HOUSE OF COMMONS

Treasury Committee

Oral evidence: The appointment of John Taylor to the Prudential Regulation Committee, HC 1132

Wednesday 13 January 2021

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Watch the meeting

Members present: Mel Stride (Chair); Harriett Baldwin; Felicity Buchan; Mike Hill; Julie Marson; Siobhain McDonagh.

Questions 1 - 21

Witness

I: John Taylor, Appointee as External Member, Prudential Regulation Committee.

Examination of witness

Witness: John Taylor.

Q1 **Chair:** John, good afternoon. I would like to begin with one of your questionnaire responses, in which you noted, "The single most significant ongoing risk relates to credit risk for lending institutions". What prudential and other measures do you think should be taken to mitigate that risk?

John Taylor: The key challenge for banks here is once the Government support schemes start to come to an end and the exposure to credit risk lies primarily on their own balance sheets. The challenge there is for the PRA, first of all, to make sure these lending institutions remain robust and resilient throughout and, at the same time, continue to support the economy in a time of ongoing need and individual members of the public.

From a prudential perspective, I would probably build on Antony's answer earlier. It is about the PRA having a look a wide variety of scenarios. There are the public health scenarios and the economic scenarios. We still have a very wide funnel of doubt. While we are all very hopeful that the vaccine rollout will quickly narrow the scope of potential outcomes, that is yet to happen. The supervisory teams need to explore with each individual firm how resilient they are to those range of economic scenarios.

There may also be further measures, again as Antony mentioned. There is encouragement at the moment to be prudent around dividend and bonus distribution. If something deeply unfortunate was to come along—for example, the vaccines no longer being effective against a new variant—perhaps that measure might need to be revisited and made more definitive. It is looking at scenarios and then, for individual organisations, looking at specific measures to make sure they remain resilient.

Q2 **Chair:** As Antony referred to, you obviously have quite a lot of experience on the insurance side. Could you share with the Committee your thoughts around the resilience of insurers in light of the risks around business interruption insurance claims, etc? I think I am right, from memory, that it might be the end of this week that the Supreme Court is going to pass its final judgment on the remaining disputes between the view of the FCA and the insurers as to the meaning of their policies and hence liability. Depending on where that judgment lands, is this something that we should be worried about, from a stability point of view?

John Taylor: It is probably worth taking a bit of a step back and looking at the beginning of the crisis again, where the insurance sector in general was pretty well capitalised and resilient in a whole range of operational issues. Throughout the turbulence of the last nine months, despite equity markets moving, credit spreads widening, it has been pretty resilient. As you highlight, the single biggest challenge to firms is the extent of business interruption claims. I have yet to start at the PRC. Tomorrow will be my first committee meeting, so I do not have that line of sight through to individual firms. I hope and believe that the range of uncertainty has narrowed somewhat. Indeed, it is probably more likely to characterise the impact of coronavirus as a depressed earnings event rather than a material solvency concern.

Going forward, it probably has illustrated the need for the sector to be much clearer on its terms and conditions. That is just as much a valid point from a prudential regulatory point of view, to make sure firms are not unwittingly exposed to greater liability. It is also vital from a customer treatment point of view that the people buying these policies are very much aware of what they do and do not cover. That is probably the key lesson from both a prudential and a conduct perspective.

Q3 **Chair:** Thinking about dividends, banks were lent on and really instructed not to issue dividends. There may have been some suggestions that the insurance sector restrict dividends, but there seems to be a much more lenient approach to them from regulators. Do you think that was the right thing? Why would it be the right thing?

John Taylor: I absolutely think it is the right thing. It is worth remembering how the pandemic and restrictions are affecting different parts of the financial sector. As we have already touched on, banks are very much in the front line in terms of exposure to significant credit risk. General insurers are also very exposed to business interruption claims, potentially directors' and owners' liability insurance. The life sector, somewhat perversely for an industry offering life insurance, has not been materially affected by the virus, simply because many of the unfortunate premature deaths are later in life, which is not where insurance typically lies.

For individual firms that do not have those exposures and may be resilient to market movements, it was quite appropriate for the PRA to give them individual discretion, encouraging them to be prudent but assuming they were able to satisfy themselves and their supervisory teams that a dividend distribution was appropriate. That is quite a reasonable degree of flexibility to offer.

