

Treasury Committee

Oral evidence: [Prudential Regulation Authority, HC 865](#).

Wednesday 14 December 2016

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Members present: Rt Hon Andrew Tyrie (Chair); Mr Steve Baker; George Kerevan; Kit Malthouse; Chris Philip; Mr Jacob Rees-Mogg; Rachel Reeves; Wes Streeting

Questions 1-95

Witnesses

I: Sam Woods, Chief Executive, Prudential Regulation Authority and Deputy Governor for Prudential Regulation, Norval Bryson, External Member, Prudential Regulation Authority Board, and David Thorburn, External Member, Prudential Regulation Authority Board.

Examination of Witnesses

Witnesses: Sam Woods, Chief Executive, Prudential Regulation Authority and Deputy Governor for Prudential Regulation, Norval Bryson, External Member, Prudential Regulation Authority Board, and David Thorburn, External Member, Prudential Regulation Authority Board.

Q1 **Chair:** Thank you very much for coming to see us this afternoon. Can I begin by noting that the PRA board has commented in a number of respects on Brexit and on the negotiations and the risks and opportunities posed by it? We would expect you to continue to do so as far as it affects your statutory objectives. With that in mind, is it in the UK's economic and financial interest to maintain preferential access to the financial services markets that you regulate?

Sam Woods: I will answer that, and I will answer it directly, but if I might first say that the Government are in charge of the negotiation, and that is a very complex and difficult task. It will also be the Government who decide what, in the round, is in the national interest. Coming to your question, my statutory objective and the statutory objective of the PRA is safety and soundness, and policyholder protection, in the context of financial stability. That is the lens through which I look at the question you ask. If I look through that lens, the view I reach is that it would be



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in the interests both of the UK and rest of the EU to maintain a good degree of integration between our financial services markets within each of our economies.

Q2 Chair: Just to be clear, what you mean by “integration” is mutual, preferential access beyond that available under WTO rules?

Sam Woods: Yes, something beyond that is what I mean. I would not want to be too specific about what.

Chair: We might come on to that in a moment.

Sam Woods: We might do. Yes, a good degree of market access would be my way of putting it. Why do I say that from a safety, soundness and financial stability perspective? One of the reasons is to do with firms’ business models. One of the lessons for us as UK prudential regulators from Northern Rock was that we needed to pay attention to firms’ business models and how well their business is doing, as well as to the regulatory metrics. It is a fact that for a subset of the firms we supervise, but also firms doing the equivalent activity but based in the EU, their business will be impacted by the severance of the ability to sell financial services across borders between the UK and the rest of the EU. I emphasise that it is a subset.

An imperfect but simple way to illustrate the point is to look at the levels of freedom of services permissions that we have at the moment, some of which were set out in the letter to the Committee from Andrew Bailey. They are illustrative in that we have 13,500 firms with permissions to use freedom of services across the border between the UK and the rest of the EU. 8,000 of those are incoming and 5,500 are outgoing, which illustrates my point about the interest that both sides of the channel should have in this. If you come more narrowly to CRD and Solvency II, which are the two Directives in which we as the PRA have the closest interest, the picture is also interesting. You have 552 inbound and 102 outbound on the banking side, and on the insurance side 726 inbound and 220 outbound.

I mention these points just to illustrate my first point, which is that there is a business model question here, and we as supervisors pay attention to that from a safety and soundness point of view. If I might, I will add two other points more briefly, although they are equally important in my mind. The second is regulatory co-operation. It is a difficult job supervising and regulating international financial companies. That job is hard enough when we are all getting along well and co-operating. All of the countries in the EU have a very strong interest in ensuring that whatever results from these negotiations, we have a very strong degree of co-operation between the regulators on either side, on the prudential side of the fence.

Of course, it is not necessary to have preferential market access in order to achieve regulatory co-operation, but to my mind the most natural



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bedfellow of a deep, co-operative relationship is one in which there is a significant degree of market access from both sides as well.

The final and third point I would like to make is that in my opinion, the harder the border is in the financial services space, the more complex are likely to be the structures that firms adopt in order to be able to carry on doing business in the presence of that new rigidity. In my view, that will be a step backwards, because the more complex a firm is, broadly speaking, the more difficult it is to manage and supervise, and the harder it is to resolve.

Q3 Chair: That is quite a long and comprehensive answer to one question. It is still very interesting. You have come some way to answering which industries it is that are most affected, and it is basically those who rely on CRD IV or Solvency II for access. Can you give me some idea in more substance? I have an idea myself, but it would be helpful to have from you the types of industry that we are talking about here.

Sam Woods: I will happily do that and give you my sense of how the impact varies across the subsectors that we look at, and perhaps slightly more broadly in the financial sector.

Chair: Yes, what you are calling subsectors.

Sam Woods: It does vary quite a bit. My perception of it is that, simply put, for retail and commercial banking and life insurance it is not that big a deal. To illustrate that for you, although it is hard for us to get a sense of how much is coming inbound on the insurance side, because of the way the legislation works on that side, we attempted to get a view of how much freedom of services is coming in in life insurance, and we think it is possibly 3% of annual premiums here in the UK. That gives you a sense that it is not that big a deal in that part of our business.

If I turn next to general insurance, which is slightly more complicated, for retail general insurance—motor, home, and things that we probably all have in our personal lives—my opinion again is that there it is not that big a deal.

Q4 Chair: Tell us where the big deal is.

Sam Woods: The single biggest impact is likely to be on the trading banks. There may also be a material impact on wholesale banking, and then there is a question around clearing and asset management, where the key issue is delegation.

Q5 Chair: What is the value of what is at risk here?

Sam Woods: It is hard to get a very good fix on that, but there are two ways of coming at that question. One is that you can look at the trade surplus that we have in financial services with the rest of the EU, which is 1.2% of UK GDP. That is a material number, particularly when you consider we have a 5.9% deficit, which from a financial stability point of view is something we have been concerned about. It is important,



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though, to think about the other side of that equation. This is not the kindness of strangers. It means that companies and individuals in the EU are buying a lot of services from us. Three quarters of FX and derivatives, for instance, in the EU come from the UK. That is one way into it.

The other way is to try to size what proportion of revenues from financial services might be at risk from various different outcomes, and how that might translate into a GDP figure. There is a report out there by Oliver Wyman. It is hard to get too precise about this, but I think that is a reasonable stab and when they do that calculation—

Q6 Chair: What do they come to?

Sam Woods: They come to a number between 1.1% and 1.3% of GDP for the hardest outcome, including loss of financial services—

Chair: By which you mean the WTO option.

Sam Woods: Exactly. These are ranging shots. As I say, there is a sprinkling of salt over all of this, but it does suggest that some impact could be material.

Q7 Chair: Since financial services are roughly 10% of the UK economy we are talking about 10% of that, which is 1% of GDP.

Sam Woods: That is a reasonably approximate way to think about it, yes, for our hardest outcome.

Q8 Chair: Now there is the question of what should be done about all of this as we prepare. The question of transition was discussed extensively with the Chancellor, and you will have seen those exchanges. He was much more forthcoming than any of us had expected in what he said on it. What representations have you received about that?

Sam Woods: I would say that, without exception, in my experience those firms who are affected directly rather than indirectly by what we were just talking about would all like to see a transition period. My own way of thinking about that is that the smoother the adjustment, the lower the risks to financial stability, safety and soundness are likely to be. If you come the financial services experience, which is of course just one part of this much more complicated jigsaw, typically changes of this sort have had some kind of significant implementation phase or transitional arrangement.

I can give you a couple of examples. One I was very closely involved in was the Vickers reforms, the ring-fencing the banks. That is coming in on 1 January 2019. We first recommended that in 2011 and it was accepted by the Government in 2011 for an implementation in 2019. Parliament then endorsed it further down the track and made it law, still with a four-year implementation timeframe. Another example is Basel III, an eight-year implementation. I do not offer these as analogies to where we are now, but just to illustrate the point that these sorts of



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changes in the financial services arena have typically been accompanied by a reasonable implementation phase.

Q9 Chair: Before you move on to your second point, are you not over-egging it a bit there? Ring-fencing is, by definition, a very deep restructuring programme, which is quite complex and which nobody has tried before anywhere in the world, whereas what we are talking about with Brexit, for the most part, is not restructuring. There may be some restructuring. You may contradict that. However, it is requiring other adjustments to where firms will try to seek their markets.

Sam Woods: I am not sure I agree with that 100%. If we asked ourselves which is likely to be the more complicated disentangling, the ring-fencing of retail banks within wider banks here in the UK, or the withdrawal—

Chair: You are saying that it could be as bad or as difficult as ring-fencing.

Sam Woods: If you look at it in the round, with everything that is going on in a Brexit context, yes, I would argue that is the case. If you narrowed it to the impact on individual firms—

Chair: That was what I was referring to.

Sam Woods: I am more sympathetic in that the sorts of things that firms may need to do in order to accommodate this change are, very broad-brush, likely to be less complicated than what they have been doing for ring-fencing. However, I would not underestimate that these are non-trivial restructurings.

