

Treasury Committee

Oral evidence: [Appointment of Sam Woods as Deputy Governor for Prudential Regulation and Chief Executive of the PRA, HC 567](#)

Tuesday 19 Jul 2016

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Members present: Mr Andrew Tyrie (Chair); Mr Steve Baker; Stephen Hammond; George Kerevan; Chris Philp; Mr Jacob Rees-Mogg; Rachel Reeves.

Questions 1-73

Witness

[I](#): Sam Woods, Deputy Governor for Prudential Regulation, Bank of England.

Written evidence from witnesses:

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Examination of witness

Witness: Sam Woods, Deputy Governor for Prudential Regulation, Bank of England.

Q1 Chair: Thank you very much, Mr Woods, for coming to see us today. This is an appointment hearing. You are quite well known to me, because you chaired—well, I shouldn't use quite that word; you were secretary to the Vickers commission. You had a very heavy influence on the work; you did the donkey work for that commission, and it was a very interesting piece of work that had a considerable effect on the structure of British banking.

Can I go straight to a question about the structure of the Bank of England's policy work? We have had over the last few years quite a lot of evidence from a number of people suggesting that having more than one policy committee may lead to tension between the MPC and the FPC and taking the view that those two committees should be joined together to form one policy-making committee. You are fresh to this. Have you any thoughts on that issue?

Sam Woods: Yes, I do have views on that, in that I don't agree with the people who make that argument. I had some experience in the FPC when I was running the macro-prudential part of the Bank, and I have also attended one meeting since my appointment.

Q2 Chair: These people are quite distinguished, aren't they? One is Kate Barker. There is the financial services practitioner panel, the small business practitioner panel and others.

Sam Woods: Yes. I don't belittle their view. It is the sort of subject on which reasonable and well informed people can differ, but I am on the other side of the argument, and that is not because that is a structure that I have in front of me; it is because, in my experience, having those two committees, with their two separate objectives, will lead to a better result.

The best way to evidence that claim is perhaps through an example, and the one that I am familiar with, although this was a couple of years ago now, is the intervention that the FPC made, with the assistance of the PRA, in the housing market back in 2014. The issue was that the FPC was concerned about a build-up in the proportion and number of highly indebted households, and that build-up was enabled to some extent by low interest rates, which were enabling households to borrow more. Monetary policy was having an effect there and was one element in the financial stability risks that the FPC saw building up. Rather than the tail wagging the dog and that having to be sorted out through monetary policy, the FPC, which has different tools available, brought in the measure of limiting to no more than 50% the flow of mortgages that can be done with an LTI ratio of above 4.5. That is a good example of where, if you

have a committee with a different focus, you can get a more efficient and targeted response to a financial stability risk.

Q3 Chair: Yes, but you can get policy pulling in one direction in one committee, and in the other direction in the other.

Sam Woods: I wouldn't deny that such tensions can exist. In fact, if the tensions couldn't exist, I don't think there would be any point in having more than one committee. The point is that there can be tensions, but what we in the executive in the Bank have to do is make sure that we have, and can supply those committees with, a very rich understanding and analysis of the different impacts that their actions can have on the objectives of other committees. Then it is over to the committees to pursue their own objectives. There is a heavy governance burden for line staff in the Bank, having these three committees and the Court above, but I think the benefit is quite significant.

Q4 Chair: But what about the overlap between committees? The argument that you have just put forward implies a need for a completely separate membership.

Sam Woods: I think there is overlap of content and overlap of people. On the overlap of people, I think it makes sense to have some shared membership, because that aids co-ordination. That does rely, crucially, on people being able to wear a different hat when they are doing different jobs. I have seen people doing that; I don't think that anyone has any difficulty with that as a concept.

But you also have—this is another reason for having some overlap of people—some areas where the committees will have a strong joint interest. The one that I am most familiar with is the capitalisation of big banks. That is obviously a topic on which both the PRA board, shortly to be the PRC, and the FPC have a very strong interest. We have created stress testing as a mechanism for that debate to be played out publicly and in a transparent way.

Q5 Chair: On another issue, you will have seen—I mentioned it a moment ago—that there has been correspondence between Andrew Bailey and me, on behalf of the Committee, about disclosure and the extent to which information collected by the PRA could be put into the public domain, enabling markets to exercise some of the discipline, to do some of the heavy lifting for the regulator. The main argument against that is that if the banks know that this is where it is going to go, it might make it difficult to collect information. There may also be some genuine concern with respect to commercial confidentiality and, possibly, to security implications in a very small number of cases. I shall divide this into two questions. First, do you agree with this Committee's view that there should be a predisposition in favour of maximum disclosure, consistent with commercial confidentiality?

Sam Woods: Yes, but with the very important caveat that you provide on commercial confidentiality. I suppose the question is, what would the impact of such a caveat be? I bring an open mind to that question. I have

seen the correspondence between you and Andrew on that topic. I have personal experience of this which conditions my open mind about it, although it is not directly relevant to the financial services arena. I am originally from New Zealand and at one point I did a secondment from the British Treasury to the New Zealand Treasury. This was at a point when the FOI Act was not yet in place in the UK but one had been in place for a long time in New Zealand. It was very striking to me that there was an organisation doing the same line of business which had a completely different attitude towards disclosure.

Q6 Chair: By which you mean a much more open attitude?

Sam Woods: Yes, it was much more open.

Q7 Chair: And the sky didn't fall in? Firms didn't cry foul and they carried on trading perfectly happily?

Sam Woods: The sky did not fall in.

Q8 Chair: And markets were better informed?

Sam Woods: There were some benefits, certainly, to this high level of disclosure. I mention that angle only because it opened my mind to the possibility that bureaucrats can have too cautious a view about what the right level of disclosure is. Having said all that, there are a couple of important principles here. One is something that I have always held to in all my work: it is very important that firms are responsible for their own disclosures. I am not convinced that disclosure via the regulator is always a good idea. There are obviously some things that we do disclose—stress test results are the most obvious example.

Q9 Chair: Once they know that, first, they have to supply it to you and, secondly, you are quite likely to disclose it, we might get a higher level of disclosure from firms? It is not a question of you telling them what to do; it is just a question of it happening.

Sam Woods: Pressure can have an effect. One of the examples that Andrew highlighted in his letter to you is the enhanced disclosure taskforce. That is a private sector initiative, but in effect we have given it our blessing and given firms a shove on it and they have taken it forward. That is an example of where the interplay between us and what firms do has been beneficial, but I would like to keep the principle, as a broad-brush thing, that they are on the hook for what they tell the market. I absolutely agree with the basic point that market discipline is an important tool for us to use—use may be the wrong word, but to have—in prudential supervision. Sometimes, and a counter-cyclical policy may be an example of this, if we come on to that, the market could actually frustrate what we are trying to achieve, and that is a more interesting dynamic.

Q10 Chair: We have specifically proposed that there would be a disclosure policy, a predisposition in favour of disclosure, with reasons, at least one of which would need to be satisfied for something to be withheld. What do you think about that?



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Sam Woods: That is a very reasonable general proposition, but—

Chair: That is very good news—you can stop there, Sam.

Sam Woods: I don't want to leap to a view on that, but I am happy to have a look, and I will do that with an open mind. The reason for that is that this disclosure area is quite heavily set with a number of regulations. Also, the FCA has a very important role to play and is, in the end, the arbiter of fair markets and disclosure rules, so I would want to be sure, if we were progressing down a track, that it was something both we and the FCA were comfortable with.

Q11 **Chair:** But would I be wrong, in reading between the lines of this evidence, as I might tomorrow in the transcript, to come to the view or conclusion that you are going to push for more disclosure, that you come to it with an open mind, that you have got the New Zealand experience to draw on, that you are predisposed to think the approach being proposed by this Committee is reasonable and that you will take a fresh look at it? Have I got any part of that summary wrong?

Sam Woods: The only bit that I would wish to contest is "commit to push". Will I approach it with an open mind and have a fresh look, and do I genuinely mean that? Yes, I do.

Chair: Excellent. Thank you very much.