Q4 **Chair:** What might the longer-term impacts of the Covid crisis be on the insurance sector?

John Taylor: There are certainly quite a number of areas to reflect on. One we have already touched on is around clarity around terms and conditions being absolutely clear about which risks are insured and which risks are not. It is important not only from a prudential point of view but from a conduct point of view.

Another immediate consequence is being alive to the range of outcomes yet to work their way through in terms of mortality and longevity risk. We are obviously all hopeful that highly effective vaccines will bring much of the pain to an end, but there still may be impacts; hopefully there will be no other pandemics too soon, but there will be people who are suffering from long Covid. What will the impacts be on risk there? That is another area where we need to explore the range of longevity and mortality outcomes.

Slightly more philosophically, there is a question for the PRA and firms to reflect on about how they deal with events that may be high impact but low likelihood. Certainly, pandemics were on firms' risk registers last year, but they perhaps were not as effectively mitigated as they could have been. It is worth taking a step back, maybe in conjunction with looking at the national risk register and some of the very high-impact but low-likelihood events, trying to work through what would happen if one of those events took place.

Q5 **Chair:** What would be on that list, John, along with viruses? What other high-impact, low-likelihood events would you have on the list?

John Taylor: There are certainly a range on the national risk register. There are other health-related ones, like resistance to antibiotics and so on. That could have a very serious impact on longevity and mortality. There are other more obscure events. Some of you may have heard of the Carrington Event in the 1850s, where solar activity effectively caused very substantial electromagnetic disruption on the Earth's surface. Given the dependence we have nowadays on communication and internet, the implications there could be very serious from an operational risk perspective.

Another one that is probably not on the national risk register but that I know that financial services forums are already contemplating is around developments in quantum computing that could move computing power on by several orders of magnitude. That would overall be a good thing but, for example, many of the typically employed encryption methods could be vulnerable to that type of computing power. I would not claim that as a comprehensive list, but I hope it gives a flavour for the diversity of high-impact, low-likelihood risks that are worth contemplating.

Chair: Thank you, that is extremely interesting.

Q6 **Mike Hill:** Hello, Mr Taylor, and thank you for coming before the Committee. We are now two weeks along from the end of the Brexit transition period. What is your assessment of the state of financial stability and how the firms and sectors regulated by the PRA have handled the changes?

John Taylor: Again, I would probably have to qualify my remark by saying I have yet to start on the committee, so I am not privy to the individual readiness of various firms. My sense from my networks and from observing industry is that the actual moment of departure has not created too much turbulence, probably by virtue of two equivalence agreements that the UK has reached with the European Union. Much of the financial infrastructure has remained in place and has enabled institutional transactions to continue. That potential serious risk to stability was somewhat mitigated. The one caveat is that I gather those permissions are temporary. I would imagine my colleagues in Treasury will be working quite hard to figure out what happens at the end of that.

The lack of broader equivalence is probably more of an operational challenge. I know that Sam Woods told this Committee that a number of UK banks are having to offboard retail customers who are on the continent. There are insurance implications that are not quite as clear cut, because many of the relationships between insurers and policy-holders are contractual long-term relationships, so offboarding is not an option. There are some customers who may well be in limbo and would benefit from some type of equivalence. That would be my sense of the immediate impact but, clearly, there is a longer issue to play out now.

Q7 **Mike Hill:** In your questionnaire response, you say, "Taking advantage of the freedoms available in leaving the EU may be constrained by the desire to have the UK regime recognised as equivalent", as you have just said. Would you place a high premium on achieving UK regulatory flexibility in the March memorandum of understanding, even if that meant sacrificing access to the EU markets under equivalence?

John Taylor: This is clearly a key question for my Treasury colleagues to be focusing on over the next few months. From where I sit today, my perspective would be that there is an opportunity to be realised here in developing a successor regime here, because the current European Solvency regime is highly prescriptive. It is very much a one-size-fits-all arrangement that certainly makes some accommodations for the UK but is not highly designed for the UK. The opportunity for the successor regime is to be less prescriptive, offer more discretion, be more agile and be more tailored to the UK. There are certainly specifics around the Solvency II insurance regime that could be highly beneficial to the UK insurance sector.