Q10 Chair: What we need is a transition, which one might normally think of as a taper, in which measures are introduced gradually over a period after the point at which we have left the EU. That is, the direct applicability of UK law by virtue of the 1972 Act has been repealed. Or are you suggesting something else that has been put to me? That suggestion is a standstill, where the full gamut stays in force for a period after the implementation of the repeal, and at the end of that period, in one go, there is a day of adjustment like there was a day of adjustment in technical terms to Y2K.

Sam Woods: I have not got a firm view on that, but I will offer you a view. We have both sorts of transitionals in the financial services world. The Vickers one is a standstill one: it will go live on 1 January 2019, and that is just a change of game on that day. That is more like your Y2K example. If we take an example from the other end of the spectrum, we have the Solvency II transitional, which began on 1 January this year and will take 16 years to phase in, in a taper, exactly as you say.

To my mind this process is more akin to the ring-fencing process in that regard. The most important thing is to have some kind of transitional and clarity on that sooner rather than later would be beneficial.



- Q11 **Chair:** My last question in this field is: do you think it is in the UK's interest that we should continue to take a view about and participate in, as far as is reasonably possible, the regulation of continental banks? At the moment, we sit around the table and have an opportunity to discuss this issue in the round. Are there prudential risks that could be thrown up by their banking system, with which we will have to deal whether we are in or out of the EU, and about which we would like to be able to express a view and try to influence policy, or is that not a prospect you are considering?

I am thinking particularly that if you go back a decade, we were heavily blamed by some members of the eurozone for the crisis with which they were then hit. They said, "Why did you not regulate your industry better?" It looks as though we have done something about our banks; we have not solved all the problems, and we will come onto that in a moment, but we certainly have a much stronger banking system than we had. Many would argue that it is parts of the eurozone that now have some of the weakest banks, with the highest contagion risk for us all.

Sam Woods: You are right that close co-operation amongst regulators in different countries is a global good. It is essential for us to do the job we have been given, in overseeing large, complex, cross-border financial institutions. I certainly think a world in which that was not able to continue, which is a conceivable world, would be a step backwards and would be a dangerous step both for us and for the rest of the EU.

- Q12 **Chair:** I am asking you whether you see merit in being at the table, as far as possible, to try to influence the way they regulate their banks.

Sam Woods: I do see, but there are two different types of table. There is the regulatory, rule-making policy table, and then there are supervisory colleges. Whether we are at the regulatory policy table will depend very much on what deal the Government strike in terms of—

Chair: I am asking you, from a regulatory perspective what your preference is on what they strike. That is what I am asking you. Sorry to interrupt twice.

Sam Woods: That is fine. I am sorry; I am not deliberately trying to obfuscate. I am trying to get to the nub of your question, and I think I now have it. I think I was clear last time I was here, which was a few days after the vote, that having influence over the rules that we are using here and, by inference, those which are used elsewhere remains very important to us. It is worth mentioning, however, that doing that within Europe is not the only way to do it. We engage very actively at the international level and upstream.

Chair: With Basel.

Sam Woods: Yes, and we obviously will carry on doing that.

- Q13 **Chair:** Was that a "yes" to my question, or did I get a feel of—?



Sam Woods: It was a cautious “yes”, a mild “yes”.

- Q14 **Chair:** There is still some lingering Treasury official there, I feel, in Sam Woods. Brilliant though Treasury officials are, what we are seeking is a new, independent and at times quite noisy figure: cautious but not quiet, and also clear. It was a “yes” to the question. Am I being unfair?

Sam Woods: I shall try to become noisier in future.

Chair: Good; with that in mind, see how you do with Rachel Reeves’s questions.

- Q15 **Rachel Reeves:** Thank you very much to the three of you for coming along to our Committee today. Building on what the Chairman has asked, the Monetary Policy Committee and, indeed, the FPC were quite noisy and vocal about the risk posed by Britain’s exit from the European Union. The PRA board have been relatively quiet on this front. Do you think that reflects a lack of concern about the result of the referendum, or is it just a different stance you are taking in terms of, as the Chairman said, how vocal you want to be on what are political issues?

Sam Woods: Maybe I should say a quick word and then invite colleagues to jump in too. I will be brief. To me it is more of a difference in the operating model. I am on the FPC and PRA boards, so I am familiar with those two, although not so much with the MPC, having not been in that committee. Public communication as an instrument of macroprudential policy is a bigger part of the toolkit than it is on the microprudential side, where more will be done firm by firm. It is largely reflecting that, but my colleagues may have other views.

David Thorburn: I agree with that perspective. Our focus as independent directors is, first, to be independent and, secondly, to be very focused on the statutory objectives of the institution. It is about the safety and soundness of banks, the protection of policyholders, and our secondary competition objective. That is a very time-consuming and detailed role and we do not really extend our discussions beyond that. Because of the nature of it, as well—we are talking about institutions, so there are commercial sensitivities—you are not likely to want to speak publicly about most of the work you are doing.

Norval Bryson: I would echo that. The PRA does have a different perspective on things from the FPC and MPC, as I understand it. It is much more firm-specific. Clearly, we have an interest in what happens, in the sense that for financial stability we want orderly things to happen. To that extent, we are very interested in what goes on, but there are other aspects on which it is more appropriate for the MPC or FPC to comment.

- Q16 **Rachel Reeves:** Building on that, what analysis has the PRA done on how the UK’s financial sector will adapt or cope with different models of what our exit from the European Union might look like that?



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Sam Woods: We have been mainly focused on what the contingency plans are that firms are putting in place around the various eventualities that they might face. From a narrow safety and soundness perspective, that is the immediate question. We have been very closely engaged with firms in understanding what their planning is like. We could come on to that. That has been the bulk of the work so far. As we progress further through this, it will become more of a policy issue, particularly as we are supporting the Government and engaging with the Government on what they want to do. I could expand on that point if you like.

Q17 Rachel Reeves: Has the PRA done analysis to the extent to which the firms you regulate will be able to operate or the extent to which it would impact financial stability under different models? Have you looked at, for example, a model where there are no passporting arrangements, where there are transitional arrangements, or where we are in the single market? Have you looked at different analyses?

Sam Woods: Yes, we have, and maybe I could describe it briefly to give you a sense of it. It starts with the firms. Here I emphasise again that it is a subset of the firms we are talking about here. We supervise 1,580 firms, and it is really the ones in those sectors I have talked about we are talking about here. They are having, in effect, a contingency plan for what, from their point of view, is the worst-case outcome. They are going to the right and saying, "There is a possibility of a moment on 1 April 2019 when we are no longer able to transact a set of our business that is currently important to us. We need to be in business on that day; therefore, what steps do we need to take to be in that position on that day?"

They are then working back from the right of the chart, if you like, and working out what they need to do. What the actions are depend a bit from one firm to another, but, broad-brush, it tends to amount to the same thing: either creating or beefing up an existing subsidiary on the EU to do things that are currently done for EU customers out of the UK. We have obviously been looking at those plans and taking an interest in them. None of them are free of risk. That is really where our focus has been.

Q18 Rachel Reeves: When you say none are free of risk, are there particular approaches to exiting the European Union that would cause you, as a regulator, some concern?

Sam Woods: Yes, there are. Put the question to me the other way round: would a sudden and complete severance of all financial services flows across the border be a financial stability, safety and soundness problem? Yes, it would be. The way to think about that is if there is no transition period, and those contingency plans for some reason are ineffective, then you could be in that world. I do not think that is likely, by the way, but that is a conceivable world, and we are paid to worry about those sorts of things.



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If you come one level inside that, there are also downsides to us from a financial stability perspective of the sorts of things that firms may need to do in order to cope with the change. They are the things I referred to earlier, which all have their root in higher complexity, which makes it more difficult to do our job well.

Q19 Rachel Reeves: There are two things, Mr Woods. It is where we get to in terms of our new relationship with the European Union, and it is the transition to get there. I will come on to the transitional arrangements in a minute. In terms of where we end up, though, are there particular end states in terms of our new relationship with the European Union, which we will no longer be part of, that give you cause for concern as a regulator? Regardless of the transition arrangements for getting there, are there end points that give you cause for concern?

Sam Woods: I have to come back to the response that I gave to the Chairman. I will answer your question, but it is the Government's job to define what is in the national interest.

Rachel Reeves: Totally; I am not asking you to say what is in our national interest, but you have an interest in this.

Sam Woods: Within that, outcomes without market access, without regulatory co-operation and with a higher degree of complexity of firms are not great outcomes for us.

Q20 Rachel Reeves: In terms of what the firms that you are regulating would need in the new end state, it would be some co-operation on regulation and favourable access of some sort to European markets?

Sam Woods: "Need" is a strong word, but to my mind, that is the path that is most consistent with us being able to do our job well.

Q21 Rachel Reeves: On the second point that I raised, about the process by which we get to the end point, the Chancellor was in front of our Committee on Monday, as you know. He said that there was an emerging view among businesses, regulators and thoughtful politicians—whoever they are—that a transitional deal would be needed. He said it would run fewer risks of disruption, including, crucially, risks to financial stability, which must be a fairly real concern. Do you agree that a transitional deal would reduce the risks to financial stability, and do you think it is right for the Government to pursue some sort of transitional arrangements?

