

Treasury Committee

Oral evidence: The work of the Prudential Regulation Authority, HC 704

Wednesday 11 July 2018

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Members present: Nicky Morgan (Chair); Rushanara Ali; Charlie Elphicke; Stephen Hammond; Stewart Hosie; Mr Alister Jack; John Mann; Catherine McKinnell; Wes Streeting.

Questions 71 - 156

Witnesses

I: Sam Woods, Deputy Governor for Prudential Regulation and Chief Executive Officer of the Prudential Regulation Authority; Sarah Breeden, Executive Director, International Banks Supervision, Bank of England; David Belsham, External Member, Prudential Regulation Committee.

Examination of Witnesses

Sam Woods, Sarah Breeden and David Belsham.

Q71 **Chair:** Good afternoon. Thank you very much indeed for being here this afternoon. We are expecting a vote by 4 o'clock, so we are going to try to contain ourselves for that time limit. I am going to ask you to keep answers pretty pithy so we can get through. As you might imagine, we have quite a long list of different areas we would like to discuss with you all. For the benefit of those watching who are not here, can I ask you to introduce yourselves?

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

Sarah Breeden: I am Sarah Breeden, the executive director for the international banks of the PRA.

David Belsham: I am David Belsham, external member of the Prudential Regulation Committee.

Q72 **Chair:** Lovely. Thank you all very much for being here. I want to start, inevitably, on the issue of Brexit and the European Union. That is not going to be any great surprise to you. I want to start with the announcements from the Treasury, the Bank and the FCA last week about a temporary permissions regime, which is intended to allow banks and insurers in the EU 27 to carry on doing business here, even in the event of a no-deal scenario. I would like to know what risks you think such a regime would have to the PRA's objectives.

Sam Woods: I am very glad you begin with that, because that temporary permissions regime is massively more opportunity than threat from the PRA's point of view. Indeed, I would describe it as the lynchpin of our planning for what we think of as the inbound firms. If I may just give a bit of colour on that, we have 160 firms here from the EU 27 that will need to be authorised to carry on operating, and we have taken the view that to try to do that at warp speed by March of next year would be very unwise. It would require us to drop all sorts of other things. It would also be very difficult for the firms.

Partly in order to give effect to the implementation period, we asked the Government to make a commitment such that, even before the implementation period is ratified, we can say to firms there is a backstop of the temporary permissions regime. We are very keen on that piece of legislation. The Government, I know, hope to lay it before recess. I hope they succeed in that. Basically it will allow us to bridge firms through that period. There is very little risk in it for us and it helps massively.

Q73 **Chair:** It is just for the implementation period, is it, so up to December 2020?

Sam Woods: It will be slightly longer. It will be a three-year period starting from March of next year. The idea is to give three years from then for firms to get through the process with us, which we think will be entirely manageable. There is one other aspect of it, and this will all come to you for your views and hopefully agreement. Separately, where firms apply to us there is a statutory clock that starts ticking, which is six months or 12 months. As we sit here today, 45 firms out of the 160 have applied. We also need to stop that clock in order to give effect to that three-year period, so that is another part of it. Of all the mitigations that we have for cliff-edge risk and for basically managing the UK end of this in an orderly way, that is the most important.

Q74 **Chair:** Is there a danger that, in giving people temporary permissions, you let through somebody who normally would not meet the safety and soundness objectives? What sort of tolerance will you apply for that?

Sam Woods: There is plainly that risk, but that is a risk we have in a way today, because these firms are here at the moment. They arrived here without—

Q75 **Chair:** It is for existing firms.

Sam Woods: It is for existing firms. There are two other things that will come along later, which I would like to mention very briefly. One will be a

supervisory run-off regime. That is for a firm that does not want to carry on, but needs to wind down its business in an orderly way. Then there is the contractual run-off scheme, which is for firms that only have a back book of contracts and do not want to do anything else at all. That speaks to the contract continuity issue.

Chair: You are going to pick that up.

Sarah Breeden: We will start supervising these firms the minute they get the temporary permissions and our powers under the legislation will become available to us. We will be in a much better position to deal with any of those risks the day after a firm is in a temporary permissions regime than the day before.

Q76 **Chair:** Your expectation is that those firms would be on their way to full authorisation.

Sarah Breeden: Exactly.

Chair: This is a stop gap.

Sam Woods: Exactly.

Q77 **Chair:** Warp speed could be slightly different from several years, so in terms of the authorisation process will you have to have more resources to administer temporary permissions and then separate teams to do authorisations?

Sam Woods: We are already in that world currently. The best way to think about it is that we have absorbed about half of that load today, because the teams are already running a lot of this stuff. The other half we have charged an extra fee out to the industry for, and that for the moment is perfectly manageable. We have had to cut into a few things, for instance our supervisory oversight function, insurance data analytics, a thing we call continuous assessment, which is very important but we have been able to tweak a bit. So far it is manageable. The nightmare for us, to be frank about it, is the one in which for a combination of reasons there is no TPR and no implementation period, and we have to get the whole thing done by March of next year. That would be an enormous scramble. We would have to stop doing loads of other stuff.

Q78 **Chair:** Mr Belsham, has the PRC discussed the temporary permissions regime?