The prize in terms of equivalence is not to be sniffed at. The benefits in having a single market are good for consumers; it gives greater liquidity and greater choice. I would point out that individual savings markets across Europe are quite different. The benefit of UK insurers accessing individual territories in the UK probably is not as valuable as it might be for suppliers of goods. My overall conclusion would be there is a lot to be gained by taking advantage of the successor regime. As the Governor said previously, becoming a rule-taker is not a price worth paying for equivalence.

Q8 **Mike Hill:** Your questionnaire response also discusses some of the opportunities that may be available to reform aspects of the Solvency II regime for insurance in the UK. Can you outline what you see as the priorities for reform?

John Taylor: First of all, I would say that the broader underlying principles of the Solvency II regime are pretty solid and robust. Indeed, the PRA have been supportive of some features like using a realistic balance sheet, market equivalence and so on. Those are features that any successor regime should retain. If I were to highlight an area to consider changing, that would be the risk margin. That is a component that can be very onerous for insurers, particularly in a low-interest-rate environment. Indeed, it creates difficulty for longevity insurers. Many of those are offshoring the longevity risk outside of the European Union. Reform there might give us something that is more anti-cyclical and benefits longevity insurers.

Q9 **Mike Hill:** You recognise that there are risks from the reforms.

John Taylor: Yes. In taking advantage of changes and developing a successor regime, we need to make sure that whatever we put in place does not compromise the financial stability objective. That is first and foremost. I am a great believer that we can take advantage of more discretion in a way that suits the UK market without compromising that objective.

Q10 **Mike Hill:** Do you foresee any difficulties in the UK making these reforms if they threaten equivalence with the EU, if that is what your opinion is, or divergence from global standards based on Solvency II?

John Taylor: In terms of diverging, there is certainly the issue I described earlier about the UK financial services market and its relationship with clients that are currently on the continent. That is an issue that would have to be addressed. It is about looking at both sides of the equation here, in that a more liberal regime that still protects solvency might confer benefits to the UK financial services industry.

If I can give you another example of that, the current regime makes it quite difficult for institutions to invest in the infrastructure that might be beneficial to UK plc at a time of recovery. Embracing a regime that might facilitate that type of investment, while still recognising that there are risks in infrastructure investment, might well overall be a good thing and is potentially a price worth paying to forgo a rule-taking version of equivalence.

Q11 **Mike Hill:** Talking about UK plc, it is noted that the Treasury has proposed that Ministers are consulted by regulators more systematically, and certainly at an early stage, on any proposals for rule changes. Do you have any views on the suitability of that and whether it has any implications for the Bank's independence?

John Taylor: One of the interesting things about a potential successor regime is that it may well afford the Bank and the PRA greater discretion. That certainly has to be exercised responsibly. Part of that probably involves greater accountability to Parliament and greater transparency. This Committee is clearly one manifestation of the current accountability, but I would certainly be open to a revised form of accountability that might be appropriate for the greater discretion that the PRA will have in future. To your specific question, I certainly do not have any qualms about consulting the Treasury in advance. It is not necessarily a direction and the PRA's independence would require it to consider the consultation response but not necessarily follow it.

Q12 **Siobhain McDonagh:** John, what is your view of the operational resilience of UK financial service firms and how they have coped with coronavirus?

John Taylor: It has been remarkably strong. If I think back to the history of operational risk and resilience, it was probably the poor cousin of financial stability, solvency, liquidity and so on. The work that firms, encouraged by the PRA, have undertaken in the last few years has been quite remarkable in raising the standard of operational risk. What has been a pleasant surprise for me is the way that firms have responded to the various pressures of the pandemic. The risk and stress scenarios certainly did not anticipate this particular type of risk.

For example, disaster recovery was a key part of operational risk that envisaged that, should a head office become unavailable, firms would relocate to a city boundaries warehouse and use that as their head office. Clearly, the nature of this pandemic means that is an inappropriate mitigation. They have had to be quite agile to move through to a distributed way of working for a prolonged period of time. They have done that fairly successfully.