Sam Woods: It would reduce the risks, for the reasons I gave earlier, but it seems to me to be just as true for the rest of the EU, the other 20 member states, as it is for the UK. It is in the interest of all parties to have a reasonable implementation phase for this thing.

Q22 Rachel Reeves: So you hope that the Government will be pursuing transitional arrangements on the way to an end state that has those specifications that you set out earlier.



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Sam Woods: Yes; I hope that is where we get to, but I recognise that it is a very big and complicated thing that we are doing here.

Q23 **Chair:** I just have one point of clarification on what Rachel has just asked you. To be clear, if we are going to have any of these transitional arrangements, we have to sort these out right at the start of the negotiations, have we not? Otherwise you end up with a cliff-edge in 2019, and firms will take pre-emptive action.

Sam Woods: It is a question of the sooner, the better. I would not want to be sitting here in a year's time, a transitional not having been agreed, and say that transitional still had no value. Clearly, the sooner we have it—

Chair: So within nine months of March 2017?

Sam Woods: Yes. The firms—

Chair: That is what you have just said.

Sam Woods: Exactly. What is going to happen is that firms will make their first set of decisions about these contingency plans in the coming small number of months. They will then begin to invest in the various things they need to do to get these things done, and the level of that investment will increase through time. The sooner a transitional is agreed, the better in terms of obviating what may be unnecessary activity; or, if not that, allowing more time for regulators—us and our colleagues on the continent—and firms to agree on the way through this that makes the most sense from a safety and soundness perspective.

Q24 **Chair:** Just to be clear, Mr Bryson and Mr Thorburn, has this been discussed by the Board?

Norval Bryson: Yes. We have had the Board; we have seen the contingency plans that firms are considering, and discussed them relative to our objectives.

Q25 **Chair:** You are in full agreement as a whole Board on this point.

David Thorburn: Yes, I think so, but our focus in particular has been to start to think through how this might play out from the perspective of firms' business models, and to start to think about what we would like to see and what we would not like to see. Different structures bring different risks and are harder to supervise. Firms have not made these decisions yet, so we are not making them, but we are starting the thought process.

Q26 **Chair:** Financial firms lobby all the time. Are you getting a sense of the degree to which we should be—how should I put it?—taking with a pinch of salt or dividing by a number or aiming off for what might just be vested interests lobbying, Mr Thorburn?

David Thorburn: I have not been lobbied personally at all by anyone, so I am speculating.



Chair: I am sure you have, Mr Woods.

Sam Woods: It would be wrong to be complacent about the risks. You perhaps always have to apply a pinch of salt, but there are as many regulatory reasons to be interested in a reasonable implementation phase as there are firm reasons.

Q27 **Chair:** So this is not one of those where they come with special pleading.

Sam Woods: No, I do not think so.

Q28 **Wes Streeting:** I want to turn to the issue of the senior managers regime and executive pay. Andrew Bailey recently wrote an article in *The Guardian*, citing concerns that some firms have not been implementing the senior managers regime correctly, either by assigning overlapping responsibilities, or placing the burden on junior staff. Are those concerns you share, Mr Woods?

Sam Woods: I do. I thought Andrew put it very well in his article. It is very early days in the senior managers regime. As you know, we brought it in on 7 March this year. It is a very important plank of the new regime, along with the certification regime, where the first round of attestations will happen on 7 March next year, which we then intend to roll out to insurers. We are in the early days of implementation, and we are seeing the sorts of things Andrew described. However, we are seeing already as a result greater clarity within firms about their governance, and greater transparency about who is responsible for what. I think we can see that, but we need to embed that in the day-to-day activity of the firm.

One piece we need to move forward further is around operations and operational resilience. We have a proposal out there at the moment to add a new Chief Operations senior management function to the regime, because that is frankly something we missed in the first round.

Q29 **Wes Streeting:** In terms of your relationship, do you think the imposition of both SMR and certification have led to any changes in the nature of the supervisory relationship between the PRA and the firms that you supervise?

Sam Woods: The relationship we have with the firms is very different from the one that firms had with the regulator before the crisis; it is like night and day. It is sometimes a very difficult relationship, because we are often arguing about things. Have I seen a change in tone in terms of the relationships with us following the regime? Not obviously, but I do not think that is the central purpose of it. The central purpose is to make clear who is accountable for what and make that clear within firms, including when things go wrong, so it is easier to hold people to account. I would not necessarily have expected that as a short-term result.

Q30 **Wes Streeting:** Let us bring in the external members now. Some banks have suggested the UK requirements are burdensome when compared with other jurisdictions. Do you think the UK's accountability



regime makes it a less attractive place for banks to do business, or are they over-egging the pudding a bit?

David Thorburn: I have not operated overseas, although I used to work as part of an international group, so I recognise the situation. I do not think it matters. There are certain standards that we want to see in our industry and in this country. It is a good piece of legislation, a set of legislation that I support, which embodies the kind of practice that should have been in place in the first case in organisations. We should stick to that even if there is some short-term pain associated with it, which I have not seen. I have seen no evidence of that. I think it is the right thing to be doing and we should stick to our guns.

Norval Bryson: I have heard some people saying it is difficult if they have operations worldwide and they want to bring somebody, say, from the States into the UK. They have to spend more time explaining to the individual what our regime, is because the initial reaction is one of, "This is different from what we are used to." Once they do the explanations, however, it becomes easier to move them. I take the view that a lot of this is what should always have been happening. If somebody really objects to the regime, you have to ask whether you want to have them employed.

Q31 **Wes Streeting:** That is fair. Sticking with the external members for the moment, the Government have issued a Green Paper on corporate governance, and among the options for reform, as you are probably aware, are binding votes on executive pay and setting up shareholder committees. Do you think the financial sector would benefit from those proposals, or any of the other proposals in the Green Paper?

Norval Bryson: I find it difficult to form a judgment as an individual on that. As a member of the PRA board, it is not one the board has particularly diverted its mind to as yet.

David Thorburn: We have not yet discussed that as a board, so it would only be individual impressions.

Wes Streeting: You do not have a personal view on this.

David Thorburn: It is complex. I have read it, obviously, and it is a complex area where it will be interesting to see what comes back through the consultation process. I am trying to keep an open mind.

Q32 **Wes Streeting:** What is the feedback you have received from the industry?

David Thorburn: I have not had a tremendous amount.

Wes Streeting: So they are all delighted, then.

David Thorburn: That remains to be seen.

Sam Woods: I have heard very little. The reason for that is that this is a heavily regulated industry and we have done a load of stuff in the



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governance space, the most important element of which you were just talking about. In the financial services arena, the sort of ideas that are being debated in that wider debate are quite mild compared to where we have gone in financial services. That is probably why. There was some noise around the discussion on having worker representation on Boards; I did hear a bit of that from firms, but the version of that that came out in the final statement did not attract any further comment.

Q33 Wes Streeting: You have anticipated my next question, because in terms of the feedback you had from firms when that was writ large in the newspapers as the direction of Government policy, what was the reaction that you picked up from the industry?

Sam Woods: It is important to say that we did not get any formal reactions to it, but we probably got similar sorts of views to those that were aired in the newspapers by many corporate leaders, which was some disquiet around what appeared to be the shape of that regime. That noise has fallen away entirely, however.

Q34 Wes Streeting: Have you considered worker representation on your board?

Sam Woods: I am a worker, so I consider myself—

Wes Streeting: Come on; that is a cop-out. That is a real cop-out.

Sam Woods: I was told I should not say that

Q35 Wes Streeting: You should listen to your workers. They give good advice.

Sam Woods: I know it is not the same thing, but we do have a very important thing, which is that the people who do the work come and pitch their ideas to the Board. I know the motivation is coming more from a management space, but I think it is very important that we have in the Boardroom the people who have done the work and can present their ideas, and people on the case. That aspect is very important, but I have not thought about it more broadly. Others may have views.

Q36 Wes Streeting: I pick on the issues around pay and also workers' representation—particularly in terms of pay, high pay is always going to be a source of discussion, debate and criticism—is because both of those issues really go to the heart of culture, and particularly the culture of this industry, where there is an overlap with public interest. The public are interested in issues around executive pay. The public are also interested in the culture of the financial services industry, for obvious reasons. When the Parliamentary Commission on Banking Standards issued recommendations on executive pay, particularly around deferred pay and clawback, it was intended to address the problem of bank executives focusing too much on short-term gain.

I wonder if you have noticed any change in bank business models or processes, as a result of changes to pay rules, that have encouraged a



longer-term perspective?

Sam Woods: Perhaps I will offer a view, and then David has been on the receiving end of this, so he will also have a very informed view. It is my opinion, which I think is consistent with where the PCBS came out, that some of the pay structures there were before the crisis were part of what went wrong. The particular one I have in mind was the pay structure at one of our best known banks, which was 100% cash year-end. I was closely involved in the immediate reforming of that pay structure in the first instance, not by the regulator, but in 2009 by the Government as shareholder. I do believe that that structure is part of what went wrong at that firm.