David Belsham: Yes. We had a paper on it fairly recently, which went through how it operates and this point that only firms that are already using passporting qualify. We also discussed the incentives it might give to firms to go slowly. They have the temporary permission, so why rush? We have the power to take away that permission if we do not get a proper application in within a period—yes, we had a good discussion of it.

Chair: Did you discuss potential risks to the PRA's objectives as well?

David Belsham: Yes. Generally, as Sam says, this is a necessary thing for us. It is a backstop on our whole plan of how we are approaching the authorisations. It is also relevant to contract continuity. You have 10 million UK policyholders of EEA firms. At a stroke, the temporary permissions regime protects their interests. They can carry on paying premiums. They can carry on making claims. It is pretty central now to the way we are moving forward.

Q79 **Chair:** What parallel discussions have you had? Are you offering advice to your counterparts in the EU about something similar they might do?

Sam Woods: That is a bit of a sore point.

Chair: Good, I like asking about sore points. Please tell us more.

Sam Woods: You may have seen that we voted against, because we disagreed with, an opinion from each of the insurance body of supervisors, called EIOPA, and the EBA, which is the banking version. The key reasons for that were two things. First, there was no mention, even of the temporary permissions regime here in the UK. We thought that was a mistake, because although Parliament has not yet even seen it or agreed it, we are very optimistic that Parliament will do such a thing.

Secondly, there is no recognition of the issue David described, which is large numbers of insurance policyholders and very large volumes of derivatives contracts that require an authorities fix for a complete fix. There is a recognition of the problem, but the stance at the moment from EBA and EIOPA is that firms take care of it themselves. We are just saying they can do some of that, but there is no way that is complete.

Q80 **Chair:** The other point that the Chancellor has just written to me about and we talked about in the House is on the binding technical standards that will be made. The Bank is going to take on powers that currently sit with the European supervisory authorities. How do you think the Bank should be held accountable for the drafting of those new standards?

Sam Woods: There are two main ways. First, I would expect us to come and account for what we are doing here, which I am sure will arise at some point. There is quite a bit of it. There will probably be 6,000 pages of the 16,000 coming on financial services that are for us to deal with. Secondly, we will consult on the changes that we are making in a normal way. I do not want to pin us to a timetable, but I hope we will be able to start that by the end of September.

Just to give a quick word on our approach, philosophically our approach is that we fix only the stuff that obviously does not work if left exactly as is. It is the minimum necessary to get the thing in place for day 1. We have been resisting all other ideas for more fancy changes and said, "Let us keep it as simple as possible". If we keep ourselves to that, it is not that big a process at our end.

Q81 **Chair:** We are going to come on, in a bit, to how you work with other stakeholders and interested parties, so we might pick that up there. I want to talk about a different subject, bank auditors, because it has been

reported this week that you are querying the appointment of Grant Thornton as the Goldman Sachs auditor. Is that correct?

Sam Woods: My only issue with that is the word "querying". It is true that we have an issue, given the ever more concentrated pool of large auditors, with their capacity to audit large firms, while meeting the rotation requirements here in the UK. We have one particularly awkward issue with the subsidiaries of foreign firms that do not have the rotation thing at home but do have it here, and how they manage that. In the context of that, we have been discussing with firms who they go with. The inference of the story was that we were against it and that is a bit strong.

Sarah Breeden: We are keen to make sure that the auditors have the necessary skills, expertise and competence to audit a business like Goldman Sachs International, which as you can imagine is a very complex investment bank. It is a dialogue that is happening, rather than a querying.

Q82 **Chair:** We can dance on the head of a pin about the use of a word. There are good reasons why, as an auditor, you have to be of a certain size to audit complicated investment banks, but it sounds from what you are saying as if there might only be four firms in the UK that are big enough to do that, and potentially Grant Thornton is the fifth. I do not want to use them as the example, but the next size down auditor might not be up to the job of auditing a bank.

Sarah Breeden: The aim is to demonstrate to us that they do have the skills, experience and competence.

Q83 **Chair:** They have been asked to demonstrate that.

Sarah Breeden: That is exactly right.

Q84 **Chair:** Do you work to assure yourself of the quality of bank audits and auditors, or do you rely on others, like the FRC?

Sam Woods: That is strictly the FRC's job. However, by law, but also as a matter of common sense, we have to have a close dialogue with the auditors at a strategic level. I have a regular series of meetings with them, but to be honest with you the more important bit of that is the line supervisors of individual teams meeting the relevant line auditor and comparing notes. That is often quite a useful discussion.

Q85 **Chair:** The CEO of the FRC has recently stated that the big four must improve the quality of their audits and do so quickly. Is it of concern to the PRA that the FRC chief executive is sounding a note of caution about the way the big four are generally approaching their audit function?

Sam Woods: That is a bit of a worry. It is not a bad thing to see a fellow regulator showing its teeth a bit. That is okay. It is a bit of a worry, and the concentration issue is a worry. It is more of an issue currently on the banking side, because the audited numbers feed straight into the capital framework. On the insurance side, there are two parallel regimes, so it is important, but not quite in the same way.