Q12 **Stephen Hammond:** Mr Woods, good morning and thank you for coming. Can I turn your mind back five months, when you very kindly answered written questions? In an answer to a question about experience, you said: "I do not think there are any areas where my experience or knowledge falls short...One area in which I intend to develop further is my experience of international supervision".

You have a very impressive CV, but can I just test you? You are going to be on the board of the FCA. In that area, I think it would be very helpful for the Committee to hear your views on four things. First, there have been significant intentions within that organisation about its ability to supervise retail and wholesale operations. In particular, wholesale markets have been extremely unhappy about that process. Secondly, what lessons do you think there may be for the FCA in the debacle over recent leadership departures? Thirdly, what is your view of the FCA's inconsistent interpretation of ESMA language with regard to CSAs? Finally, what is your view on the asset manager's review?

Sam Woods: Look, I am very happy to say a few words about all of that. I should point out that I have not yet had my first FCA board meeting. I am conscious also that Andrew Bailey—

Q13 **Stephen Hammond:** So you won't be corrupted by any view the organisation may have put to you, and we can hear your view unbiased.

Sam Woods: Well, it's more that I—

Q14 **Chair:** We hope you're not being corrupted by anything at all.

Sam Woods: I am entirely devoid of corruption; I can state that clearly. No, my point was more that I will be better informed once I have been involved in a board meeting.

- Q15 **Stephen Hammond:** I understand that point, but the first two points are broad points; I accept that the second two are points of detail.

Sam Woods: Let me focus on the first two points. On the first, I think the FCA's task is in some ways more challenging than the PRA's. I think we have a difficult job to do, particularly in relation to supervision. They have such a massively higher number of firms than us that they cannot possibly man mark in the way that we do. To give you a crude sense of that, the number of firms that we supervise—we published an annual report—is 1,600, but my working number is actually 1,260. That is because when you have a big international insurance company, you count it as several companies rather than one.

We have 1,280 staff in the PRA, so as it happens, we have about the same number of staff as firms. Obviously, we do not do one-to-one man marking, but it is feasible for us, particularly with the big firms, to do that. The FCA, because it does not have a safety and standards objective and because of the number of firms it has got, has a more limited ability to do that, and I think that presents it with a particular challenge. I know Andrew is going to bring a fresh perspective to that, having just come out of our shop. I think he may have a look at how that works. It may be something that he will comment on tomorrow.

On the leadership issues at the FCA, the organisation has been through an incredibly difficult time. This goes back to the first set of questions from the Chair. It took a big hit over the bungled briefing/leak—I am not quite sure what the right phrase is—of issues relating to insurance companies. I think that was part of the price that was paid, with the decision by the Government not to renew Martin Wheatley's contract. However, I think Andrew is an outstanding leader. He has done a brilliant job in the PRA. Indeed, my chief reservation in whether or not to apply to succeed him was precisely that. He is going to have an enormous impact. What I hear informally from people there is that that is already happening, so I am hoping that the organisation will be able to move on.

- Q16 **Stephen Hammond:** Perhaps when you are next here we can tackle the detailed points. Can I move on to MiFID II and ask your views on a few things? If you look at the third country regime laid out at the moment, which business areas of the City do you think will have the opportunity to enjoy continued access to the single market were the UK to—well, we are going to leave the EU, but also, if we were not to remain a member of the EEA?

Sam Woods: Let me answer that very specifically in relation to MiFID, then, if I may, make a broader point. Like many other people, including—as far as I can judge from the press this morning—Patrick Jenkins, I have been having a closer look at how that works. My understanding is that there are two parts that are most relevant to your question. One is the



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ability that firms from third countries—non-EEA countries—may have to sell services cross-border without a branch. My understanding of the way the regulation works is that they may do that, but not to retail, but only if the Commission has deemed that country to be equivalent and if ESMA has agreed to place the firm in question on its register of firms. That is one piece.

The second thing is about branching. As I understand the way the regulation works, if countries switch on this thing called article 39, there is then a right of establishment to a third country branch if you are outside the EU. The Government in the UK, I think, is currently consulting on whether or not to turn those on.

Clearly, either or both of those and how they play out could have a significant impact on the ability of British firms to sell services within the EU in a post-Brexit world. How that plays out is not yet certain. My one direct experience of an equivalent thing is on Solvency II. As an illustrative point of the complexities of these things, under Solvency II, the US is deemed provisionally equivalent under something called article 227. That means that we as a group supervisor of firms—please tell me if I am going on too long—who have operations in the US can basically add up the capital requirement and position from the US and put it into a group calculation. The US has provisional equivalence for that piece of Solvency II, but it is not yet equivalent for reinsurance or for group supervision, which are two other very important planks. A discussion is going on between the European Commission and the US about how to navigate through that, and there are some tensions about collateral requirements and all that kind of stuff. This can get quite complicated, and 11 directives have these passporting aspects in them.

My broader point is that while I think we are right to scrutinise things like MiFID II very carefully, my assumption—it is only an assumption; I have no more evidence than you—is that there is going to be a much wider negotiation between the British Government and our partners in the EU about how Brexit is going to work and how we are going to extricate ourselves. All this stuff will be swept up in it, so while I think it is important, I would not place too much weight personally on the fine specificities of MiFID II or any other one piece of the passporting regime.

- Q17 **Stephen Hammond:** I take your point on that; I suspect there will be. In the answer you have just given, you mentioned article 39, which, as I understand it, allows business to be conducted in the single market by firms based in London—arranged so that they carry out trades in the single market area. The follow-on question is, if the negotiations post-Brexit basically ended up somewhere around article 39, do you think that would be enough for the City of London to hold on to the vast bulk of its passporting regime and financial hub? Also, where do you, in your understanding, think the profits from those trades get booked?

Sam Woods: I think the answer to that is that it might be, but it is not certain. The reason is that MiFID is primarily targeted at investment firms. Some aspects may be applicable to credit institutions—banks—where they



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are involved in the provision of investment advice or investment activity, but if you were a bank that was not doing any such thing that met that test, that might introduce a caveat to how broadly it could be applied.

The other piece, in my understanding, is that it does not apply to insurance companies, so that would be another potential gap. While that does appear to be one avenue through which non-EEA firms will be able to sell services in the EU—in relation to article 39, it is specifically about branches, so it is not about freedom of services cross border—I think it would be hard to be confident that that was the sweeping solution for everything.

That is partly because of the scale of this activity at the moment. It is coming the other way too. The latest number that I have is 66 branches coming in from banks to us under the passporting regime, and 24 banks will be the UK branching out. There are going to be multiple branches in each case. The numbers on the insurance side are, I think, 79 going out and 41 coming in, but that is only branches. If you step into freedom of services and sell yourself across borders without a branch, it is harder to get a grip on that but it is probably something north of 200 insurance companies and 100 banks undertaking that kind of activity. That is before you get to asset managers and all the rest of it, which the FCA is more in charge of.

- Q18 **Chair:** Can we come back to what you would say about article 237 as well? As I understand it, the opportunity to continue in the regime is based on the view that the EU Commission has to signal equivalence to the UK regulatory regime. There are a lot of people making the proposal—I guess this is shades of grey rather than black and white—that post-Brexit, one of the potential competition tools is to have a regulatory regime that is on the margin of equivalence, but the regulator becomes more of a competition regulator rather than an oversight regulator.

Sam Woods: I haven't heard that idea and I don't think that it is a very good idea. If you look at the various disasters that we have had in recent years, one of the most profound was the global financial crisis. What we learned from that was that our system of prudential regulation was fundamentally derelict. It was partly a global problem but one of the problems locally was, in my view, that the FSA had been given a very large number of objectives. Quite properly, we have a secondary objective around competition which I am happy to talk about subsequently and which I think we made good progress on, and I am very committed to it. The FCA has a primary objective to promote competition but the idea of, in our space, flipping that around and saying that we should be a competition regulator with a secondary interest in safety and soundness and policy protection is something that I would resist very strongly, if I could.

- Q19 **Chair:** To clarify one point, I don't think I heard a complete answer to one aspect of the points that Stephen raised, which is: would profits of trades have to be booked in the other country, thereby depriving the UK Treasury of significant tax revenues if we went down that approach?