We have moved a massive distance from that. For senior managers now, you have seven-year deferral, plus another three for clawback, and I think that makes for a safer system. The proof of that will be in the pudding, when we come into the next stress, but I do think that that has removed a very dangerous and gung-ho incentive that there was previously in parts of the banking sector. David may have a different view.

David Thorburn: I agree with that. This is a personal perspective, but the unfortunate by-product of what has happened has been a move away from variable remuneration towards fixed, and the mix between the two. Having a good proportion of your remuneration that is at risk and can be subject to clawbacks is an important part of what we are trying to do here to create the right culture. There has been quite a significant shift, as the data would tell you, in the mix between variable and fixed remuneration. It is much more skewed towards the latter, which is unfortunate.

Wes Streeting: Mr Bryson?

Norval Bryson: I do not think I have much to add to what has been said. Culture, though, will take time to change, because you can change the culture at the top, but it takes time to change the culture in the middle, in particular. Very often, in my experience, culture change can happen at the bottom and it can happen at the top—sorry, I am using pejorative terms, but I think you know what I mean—but the middle is sometimes the most resistant to culture change, and it takes time. In terms of the changes that have been made, there has been some effect, but it needs more time to work its way all the way through.

Q37 **Chair:** Just on that point, Mr Woods, of course two major proposals were published. One you have already alluded to: one was the SMR by the Banking Commission, and the other was certification, which was originally known as licensing. This is the idea that you need a licence or a document in order to do things in an institution where you could do serious harm to that institution, its clients or markets, such as had been done before and since, for example on trading floors. Do you think the purpose of certification was to roll out a system in these institutions



where they really knew who could put risk onto balance sheets? Are you confident now that the institutions you are regulating do know who does and who does not add to risk on the balance sheet?

Sam Woods: I do see that as the purpose of the reform, along with what is perhaps a softer thing, but equally important, the point that Dr Bryson was describing about affecting the culture in the middle, not just at the top and bottom. Do I feel that firms are there yet? I do not. Between the regulators and the institutions, we have a better grip, in financial terms, of what the risks are and where they lie, but even that is not perfect. The example I give you there is that in the stress testing—which we might come on to; I am not sure—we still have to make quite a lot of adjustments for some firms as to what they put. We have a different view of what the risks are from theirs.

In terms of the activities of individuals, which ultimately is what counts, it is hard to have confidence that that is yet in the place where it needs to be, partly because the certification regime is not yet fully operational. It is not even there yet on the insurance side. However, it is also, if you look at the ongoing issues our banks are having, particularly around the less obvious risks, perhaps, with some of the conduct risks with a financial consequence, and things of that kind. “Could do better” is probably the summary.

Q38 **Chair:** Let us just do a comparison, which you have heard me make before publicly, with a hospital. They may make mistakes, and occasionally they kill people who would otherwise be alive, but when you walk into a hospital, everybody knows who has the power to administer a drug, and everybody knows who has the power and authority to dispense the drug and decide that that drug should be given. Everybody knows who has the power to wield a scalpel, and who has not, and so on. They are full of risks of various types, including to some degree systemic risk with infections, and they have a sophisticated body of procedures that run right through the institution, not just at the top.

Of course, some of that is imposed on them, but a very large proportion of the systems that hospitals have in place are designed by the hospitals themselves. The purpose of certification was that firms, being each unique and very different in structure, should try to think through for themselves how best to do this. They should not have a template imposed on them. It should not be a box-ticking, bureaucratic exercise. You have said that you are not confident; I have to say that I am not at all confident when I discuss with people, particularly people in the middle ranks who are in these sorts of roles, that their bosses are fully aware of the scope and limits of the risks they can add to the balance sheet.

I am becoming increasingly concerned that as time passes, the impetus required to push these reforms through might be lost. What are you going to do to plug that gap that you yourself have identified? How do you go about intending to check whether this is being properly done? Otherwise it does not really matter how pretty the SMR may look on



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paper; we are going to have another problem on the trading floor, in the back office, or somewhere else, with people playing fast and loose with an institution, about which the CEOs knew nothing.

Sam Woods: Again, colleagues may have further views, but I agree that if we regard the certification regime purely as a piece of regulation that firms just get on with, it will not work. It will need to become an important part of the supervisory cycle, where we go into firms in the same way as we do currently for risk management controls and all sorts of other things. We would go into firms and lift the lid on how they have implemented this certification regime in one part of their business or another, to find out if they have done it properly and are doing it in the spirit in which it was intended, as well as just the letter. I am not on an increasing trajectory of concern about this at the moment.

Q39 **Chair:** Have you gone in? Do you have a system in place for doing that already?

Sam Woods: We have a central team, which has the expertise in exactly how the regime works. We will be, but it is a question of timing.

Chair: But you have not done that yet.

Sam Woods: No, because I think it makes sense to let firms do the first round of fit and proper assessments of their staff before 7 March next year, and then start to bake it in. We have obviously been in dialogue with firms and inspecting some of what they are doing from a design point of view.

Q40 **Chair:** So D-Day for this is March next year.

Sam Woods: Yes, for the banks, and then for the insurers the Treasury has not yet set a firm timeline. We are bringing something to the PRA board, I hope, in January, but that may be 2018. It will become an important part of the risk management and controls assessment that our supervisory teams will do on a regular basis.

Q41 **Chair:** It is quite concerning, is it not, that we have firms out there with people in middle ranks and they are unsure who exactly it is in their firms who could add these big risks to their balance sheets?

Sam Woods: The degree to which firms do that currently, and in the absence of certification, varies. Some are good at that, and others are less good.

Chair: I worry about the ones that are less good.

Sam Woods: Yes, and the certification regime is giving us a fantastic new regulatory and supervisory tool to go after that issue. I feel reasonably optimistic that that will be a move forward.

Chair: We will have to come back to this in March next year and afterwards; it really needs to be properly done.



Q42 Kit Malthouse: Good afternoon. I just wanted to ask you some questions, if I can, about enforcement and competition. I should, at this stage, draw the Committee's attention to the fact that in my business life I do deal with a number of banks, including some of the challenger banks. They are, from time to time, challenging.

Just on enforcement, you have been consulting on the new, admirably literal enforcement decision making committee. A question arises in our minds about the perceived independence of that committee. As I understand it, there are 15 members who will not be employees of the bank, but are effectively appointed by the bank. They seem to have quite a short term; it is only three years or so. Looking from the outside, it does not seem to be a structure that would instil confidence that it is completely independent. How will you make sure that it is?

Sam Woods: I know that this is a live topic of debate between us. The ultimate independence you could have would be the view that the Committee has been putting forward for some time: to take that function out of the organisation. There could then be no question of independence whatsoever. I personally would not favour doing that and the reasons for that are twofold: one is that we have already chopped the financial regulator in half with the post-crisis reforms—which, by the way, I think was a good idea, and the new system works much better than the old one. However, there is a limit to the benefits that you get from further atomisation.

The second point is the hand-off that the Committee is concerned about, brought to light in part by the Green Report, between supervision and enforcement. That is naturally a difficult boundary. It is difficult for substantive reasons. It is not at all obvious to me that that problem will be mitigated by taking it out entirely.

What can we do within it? The first thing is that we try to approach it across the bank, which I think is genuinely helpful, because that takes it one further degree away from the PRA and, in effect, the way that the EDMC would work is that the PRA board would give its powers that it currently has to that committee. Having a big pool is a good thing. The three years is not intended to impede independence. We have to trade off how long people will be willing to commit for as well, so I think that strikes the right kind of balance. That is more how I see it but I am conscious that there may be a difference of opinion between us.

Q43 Kit Malthouse: Given the profile of the sort of person who is going to sit as one of these 15 people, who will inevitably have to be drawn from the City and the financial services system itself, do you not see that there could be a perception of it being a bit of a bank/City stitch-up? People who worked their way through the organisations that are now being enforced against are effectively sitting in judgment on their peers.

Sam Woods: I hope not, but obviously one would need to have an eye on the appointments to the ability to be independent, and that is also at



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the forefront of the Treasury's mind in terms of any appointments to the PRA board, which is analogous in some ways. I do not see why it should not work but it is a better arrangement than what we have today where we do not have that at all; and, to be honest with you, it is a puzzle that lands in between where we are today and the extreme case of the independent enforcement agency. I think it will work okay.

The other point that is perhaps worth mentioning is that enforcement is an important tool of prudential supervisors. However, as a general proposition, it is likely to be a more regularly used tool in the conduct space and I think that that is perfectly healthy.

Q44 **Kit Malthouse:** Given that supervision and resolution are supposed to be legally separated, do you think it is appropriate to share the same committee?

Sam Woods: Resolution does not come into the PRA board. That actually goes up, so that is a separate committee.

Q45 **Kit Malthouse:** I thought that the EDMC is going to have the power to decide enforcement cases concerning bank resolution.

Sam Woods: Sorry, my apologies. It is true that we are bringing together the resolution notes, FMI enforcement and PRA. That is frankly efficient. How many committees do we need within the Bank of England? Do you need more than one to do that kind of stuff?

Kit Malthouse: It is more the legal separation issue.

Sam Woods: Our lawyers do not seem troubled by that. Perhaps they should be but I do not see a reason why that should be a big problem.

