel and Solvency II. Is there anything beyond that, in terms of



what the new Act requires of you?

Sam Woods: I would expect so. We are doing the front edge of it now in the context of the Edinburgh reforms, ringfencing and SMCR. There will be an ongoing thing now. Whenever we bring in a new piece of legislation or change a piece of legislation, we will be thinking, "How do we advance that secondary objective?"

I cannot give you all the details yet because we have focused on the things that we have been discussing in this meeting, but in the last 10 years there was a massive rebuild of regulation post the financial crisis. That was very important. In some areas we may have gone a little bit far or we may not have done it in the most efficient way. We were just talking about some of those on ringfencing.

Secondly, we have just left the EU. We had to sign up to various things that we did not want to do. The bonus cap is a colourful example. I predict that there will be a process in the coming years where we are going around our rule book saying, "We want to maintain very high standards. We want a strong system. Where are the things that we do not need?" I think there will be a stream of things. It may be quite a lot of small things that make it more efficient.

Phil Evans: I have a couple of things to mention. One area that Sam did not pick up on in that list is innovation. We have the banking data review, which is going to be ongoing for a number of years. We are also going to hold a roundtable with industry so that we can pick up industry's ideas and try to make sure we reach out and do things under the innovation heading.

A second heading is the navigability of the rules. The rules are spread all over the place. They are complex; they are hard to navigate. Industry tells us that that holds them back. As we discuss this process in which the rules get handed over to us in regulated rule books, we have a medium-term ambition to make that much more coherent and easy for firms. Firms say that will make a difference.

Q143 **Stephen Hammond:** The data sets that you ask for will be provided in a more coherent fashion and a more understandable way.

Phil Evans: Yes.

Sam Woods: We are also going to report on a new metric.

Stephen Hammond: Yes, you are.

Sam Woods: That is about how many data requests we are making. There is that metric side to it as well.

Q144 **Stephen Hammond:** In essence, do you think that what the secondary objective is requiring of you is to think very carefully, when regulation is in front of you, about the appropriateness and proportionality of



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regulation? Has it forced you to do more of that?

Sam Woods: Yes. It is a bit more than that. It also requires us to have very specific regard to how what we are doing compares to what is going on in other jurisdictions. We have always been aware of that but it puts more weight on that.

The way I think about it is, "How well does what we do equip UK firms to compete elsewhere? How attractive or not does what we do make the UK as a place to do business?" All of that is secondary to safety and soundness. That is the right way to do it. That is how we think about it.

Practically, it will mean two things. First, there is this process of going around our rule book—we did the same with competition at the beginning—and saying, "We now have this new objective. If we look at the stuff that we did a few years ago, would we do it a bit differently now?" That will be quite a rich seam. Secondly—Basel 3.1 is a good example of this—when we bring in something new there is always going to be that secondary objective part of it. It will be those two things.

Q145 **Keir Mather:** Thank you all for coming today. Mr Woods, I would like to ask you some questions about the proposed removal of the SME supporting factor. About a month ago, the Governor appeared before this Committee and told us, in relation to the removal of the supporting factor, that he hoped people would feel the Bank had reached an "acceptable balance" regarding implementation. Can you just start by explaining how that balance is going and how the PRA views the issue as it stands presently?

Sam Woods: Congratulations, Mr Mather, on your arrival on the Committee. This is a very important topic. I take it from the fact the Committee is asking about it in this session that the Committee is pretty interested in it too.

We have consulted on removing the supporting factor, but I would make a couple of points about that. First, we are not proposing to do that unmitigated. We are proposing to bring in a new discount factor of 15% for corporate SMEs, which Basel has but, by the way, the EU is not planning to do. We have also proposed to continue with the existing 25% discount that SMEs get relative to corporates.

We have also looked carefully at the evidence around how these changes can or cannot impact lending to SMEs by banks. We are looking at further evidence on this. Andrew touched on it briefly, but shall I give you a little bit more colour on why he said what he said?

Keir Mather: Yes, please do.

Sam Woods: There are four main studies of this. One was by the European Banking Authority in 2016. That was specifically on the SME supporting factor. That found that it had no impact, zero. There was a study by the Banco de España that found it had some impact—it was



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modest—for large SMEs but none for small SMEs. The Banque de France did one that suggested there might be an impact, again quite modest, with a two-year delay. The most comprehensive review of the effect of capital requirements in this area was by the Financial Stability Board in 2019. That found no effect.

Why might that be? It is because all sorts of different things are affecting how banks decide to lend. A point that is often missed is that only about 5% of the funding that is used to fund those loans to SMEs comes from equity. If you move the equity dial around a bit, it does not change the entire stack that much. There is also the famous Modigliani-Miller theorem, which says that, if you have more equity, debt becomes cheaper. That is not perfectly true for banks for various technical reasons.