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Sam Woods: My apologies, I forgot to answer that piece.

Chair: This is the Starbucks issue in reverse. This is us looping out, rather than trying to grab the cash that someone else feels is theirs. This is trying to hang onto it rather than let someone else get their claws on it.

Sam Woods: Put simply the answer is no if it is a branch, because if it is a branch it is the legal entity back in the home state. If you are branching out of here then the stuff is being booked back into the UK.

Q20 **Chair:** But if we did go down this approach it would cost the Revenue a package. So the biggest single argument from the public policy perspective after the whole economy effect—which is getting some money in, since we are short—is set aside.

Sam Woods: You will, I am sure, also take evidence from HMRC, who will probably give you a richer view but, put simply, where is the trade booked if business is being sold in other countries in Europe? It is booked here in London, either through a branch or through freedom of services—selling across a border. If that arrangement is preserved, I think that it is a non-issue.

Chair: As long as it is booked in London it could be taxed in London.

Sam Woods: On the precise taxation arrangement around those trades I would not claim to be the first expert, but as in where it is booked: it is booked here and the taxation consequences would be unchanged.

Chair: What was the last part of that sentence?

Sam Woods: If a business is being sold through a branch or cross-border, it is booked into the home entity. We have many businesses that are currently here and are branching out across the EU or selling cross-border without a branch. If that ability to branch and/or to sell cross-border was preserved, I don't see why that should make any difference to the booking arrangements. What would make a difference would be if in order to sell business in that way you had to establish a subsidiary, which is a separate entity, in the EU and outside the UK.

Q21 **Chair:** Isn't that what is currently held would be required?

Sam Woods: I think it is uncertain. There are non-EEA branches—we have some and we have been exploring one avenue through which they could be preserved. How that plays out, from our point of view in the Bank, is going to be a very important part of the negotiation.

One other element is that a lot of the conversation, not in this room but outside, seems to me to be at the moment to be very focused on the issue of access to the single market for financial services. Of course, that is an extremely important topic and is likely to be at the heart of any discussion, but there is another side to this debate that I think is relevant from a PRA perspective in terms of safety and soundness in the Bank and in terms of financial stability. If it transpired that there was some trade-off between access to the single market and our ability to have some



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influence over how we write our rules and how we do supervision, that trade-off should be weighed very carefully. Running a leading global financial centre and a massive banking system with a set of rules over which you have no influence is not something you would easily choose to do.

- Q22 **Chair:** Isn't that the logical implication of full EEA status, where you have to grant equivalence without control of the rules?

Sam Woods: The examples we have in front of us today that have that status have precisely that status, but I come back to my—

- Q23 **Chair:** So that was a yes?

Sam Woods: Yes, it would follow. The Norway deal is more or less of that sort, as I understand it, but that is why I assume there will be a much broader—

- Q24 **Chair:** So if we go down the EEA route, we have the equivalence problem bearing down on your ability to deal with the financial stability aspects of all this. If we go down the non-EEA route, we are at greater risk of losing some tax revenue, possibly the lot.

Sam Woods: I think that these are the sorts of trade-offs that will need to be weighed. Day one—we have the rules, and it is probably more about how the rules will evolve through time without our having any influence over them. Although we are not happy with all the EU rules, we have had a very significant influence over them.

- Q25 **Chair:** There is a lot of cash at stake here, isn't there—a lot of business? This is not small beer.

Sam Woods: No. There is a lot at stake in a number of respects.

- Q26 **Mr Baker:** I would like to turn to independence and the remit letter. What conversations have you had with the Treasury about the contents of the PRC's remit letter?

Sam Woods: Zero.

- Q27 **Mr Baker:** That is interesting, because Andrew Bailey gave us to understand that he expected that conversations would take place before the letter was provided. Do you believe that not only have you had no conversations but nobody involved has had a conversation with the Treasury?

Sam Woods: I cannot say that for sure, but I think it is a question of timing. The PRC does not yet exist. When it comes to it, what the mechanics around the remit letter will precisely be I am not sure. Would it be a bad thing if we had sight of the letter or discussed it with the Treasury before it came? I'm not sure; I think that might be okay. The crucial point for me is that we need to remember—I certainly will, and I am sure other members of the PRC will—that we have statutory objectives laid down for us by Parliament and that is what we are about. The Government will send us a letter and we have to take note of it, but in the



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hard case that what the Government was trying to achieve was fundamentally in opposition to our statutory objectives, it is clear that we should just proceed with our statutory objectives.

Q28 Mr Baker: So what is the purpose of this remit letter, if it is not to influence the course of your actions?

Sam Woods: I think it is to highlight to the PRC what the Government is trying to achieve. To put it at its crudest, it is sometimes the case that in order to get from A to B in pursuit of your statutory objectives you can go one way or another way and either is equally effective. If it is the case that one route is more consistent with what other parts of the public authorities are reasonably trying to achieve in their view, that would be a factor, but I don't think that would be a major issue. I think it is different from the FPC set-up, where there is a secondary objective to which the letter plays in. I will, of course, read that letter and take an interest in it, but I am absolutely clear that our statutory objective is what we have been asked to do, and that is what we need to deliver.

Q29 Mr Baker: How interesting. Have you given any thought to what an ideal letter might contain?

Sam Woods: I confess I have not. I think it is for the Treasury to think about that first and then put their foot forward.

Q30 Mr Baker: Okay. It is interesting that that stands in contrast to Andrew Bailey's evidence, that he expected conversations to take place. Do you have any light to shed on why there is that difference in understanding of how the process will work?

Sam Woods: I think you may be exaggerating the difference. Andrew said that he expected a conversation to take place. I am saying that I have not had any such conversation. It might well be sensible for such a conversation to occur. I am clear that this letter is in no way directing me or the PRC. It is something to which we will have regard, and it is nothing beyond that.

Q31 Mr Baker: You have been very clear about your independence in relation to it. Are you concerned that the PRC will have six members chosen by the Chancellor of the Exchequer?

Sam Woods: I am not worried about that. The reason is that my experience of the externals on what is currently the PRA board is that they are extremely independent-minded, very challenging and expert in what we are doing. So just my personal experience of it is that that works very well. It is quite an important ingredient of our policy making.

I recognise that that answer is conditioned on the people who have been appointed so far. If somehow appointments were made that did not meet that bar then I would be more worried about it, but I don't see any sign of that.

Q32 Mr Baker: If you were to see signs that there were political interference in their actions, what would you do? What action would you take?



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Sam Woods: If I came under any political pressure from the Government or anywhere else, the first step is simply to resist. I think I am able to resist to a reasonably high degree. If that proved ineffective, and I felt that I was unable to pursue my statutory objectives because of some kind of political interference, the most obvious course would be to raise that issue with Parliament through this Committee.

Q33 **Mr Baker:** Do you agree with the policy of not publishing the minutes of the PRA board and the PRC? Would you not want the minutes published in a similar manner to those of the FPC?

Sam Woods: Now, I recognise that this answer might not be popular with everybody on the Committee but the truth is that I do agree with that policy of not publishing. Let me explain my reasons, because it is not out of a knee-jerk reaction of excessive concerns about confidentiality.

Our transparency and accountability as an organisation are incredibly important, given that we are non-elected. The first and, in my view, by far the most important bit of that is what we are doing right here. We are accountable to Parliament through you for what we are up to. I think that is the most important discipline that we have.

But there is also a role for documentation. If you think about what the PRA has done in its first three years, we have published more than 330 substantive publications. That includes 104 supervisory statements, which are where we explain how we are approaching a particular issue. There have been more than 90 consultation papers. We are putting a huge amount into the public domain about what we are doing, and allowing a very public debate about all of that.

We also have our approach documents, which explain matters in very accessible terms. If you want to find out how we approach insurance supervision, you can go and read that document, which we keep updated and it is publicly available. Around big events we have very big disclosure, stress testing being the most obvious.

So there is quite a weight of disclosures that we do already. Then to come narrowly to this, what would be the cost and benefit of adding to that disclosure of the PRA board or PRC minutes? When you think about what business goes on in the PRA board, it is basically two things. One is that we have a set of supervisory decision making, with is firm specific. I would argue that that must remain commercially confidential.