Q86 **Stephen Hammond:** Good afternoon, Mr Woods, and thank you for coming to give evidence. Along with the Governor, you have repeatedly highlighted some of the risks arising from derivatives contracts with a no-deal Brexit, most recently on 27 June. Others are suggesting there may be legal workarounds: the right to property under the European Charter of Human Rights, et cetera. What is your view on those workarounds?

Sam Woods: It is impossible to have the degree of confidence in them that one would want, and to say Governments do not need to do anything. It would be very unwise to do that. Can I give a flavour of the issue and say why we think it is difficult?

Stephen Hammond: Yes, although we have probably got the point.

Sam Woods: There is a practical aspect to it, which may not have become fully visible, which is what it would take for firms to move, which is what they would have to do. A large UK broker dealer might have, say, 4,000 clients on the other side of the border in the EU 27. They might have something like 20,000 underlying clients whose agreement might be needed to novate their stuff. We have been involved in moving derivatives books across borders in individual cases and, in our assessment, this takes about four years.

The other way of doing it is through a part VII process. That is a bit slicker on the insurance side with a court process. For banks, the most recent version of that is what we have done for ring-fencing, which again was about a four-year process. In our view, it is simply impractical to think this is going to move in the timeframe that has been talked about. Secondly, none of those fixes or alternative ideas that have been put forward seems to us to be certain enough to rely on.

Q87 **Stephen Hammond:** You talked about the practical element of it. In the press conference, you said it would be illegal to service derivative contracts without the authorisation. What legal advice have you taken on that? Can you tell the Committee about it? Are you clear that you could not just move the authorisation to another jurisdiction?

Sam Woods: Our teams have been all over it. Our legal team has been all over it. They have taken multiple soundings. Our view is very well grounded that, to varying degrees in each of the 28 different jurisdictions, performing normal activities to service a contract, such as exercising an option, is illegal without permission.

On the second question of whether it could easily be moved, the issue is that you would need a new authorisation in order to do that. Either you need to move the client, which runs into all the difficulties I have just described, or you need to use the courts, which on the timing we are talking about here is not practicable.

Stephen Hammond: Just to follow up that answer, the legal advice the PRA has taken is clear on this point.

Sam Woods: Yes, very clear.

Q88 **Stephen Hammond:** On the second point of that answer, if I have done my KYC and AML, if I establish an authorisation outside, why can I not do it?

Sam Woods: The problem is not identifying the client, with the single exception of the Lloyd's market, where there are some client identification type issues, which you are probably familiar with. It is more just getting them to agree. Calling up that number of folks and getting them to agree at the sort of speed we are talking about is the problem. There is a commercial aspect to that as well. If you renegotiate something and someone has an edge, they may want to take something off you.

Sarah Breeden: We have had experience of firms doing this for other reasons and, as Sam explained, they take two to four years because of their complexity.

Q89 **Stephen Hammond:** It depends on the complexity. I was talking to a financial services firm that had done it for another reason and had managed to switch all its clients over to another jurisdiction on a two-month basis. Have you seen today what the European Commission vice-president responsible for financial services policy has said, and what is your reaction to it? It is in stark contrast to your view.

Sam Woods: I did see that and it was in contrast to what I have said, but it was entirely consistent with what everybody from the EU side has said, which is that firms need to sort this out for themselves. I think that is wrongheaded and, in the end, that view will change. The damage that will be caused if that is not fixed will be felt quite widely and in no sense disproportionately in the UK.

There is one rider that I want to add to everything I have said. The insurance side is a bit different. It is more practicable for insurance companies, given enough time, to move quite a lot of this in the sort of timeframe that we might be talking about, i.e. the implementation period or temporary permissions type timeframe. It will not solve all the problems, but it is a bit more tractable on that side than on the derivatives side.

Q90 **Stephen Hammond:** On the derivatives contract side, could it be along the timescale of the temporary permissions, i.e. March 2022?

Sam Woods: It could be longer than that. This will all come to you to opine and vote on, but the contractual run-off scheme is intended to help with that longer run-off question.

Q91 **Stephen Hammond:** The Chairman asked you about the opinion on Brexit of the European Banking Authority. The opinion places an onus on firms to transfer or novate derivative contracts, starkly at odds to your view. How was that session? Can you give us some flavour of why your view did not prevail?

Sam Woods: You test me on how long the discussion on that was. It was probably an hour or two for the discussion in the board of supervisors. I

think our view did not prevail for two reasons. First, when you look at how EIOPA and EBA describe the problems we are talking about, they describe them in a pretty similar way. They just do not go the last yard of saying the authorities ought to do something. I hazard a guess that that is because they are very nervous about getting inside what they see as the Brexit negotiations, whereas we do not see this issue in that way. That is one reason. The second reason is that, unsurprisingly, our negotiating capital in these fora is very close to zero or is zero, so it is difficult to get stuff done.

Q92 **Stephen Hammond:** Without putting words into your mouth, it sounds to me like you might have thought the opinion was more politically motivated than for reasons of financial prudential regulation.

Sam Woods: I would not want to go quite that far, but the reasonable person could infer that there was something of that in the mix.