Q46 **Kit Malthouse:** I will just move on to competition. Are you frustrated about the lack of competition, still, in the UK banking market, particularly with retail banking? You do not seem to be making much progress at all.

Sam Woods: It is true that this is an extremely long-running issue and it is unsatisfactory in that regard. The short answer is that I am frustrated. We have been doing quite a lot in this space. A lot of what we have been doing is not so much with what are typically called the challenger banks but with the new entrants, and we have really done quite a lot there, which we talked about when I was last in front of the Committee. This figure of roughly 20 new bank entrants since the PRA was created three and a half years ago is quite a good illustration of that working. The approach we take there, with things like the mobilisation phase where banks get the chance to start running—without the permission to go really big but they get a chance to get into operation—is regarded by the international prudential regulatory community as quite a racy construct, but we are sticking with it. Given our second objective, we think that it is a good thing.

Given his background, Mr Thorburn will probably have views too with regard to the challenger banks. It is true that the inroads that we have



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made there over time have perhaps been less than one would like from a competition perspective. There is the very vexed issue of the risk-weight difference between standardised firms and firms with the ability to run models. If I am not going on too long, I will describe that briefly.

Kit Malthouse: Please do. I was going to ask you about that.

Sam Woods: The 35% risk-weight that we have under the Basel standardised formula is significantly higher than the type of risk-weights that firms who run models can typically demonstrate are appropriate for mortgages sub-70% LTV. That has troubled me for some time. We talked about this a bit last time. The introduction of a leverage ratio is very helpful because it cuts across that, but it only cuts across it really directly for a monoline mortgage lender here in the UK who is on the model. They will lose that advantage. That is helpful but it is not enough.

As part of the work that we did for the CMA—and I know this Committee has paid very close attention to the CMA's report—we provided an annex to their report and that does actually effectively hand a smoking gun to those who wish to make this argument. Our team looked at this and did an event study from 2008 when IRBs and the model approach came into the UK in terms of whether we could see a difference in mortgage pricing between modelled banks and standardised banks. The answer to that question is that you are getting a lot of different cuts, as always in these econometric studies, but all of them suggest that the differential in mortgage pricing between standardised and IRB is either zero or positive up to 60 basis points. In other words, the banks on the standardised treatment were charging up to 60 basis points more. I do not know what you think but most people would think that that was a big enough difference in the mortgage price for people to make a different choice. It might also be zero but none of the answers were negative. I thought that was interesting.

The key to moving forward on that is Basel, and we have been advocating a 20% risk-weight for low LTV. There is a reasonable prospect of landing that, and that together with the leverage ratio are significant changes in this situation.

David Thornburn: There are a couple of other things that we are going to do to try to help as well. Without getting too technical about this, we have traditionally been looking at standardised organisations and calculated a variety of things and stacked them all up, and it can lead to this higher capital requirement for standardised banks than IRB banks, which creates this pricing difference. One of the things that we are looking at just now is a more proportionate approach to that in terms of a sum of the parts rather than adding everything up. It is about stepping back from the analysis and then deciding whether or not in fact the capital requirement that we are setting is a bit too high. There is scope to do something there that will definitely help.



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In addition to that, we are also looking at a more proportionate approach to the IRB journey for standardised organisations. It is a higher hurdle for them to jump. It should not be a low hurdle but it is quite a significant step for a standardised bank to take if it wants to overcome this pricing disadvantage. We can help make that process that bit easier. In fact, we have a seminar planned in February with the standardised bank chief executives to go into how we might do that in more detail.

Q47 Kit Malthouse: Do you think there might be progress at Basel quite soon?

Sam Woods: Yes, it is part of the wider proposal to finalise Basel III, which is a very hotly contested negotiation, of which this is an important but not central part and is not the most hotly contested part. It depends on whether the wider package lands.

I am conscious of giving a long answer here but I would like to add one further very brief comment. It is also the case that the challenger bank lobby is a very effective and noisy lobby. However, we should all recognise that the last thing we need is under-capitalised challenger banks. While there are many things that we can do, and which we have just described and we intend to do under our competition objective, we do also need a robust capital requirement for all of our banks, including the small ones.

Q48 Kit Malthouse: Is that right? Would we not be more resilient if we had a whole slew of small challenger banks that were easily resolvable if they got into difficulty rather than these great systematic leviathans?

Sam Woods: That is reflected in our capital requirements in the sense that we have these buffers for the bigger banks, and we will bring in the Vickers buffer later. We already have the global version of that. That is where we try to aim off for that.

Q49 Kit Malthouse: It is still quite difficult for a micro bank with a small amount of capital. In the old days you could have quite small banks with £10-million or £20-million lending books and little local banks. Nobody would really do that these days under the capital requirements or even the regulatory costs.

David Thorburn: In a sense, credit unions fill that space to some extent and a reasonably regular failure rate goes on in there. We have a different and more flexible approach to credit unions, and they are very important in different parts of the country like Northern Ireland and Scotland.

Q50 Kit Malthouse: What is the pipeline looking like on that?

Sam Woods: The best answer to your question is that there are 20 or so banks that we have authorised, and they will have grand plans of various kinds.

Q51 Kit Malthouse: My perception might be wrong but there was a flush of



them and a lot of them came in and effectively were cherry-picking a bit. It is all secured lending and quite a lot of property lending and almost entirely commercial. I think I am right that it is all bar one: it is only Metro bank that is non-commercial.

Sam Woods: There is a very wide range but you are right that some of them are niche players; but these niches are often quite big. The pipeline is reasonably strong, so I am expecting this number to increase over the coming years. You will see it the next time that I am back here. It was not just a one-off hub. It may be that the approach to the changes that we made, which made it more feasible, allowed this to start occurring, but I am expecting it to carry on.

Q52 **Kit Malthouse:** In terms of the two sectors, the bulk, I am assuming, are commercially focused B2B-type banks. We have only had one new retail bank. Is that right? We have had Metro bank and that is it.

Sam Woods: Some of the smaller digital banks are retail. Atom bank is one.

Kit Malthouse: They are retail deposit takers but they are not clearing.

Sam Woods: No, but they are certainly retail banks. They are smaller, which is why they probably have not come up on your screen yet.

Q53 **Kit Malthouse:** It alludes to a different inquiry that we are doing at the moment into retail banking competition; and part of the issue, as far as we can see, is that the market is carved up by the big banks. You get one challenger who has come in and is making some inroads but is really miniscule compared to the size of the market. We do not seem to be stimulating any others. If you talked to them as well, they would probably say that, if they knew then what they know now, they probably would have taken a different decision.

David Thorburn: Access to the payments system is a factor. Some of the digital players want to offer current accounts but they are required to enter into agency agreements with the large banks to access BACS, faster payments and so on. That is difficult for them and they do complain often of not getting the development and the support that they need. That is one of the barriers that remains here.

Q54 **Kit Malthouse:** The large banks have become a bit like BT: to play you have to access their copper wires.

Sam Woods: We have a heavily tiered system, which is what David is talking about, and this is not a PRA responsibility but a wider banking responsibility. The bit of that that we have an interest in is that we want to reduce that level of tiering, both for resilience and for competition reasons. I do not want to be Panglossian about this. There is a frustration around this topic and it does seem to move very slowly; and a lot of the root of this is the very slow rate, as you well know, at which consumers are prepared to change where their current account is based.



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Q55 **Chair:** Can you blame them, bearing in mind the offer that is being made to them and the perceived risk? Can you?

Sam Woods: They are making a rational choice.

Chair: Yes, so what we need to do is shake the institutions up a lot.

Sam Woods: Sure, and I am not adverse to that in any sense.

Q56 **Chair:** That is not what we are getting from the CMA, is it?

Sam Woods: I do not want to comment on what other agencies are doing.

Q57 **Kit Malthouse:** They have an impact on your responsibility for competition.

Sam Woods: That is understood but what I have tried to describe to you is what we are doing in this space. We are doing quite a lot in this space at the moment and, if I worry about anything that we are doing at the moment, I worry whether we are tilting too far away from our primary objective. I do not think we are but I think that is a reasonable question to ask when we are going into Basel and arguing hard for a very significant reduction in the capital requirement for our biggest asset class.

Chair: We will worry about that with you together and, as you know, a worry shared is a worry halved. We just encourage you to get on with it because we are very eager on this Committee to see that those millions of retail bank customers out there, for the first time in living memory, get a better deal than they have had hitherto where they feel ripped off—and in many cases they have been ripped off—by large banks operating in what many would call a cartel.

Sam Woods: Understood.

Chair: Okay. I think that message got through, colleagues.

Q58 **George Kerevan:** Good afternoon, gentlemen. I shall not be asking Mr Thorburn any questions about tailored business loans. Mind you, thousands of people whose lives were ruined by them probably still think it is a current issue.

Let us talk about stress tests. RBS notably failed, for the first time, the last set of stress tests. That was partially to do with the overhang of potential misconduct findings from this Committee. Does the PRA have a view on whether the balance between fines for misconduct, which can have a conduct impact, and enforcement against individuals is the right one?