So that is one piece, and then you have the rule-making activity. That tends to be informed by a cost-benefit analysis that will also include some firm-specific information, but the decisions that we make, which are always consulted on when we are making this case, all come out, and many of those publications I described are of that sort.

Then, if I weigh the cost against that—to come to your specific point about the comparison with the FPC—I think it is very different across the two committees. The FPC is not dealing in firm-specific information; it is



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dealing with the system as a whole, so the whole aspect of commercial confidentiality is far lower as a practical matter.

Secondly—this has been a subject of some controversy in relation to the referendum, obviously—the benefit of communications as a tool of macroprudential policy, stating clearly what you think the risk assessment is and how you reached that view, is very high for the FPC. I think there is a much lower cost and a much bigger benefit, and it makes sense to have two different regimes.

- Q34 **Mr Baker:** Thank you for that clear answer, but how could this Committee be reassured that there is sufficient challenge on the PRC if we are unable to see minutes which explain how differences of opinion were explored before a collective decision was reached?

Sam Woods: To be honest with you, I think the best way to do that is for you to have all of us up here in front of you and form your view on whether or not we are capable of challenging and forming an independent view. I honestly think that is a better decision than going through minutes, which would have to be enormously redacted for the reasons given.

- Q35 **Chair:** We are doing our best. The problem is that if people come after having been heavily coached, or if the Bank of England lie about something, it gets quite tricky, so minutes tend to help. That is the point that Steve is quite reasonably making. They do help a lot with the MPC.

Sam Woods: My only comment would be that I do not think that the members of the PRA board, particularly the external members, are amenable to being schooled on a Bank of England line.

Chair: We might test that out and see.

- Q36 **Mr Baker:** Finally, on the point of leadership, the website indicates that you have given three speeches so far, all on Solvency II, an area of expertise for you. How will you rise to the challenge of having a public persona and making speeches over a wider range of subjects on which you are perhaps not quite so expert?

Sam Woods: I have one small advantage, which is that the job is about banking and insurance and I have done both sides of it, so I don't feel uncomfortable with the content. I do think it is important that the CEO of the PRA, as part of our transparency efforts, makes a regular cycle of speeches so that people can understand what our thinking is in an accessible way, but I do not think they need to be super-high frequency. My current intention is to give a speech at Mansion House, I think in October. That is the first time that I plan to do an open and on-the-record speech. I would expect to do something like three a year. That is my basic plan.

- Q37 **Chris Philp:** Welcome, Mr Woods. I would like to return quickly to a question which Stephen Hammond and the Chair touched on about having to adopt equivalent regulations were we to access the single market via the EEA. You have expressed a concern that we would then potentially lose a measure of control over our own regulatory framework.



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Would not equivalence require us to go to at least the standards required by the EEA, or to European standards? If we chose to go beyond those, as we currently do in a number of areas, we would still be free to do that.

Sam Woods: I think both parts of that proposition are uncertain. On the first, about whether we would have to go to “at least”, equivalence has proven in reality to be quite a broad concept. As I said, the one I have been closest to is in Solvency II space, because we have been doing it live. Sorry to come back to this example, but I think it illustrates your point: although the US has been deemed equivalent for the purpose of adding up the capital of international groups, it is absolutely plain that the regime for measuring insurance capital in the US is quite different from Solvency II. It is a different beast, but a decision has been made that it is equivalent. So it does not necessarily follow that to have equivalence, you have to have exactly the same thing.

In terms of whether you can go further, this has been an issue for us in the current regime. As I am sure the Committee is very well aware, a number of parts of the existing financial services regime within the EU are maximum harmonised, meaning precisely that in those spaces, you cannot do what you described. You can in some other spaces—you are right that we have gone beyond in some places—but in those areas which are curtailed, that has occasionally been a source of frustration to us.

Q38 **Chris Philp:** In the last hour or so, other Committee members have touched on the multiplicity of bodies active in this area—the FPC, the PRA and the FCA. That strikes me as quite a large number of bodies active in broadly the same area: the FPC on systemic risks to the financial system as a whole, including banks, the PRA as the prudential regulator for 1,700 financial institutions and the FCA as the conduct authority. Those remits, particularly those of the FPC and the PRA, strike me at first glance not just as slightly overlapping—you mentioned there was some joint discussion—but as substantially overlapping. I wonder if you could comment on that and on whether you think having two bodies active in such a similar area, albeit both under the Bank of England’s remit, might create some confusion and unnecessary duplication of effort.

Sam Woods: I agree with your basic proposition that there is a substantial overlap in terms of the content that the PRA board and staff and the FPC are looking at, but I do not think that that is a bad thing. It is easy to think about this in terms of the committees, but it also reflects on the staff, who bring a different perspective to those questions. To bring that alive for you, one example is that when I was running the macroprudential area within the Bank, we did our first concurrent stress test of the UK banking system. One of the things I did there, as a staffing matter, was to bring together the economists from the Bank, who think about stress-testing, with the risk specialists from the PRA, who have the deep technical knowledge in particular areas like credit risk or trade risk. Those people are interested in the same thing—how the banks would fare during a stress—but they bring a very different perspective to the question. The trick is to preserve those two perspectives, which are often quite different, without creating a lot of bureaucracy.



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There is certainly an overhead efficiency cost to having two committees going. If I am not going on too long, I can come on to another recent example, the counter cyclical buffer, because it illustrates exactly what you have described. The FPC had announced in March its intention to raise the counter cyclical buffer to a half a per cent. There is a year of time-lag implementation. As it happened, because this is the first time we are using the buffer, the counter-cyclical element of it was held within a PRA buffer. The reason for that was that when we did the first concurrent stress test back in 2014, we decided, for the sake of simplicity, that because it was our first time doing it we would not complicate things too much: we would put everything into one stress and hold that all in the PRA buffer. The PRA agreed in March that it would release that part of its buffer; in effect, that buffer was the FPC's counter cyclical buffer. When the FPC decided a couple of weeks ago to release that buffer, we were caught mid-step. Normally, the PRA would not have to do anything—the FPC would just release its buffer—but because we were mid-step in terms of moving from one buffer to another, the PRA had to make the decision whether we were happy to implement that FPC decision through our buffer. The PRA was happy to do so, subject to the important caveat that the firm should not use this as an opportunity to pay out extra dividends, bonuses or things of that kind. I mention that just to illustrate that there is some bureaucratic overhead to this, but it is small in relation to the benefit of having those two different perspectives.

Of course, the FPC does a lot of stuff that is not in the PRA space, so that is the other part of the answer.

- Q39 **Chris Philp:** You could, of course, retain both those sets of expertise—macroeconomic and firm specific—by simply having members of staff with different areas of expertise under the same umbrella, so you could have the benefit without the overhead. On the counter cyclical buffer, which you have just raised, you anticipated my next question: first, did you agree with the cancellation of the counter cyclical buffer—you have already answered yes—and secondly, do you think there is any risk that that will induce excess provision of credit at a time of heightened economic risk?

Sam Woods: On the first question, to be clear, yes, I agree with it; that is the way this tool is meant to work. If we form the view that we may be going into harder economic times, the idea is that you move this thing in advance in order to reduce the probability that the banking sector contracts the flow of lending. It is the first time we have done that; to my knowledge, it may be the first time globally that that has been done. I will come on to your second point, but there is an interesting point here that links back to the earlier discussion on the markets. The question you always have in these situations is, "Yes, we the regulators might loosen our constraint for the reason given, but will the market actually hold banks to a higher level?" The experience of the global financial crisis was exactly that. The market went to a massively higher level than where the regs were because the regs were patently too low.



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Unlike the other buffers we have, where we can say, "Buffers are there to be used and we mean that", the benefit of the counter cyclical buffer is that we actually release it. I very much think that that was the right thing to do.

On the risk of excess credit provision, I am not overly worried about that for two reasons. One is that the overall level of household indebtedness in the country has come down quite a lot. It was 157% before the peak of the crisis and the latest number I was given was 132%. I am not complacent about that.

Q40 Chris Philp: It is still very high, isn't it?