Q93 **Rushanara Ali:** I am going to focus on the post-Brexit long-term relationships. The EU is pursuing a banking union with a detailed single rulebook, a single supervisory mechanism and a common deposit insurance scheme. Can you describe how you expect that to develop after the UK leaves the EU and what the implications would be for us?

Sam Woods: The broad direction is clear if the past is any kind of guide to the future, which in this case it probably is. It is in effect an ever greater centralisation of rulemaking and activity, both on the banking side within the eurozone banking union, for which the supervisory side is run by the SSM within the ECB, but more broadly for insurance, banking and markets within the three ESAs—the supervisory authorities we were just talking about.

The reason that is happening, particularly the ESA part of that, is a perfectly understandable desire to make sure that the people who do our job in one country or another country do it in exactly the same way as we do. That is why there is an ever increasing scope of detail in terms of how much stuff is looked at.

Q94 **Rushanara Ali:** So far, the Government's call for mutual recognition and reciprocal regulatory equivalence for financial services has not gained traction. There have been various suggestions: mutual market access, enhanced equivalence and so on. There has been lots of debate, whereas a few months ago we were all much more optimistic that there might be some unity around the idea of mutual recognition and reciprocal regulatory equivalence. Can you say more about where you think this is going and what we should be expecting? I am getting you to read the future.

Sam Woods: I can. Whether I know more about that than any of you is a very good question, but I will happily give you a view.

Chair: Tell us what you know.

Rushanara Ali: Tell us what you know and then I will throw in some supplementaries.

Sam Woods: The first observation is that I agree with you. The message from the EU 27 and in particular from the Brexit negotiating team about mutual recognition type ideas has been consistently and very strongly negative. I am not involved in the negotiation. I do not know what weight to put on that, but I place some weight on it, given how consistently strong it has been. At the other end of the spectrum is the existing equivalence regime of the EU, which gives only very limited access. We can come on to that, if we want to. It has various other deficiencies.

Q95 **Rushanara Ali:** You have the third-country approach or the EEA. You are referring to those. What are the pros and cons?

Sam Woods: Equivalence is the friendly end of the third-country spectrum. It is one in which the Commission opines that you are not in totally a different place. That is quite a broad church, by the way. The Commission has found to be equivalent, for instance, on the insurance side, which I am closest to, various jurisdictions whose underlying regimes are manifestly different, but it deems them equivalent. It is quite a broad concept. But in very few cases—the only exceptions are MiFID II, EMIR, AIFMD and possibly Solvency II reinsurance—does it give access. It is often about other things, such as regulatory treatment and all that stuff. That is the way to think of equivalence, as being at that end of the third-country spectrum. The EEA world comes with much more access, but with the rule-taker aspect.

Q96 **Rushanara Ali:** What would be your preference? Suppose we had to choose, in a context where we are all having to be pragmatic—some people are more pragmatic than others—between the EEA approach and some other variants of these models. There are discussions about a negotiation that could give us access to the single market and some sort of settlement so we do not end up in a hard Brexit situation for services. If we do not achieve that, what are the alternatives? What would you go for? I would like to know what others think as well.

Sam Woods: I will answer directly. I should put as a rider that I hope the Government are not going to be presented with a black and white choice of quite that kind. There are many middle paths that are far more appetising.

Rushanara Ali: That often gets described as Britain trying to have its cake and eat it, including this idea of equivalence, mutual recognition and so on.

Sam Woods: I see that, and it may be that in the end that view dominates the reception on the other side, but the practical reality of what we are talking about here is the ease with which firms can sell in both directions across the UK-EU 27 border. If we make it more difficult and more frictional, it will become more expensive, and the cost of that will be borne by a whole bunch of EU 27 companies and people, and by UK consumers and companies.

Q97 **Rushanara Ali:** We made those arguments and hoped that there would be interest and support from the EU 27 on mutual recognition, and we are not there.

Sam Woods: It remains to be seen whether it is as black and white as you describe.

Q98 **Rushanara Ali:** Is the fundamental issue that the EU 27 are a lot clearer about what they expect, and it is a lot more black and white than the UK position, whether you want to call it having our cake and eating it, or seeking flexibility? It strikes at the heart of our tensions, as well as the historical tensions, that we are going to have more of a black and white position—take it or leave it—and there are some options, such as EEA. You and some others have expressed anxiety about that turning us into rule-takers, but at least it gives us access to the single market and gives us some answers to the woes of financial services, versus other options that are less favourable. Which is it? What are we trying to achieve here?

Sam Woods: Let us wait and see what the Government put on the table, because they have not yet put anything very concrete on the table. I do not want to dodge your question. I will give you a direct answer.

Q99 **Rushanara Ali:** The Government might need help from the experts these days, because the Government keep falling apart. It might be that the days of the experts will be back, and people will be less hostile to the likes of you and will be looking for solutions from you, so keep going.

Sam Woods: We look forward to that day. We are involved in a very constructive discussion with the Government about what they do, and I do not detect any hostility in our discussions at least. On the question you asked, I was here two weeks after the vote. My view has not changed since, which is that it would be undesirable to try to oversee a financial system that is 10 times GDP without any say over the rules.

Q100 **Rushanara Ali:** Back to the flexibility point, what messages are you getting about whether there would be any room for adjustment, given that we are such a big player, if we were part of such an arrangement?