Sam Woods: It probably has not been. In fact, it certainly has not been the right one in the past. One of the great advantages of the senior managers regime and the certification regime is that they will make it much easier for us to pursue the individual cases. There is a role for the corporate angle to that as well and, where banks have done something



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wrong in the conduct space, the first thing is that they need to make that good. That has been very inconvenient for us as the prudential regulator. To give you a sense of the scale, £58 billion has been either paid out or set aside by banks so far for misconduct since 2010. In our stress tests, as you quite rightly say, we made a stress forecast for future misconduct losses—so I emphasise that this is not a base case—and we had another £40 billion coming through in our five years. That is on a 90% confidence interval view but it has been a major headache and continues to be a major headache for us.

Q59 George Kerevan: Can you give me a sense of how stress tests are conducted? Is there a prior discussion between the banks and the PRA before the final version is given? In other words, would RBS have known that it was likely to be failed and would there be some discussion?

Sam Woods: It is tricky. For reasons of maintaining market discipline, we have to tell banks very late what their result is and the PRA board and the FPC decide the final results on the day before they are announced. However, in this case, to give the team at RBS their credit on this, it was apparent to them from their own results—we subsequently made further adjustments as we do with many banks—that they needed increased “stress resilience”, which is a term we use for this. That made the discussion easier because we said, “That seems plausible. Given what you think your results are, we will do our further work.” We were able to work with them on a plan on a contingency basis such that, on the day we came out with the results, there was a plan that had been agreed by the PRA board to lift them above where they needed to be.

Q60 George Kerevan: That leads me to a wider point as to whether the stress testing process has an impact on managerial behaviour prior to the stress test, if you see what I mean. Is it a case of, “Here’s a stress test. We will do it and tick the boxes,” or has the process over the years led management across the banks to think, “Maybe we should be doing things differently”?

Sam Woods: It is a game changer. If you want to have a good view of bank capital, you want to have risk-weighted loans and leverage loans and you want to know how much capital the bank has now versus its requirements and what the forward path is on a base case, and then what the stressed view is. It is no good having a bank that looks great today but that looks terrible once you get into a stress test and you did not know that that was going to happen. That was not part of the old regulatory framework. It has always been part of the “better banks” framework but it was not a part of all banks. That has led to a shift and particularly this year we saw that banks are getting used to that being one of the ways that we think about capital. The system is working very well for us if they pre-empt and can see that they have a problem and take action to avert it.

Q61 George Kerevan: I have a short question for the externals, just to take this a stage further. Even after you have been through a stress test



scenario, the equity capital that the bank has to keep is still quite high by PRA rules at 6% or 7%. Given that the equity capital is there to be used to grow the business, after the experience we had with stress testing, is the equity capital ratio you are expecting the banks to keep too high or too conservative?

Norval Bryson: One other aspect of the stress test, in addition to the scenario and the stresses being imposed, is concern as to whether the banks will continue to be able to lend to industry and so on and the economy. I would postulate that, if you let that equity ratio fall too low, you would probably restrict the lending to the economy and you would damage the wider economy if that fell too low. I am quite comfortable with the number that we have got.

David Thorburn: As am I. I have nothing much to add to that.

Q62 **George Kerevan:** There is another small technical point about the stress testing. The latest round of stress testing assumed that the banks would have to trigger their additional tier 1 in order to conform. I can see the reason for that as a way of letting the wider market know that that was a possibility at some point if there had to be some resolution. Have you seen any impact in the bond market from the stress tests on that particular point?

Sam Woods: There was a very modest impact on the AT1 spreads of at least one firm but nothing significant. More widely, the dynamics of that market since the stress test have been swamped by a whole bunch of other factors so that AT1 spreads for the UK banks, including those who triggered in our test, have come in very significantly since the test. I do not think that it is to do with the test; that is to do with other things going on in the search for yield. You are right that it was an important part of this test that the banks would have ended up at 8.4% CET1 without the trigger. They hit the trigger through them and then moved 40 basis points in aggregate to 8.8%. That was a useful illustration for investors to say that there are states in the world in which these things will trigger and they need to be aware of that.

Q63 **George Kerevan:** Did the market really notice that? You said that it did not.

Sam Woods: In a small way. Another way for me to answer that question is to say that AT1 spreads through some of our biggest banks have been as high as 930 basis points when we did the stress test and have actually come back in a bit to 780 or 790 basis points. That is quite a big yield. Investors are demanding quite high compensation to hold this instrument, and that, in a way, is reassuring; however, I am not at all complacent about how, if you actually got close to the trigger, you would have a very complicated market dynamic around these things that might be quite difficult to deal with.

Q64 **Chair:** Could you just expand on that? If it turns out to be sufficiently complicated to distort the market to the point that it is not functioning, it



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has not succeeded, has it? The policy has been a failure because that is when you need it the most.

Sam Woods: Exactly.

Chair: The purpose of it is to create a market.

Sam Woods: There is no reason to assume the worst, but any bank situation where you see that a bank is getting into difficulty causes a lot of volatility in all of its financial instruments. We saw that earlier in the year in relation to one European bank in particular. From a supervisor's point of view, equity is the best because it is less complicated in that regard. That is why, when it comes to setting the PRA buffer, we do not give a pass because of AT1. We say, "Fine, we can afford to take a bit more time for you to rebuild your equity position but this is an extra layer of insurance."

Q65 **George Kerevan:** One thing that has always puzzled me about the construction of the stress test is that, if we were actually in a situation where a bank was threatened with going under, the resolution procedures we now have are quite strong. However, in previous historic situations, particularly going back to 2007 and 2008, it is not just one bank but several banks that go down at the same time. That always seemed to have a markedly different impact on the markets and the general economy than simply one bank that you can resolve. Why not have a stress test scenario where you are already assuming that a major bank has gone, and look at how other banks are responding in that event?

Sam Woods: We have bits of that in what we do. The way we used to do stress testing, before we moved to this concurrent exercise, ran massively afoul of the risk that you have just described in that it was individual tests. We quite deliberately pulled them together to have a single exercise in which both the FPC and the PRA board can form a view as to how the banking system as a whole would do. In the trade risk tests, we do assume a counter-party default, so banks have a bit of that going on. It would be a different test to assume that it begins with a big bank imploding. I do not think that that would be an unwise thing for us to look at. It is the sort of thing that we can think about in the context of the exploratory scenario, which is a thing we plan to run every year, which is a slightly looser construct that might be well fitted to that.

Q66 **George Kerevan:** I want to move on to the wider issues of regulation that we have already touched on. This is a speculative question, so I will respect the limits to which you might reply to it. It seems to be a game changer with the new American Administration and that might lead to the US authorities wishing to see the introduction of a much more benign regulatory regime for America and at the global level. How would PRA react to that kind of discussion taking place?

Sam Woods: The financial markets have formed the view that you have just described, in that the big US banks are trading up, last time I looked, at 17% on the election. Some of that is to do with the slight steepening



of the yield curve and the increase in rates. However, a lot of it is to do with exactly that assumption that this regime will somehow be lighter on financial regulation than the alternative regime would have been. However, I am rather doubtful as to whether that view is at all well-evidenced. I have looked for the hard evidence that that will be the case and I cannot really find anything.

As far as we go, we have been very clear at the PRA and the FPC that we are not going to go backwards. We have had a period of huge financial reform. We have more reforms still to land such as certification, senior managers bedding in, ring-fencing and bail-in debt; and we are going to land those. We are not going to push massively beyond that but nor will we go backwards. If other countries did choose to go backwards, of which there is no evidence currently, that is not what we would be doing.

Q67 George Kerevan: That might have an impact post-Brexit if banks relocate to the United States.

Sam Woods: Whatever the outcome of the Brexit negotiation, my view and—I think probably those of my colleagues and certainly members of the FPC—is that we do not want to step backwards. We need to maintain the degree of resilience that we have put a huge effort into building.

Q68 Chair: Do you think there is anything to what Ed Balls had to say about resolutions and that, in practice, it would need political sign-off? It would need to be signed off by politicians and that, therefore, they might as well be involved more formally in the whole process. Or do you think we could dismiss that view and stick with what we have?

Sam Woods: It is right that, if public funds were at risk, then of course the Government should have a role.

Q69 Chair: We are talking about resolution here.

Sam Woods: Exactly. The hope is that the mechanisms that we have put in place will obviate that. I do not agree with the view that that should be put back into the arms of Government.

Q70 Chair: You have not yet set out clearly, as an institution, what regulatory reporting requirements you will be putting in for MREL. When are you going to tell us what that is likely to look like?

Sam Woods: I would need to liaise with my colleague, Sir Jon Cunliffe, about that as he is in charge of the resolution of the Bank. We have obviously just published the final policy within the last month and a half, which is a major milestone in terms of post-crisis reforms in the UK. It is the last big shoe to drop, in my view. As to the reporting, it has certainly been discussed in the working committee in the PRA with resolution colleagues. I do not know the exact timing but I expect that it is next year.

Chair: Okay. This Committee will be expecting the regulator to give detailed assessments of each banks' progress towards MREL. I just



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thought it would be helpful to put down a marker on that point now.

Sam Woods: Thank you, and I agree that it is vitally important.