Sam Woods: You can debate whether that is high or not, but it has certainly come down a bit. The main reason that I am not overly worried about that at this point is that the question is: will the demand be there? The amount of capacity we have freed up—it depends how you do the calculation—is about £150 billion, if you assume a standardised risk weight. That is a lot higher than the £60 billion of net lending to the economy last year. It is uncertain what that demand will be going forward. Early signs seem to be that the activity and demand may be lower, given what we are seeing in the housing market.

Q41 Chris Philp: That brings me on to another question. You mentioned standard risk weightings but, of course, many of our largest banks use their own internal risk weights. Challenger banks have complained that they do not have access to the internal risk weightings that larger banks do, owing to a lack of through-the-cycle data. They say that that puts them at a big disadvantage. For example, under the most recent Basel III proposals, the standard risk weighting for a 50% loan-to-value prime mortgage is 35%, yet the average IRB risk weighting is 3.3%—one tenth. The disparity is less as you get to higher leverage points, but there is still a disparity.

Challenger banks say that they need to put aside ten times the amount of capital compared with a large bank, and that that puts them at a structural disadvantage, even though you are talking about an extremely low-risk type of loan—a 50% loan-to-value prime mortgage. That therefore inhibits their ability to lend, grow and provide competition. Given we are leaving the EU, we will have more ability to vary those things because we will not be subject to some of the same constraints. Will you give the Committee your views on whether that enormous disparity between the IRB risk weightings and the standard risk weightings is fair to challenger banks?

Sam Woods: Yes. I am very happy to do that. First, there is a genuine issue, which I have been troubled about for a while. We need to move forward and I will explain more what I mean by that. Secondly, there is an important caveat. Some of the ways in which those gaps are portrayed are an overly crude reading of what is going on—and I can explain that briefly—but that is not code for, "I don't think there is an issue." There is an issue. I just think that the ten times claims and all that stuff is overblown.



- Q42 **Chris Philp:** Well, it's ten times for low leverage loans but there is still a significant difference for higher leverage loans. For example, for a 90% loan-to-value loan, the standard risk weighting is 36% and the IRB is 18%. Even there, the difference is double.

Sam Woods: The reason that it is more complex is not the risk weighting framework, but the leverage framework. The leverage framework is a game changer. In effect, it establishes a risk weight floor for a monoline mortgage lender of 37.5%, because 37.5% times 8%, which is a pillar 1 requirement, gets you to three. That is the level at which we have set the leverage ratio.

If you compare, in a post-leverage ratio world, the binding capital requirement for a monoline standardised firm versus a monoline firm that is on IRB—by monoline, I mean mortgages only—the differences are now not that great. That is set out neatly in a letter that my predecessor sent to the Chair of the Committee. The issue is that you have diversified lenders and, for those diversified lenders, the marginal capital requirement is likely to be quite a lot lower than it would be for a firm on the standardised approach for low LTV mortgages.

The one that I tend to focus on is 70% or 80% LTV, where the average risk weight is 12.7% versus the 35% under the standardised approach. I am a bit troubled by that difference and have become slightly more troubled recently because this debate has been going for a long time.

- Q43 **Chris Philp:** So what do you plan to do about it?

Sam Woods: Can I just give you one more piece of evidence that I think is interesting?

Chair: Please do that quickly to allow for other questions.

Sam Woods: My apologies. We did a very interesting piece of research for the CMA—it's in the annexe to their report. It's an event study and says: "What's been the pricing impact since '08 of firms on the standardised versus on IRB?" It suggests there is a positive pricing difference, may be as high as 60 basis points, may be lower, but it does appear to be positive and that is troubling.

The main way we are going to go off this is in Basel, because the 35% risk rate comes from Basel and I think it is very important that we try to get a more risk-sensitive standardised formula. The reason for that is partly the competition reason but it is also safety and standards—it is rational if you are constrained in that way to go into high-risk mortgages.

- Q44 **Chair:** The problem with Basel is that in the long run we are all dead and it sometimes takes a long time to get agreement out of Basel. I wonder whether you could consider some other approach that is more directly in your control.

Sam Woods: The other thing we are being very clear about is that there is no bar—an in principle bar—to small firms building models. If models are done well—particularly now that we have the leverage ratio as a kind



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of guard rail against the sort of things that happened before the crisis—those firms should be able to do so.

Q45 **Chris Philp:** They don't have sufficient length of through-the-cycle data. They say they want to do it, but they can't.

Q46 **Chair:** I should not have prolonged the discussion, but I think you are getting the sense that this is something about which the whole Committee is very exercised and has come to a pretty clear view. We are not quite sure what the solution is—indeed, that's not our problem, it's your problem to sort out. But we certainly have concluded that there is a serious problem and you are pretty much saying the same thing, with a good deal of detail and some qualification. We would like you to have this high on your agenda in your new job, please.

Sam Woods: I will keep it there.

Q47 **Rachel Reeves:** Welcome, Mr Woods. I want to ask some questions about the role of the PRA in the lead up to the vote on our membership of the European Union and your actions since. Last week, the Governor told us that the PRA had catalysed change in the run up to the referendum to make sure that the regulated banks had no open currency positions. Can you explain what would have happened if the PRA had not acted?

Sam Woods: As you would expect, we did a huge amount of contingency planning around this event. It was focused on three strands: one was the funding position of banks, second was trading losses and the third was around insurance companies.

I will speak to the first two and the bits of those that are most relevant to the FX question. On funding, we encouraged banks to term out their funding such that they could survive a prolonged total lockout from the wholesale markets. That was a very severe assumption to make, but such lockouts have occurred in the past and for some firms they have been quite prolonged. There is another aspect to effects on trading, but included in that we paid particular attention to making sure that firms were going to be able to sustain their funding in single currencies. So in the event that there was a problem in the FX market and it was not possible to shift things across the currency boundaries, they would also be robust to that. We always had that as part of our framework, but we paid more attention to it as part of the referendum planning, because it seemed fairly likely that one of the things that could be run quite a lot would be sterling.

What would have happened if we didn't do that? It varies a bit by firm. As usual in these things, the advantage we had in this case was that there was a clear date for the referendum, we could see it coming and so could everybody else. Many of the firms were already doing contingency planning and developed their own thoughts around what scenarios they should be able to survive. We brought everyone to the same standard and in doing that there were probably some laggards who perhaps wouldn't have been so sensitised to the risks and whose position was therefore shored up. That's the funding side.



On the trading side, we looked at a variety of scenarios. Would firms lose money in the event of different outcomes and different moves in financial markets? Some of that was related to effects, but it was also related to a lot of other things. We would not expect big trading banks to be running on major, open FX positions going into an event like this, but the firms themselves did quite a lot of scenarios, and we ourselves did to assure ourselves that the boundaries of what could be lost were not going to present a risk to safety and soundness. If we had not done that, might firms have run more risk? It is hard to say. I suppose some might have done, but you could not prove it.

- Q48 **Rachel Reeves:** That leads me to my second question. I presume that banks are obviously doing their own risk management, so what was the PRA able to add that would not have happened anyway? You suggested that you brought some laggards up to standard. Is that it, or is there a more systemic—

Sam Woods: Also, we established a standard by saying, “We want you to be able to withstand x and show us that you can withstand x,” and it is not at all clear to me that left to their own devices, the banks would have all gone to that point, so I do think that made a significant difference. As with many aspects of supervision, it is not amenable to precise measurement, but I think it did put the banks in a much stronger position. I think it was also important for all the banks. There is also an insurance side to this that we should not forget. You understand that we had an appreciation of the issues, that we were doing planning, that we were there and that we had multiple calls going into all the institutions through the days around the vote and liquidity reporting coming in daily. Then of course there was the action for us as the Bank, which was to make it clear that the Bank itself was ready to provide liquidity as needed, which we did through the weekly indexed long-term Repo operations. That, again, was an important part of the message that the Bank was open for business should it be needed.

- Q49 **Rachel Reeves:** I totally understand that second part of it. With the first part, in terms of what you were doing to get the banks in a better place, it does sound a little like the banks were getting the PRA to do their risk management for them. Would that be fair, or is it unfair?