Sam Woods: Technically, it is completely doable. There are many middle paths.

Q101 **Rushanara Ali:** You said earlier that it is not black and white.

Sam Woods: From a technical point of view, there are many middle paths that can be struck, which would be better than either of the extremes you describe. We have had zero conversations as the regulator with the other regulators, because we all definitely acknowledge that that is for the politicians to negotiate. At the moment, I can only go on what you correctly detect, which is a strong hostility from the other side to a set of ideas that is somehow too permissive, in their experience. Does that write out anything that is not one of the two extremes? I hope not, but we will find out.

David Belsham: From a PRA perspective, our remit is safety and soundness. If you look at it from a safety and soundness point of view, access to markets is good because it avoids fragmentation. It avoids all the difficulties of supervision.

Rushanara Ali: Even if we became rule-takers.

David Belsham: I was going to say that rule-taking is just not acceptable for such a large financial sector.

Q102 **Rushanara Ali:** Do you believe the Government would not be a rule-taker, even if they came up with a bespoke deal with the EU 27? Is that not a contradiction in terms?

David Belsham: When you have such a large financial sector, it is very dangerous to be a rule-taker. Taking something specific like Solvency II, that would have evolved in a way that simply suited the EU countries if the UK was not negotiating.

Q103 **Rushanara Ali:** I agree. I am not keen on us being a rule-taker, but, if we end up in a situation where it is a cliff edge, we are stuck between a rock and a hard place, are we not, on services anyway?

Sam Woods: That is partly why the temporary permissions regime is very important, because we do not want to go off a cliff. We need to be in a safe situation as they move us to third country, so that is the mitigation.

Sarah Breeden: I very much agree with Sam and with David, as you will not be surprised to hear. Given the size and complexity of the firms that operate here, and in particular given that we host an international financial centre, being a rule-taker would be a very risky place to be.

Q104 **Rushanara Ali:** I have one final question, which I would appreciate a response from all of you on. Say we are in a situation where we get black and white responses from the EU 27: they are just not going to have it, and they are not willing to compromise. We try these different options and approaches that give us more say, and we come up with something that is more favourable for us, in terms of not being a rule-taker. If our Government come up with a deal that is rejected, what are the implications?

What do you think businesses will do as they start to see noises of that happening, in terms of exit and relocation? Businesses are doing that already. How much do you see that accelerating? They are making very rational decisions. They are not going to hang around for the Government or the experts to sort it out, because they are not being inspired with confidence at the moment. What are your reflections on what is happening and what you expect to happen in that scenario?

Sam Woods: Why do I not quantify what we see happening and where that might go? I do not know whether you are seeing this in your constituency. The easiest way to think about this is in terms of jobs, which is not our objective in the PRA, but it is a nice way to bring it to life. Our estimate for some time has been that on day 1 the number of

jobs created in the EU 27 as a result of a move to third-country status, with all firms making that assumption, would probably be in the region of 5,000 to 10,000. I am inclined to think it will be closer to the bottom end than the top end of that range; it might even be slightly under that. This is for banks and insurers by the way, which is not the complete picture, but is a big part of it.

That is a day 1 picture. The number of jobs moving out of the UK will be slightly smaller, because some of these jobs are new jobs where you have to have two people doing something that one person used to do in London. To put that in context, the number of people employed by banks and insurers in this country is about half a million, so it is 1% of that, to put it crudely. As to where it goes after that, it depends to a considerable extent on what sort of deal is struck.

There is an outer limit estimate, which is the one that Oliver Wyman put out a year and a half ago. They did a calculation of £200 billion in revenues, of which £40 billion is EU. If you lose half of that and then you gross up the ancillary services to £32 billion, it feeds across into a 65,000 or 75,000 job figure. That is the estimate they put out. The maths is correct, but whether we get to anything like that—

Q105 **Rushanara Ali:** Sorry, who put that out?

Sam Woods: Oliver Wyman, which is a consultancy. The maths and the logic is—

Q106 **Rushanara Ali:** Is that still credible or is it higher?

Sam Woods: It is within the plausible range of outcomes, but it is a long way from a central case.

Q107 **Wes Streeting:** I find this notion of Britain as a rule-taker on financial services quite implausible. Are you saying that London as a financial centre, the Bank of England, the FCA and the PRA are so poorly regarded by EU 27 member states and the European Central Bank that, even after exit, there would not be real British influence at the heart of EU regulatory decision-making? The safety and soundness test is surely the risk of a cliff edge, with derivative contracts not being serviced and us tumbling off the edge, especially when you see where the politics is going at the moment. I am slightly surprised that, in the portrayal of the single market scenario, Britain is presented as being a passive rule-taker. I do not see that happening. Why do you?

Sam Woods: Let me answer that with two points. First, we engage heavily upstream. We engage massively in Basel. My colleague Vicky is the chair of the equivalent of Basel on the insurance side, the IAIS. We do that for a strategic reason, which is that we want to have influence on global thinking, because that often gets translated through the European machine to what we have as a matter of hard law in this country. We will continue to do that, and that gives us some influence on the shape of the rules, more on the banking side than on the insurance side.