Q71 **Chair:** You agree that there should be that reporting line to us.

Sam Woods: Yes, of course. We would be very happy to tell you how the banks are doing in terms of getting to the MREL requirement, which is essential.

Q72 **Mr Baker:** Good afternoon. I would like to touch on three of my favourite subjects: the EU, stress tests and cyber. If I can get away with all three of those, I will be very pleased. Do you happen to know how many countries outside the EU single market are forbidden from trading with the single market? I am thinking back to some of the horror scenarios that we were talking about earlier.

Sam Woods: I am afraid that I do not know that number but I judge that you might.

Q73 **Mr Baker:** It is zero. I checked with my researchers while we were here. I noticed that Lord Stoddart asked the Government if there are countries outside the single market that carry out a greater level of trade with the rest of the EU than with the UK and, if so, which. The Government replied that for 2014 there were 200 countries and territories where the value of trade and services with the rest of the EU was higher than their trade with the UK. I do not know why it was phrased that way. Given that there are so many countries outside the EU that trade more in services with the EU than we do, do you think there is perhaps cause for optimism that we might find that we reach a deal?

Sam Woods: To be clear about my remarks earlier, I am not pessimistic. I am just making the point that an outcome in which we were somehow cut off in the financial services arena from the ability to access that market in a thorough way would be bad.

Q74 **Mr Baker:** You indicated earlier that you see that as an edge case that you are paid to worry about rather than a likely scenario.

Sam Woods: It is very hard to say because it is not at all clear yet what the Government's plan will be or how the other side of the Channel will respond to it. It is true that I am paid to worry about a span of risks including those at the harder end, and that is at the harder end.

Q75 **Mr Baker:** Obviously, having campaigned to leave the EU, I am keen to make a success of it so I have done a fair bit of work with the Legatum Institute. I wondered if you had had an opportunity to look at their financial services report, which was written by Victoria Hewson who is with CMS. It makes quite a lot of recommendations for how we make things work in the withdrawal agreement, and I wondered if you had an opportunity to look at it.

Sam Woods: I do not believe I have unless I know the report by a different name, but I will make sure that I do if that is the case.



Q76 Mr Baker: I would be very grateful if you did. It is really high quality and it makes some very practical suggestions. In particular, if I may, it makes the point that what we need to secure for the four key areas that it covers can be done in the withdrawal agreement through mutual recognition and deemed equivalence. In particular, there are some third country arrangements that we can already take advantage of. In particular, with MiFID II, you mentioned clearance and trading. You mentioned trading in particular. It is in relation to trading that they point out that MiFID II makes certain third country provisions for the future, which we will be able to take advantage of. I will perhaps ask the staff. Via the staff, I will make sure that that report comes to you, and I would be grateful if you would have a look.

You mentioned global standards and Mr Kerevan touched on the impact of fines. Just thinking to earlier evidence that we had from Andrew Bailey, he was talking about the prudential risks of US fines. Do you think that US fines continue to be a major prudential risk and how does that compare to EU fines?

Sam Woods: We have had a fairly significant EU fine announced in the last week or so but even that fine is lower than many of the fines that have been levied in the US. It is true that, for our banks who are involved in those markets, that is a significant prudential issue. Back to Mr Kerevan's question, it is a significant factor in our stress testing. Our job is to make sure that the banks are capitalised to be able to withstand these sorts of problems if they want to be involved in those types of businesses.

Q77 Mr Baker: We have talked about Basel and so on earlier. Do you think we are moving into a world where the global standards are more important than regional standards, partly bearing in mind the transatlantic relationship?

Sam Woods: We have always seen it as important. We have always invested very heavily upstream in the global discussions such as Basel and FSB where we had the benefit of having the Governor as the chair, as well as in Europe regionally. Our experience in the past has been that it is probably equally important to invest in both. Evidently, in a post-Brexit world, the extent to which we are at the table, as we discussed before, for the regional one is still up in the air.

Q78 Mr Baker: I will just turn to the stress tests. I should say that I consider Kevin Dowd a close ally and that Kevin has once again put the boot fairly firmly into the stress tests for the Adam Smith Institute. I will not go through the whole report but, again, I might ask if you could have a look at it if I forward it.

Sam Woods: I have read that one.

Q79 Mr Baker: Since you have read it, would you mind telling us what you made of his criticism?



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Sam Woods: He puts his fingers on a number of things that he thinks we are basically too soft on, and the sorts of things that he is concerned about include the fact that we allow for the possibility of some management actions. That is a sensible thing to do. We are trying to project what would actually happen through the stress. We set a high bar for management actions but we do accept that if a firm has a dividend policy, it might choose to cut its dividends. We scrutinise that. We then publish very clearly what this firm is deciding to do. We think that that is helpful in terms of educating the investor community about what is going to happen if we go into a stress. That is one thing that he is concerned about.

He has also been concerned, if I recall correctly, about the hurdles that we use in two respects. One, he says, is that we are not including enough ingredients in the hurdles. Our new framework actually meets his original complaint on that because we have a systemic risk buffer. He also raises the question of whether this is all too low. I do not think I agree with him there because we need these capital buffers to be usable. I am not trying to pretend that a world in which the UK banking system was at 8.8% CET1 is one that we would find at all comfortable but I think that that is a world in which the banking system would continue to be able to do its core job. Another way to look at it is that we hit the UK banking system with £44 billion in the first two years of this stress. The equivalent number for 2008-09 was £9 billion. This is not a soft test and there is a fundamental difference of view between us and Mr Dowd on that point.

Q80 **Mr Baker:** That was a particular point I wanted to bring up because one of the points he makes in the report is that the banks spread out their losses in order to avoid incurring these huge losses in the first couple of years. One of the things he writes is that, since the GFC, the accumulated loss rate so far has been about 10%, i.e. five times bigger than, rather than five times smaller than, that simulated by the bank. He makes a number of similar comments, suggesting that your model does not generate large enough losses to be representative of what was truly incurred by the banks but deferred over a period to avoid taking the hit.

Sam Woods: I just do not think the facts support that argument. How big a hit do we want? This is £44 billion versus £9 billion. That is the two-year view. The cumulative number over the five-year stress is something like £104 billion. These are bottom-line losses. These are ginormous numbers. We could stress our banks for Armageddon if we choose to. We are choosing to stress them for a very severe UK downturn combined with a global downturn combined with a massive trading stress and a misconduct stress. There is a limit to what is reasonable to expect the banks to do because there is ultimately a trade-off in here about the amount of capital we want our banks to hold and the lending that we want for the economy.

Q81 **Mr Baker:** That is a very thoughtful and robust response on that



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particular point, for which I am grateful. I will not labour this too much, but he picks up on what the Governor said about IFRS. He made the point that the stress tests are not adjusted for IFRS 9 under the incurred loan loss model. What conclusions have you drawn about where we stand today on the effective IFRS on loan loss provision?

Sam Woods: This is a difficult area. It is difficult even before you get to the meat of IFRS and stress testing. I have recently written to major firms to express some concern about the degree of heterogeneity with which they are approaching IFRS implementation, which I worry will create culpability issues for us and for investors. Secondly, to come to the stress-testing point, it is true that we have to think through. The IFRS 9 involves looking at multiple forward scenarios and we will have to think about how, as we go through a hypothetical stress test, we expect banks to think about the forward scenarios that they would run at each end of that stress as they went through it. It really is quite complicated. I expect, very broad-brush, that one result of that may be to pull forward more losses into the earlier part of the stress even more than we have at the moment. If that is the case, we will have to think about what view we take of that but it would not be my assumption that we are going to conclude from the change in the accounting standard that we need more capital in the banking system.

Q82 **Mr Baker:** The other aspect of IFRS that has come up has been mark-to-markets; and Andy Haldane was particularly critical in suggesting that it is pro-cyclical. Is that something else in IFRS that you are taking action over?

Sam Woods: We have been less focused on that angle for the moment. We feel reasonably happy about the hold-to-maturity mark-to-market split that we have on the regulatory side. We would be more concerned about the CR issue and variety of ways in which banks are apparently choosing to implement that.

Q83 **Mr Baker:** The last one I wanted to bring up with you—and I cannot find the exact words at the moment—is that he makes the point that things like deferred tax assets are not a suitable form of capital to count when you are looking at the banks' robustness. Is that a concern that you share? Is that something that you wish to do something about?

Sam Woods: I agree with him entirely and that is why we deduct it from bank capital.

Q84 **Mr Baker:** Okay. I missed the detail there, Chair, for which I apologise. I have a couple of points on cyber and then I will probably finish. Have you taken a view on whether we need a single point of responsibility for cyber-risk? If so, where do you think it should be?

Sam Woods: Yes, I have given that some careful thought. It is not straightforward and I do not think it would be quite right to prescribe a single point and I will tell you why. It is not because I am trying to duck the question. We have a strong interest in the PRA, which is from a



financial stability and safety standards perspective. The FCA also has a strong interest from a market disruption and consumer disruption perspective. The Treasury also has an interest. In the same way that there is not one person or one institution in charge of all financial regulation, I think the same should apply to cyber.