Sam Woods: Well, this is a perennial issue in supervision. We have our objective, which is safety and soundness. The firms themselves typically have some interest in safety and soundness as well, but they have other objectives that they are trying to pursue. How a lot of supervision plays out is by us making a slightly different trade-off from the firms and having to pull them in a certain direction. I made the point in my written evidence that the successes that we have in supervision are very often crises avoided. That is one of the challenges in this line of work—that that is more difficult to celebrate.

- Q50 **Rachel Reeves:** May I ask about the way in which you treat big banks compared with challengers and other financial institutions? Should we



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worry about banks that are too big to fail receiving preferential treatment because of the systemic risks?

Sam Woods: I think the opposite is true. We have much more intensive supervision for the biggest banks. To give you a sense of it, the size of the teams that we have on our biggest banks is around 20, whereas once you get down to the smaller end, you will typically have a portion of a person. But also, of course, the capital framework now includes the systemic buffers, which means that if you are a bigger bank, you have to hold more. So the push is very much in the other direction, but we obviously do need to keep a watchful eye on smaller institutions as well, and we try to do that in a proportionate way. I do not know whether this evidence has been brought to this Committee before, but there is the whole thing about new banks. We have authorised, including one last week, 16 new banks since the PRA came into existence three years ago. I think that is probably more than most people think. We have been able to do that partly through creating a thing called the mobilisation phase, which gets round the chicken-and-egg problem whereby you cannot get authorised until you have got some other thing. We say, "Fine, we'll create this phase where you have a very limited authorisation but where you can get up and running as a bank." I was talking to one of these new banks recently and the way they put it to me was that the existence of that mobilisation phase was a necessary condition for them to have gone into business.

Q51 **Rachel Reeves:** This is not the same thing, but what is the share of the big five banks in the last three years?

Sam Woods: Of?

Rachel Reeves: Of current accounts or savings.

Sam Woods: I'm sorry: I haven't got all those numbers in my head, but it is very high.

Rachel Reeves: And it has not changed, has it?

Chair: It has gone up.

Q52 **Rachel Reeves:** Exactly. I am pleased that there are 16 more banks, but I think this is a massive problem. It is fine to have more banks, but if the concentration is increasingly with the big five, that is pretty meaningless, and certainly in the last 10 years the concentration in the big five has gone up, because the big five have gobbled up all the other banks and not enough effort has been made to break up the big banks.

Chair: We are very worried about this issue too, Mr Woods, in this Committee—all of us.

Sam Woods: I do not want you to misunderstand what I say as complacency about those competition issues. I think they are very real; they are very vexed. As the Chair mentioned, I was secretary to the ICB, which did a lot of work in this space, so I am very alive to them.

Q53 **Rachel Reeves:** More broadly, on the same issue of post-referendum and



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financial stability but about the UK economy, how much do you think the downturn that we have seen in the first half of this year is down to concerns about leaving the EU before the referendum, and how much do you think it is about other factors—slowdown in China, increasing rates in the US? How much is it down to the referendum question?

Sam Woods: I will give you my view with the caveat that I, myself, am not a macroeconomic forecaster. I have colleagues in the Bank who are far more eloquent on this topic than I am. Coming to the first half of the year, the most visible slowdown that we were seeing was in the commercial real estate market, where in Q1 versus Q4 we saw, I think, a 34% drop off in transaction volumes, including 53% in London. Part of that story was about a halving of the flow of foreign capital into that market.

Why was that occurring? It is hard to disentangle: was this a view being taken by participants in that market, which is of course famously cyclical—it had reached some sort of peak and was going down, therefore they were becoming more cautious—or was it concerns about the uncertainty around the referendum? My assessment of the evidence, for what it is worth, is a combination of the two things. That is the place we have seen it.

Much more recently, we are just starting to see the little bits of evidence around the housing market. This has only been coming out in the last few days. I think the RICS survey, the Halifax data and the stuff from Rightmove that was out yesterday all seems to be consistent with the slowing of that market both in terms of pricing and expected activity. On the extent to which that is referendum related, it seems to me to be quite plausible that the referendum and uncertainty is having some effect on that market.

Q54 **Rachel Reeves:** You spoke earlier about preparing banks for the referendum and you had the fixed date of the referendum, which everybody knew. If, as seems likely, this slowdown persists through this year and perhaps into next—indeed, forecasters seem to have revised down their growth forecasts into 2018 as well—and that slowdown is protracted, do you think that the firms that the PRA supervises are sufficiently capitalised in the event of a prolonged slowdown?

Sam Woods: The short answer to that question is yes; but I am paid to worry about these things, so of course I do, and I will be worrying about that issue and following it very closely as the situation unfolds. To give a sense of why I say yes—again, if I can come back to the commercial real estate market, as that seems to be the one most in front of us—we ran a stress of a 30% drop for that market in our stress test last year. The amount that the big banks lost in that stress was £3.5 billion; that compares to a common equity tier 1 base of around £244 billion. Of course other things could be happening at the same time, but I do believe that we have capitalised the bank to withstand a stress of that kind.

There is another way to think about the question—tell me if I am going on too long here. One of the most extreme reactions in the financial markets



to the referendum result was the hit on UK bank equity—particularly UK-focused bank equity. As you know, some of our major banks lost a third of their market cap in the process of a day or two and some of the smaller banks—back to your earlier point—lost more than that. We did run a little bit of a thought experiment, which we put something on in the financial stability report. If you make the very extreme assumption that none of that move in share values was to do with an increase in the equity risk premium, and was all to do with a changed reading among market participants about what sort of economic environment we were going into, it seemed to us that that was consistent with a stress that was about half of what we did in our 2014 stress test—which would cause a very severe UK slowdown, even if you take in a lower path for interest rates. Another way of thinking about the question is that if that thought experiment is right, we have capitalised the banking system to withstand something much worse than that. I feel confident about that but I am going to watch it very closely.

Q55 Rachel Reeves: You said you were paid to worry. What things would you most worry about?

Sam Woods: The obvious one to watch is the housing market. That is the biggest asset that our banks have. It is £1.15 trillion across the big and small banks, of which £1 trillion is in the big banks. As I say, we have stress-tested that very thoroughly, including a 35% fall in the 2014 tests, but I think I would be asleep at the wheel if I did not pay close attention.

Q56 Chair: Let me take one point that you made there and link it to something you said earlier. You said at the beginning that maybe the FSA had too many objectives. One of them was not competition, and we have had great trouble getting the focus on competition in both the regulators, and you have described it as a secondary objective. Is it not the case that getting more competition and providing greater financial and systemic stability are linked? If you do something about competition, you are likely to do something about the too big to fail problem at the same time.

Sam Woods: I agree with that proposition. The only caveat I would introduce is that John Vickers has done a very elegant one-sider on this topic, which we published, I think, in the interim report of the ICB—

Chair: Which I read.

Sam Woods: His conclusion was, I think, a little bit more caveated actually, but for all that, I agree with it. The most obvious part of that is higher capital requirements and bearing down on the too big to fail problem, which I think should be both pro-competitive and pro-financial stability.

Q57 George Kerevan: Good morning, Mr Woods. In 2012, the US Attorney General rejected a recommendation from his money-laundering unit to prosecute HSBC. HSBC had been laundering money on behalf of a number of states against which were international sanctions, and was laundering money on behalf of major drug cartels in Mexico and Colombia. It subsequently transpires, according to a report from the US



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House of Representatives Committee on Financial Services, that the decision not to prosecute was the result of an intervention, or was heavily impacted by an intervention by the FSA, which was worried that prosecuting HSBC senior staff would have an impact on the bank's stability, with the possible loss of licensing. The FSA was also worried about the level of the potential fine. The obvious question is: from your position both as a prudential regulator and on the FCA board, are British-domiciled banks not only too big to fail, but too big to jail?

Sam Woods: Let me explain my general philosophy on that, then come directly to that question and to the case that you cite. This has been a major issue throughout my time as a prudential supervisor, and I have HAD to deal with it in a number of guises. As it happens, I was not involved in that particular case, because at the time, HSBC was not one of the banks that I had, but I have had a look at it.