Having said all that, we are very conscious that moving this around could have an impact on either the price or the quantity of SME lending. It is an important thing for the PRC to consider. We are considering whether to evolve our position. We will not want to take forward a measure that we believe would have a damaging effect on SMEs. That would be a very odd thing for us to do.

Q146 Keir Mather: Forgive me—this is in part because I am new on the Committee—but what are the secondary objectives that you are attempting to balance against? On the one hand, you hopefully have a policy mechanism that will facilitate scale-up, greater employability and a concurrent effect on growth. What is the other side of that coin that creates the dilemma for you, in a sense?

Sam Woods: That is well expressed. Our primary objective is safety and soundness. In this space, that means we ought to make banks hold the right amount of capital for the risks that they run.

If you deliberately do not do that in regulation, if you just say, “Let us just not do that because banking is a favoured industry”, or whatever, what will happen—this is what happened with Silicon Valley Bank in the US—is that markets and depositors will realise that you have done that. At the worst possible moment, you will have a panic. You will then have a thing that is really terrible for SMEs, which is their bank going bust.

We have that on the one side. On the other side, we have the very important role that SMEs play in employment and growth. That is relevant to our primary objective because a healthy economy is good for our primary objective, but it is also relevant to our new secondary objective.

We are not trading those things off exactly, because the way that the objectives fit together does not allow us to do that, but we are mindful of it all. The industry has put forward a proposal for a transitional period to allow adjustments to be made. That is an interesting thing that we will have a close look at.



Q147 Keir Mather: I want to dig a bit deeper into certain types of SMEs and how they might be affected. I believe you said that one of the studies showed there was some correlation in terms of SMEs of a sufficient size being able to benefit from the supporting factor being in place.

My question is about the SMEs that we are hoping will be able to scale up, employ more people and have a regional economic impact and the issue around high-risk SMEs and their ability to access finance. In regard to those high-risk SMEs that are about to scale up and move out of being SMEs, does the SME supporting factor, as it presently stands, provide them with assistance that is valuable from the PRA's perspective?

Sam Woods: The answer is probably no but for a specific reason. I might be wrong on this. The type of capital that you are talking about there is really equity. That is what firms are looking for when they are trying to do those sorts of things. This really attaches to debt, which is typically from banks to those sorts of firms.

As an aside, the Government are proposing to take forward—we agree with this—something on the ringfenced bank review that will make it a bit easier for ringfenced banks to hold, in an appropriate way, equity in SMEs. It is probably less relevant for that and more relevant for the normal flow of lending to SMEs that need to do things with their finance. Let me just bring in Phil.

Phil Evans: The business growth fund does a lot of equity-based investment. That is a collective investment scheme across the banks. Sam is right: this is more about debt.

Q148 Keir Mather: In March last year, the BCC wrote a letter to our Chair regarding their support for the SME supporting factor. One of the justifications was that it was implemented just after the financial crisis at a time of economic precariousness that prohibited the SME lending that was conducive to growth.

Does the fact that the PRA is considering, albeit with a transitional phase, a removal of the SME supporting factor now say anything about what your perspective is on where we are set to go economically over the course of this year?

Sam Woods: No, it does not. We plan to set this regime to last for a long time. The whole regime only transitions in over a five-year period. There are some other bits of it, including something called the output floor. We will not make it with a view to specifically what is happening in the moment. Indeed, the intended go-live date at the moment for these rules is mid next year. That would probably go past the timeline that you gave.

As a general point, yes, we are trying to be very sensitive to the interest that the Committee and the Government have in there being a good supply of finance to SMEs. We have no desire to disrupt that. We will not take forward a proposal that we think will have that effect.



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We are still thinking about what to do, but, if we did put something in place and it then became apparent to us that it was having quite a negative effect on SMEs, we would at the very least reconsider the position. It is unlikely that we will do anything that will in fact have that effect.

Phil Evans: I have one thing to add. You are right to focus on this particular thing, but there are other important elements of the SME package. We have received a lot of feedback on those. We had something like 125 responses and we had more than 70 meetings with firms. Many of those raised the SME package. We are looking very closely at other elements as well, not just the area that you are asking about.

Sam Woods: We will evolve on some of those points.

Q149 **Keir Mather:** Just finally, despite you making the case very well, if, due to concerns around the removal of the SME supporting factor, Parliament decided to mandate the PRA either to hold the supporting factor in place or to institute something very similar to it, how would that affect your ability to manage the overall landscape of SME finance?

Sam Woods: Under the hierarchy in our system, we would always fall in line with a law passed in Parliament. It would be wrong for us, in that context, to try to re-engineer it in some backdoor way. We would just have to accept it.

However, it would create the risk that I described. We would have a part of the banking system that was deliberately, by design, not carrying the amount of capital that all the evidence suggests is needed for those sorts of exposures. That might be fine in good times, but in bad times it would not be fine. It would be much better not to go down that route without extraordinarily strong evidence, which we do not have, that what we are thinking about would have a very negative effect.