However, my second point is that it is naive to think that we will have much influence if we are not in the room. That is just how this stuff

happens. This stuff is high volume; it is very detailed. We have a policy area of 300 people. A substantial chunk of them devote themselves to negotiating good outcomes for the UK in these fora. I would like to think that our reputation and influence would count for something, but I would hesitate to put much weight on that for a world in which we are not in the room or we are in the room but with no vote.

Q108 **Wes Streeting:** You do not think the direction is towards regulatory alignment anyway, not just across the European Union, but trying as best we can to have regulatory alignment between Europe and North America. Is the whole thrust of direction of policymaking globally not around as much regulatory alignment as possible, so we have as much simplicity as possible?

Sam Woods: For the last 10 years, that has been the case. That is getting more difficult. The best evidence for that is that we did this deal in Basel a few months ago, which is a big deal for all the banks. It took years to agree that thing. It was quite a modest change, although it was helpful. We did a much bigger thing in a few months, say, four years ago. There are dispersive tensions—apologies, I do not think dispersive is a word. You know what I mean—centrifugal, is it? Someone can help me.

Chair: I am sure someone on Twitter will help you.

Sam Woods: Someone on Twitter will correct me.

We cannot hang on to that.

David Belsham: Global insurance standards are still a long way off. The US and the rest of the world have very different ideas on them. If that does not develop, what is the position if we accept Solvency II as it develops in the way that the EU would want? I take the example of the matching adjustment. When Solvency II was developed, the matching adjustment was not in it, because outside the UK it was only Spain that had an interest in these very long-dated fixed liabilities. The UK's influence negotiated it in, and the impact of that is about £60 billion in terms of capital, or something of that order.

It is critical to us, because insurance firms had already been investing in long-dated assets. They had been earning a liquidity premium and passing it on in their annuity pricing to customers. That was an area in which the UK worked in a certain way for probably the last 20 years. If we now do not have any influence over that and it is only Spain that has any interest in it, we are left with a material risk that the EU could develop Solvency II in a way that suits its market, but because its market is different it could have major impacts on the UK market.

Sarah Breeden: Having been an interlocutor with the US, the European, the Swiss and the Japanese in the job that I do, we achieve equivalent outcomes, but we go about it in very different ways. The extent to which agreement at global level can make rule-taking okay for the UK is therefore open to some considerable question.

Comment [HT]: Please can we add the word “regulators” after Japanese as a footnote correction?

Chair: We are going to move on from that. We are going to move to something a bit closer to home.

Q109 **Charlie Elphicke:** Staying briefly where we were, I have a few follow-ups. Is the obvious way forward not equivalent outcomes and mutual recognition, rather than one side trying to impose all its rules on the other?

Sam Woods: Our preferred way forward would be exactly something in the form of outcomes-based equivalence, which is what you are describing. That would be the best answer for this. I do not think you need it for all financial services; you need it basically for wholesale that crosses the border. That would make sense for everyone, but whether it can be negotiated seems open to question.

Q110 **Charlie Elphicke:** How, then, do Europe and banks in the United States manage to trade with each other?

Sam Woods: Under the equivalence regime, you are largely doing it as a third country. The banks do what they will have to do in the future from here if something is not put in place, which is to have an entity within the EU, which currently happens to be here in the UK, that runs their business.

Q111 **Charlie Elphicke:** In other words, they have mutual recognition and equivalence under the Basel regime. That is what happens, is it?

Sam Woods: The current equivalence regime is much narrower as it applies between the US and the EU. The notion of an outcomes-based equivalence, which is more naturally how we would think of it, would be a step beyond what the EU has done so far, and that is the source of tension.

Q112 **Charlie Elphicke:** Looking at Basel, let me ask you this: is it a dead duck, because the US has decided to ignore it altogether and there are endless let-outs for everyone else? Are we seeing the end of the whole Basel process?

Sam Woods: No, it is not a dead duck, but it is going to become a bit of a sleeping duck for the next period. That is completely natural, because we have been going through an incredibly vigorous and somewhat wrenching period of reform, which we needed to do given the terrible state we had got into, but you cannot live in a permanent revolution, to mix the metaphor. As Vicky Saporta was saying in a speech recently, we are moving from that very activist phase into a more passive phase, but that is okay.

Q113 **Charlie Elphicke:** Let us look at banking stability. What is operational resilience?

Sam Woods: I do not know whether any of you have the discussion paper that we have put out.

Q114 **Charlie Elphicke:** Yes. Can you describe it in a few sentences for viewers at home, so it will not take us until 3 o'clock tomorrow morning?

Sam Woods: It is the ability of firms to keep going operationally as well as financially. That is what it comes down to. Most of our work is about financial resilience. Is there enough capital and enough liquidity? Is the governance right? Is the risk management right? We have done much less historically on operational resilience. We are doing a lot more now, including the discussion paper that we recently put out, which I would be happy to talk about, if the Committee would like.

Q115 **Charlie Elphicke:** How can you measure it with real and objective measurements? Liquidity and capital are real and objective. Is this just some kind of soft skills, "suck it and see" measurement?