My starting point in all of this is: if the banks have done something wrong, they need to be punished and they need to clean up their act. That is where it starts. Our job as the prudential regulator is then to take account of that in the supervisory strategy that we deploy for the firms. To bring that alive for you—this is only one narrow aspect of this, but one aspect is, of course, about capital levels and the expense of these fines and redress. On my latest count, the 2009 to 2015 conduct hit to the banks has been £58 billion. That includes £15 billion provision in the last year, which halved banks' profits. We as a prudential supervisor obviously need to think about that, and when we are talking to financial institutions about their capital plans, we need to urge them to make realistic assumptions about what is going to happen. My experience of that, over many years, has been that bank management tend—if not in all cases—to be more optimistic than we are, perhaps unsurprisingly. I would say that history has been more on our side in that equation. That is way in which I approach those situations.

Of course, part of our job as prudential supervisors is to be across what is going on. We need to liaise with our colleagues in the US and the conduct authority here to have an understanding of what is happening, so that we can build that into our strategy, and I think that is entirely right.

Coming to too big to jail versus too big to fail, I am more worried about too big to fail for the simple reason that two of the biggest issues—structural reform and bail-in debt—are yet to drop fully. I am confident they will drop, but until they are in place I retain a warning light over that issue.

On too big to jail, first, a number of financial institutions—seven global ones at my last count—have pleaded guilty to criminal charges and some of them have been subject to heavy fines. The most famous is, of course, the BNP Paribas case. It is not as though these firms are able to evade criminal sanction. Secondly, a very important aspect of this is the accountability of individuals as well as institutions. That is not to shy away from institutions, but I think the individuals issue is very important.



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One of the striking things about this last crisis, although many bankers' careers have been destroyed, is that the number who have actually been brought to book is fewer and I think, therefore, one of the most important reforms brought in in this country was the one we brought in following recommendation from the Parliamentary Commission on Banking Standards for the senior managers regime, which will make it a lot easier for us to hold people to account. I am not relaxed about the too big to jail question, but I think that part of the regime in particular is going to help us a lot.

Q58 George Kerevan: Let me press you further on that. In an analogous situation to HSBC, where a major British bank in the United States is facing—or you will hear—the possibility of criminal charges, which could clearly affect the bank's stability, what would you do?

Sam Woods: I would certainly not put pressure on other authorities not to do the right thing in relation to conduct issues because it creates me a prudential headache. I think that is the wrong way round. It is best to think about that in terms of redress. If the bank has ripped off the customer and needs to pay them back, they have to pay them back and we have to deal with the consequences of that.

There is a subtlety, however, in the fact that the authorities dealing with conduct issues do—quite sensibly in my view if their aim is punishment and deterrent—need to take what the impact of their action is going to be into account. To put it at its crudest, if you had two banks that had committed the same crime but one was a hundred times the size of the other, I would expect the bigger one to have a much bigger fine. I don't think there is anything wrong with that.

I think it is sensible for us to be talking to those authorities to help them calibrate what degree of punishment is sensible, but that is quite different from any push from us to go soft in a way that would be wrong.

Q59 George Kerevan: What acts as the greater deterrent: institutional fines or the threat of criminal redress against individuals in the bank?

Sam Woods: I think both have an effect. Criminal sanctions against an institution and the threat of prohibiting certain business activities have a very strong incentive effect, as some of the results could be much stronger than the sheer financial hit of a fine. I do think, however, that that limb of the regime regarding the accountability of individuals is at least as important. In my personal book, it is probably more important because in the end it's people making—

Chair: So you can say it's the orange jumpsuit—

Sam Woods: We do not have any orange jumpsuits in the PRA, but I can tell you for certain that the introduction of the senior managers regime in banks and insurers has focused minds very tightly on what accountabilities are. It is a simple idea: you are approved for a job, you have got prescribed responsibilities, you can delegate them, but you are still on the



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hook. We have applied that to ourselves and I think that is going to make a big difference.

- Q60 **Chair:** The purpose of introducing that range of measures was to get across to those individuals that great effort was going to be made to identify who had been made responsible for what—ex-post—in a reasonable and proportionate way. Just as important, they became responsible for ensuring that individuals beneath them in the certification regime—which you have not mentioned and in many ways is the most important of all—would also be identified for misdemeanours. Most of the big scandals did not derive from decisions taken at senior level but were perpetrated lower down the bank and then neglected at senior level. It is the absence of personal responsibility in the middle rungs of the banks that is probably the most important single issue that now needs to be addressed and still hasn't been, with certification. Do you agree?

Sam Woods: I think that both limbs, the senior managers and the certification, are very important. I don't violently disagree with your assertion that the latter is more important, but it is not my personal perspective—I think both are important. The crucial part though is the conduct rules. We have seven conduct rules. The first three apply both to senior managers and to everyone in a certification regime. They are just a simple annunciation of what you should do, including, crucially for me, the third conduct rule, which is to be open and transparent with the regulator. I agree that if all you had was something at the top of the shop, that would not capture it sufficiently.

- Q61 **George Kerevan:** What do you do in the situation where it is becoming a possibility that redressing legacy claims for mis-selling and/or fines for misconduct threaten the capital base of the bank?

Sam Woods: As I say, this has been a live issue that we have been living with. The numbers I gave you before are very big numbers in relation to the capital base of the UK banks, so it is in front of us. It is all a question of degree. If you had a bank that was going to lose so much money from conduct that it was going to breach its capital requirements, you would have to look for it to raise more capital. If it was unable to do that, you would be into a more difficult world. More typically, the situation we find ourselves in is one in which the earnings capacities of banks have been very significantly impaired, so their ability to generate capital organically has been lower and they therefore have to look to do it to some extent in other ways, one of which, of course, is to shrink themselves.

- Q62 **George Kerevan:** Is there a case for separating from the regulators the power of enforcement, to remove from you, the PRA/PRC, the conflict of interest? In a situation where a bank was in serious, sustained risk, you might feel, in the best possible world, there was a danger that the bank was going to go over. Would it not therefore be better to take enforcement away from the regulatory agencies and put it with a separate agency which, if there was an issue, would take enforcement, separate from your role as the regulator and prudential authority?



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Sam Woods: I go along with some of that but I would not go the whole way. I agree that at some point in the appeals process there should be some independent aspect. I think that is a sensible idea. We are bringing forward proposals on exactly that topic. But more broadly, I would be reluctant to see the entire enforcement function departing the regulators. That is because, in our pursuit of safety, standards and policy on protection, we have a suite of tools. My predecessor, Andrew, was very clear that he didn't think the PRA should be generally enforcement-led, and I agree, but I think it is important that we have that tool available to us; first, so we can use it sometimes; and secondly, in order to focus minds. I would be reluctant to see that go.

Chair: Jacob Rees-Mogg has a question on, I think, your pet subject.

- Q63 **Mr Rees-Mogg:** Absolutely. Thank you, Mr Woods for coming in. I am about to go on to your specialist subject, but since you are on the board of the FCA and I am chairman of an investment management company I must make reference to my declaration in the register of members' interests, which I know you have to do at the beginning of FCA meetings for different reasons.

Sam Woods: That is right, yes.

- Q64 **Mr Rees-Mogg:** If I can come on to the design of Solvency II, what was the role of the FSA and the PRA in developing Solvency II?

Sam Woods: Both the FSA and the PRA had a strong hand in the development of that regulation, the results of which are not perfect. I am sure we will come on to that. In its crudest, you can see that, because the idea is that Solvency II should be a market-adjusted regime. Broadly, the idea is that a company's assets and liabilities should move around as financial markets and other things change—we have seen that in relation to the referendum outcome—but that there should be some shock absorbers, such that you do not encourage parasitical behaviour by insurance companies. The most obvious one is a thing called a matching adjustment, which basically says that if spreads blow out on your assets and you have the ability to use this thing called a matching adjustment, you are allowed to add some of that to the discount rate for your liabilities, and that cushions the impact in the short term. That basic framework is not dissimilar to the ICAS framework that we had in place in the UK until 31 December last year, but it is quite different from what many other countries around Europe were doing. With Solvency II, the other countries, with some exceptions, have come closer to our way of doing things, but we have also moved on in toto, and there are some things in Solvency II that would benefit from a tweak.