As I say, partly in view of your interest and that of others, we are wondering about the right way forward. You should expect the package to evolve somewhat relative to what we consulted on.

Chair: That sounds like news for the Committee and something to include in our report. Thank you very much.

Q150 **Dame Angela Eagle:** I want to ask about potential conduct fines in the car financing market. You will have been following the news, like all of us have, about potential fines for mis-selling because of discretionary commission, which was being applied by various brokers to those financing the buying of cars between 2007 and 2021.

Some people have said that this might involve a possible bill of up to £13 billion in compensation due to the financial entities that have been lending that money. To what extent do you worry about this from a prudential point of view? If it were to crystallise at that level—it seems to have been very widespread—might it present a prudential problem?



Sam Woods: We have been very closely engaged on it, partly because the range of outcomes seems quite wide. You gave one estimate. It is quite a large number. There are several other estimates from analysts.

The devil is in the detail on this one. There are so many different commission structures. Quite where any type of conduct fine or redress bill might land will probably be quite specific from one to another. I think I speak for us when I say that I am not concerned at this point that this is a financial stability issue, but it clearly has the potential to become a quite significant conduct issue with quite significant financial ramifications. We are closely engaged on it, both with firms and the FCA.

Q151 **Dame Angela Eagle:** Given that the consumer duty has now come in, one would hope that such behaviours might be taken out of the market. Clearly, having a range of discretionary and hidden commissions, which give the broker a financial incentive to sell that particular product and mean that the customer gets a worse deal than they would have had if the commission was not there, would fall foul of the consumer duty that is now in place, would it not?

Sam Woods: The specific structure or family of structures that we are talking about were in fact banned by the FCA in 2021, in exactly the same spirit as you just said.

Q152 **Dame Angela Eagle:** We potentially have this big mess to clear up as a result of misbehaviour going back to 2007. It has been going on for rather a long time in a very large market.

Sam Woods: Yes. To put it crudely, the commission structure, which delivers a higher commission if the car salesman or saleswoman manages to sell a higher interest rate to a customer regardless of the creditworthiness, is just a bad structure. That is a bad incentive. I would hope that the consumer duty would preclude such things emerging in the future. The consumer duty has only been with us for a short time. We have only just dropped the “new” in front of it. We will see.

In principle, the idea of it is exactly that: to try to stop these kinds of things from emerging rather than having lots and lots of detailed rules, which firms find their way around in various different ways.

Q153 **Dame Angela Eagle:** To what extent will you be involved with the FCA as it decides whether to fine the companies that have indulged in this behaviour between 2007 and 2021? To what extent are you involved in helping them make decisions? To what extent will any thoughts about financial stability or the health of particular companies be in your mind if you do intervene behind the scenes?

Sam Woods: We have been closely involved throughout for the reason embedded in your first question. The decisions about whether and how to pursue this from a conduct lens, both from a sanctions—that is sanctions with a small “s”—and a redress perspective, are for the FCA. I am sure the FCA will keep us closely involved in these decisions as they go along.



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The FCA has taken a very sensible approach to this so far. In particular, it has decided to step into a very complicated situation with the aim of bringing a bit more order to it. That is really very helpful.

Q154 **Chair:** I wanted to close with a question for Tanya, as the external member. Have you seen any change in the behaviour of the organisation since the new secondary objective on competitiveness was implemented?

Tanya Castell: Yes, definitely. As Sam mentioned, in any policy discussion there is a section on it. Not only is there a section on it, but we ask questions about it and there is challenge about it. It definitely comes into our discussions and considerations.

Q155 **Chair:** Can you give a good example of where you have seen the PRA do something differently as a result of this new objective?

Tanya Castell: In a way that is harder because we get a relatively fully formed policy. They will have gone through the options and they will be presenting what they think is the right way forward. When we are talking about specific policies, we will always be trying to think about what the downside might be and whether that has been fully considered.

For me, it is more pervasive. It is through all their thinking. That is one lens that they are using to look at things rather than, "We saw something and then it has changed", if you see what I mean.

Q156 **Chair:** What you describe sounds more like risk aversion than thinking about the competitiveness objective.

Tanya Castell: I come from a risk background so that might just be my terminology. The primary objective is always where you start from, but, given that, it is about what the different options are and what would best achieve the secondary objective. If there are three ways of doing it, we look at what will best achieve the secondary objective to make sure we have taken that into account.

Q157 **Chair:** You have seen specific examples of that.

Tanya Castell: In most policy discussions we take that into account.

Q158 **Chair:** Is there anything that we have not surfaced that you feel you need to share with us?

Sam Woods: No. We have been very comprehensive.

Chair: Have we covered all the topics that you were hoping we would cover?

Sam Woods: Yes.

Chair: In that case, I shall say that that concludes our meeting looking at the work of the Prudential Regulation Authority. Thank you very much for your evidence this afternoon.