Sam Woods: That is exactly the challenge, but we have the bones of an answer in this discussion paper. The central idea in the discussion paper is that firms should set what we call an impact tolerance, which will be quantitative, for key business services. They would say, if they are a bank, "We want retail payments never to go down by more than X", and X would be a quantified number.

In no state of the world could a financial institution be robust against any outcome whatsoever, so the real key to this is how you test and what scenarios you use. Do people have a copy of this document?

Charlie Elphicke: Yes.

Sam Woods: There is quite a useful slide. Can I just take you to one slide here? This is page 29 of the document.

Chair: We do not have it in front of us, so you will have to describe it to us.

Sam Woods: I can describe it. Basically, the idea is that a firm will set an impact tolerance, saying, "We do not want to be out more than X for a certain service". That should then be stress-tested. We run a simulation of a cyberattack, a ransomware attack or your cloud provider going down, then maybe something more extreme, such as a pandemic or the UK power system going out. We might say, "We want you to be able to meet your impact tolerance for the first three of those. We accept that, if there is a terrorist strike on our power system, you are going to be out for longer". That way, we can make it quite crunchy. At the moment, we are lacking that language and that quantification. That is what we are trying to do.

Q116 **Charlie Elphicke:** What is the penalty?

Sam Woods: We have the full range of our regime to deploy, so we do not need a new penalty regime to attach to this. We can use what we have currently. Indeed, as you know, we have an investigation going on jointly with the FCA at the moment into TSB, which had a very severe operational outage.

Q117 **Charlie Elphicke:** What does that really mean? Other than you raising your eyebrows, what does it mean?

Sam Woods: The powers that we have in the end are to fine companies and fine individuals—these are the most important powers—or to ban individuals from working in financial services. We have used those powers.

Sarah Breeden: Those are enforcement powers when something has gone wrong. We also have our usual supervisory toolkit to ask firms to fix it beforehand when we have identified that there is a problem. I can think of an example of one of our firms, which had a recovery time objective for its key payment systems that, in our judgment, was too long. It was 12 hours and they brought it into two hours, which we thought was consistent with the sort of impact tolerance a firm of that significance should have.

Q118 **Charlie Elphicke:** Fixing it ahead is quite relevant, particularly as banks move ever more customers on to online services. IT and mobile banking will become more and more important. Is the PRA going to become less tolerant and take more of an interest in customer-facing parts of the system?

Sam Woods: We are, although I would not describe it quite in the way that you describe, because we need to be clear about the relationship between us and the FCA in this regard. We have tried very hard in this paper—which, believe you me, has complicated the governance process quite considerably, but I think it is worth it—to have a single framework that captures the Bank, as the overseer of CCPs and other FMIs, the PRA, the FCA and the FPC behind it. The way to think about that is that the FCA's tolerance is likely to be tightest, because you will get consumer detriment well before you get safety and soundness, and well before you get financial stability in most cases. With that caveat, the answer is, yes, we are putting more effort and time into this stuff.

David Belsham: This is an area that the external members of the PRC have been very interested in. We have been saying for some time that we believe operational resilience is just as important as financial resilience. We spend a lot of time at the PRC, as you can imagine, on capital and liquidity, and there are lots of economists in the Bank, so there is a danger that you get to nickeling and diming on one area of regulation and then have a gap in another area. This is putting in a hard overarching framework, in the same way as in things like Solvency II, where you have one in 200 capital levels, or in banking, where you have a whole framework developed by the FPC. This is bringing operational resilience up to that sort level.

The number of people working on this in the Bank is 40-odd. That is a relatively small number out of a very big organisation. From an external members' point of view, this is the start of far more interest at the Bank and the PRA in this as a holistic subject. There has been work on operational resilience and so on in the past, but it has been various bits on outsourcing or the senior managers regime. This is what brings it all together, so it is a big step forward.

Q119 **Charlie Elphicke:** On the issue of online services, Mr Belsham, it is no longer in the sandbox. It is out there and there are real cases, on which

Mr Jack will shortly be following up with more detail. Lastly, can I ask about ring-fencing? With ring-fenced banks, is there a risk that they will have lots of cheap money that they want to shove out the door, which will have the effect of meaning that there will be too cheap mortgages out there that, if things change to the adverse, will become problematic?

Sam Woods: There is some truth in the underlying observation you make, but what I take from it is two-sided. It is certainly the case that money is cheap at the moment; I do not know if any you have got a mortgage lately, with a two-year fix at 1.7% at a 75% LTV. There has been a ferocious mortgage war. One of the factors in that has been ring-fencing, in the sense that there is liquidity that needs to go somewhere. Interestingly, I think another driver is that the act of ring-fencing the retail part of banks—to be honest I did not foresee this—has, at least in my assessment, led to greater vigour and more supercharging of those parts of those businesses. That is all a good thing. The risk for us is, of course, less resilience if there is less money going into banks. We take care of that in stress testing. In stress testing, if margins have been coming down when banks go into the stress, they have less room to absorb losses and recapitalise.

Q120 **Stewart Hosie:** Mr Woods, in your letter to the Committee in June regarding Solvency II risk margin, you said you believed there was some merit in reconsidering the supervisory approach to calculating risk margins. However, you went on to say that, in the context of ongoing uncertainty over the UK's relationship with the EU, you did not see a durable way to implement the change. What did you mean by a durable way?