- Q65 **Mr Rees-Mogg:** But at quite high cost. It is estimated to have cost up to £3 billion for the implementation of Solvency II, a system that, certainly from your public comments, replaces one that you were quite happy with beforehand.

Sam Woods: The cost has been very high, that is true, and I agree with your estimate of £3 billion. We have a few data points, but they come in



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roughly on that spot. To give a sense of it, for ourselves it was a £107 million project, which is a very large undertaking for us. The chief benefit of the regime is that, subject to some caveats, it has moved everyone in Europe on to the same basis. There are some implementation differences, but whereas before we were all doing very different things, we have now come into a more common framework, which is broadly helpful. That is really the benefit, so far as it can be identified.

Q66 Mr Rees-Mogg: But you were happy with the predecessor regime, which you thought was good and robust.

Sam Woods: Yes.

Q67 Mr Rees-Mogg: Am I right in thinking that the really big difference between the two is that the old regime was on a wind-up basis and the new one is on a continuing business basis?

Sam Woods: Yes. There are a couple of aspects to that. One is about whether, in thinking about insurance company capital, you try to project forward right to the end of the business or take a view of just how much its capital position can move over one year—the Solvency II regime is a one-year regime. We had a slightly mixed approach to that in ICAS.

The other piece, which is probably what your question gets at, is a new regulatory liability that we have created in Solvency II, called the risk margin. Put crudely, the idea is that there should be a little bit of extra capital around—it is not technically capital, but that is the easiest way to think about it—which would, should the firm get into difficulty, give the authorities and the firm more options in terms of navigating through it. I don't think that is a stupid idea in itself. The problem is the way the calculations for that risk margin ended up being set. Putting it crudely, you project forward insurance and capital grants until they run off and then discount them back at the risk-free rate. There's the rub: as the risk-free rate drops, if you are applying a flat 6% cost to capital, the risk margin gets much bigger. We have been troubled by the extent to which that gets bigger. We think it is pro-cyclical and we don't think it is justified by the historical evidence, so it is something I would like to get changed.

Q68 Mr Rees-Mogg: How easy will it be to change that while we are within the European Union?

Sam Woods: It is an unavoidable fact that the referendum outcome complicates these sorts of things, to some degree. It is not technically difficult to get such a change, but it does require the agreement of all our partners across Europe, and they have things they would like to change as well. It is a little early to say how much it has been complicated, but I think it has been made a little more difficult.

Q69 Mr Rees-Mogg: As it was brought in, your predecessor, Mr Andrew Bailey, said that he thought that Solvency II was an example of how not to make EU law. Do you agree, or are you not quite so damning of it as he was?



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Sam Woods: I had a close look at what Andrew said—you cite him very well. His complaint was about the process, which did drag on for an inordinately long time—I had the great benefit of only coming to it late—and that added to the cost. That is an example of exactly the sort of thing that Andrew described. I know that a few weeks ago you heard evidence from Lord Turnbull, who made a comment that sounds similar but is actually quite different. He used the word “dreadful”. I think he said it is “an absolutely dreadful piece of legislation”. I have the highest respect for Lord Turnbull, but I do not agree with his broad statement. Where I do agree with him is that there are bits of it that don’t work well.

- Q70 **Mr Rees-Mogg:** Which need changing. But Mr Bailey’s comment about it being how not to make EU law ties in with how you reform the bits you don’t like, because if the process is very difficult, getting the changes you would like to see is quite a complex process. Do you think there is anything you would change post-Brexit?

Sam Woods: In relation to Solvency II?

Mr Rees-Mogg: Yes. You are now completely in charge. You might want to get some equivalence; you may not. What bits would you cut out?

Sam Woods: No. The bits I want to change are the same bits that I wanted to change in January; they haven’t changed, and the risk margin is the most obvious one. I would like to have some more macroprudential flexibility in the regime, a bit like we have on the banking side.

There is another bit to it, which does not require a legislative change but which I think is an important fact for the Committee to be aware of: Solvency II is a heavily modelled regime, and we have seen heavily modelled regimes for financial institution capital go very wrong in other parts of the forest. On the banking side, we have the leverage ratio, which is an absolutely essential guard rail. I don’t think a leverage ratio makes sense for the insurance sector, but I am concerned about the risk of model drift. One of the things we are going to need to do is to watch how modelled capital requirements evolve through time relative to various other metrics. We have put out a consultation paper on that. That is quite high in my mind as stuff that we need to do, but I don’t need the agreement of anybody else in Europe in order to be able to do that.

- Q71 **Mr Rees-Mogg:** One of the problems with Solvency II is that it is a single regulatory framework, but the individual insurance companies can present you with their own models, which you can either approve or not, and that goes against having a single framework. There is a tension between the broad thrust of the rules and the implementation of them.

Sam Woods: There is some tension there. The way we get around is that, with the benefit of a lot of these firms with models, we have done incredibly detailed and very robust benchmarking—which has resulted in quite a lot of arguments with firms—to form our own views on things like longevity in order to ensure that there is a similar standard. But of course around Europe there is a question of how much detail we show each other of what we are doing and how much they come together. Down on those



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more detailed levels, there are some differences in terms of how it has been implemented. The most glaring one is in relation to something called a volatility adjustment, where different countries in Europe have done different things.

- Q72 Mr Rees-Mogg:** One of the problems with the models is the very low levels of long-term interest rates, which essentially increase the liabilities back-dated but are also less friendly on the asset side. How much of a multi-decade view do you think regulators should take of that risk? It is highly unlikely that in 30 years' time interest rates will be as low as they are. But in 1995, many people thought Japanese interest rates would not remain as low as they have done for 20 years. How do you deal with that as a regulator: not to put an unduly onerous burden on firms, but at the same time to recognise that unlikely things can carry on much longer than people anticipate?

Sam Woods: As a supervisor, I make no prediction about the forward path of interest rates, but I have to think about different paths in terms of the stress they can put on companies. You are precisely right that for life insurers—it is much less true for general insurers—prolonged low rates are stressful. That is partly for economic reasons—lower returns on assets and higher liabilities—but it is also because of the risk margin I mentioned, which supercharges those effects in a way that is very unfortunate. The way we accommodate that is by setting capital requirements for insurance companies differently from what we do for banks. The whole thing is a stress test: the capital requirement is “How much would your capital position move in a one-in-200-years stress?” That includes a stress to interest rates. We take that into account in terms of how we set capital; it is not like it suddenly hits us when things move. But it is certainly true that there has been a drop in gilt yields—it is actually a swap rate that we use for insurers, but it is a move in the same direction—since the beginning of the year. What happened in January and February, and what happened again post-referendum—the 10-year gilt yield has dropped by 55 basis points since the referendum—has put some pressure on.

- Q73 Mr Rees-Mogg:** Finally, do you feel to some extent that insurance is a Cinderella industry? Everybody focuses on banks and the exciting and exotic bits of the City but insurance, an incredibly important earner for the UK economy, is always slightly forgotten about. Should we, therefore, be particularly pleased that you are in place as an expert in this area? Just to ask you a really testing final question.

Sam Woods: I think you would have to ask the insurance companies about that, but I do think it is helpful to come into this slot having done the insurance side. The way the PRA is arranged, once you get to a certain level of seniority, you are involved in decision making on both insurance and banks, so you have exposure to both but it is, of course, very helpful to be completely immersed.

I think there is something in your point about visibility. The insurance industry has been less visible in the public debate. That may be a good or a bad thing if you are an insurance company. My own experience, from



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doing the insurance role at the PRA, is that it is incredibly interesting, and I do find that we are able to attract good staff from across the Bank and from outside to come and do that work for us. That is the most important thing from my point of view.

Mr Rees-Mogg: Thank you very much.

Chair: Thank you very much for coming to give evidence in this appointment hearing this morning. We are very grateful to you. No doubt we will be hearing from you in due course, but for now we are going to move into private session to discuss the outcome of what we have heard. I will bring this session to an end and would be grateful if staff would clear the room.

Sam Woods: Thank you very much.