Looking back, there are definitely lessons. I know back in March, while the health service was scrambling for PPE, financial services companies were scrambling for laptops at that time, just to support the distributed way of working.

Siobhain McDonagh: A lot of people were scrambling for those.

John Taylor: Yes, indeed. I hope you were successful. Eventually, firms got there and managed to maintain critical services like lending to businesses, lending to individuals, paying out insurance claims and paying out annuity income, which is clearly critical for many families.

Q13 **Siobhain McDonagh:** On the outbreak of coronavirus, the PRA delayed its consultation and operational resilience policy. Is the PRA sufficiently focused on the issue? Does it have the right balance between operational and financial resilience?

John Taylor: On that last point, the heritage of prudential regulation has been much more on the financial aspects, as I said a moment ago. That has undoubtedly changed recently. The PRA was certainly building up a very effective momentum around operational risk prior to the virus by, for example, launching consultation papers that were describing a framework that firms should adopt for managing operational risk, measuring it and setting themselves impact tolerances and mitigation measures to be able to restore things. Of course, operational responsibility is a key part of the senior managers regime.

As you rightly point out, that consultation process was one of the things that the PRA then deferred. It is now about to recommence. We should recognise that the deferral was entirely appropriate, because not only the PRA but firms themselves were having to deal with an exceptional event. Even from an operational risk perspective, the experience might offer some helpful lessons in future operational risk.

Q14 **Siobhain McDonagh:** In your questionnaire response, you note that the coronavirus lockdown means that information security and cyber risks are heightened, given that firms are operating on a distributed basis on infrastructure not designed to be used at scale indefinitely. Looking forward, how should the PRA work to assess these risks?

John Taylor: Cyber in general is a very substantial issue from two perspectives. One is firms are becoming increasingly digital and the current way of working is one manifestation of that, and the threats are becoming increasingly sophisticated.

I have been pleased that the PRA has so far been quite a thought leader in this area, for example in developing this approach to penetration testing called the CBEST protocol that 18 of the largest firms have been through. It is developing a more proportionate version of the same technology to help smaller firms manage their own penetration testing. The authorities response framework is another helpful piece of management from the PRA, working alongside the FCA and, if necessary, the National Cybercrime Security Agency, to manage incidents as and when they happen.

The question around individuals working in unsecure environments is one that we will need to explore specifically with firms if, as seems likely, that is an enduring part of the ways of working in future.

Q15 **Julie Marson:** Good afternoon, Mr Taylor. I would like to again return to climate change, please. I will start with a couple of the general questions I asked the previous witness. What is your assessment of the PRA's assessment of climate change risks and the timelines that firms have been given to embed their own approaches to managing those risks?

John Taylor: In some ways, there are parallels with the PRA's work on operational risk, in that excellent momentum and world-class leadership built up prior to the pandemic and there was then a degree of deferral to allow the PRA and firms to focus on more immediate issues. The measures taken prior to the pandemic were exemplary. I know that regulators across the world are taking a leaf out of the PRA's book. Just as an example of what firms are having to do, they need to embed it in their risk management processes—that is setting tolerances and looking at stress scenarios—it needs to be part of their governance, regularly discussed at boards, and it has to form part of their disclosure through TCFD.

Firms are now being encouraged and mandated by the PRA to achieve that embedding by the end of the year. That might be quite an optimistic and ambitious goal, but that ambition is quite appropriate. After a year of deprioritising climate risk, the climate emergency is such that we cannot afford a further deferral. It is quite right that the PRA are demanding of themselves and the firms to move on. My inner Greta Thunberg says that a further deferral is not appropriate at all.

Q16 **Julie Marson:** Similarly, do you think that firms really get it? Do you think they understand what needs to be done and the timelines involved? What role should the PRA and the PRC play in helping that along that journey?

John Taylor: One of the organisations I am involved in is the Scottish Financial Risk Academy, where we have risk practitioners across the Scottish financial services industry. It is very clear to me there that there is a willingness and a desire to move forward very effectively on the climate risk agenda, but not necessarily having the clarity on exactly what to do. That is really the opportunity for the PRA to help give the framework some structure around this, so that great intent that resides in most firms can be used to good purpose.