However, it is vitally important that we know who is doing what and who is in the lead in any individual situation. We have a mechanism for that, which we have actually had to use more than once in the last three months, which is the authorities response framework. That is a framework that is owned by the Treasury but, when we activate it, it is a crisis management thing. When we activate it, it is always clear which authority is in the lead for that situation. A recent example that we had, which is not strictly cyber but more technology-enabled fraud—though that is splitting hairs, to be honest—was the well-publicised attack on Tesco bank by fraudsters who took some money out of that institution. The attack started on Sunday 6 November. The FCA took the lead quite rightly and triggered the authorities response framework. We were all on conference calls on the Sunday. We made immediate decisions on the Sunday about how to cauterise the wound. As we got into Monday, we were able to establish that, from a prudential safety and standards perspective, this was not likely to be a major issue as the loss was around £2.7 million for a firm with £1.5 billion or so in capital.

The FCA stayed in the lead but we had the question, of course, of whether this attack was going to spread elsewhere. We were able to get out to all the other firms on the Wednesday and Thursday and tell them what we thought was happening and asking them whether they were robust against it.

It is therefore important in each institution that we know which of us is in charge and that we have a mechanism of doing that, but it would be wrong to have one institution that was the cyber institution, because, depending on the nature of the attack and the situation, whose objectives are most threatened will differ.

Q85 Mr Baker: You just made the point there about splitting hairs about the difference between technology-enabled fraud and strict technological issues. Which are you more concerned about? Are you more concerned about the traditional frauds that happen to be enabled by technology or the strictly technological issues?

Sam Woods: The short answer is that I am worried about both. I am probably more worried about pure cyber in the sense that that seems to be evolving at a faster rate and is harder to keep a grip on in terms of data theft and all those sorts of issues. I am probably more worried about that. This whole area of operational resilience is a significant worry area both for the PRA and the FCA and we are each taking steps in a suitably co-ordinated way to up our game. The thing we have done most recently within the Bank is that we have brought together teams that were previously dispersed around the Bank into our risk specialist



function within the PRA to try to co-ordinate that activity more closely than has been the case in the past. This is an area where we are going to have to up our game through time.

Q86 Mr Baker: We have not worked the independents quite hard enough today. Would you mind me asking you, Mr Thorburn, if you have taken a view on this issue? Which is of greater significance to you and why?

David Thorburn: The independents collectively have been engaging strongly with the Executive about this over the last 12 or 15 months—certainly as long as I have been around. There has been a lot of really good work done already, mainly led by the specialist division. One of the things we were keen to see was for that to be broadened out, so that the supervisory teams, who are mostly generalists, have a better tool-kit to be able to increase the intensity of supervision engagement on this subject with a broad spectrum of firms that we supervise. There is some progress there and work being done that we are now comfortable with in terms of what is intended going forward. It is something that is very important to us and we have spent a lot of time discussing.

Q87 Mr Baker: Mr Bryson, people who are senior enough to be on a bank board are perhaps not young enough to be fully conversant with various aspects of technology. What is your assessment of the awareness of the issues from the point of view of financial institution boards and capacity to assess the risks in a robust way?

Norval Bryson: My assessment is that it is growing but it probably has some way to go. I am aware that some firms have brought in people with particular IT backgrounds. Technological fraud, if you call it that, has been around for a bit, cyber less so and therefore we really have to expect it to be a process by which they get themselves geared up to deal with these things and identify them. It is also important, in terms of preventing it from happening in the first place, that firms look to see, if something does happen, how it happened and to learn the lessons.

Q88 Mr Baker: With that just in mind, my last question is in relation to SWIFT. I believe that fraudsters managed to steal \$81 million from the Bangladesh central bank via SWIFT. What assessment have you made about SWIFT's ability to improve its cyber-security?

Sam Woods: This was a very concerning incident for us as the PRA but obviously also for the Bank as a central bank. Our direct window into that is through the supervisory college of which we are a member. SWIFT is overseen by the National Bank of Belgium and the action that SWIFT is taking is a very significant upgrade of its customer security onboarding arrangements, and that is in train. It is too early to offer a review on the effectiveness of that but our agenda on the college is to keep pushing that and to monitor how well they are doing.

Mr Baker: Okay. Thank you very much, Mr Chairman.

Q89 Chair: I want to come back to this cyber issue for a moment. The



problem is, as you said, that the response framework is owned by the Treasury and they direct who is going to be in charge. However, the Treasury is just as dependent as you are on the flow of information. Without that information flow, you cannot take an informed view of how best to manage the risk. It strikes me that the key party here is not directly responsible for the consequences. We have had this unit created in the intelligence services to perform exactly this function. It seems, from what I can gather according to the structure—and it is very difficult because there is a great deal of opacity about this—that that group are competing all the time for other demands in terms of resources internally. We are talking about GCHQ here. The Foreign Secretary and the Home Secretary, both of which have a particular interest in this, are naturally going to be looking to the risks that most concern them rather than the financial risks. We have a problem, do we not?

Sam Woods: You are right that that particular resource that we access through the National Cyber Security Centre is available but is a stretched resource and pulled in many directions. One thing that we are thinking about—I emphasise “thinking about”—is whether we can get a bit smarter about the speed at which we deploy the federated resources that we have around the various financial services firms who know about this stuff. Embedded in individual firms are a number of experts who are very focused on this particular type of cyber-crime. We have various committees for bringing threat assessments and shared practices together such as the cross market operational resilience group that does that and which has a cyber group sitting beneath it chaired by my colleague, Charlotte Hogg. However, where we might be able to do better is in the crisis response moment. It may be that, if we can more quickly share information about an individual attack with a trusted group of experts from within the firms, we can increase our bandwidth and the speed with which we can respond.

Q90 **Chair:** That is working out how quickly you can lock the stable door after the horse has bolted, mop up afterwards and then maybe claim on insurance for the lost horse. What we are trying to do is find ways of preventing the attacks and making sure that there is an informed way that those risks are accurately assessed by people looking at systemic risk. That is you.

Sam Woods: We want to do both.

Chair: I agree that we want to do both but what you have just described is not going to improve the most important part, which is keeping the horse.

Sam Woods: You have to think about a situation in which the stable door is open and the horse may be progressing through it, and the speed with which you can get it back in is affected. I think it is quite important that we get better at that but I am not trying to present to you here a view of this being a risk area with which I am at all comfortable. It is an area which is very challenging for us to deal with, where we know that we



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need to do more and up our game. We are in the process of doing that. What we are doing is respectable but it is plain, given the speed at which this thing is evolving, that it would be wrong to be complacent about this. I hope you are not getting that sense from what I am saying.

- Q91 **Chair:** I am not sure. I can hear that the spirit is willing even if the flesh is weak. The tripartite looked alright except nobody was in charge really. That was a process where a particular institution was intended to take the lead and they would sit around and have an intelligent discussion and, like rational people, decide. The tripartite for handling systemic risk collapsed at the first sound of gunfire and in fact never operated properly, and so we had the crash. I am not saying that it caused the crash but it left us ill-prepared prior to it to try to mitigate the damage that might be done—that is trying to keep the horse in—and then, once the crash had occurred, even less prepared for managing it. You were involved in dealing with that and that was after the horse had bolted.

We have just spent the best part of a decade concluding that we must have individual responsibility in the firms for these things. I am now suggesting to you that there is a case for having individual responsibility in Government for these things. I cannot believe that it is beyond the wit of man to try to think of some kind of institutional construct that is going to provide that and a measure of accountability to Parliament in a way that protects the source of the information.

Sam Woods: You are absolutely right in your characterisation of the problems with the tripartite. All I can really add is my practical experience of living in the live situation through the operation of this response framework several times in the last few months. I have found it functional as a crisis management tool. The more strategic end of it though is, as you say, the work that is going on to co-ordinate this stuff across the sector. In our world, the FPC is the overview body but, beneath that, we have these various other things.

- Q92 **Chair:** I would be grateful if you would take it away and think about it and come back. The arrangement that you have put forward to us does not sound very hopeful to me.

I just want to clarify one thing, in the last few moments that we have, on transitional arrangements. Have you discussed those at all with David Davis, Liam Fox or with other Ministers?

Sam Woods: I have not.

- Q93 **Chair:** Have you discussed it at all? Have you discussed it with the Chancellor?

Sam Woods: I have not. I speak for myself.

- Q94 **Chair:** Okay. Since the bell has not quite gone, I have one other question to ask you. The European Commission recently set out some new proposals on banking regulation, including making some foreign



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banks set up holding companies. Have you taken a look at this?

Sam Woods: We are having a close look at that. As you say, it is potentially a complication.

Q95 **Chair:** Okay. It would be helpful if you could write to us about that in terms of whether you think that is something that we should be opposing and, if so, how; also, in that, explain whether you think it is a good idea that there should be more than one leverage ratio rate for ECGD-type credit, which is what they are proposing, as against other forms of credit. They are also thinking about excluding development banks. Would you do that for us?

Sam Woods: I would be very happy to write on our position on the main issues in the CRR2 proposal.

Chair: Thank you very much for giving evidence to us today. It has been extremely interesting. It is the first of many hearings. Thank you to both of the independents for coming along and adding your contributions.