The upcoming stress test that the PRA is now about to develop in earnest will be a fantastic way of understanding exposures that individual firms are running, and indeed that the system is running. Through that learning, we will undoubtedly see a further iteration of the management of climate risk.

Q17 **Julie Marson:** What is your assessment of the risk and the prevalence of potential greenwashing?

John Taylor: The imperative here for the UK, firms and consumers is to deal with climate risk effectively. If firms themselves or the organisations they are investing in are greenwashing, it does not help anyone. I believe the motivation of firms is very strong to respond well to this agenda. They are alive to the risks of greenwashing. The mandatory TCFD disclosures that all firms will be subjected to in the UK in the coming years will be an effective way of revealing how different organisations are undertaking the climate risk challenge. Firms have a real appetite to understand how their investments are behaving; it is not beneficial to anyone to do otherwise. I know many are already active on the stewardship front in dialling down carbon exposures.

Q18 **Julie Marson:** In what ways do you think climate change will potentially affect the prudential resilience of major banks and insurers? I know you have a lot of background in insurance in particular.

John Taylor: I will maybe start with insurance. As Antony said, the general insurers in many ways are on the front line of this, because they are exposed to rising frequency of catastrophe events, whether it is hurricanes, flooding or even geographically remote events that can disrupt supply chains, which would give rise to business interruption claims. They are very much on the front line. That definitely carries with it a prudential supervision aspect, in that stress tests are potentially becoming more onerous, because what might have looked like an improbable event 10 years ago becomes more probable now. It is incumbent on firms to ensure that they have the capital to withstand such shocks.

If I think of life insurers, one of their key characteristics is that they are long-term investors. This is where investment stewardship really comes to the fore, because the risks for them and their policy-holders is that, if they do not effectively manage the risk of stranded assets, carbon exposure and so on, they are not only going to disappoint their clients, but potentially it might lead to some balance sheet strain. That is the key area of focus for insurers. Potentially, there is an opportunity to invest more in some of the new carbon technologies. Again, it comes back the question that Mr Hill asked. If we can develop a successor regime that is better disposed to investment in new technology, recognising that there is a risk in it, it might also support the broader transition to net zero.

Q19 **Julie Marson:** We have touched on it. These are big issues. These are fundamental industry issues. Do you think that there is a recognition of that at board level in financial institutions and insurers, with a real understanding and appreciation of that risk?

John Taylor: Yes, I am pretty certain of that. There is a question that we probably still have to work our way through when we look at the exposures firms are running and the mitigations that they need to take against those risks. When they then potentially run the risk of higher capital requirements or diluting profits, does the resolve start to weaken at that point in time? That is largely for firms. The PRA perspective is to make sure that, no matter what firms decide they are doing, they make sure that their firms' business models and balance sheets are resilient to those climate risks.

Q20 **Julie Marson:** In your response in your questionnaire, you say that there is likely to be a significant transition away from a high-carbon economy and that that creates risk for financial institutions. In terms of insurance in particular, do you think they are prepared? If not—it is a similar question—what can the PRA really do to help make that journey for insurance companies, for example, in particular?

John Taylor: I am not sure many firms would claim to be fully prepared for the physical risks and the transition risks that we are facing over the next decade or two. Many have made good steps towards that. I have been involved, again through my Scottish Financial Risk Academy work, and am very well aware that firms are dialling down exposure to carbon and are actively stewarding higher carbon investments away from carbon. They are doing that already. The key thing the PRA can do is to just give a structure and a framework in which firms can operate and move forward consistently. That is probably the key contribution the PRA can make.

Q21 **Chair:** John, thank you. That brings us to the end of our session with yourself. As with Antony, we do have a minute or two if there is anything else—there need not be—that you want to raise with the Committee.

John Taylor: There is nothing that I am burning to share. Thank you for your interest this afternoon. I am very much looking forward to starting with the committee tomorrow. It is just such an extraordinary time to be joining an exceptional organisation like the Bank. I am looking forward to giving back in some shape or form. I hope I will get to see you again in the future, but I appreciate your time today. Thank you.

Chair: Likewise, thank you very much for your time, John. That concludes this session.