Sam Woods: I meant that, if we make that change now, we will not be able to make it stick. The reason for that is that it would not have the support of our colleagues in Europe. That leads you down a process of challenge and eventually, potentially, infraction risk. The problem with that is that it is a risk for us, but the deeper problem—this comes to the point about durability, and David perhaps can give some colour on this—is that it then becomes impossible for firms to rely on it. If we say that we are going to do this, but they can see that there is a challenge process going on in the European fora, they will not retool all their engines to the new way of doing it.

David Belsham: Firms are managing this at the moment, because they have transitional arrangements on their back book, and on their new business they are reinsuring longevity risk outside the EU. From an annuity pricing point of view and a capital point of view, it is manageable. But we want a fix, because reinsuring longevity risk outside the UK is not a sensible prudential thing to do in the long term.

In order to move to a more sensible basis, the firms need certainty. Once they have certainty, they will be restating their balance sheets, cancelling reinsurance treaties—they will be changing hedging programmes potentially, and a firm would not want to do that unless it knew that the risk margin was solved and we had a new basis in place.

Q121 **Stewart Hosie:** Does that all imply or confirm that the PRA basically has no discretion in calculating differently the risk margin, while operating within the current directives?

Sam Woods: To be clear, we have ceded no ground on this in Europe. Our legal assessment is that we should have room to take forward the management action approach described. However, it is also the case, consistent with that fact, that the EIOPA board of supervisors has the ability to pull such things up to it for debate, and the Commission, if it disagrees with what has been done, has the ability to take things down the infraction route.

Q122 **Stewart Hosie:** If you believe there is legal certainty, presumably you would be confident of being able to bat back any infraction case that may be brought.

Sam Woods: Frankly, the judgment we have made is that to enter into that protracted legal battle at this point seems self-defeating, because none of the firms would be able to use it while that was going on. Also, of all the various moments to have such an argument, now seems pretty much the worst. We thought it was better just to bide our time.

Q123 **Stewart Hosie:** Does that also imply that, post-Brexit, whenever that is, post-2020, if we are still adhering to some kind of regulatory equivalence, or indeed the same rulebook, the approach to the risk margin would remain the same? That is to say, it would be very hard, if not impossible, to make any substantial changes for fear of some kind of legal challenge.

Sam Woods: This is, as you describe, one of the things in the mix that the Government will need to think about in terms of what sort of a deal they want to strike. If we are in the EEA type mode, I think it will be exactly as you describe, and it will be very difficult to get this changed.

Q124 **Stewart Hosie:** That is helpful. Can I move to a couple of other issues? The Prudential no longer writes annuities in the UK, or for the UK market. Why do you think that is?

Sam Woods: Again, David may wish to comment. David, are you out of your conflict period?

David Belsham: Yes. I should say I worked for 30 years for the Prudential, and I have now been on the PRC for three years. For those first three years, I have not been involved in any decisions that relate to the Prudential, as part of avoiding conflict. Solvency II gets blamed for a lot of things, but generally, in the UK insurance market, firms have been pursuing different strategies over time. Some have been going into the capital-light savings market; some have been focusing on annuities and protection, bulk annuities for example. Different companies are making different choices, as to what their strategies are. The Prudential is in a position where it has a worldwide business; it can deploy capital anywhere in the world, and I think its decision on annuities was a natural development in a long-term strategy, rather than Solvency II coming in and causing a radical

move. Firms do not change successful, profitable strategies simply because of a new capital regime.

Q125 **Stewart Hosie:** The way it is put to us is slightly different from different companies make different choices. The argument goes something like this: "We have to hold a ridiculous amount of capital for these long-term policies—far too much—when we could deploy that capital far more profitably over a shorter term". They may not have pointed specifically at Solvency II and risk margins, but the argument is fundamentally that: "You are asking us, Mr Woods, Mr Belsham, to hold all this cash on the off-chance that something might happen, and we are not prepared to do it". Hence these long-term annuity products are disappearing off the market shelves.

Sam Woods: I know you hear such things, and we sometimes hear such things ourselves, but the first point is this. I do not think you should be discomforted to hear that there is a bit of tension between some of the companies we oversee and us on the topic of capitalising. That is the normal state of affairs, when you have a prudential regulator that has to insert the public interest into firms. You hope it does not reach an extreme level, which I do not think it is currently at.

The best way to look at that question is to ask what is happening for shareholders in these companies. What is the level of profitability in the insurance sector? If you look at the published results for the big companies last year, they range from close to 9%, to in one case 25%, although there are probably some one-offs in there. That is the return on equity for our big insurers. That looks okay to me. The company we happen to be talking about right now is in the middle of that range. I will tell you that the bankers would kill to get those sorts of returns at the moment.

While it is perfectly natural that there should be debate between us and the industry, and what they are mainly talking about there is the risk margin, on which we actually completely agree, beyond that there is not too much in it. The fundamental motivation for what the Pru is doing is the one that David described. It is an issue they have long had about their high-growth Asian business and their slow-growth UK business, and I think they reached the conclusion that the capital markets would be a better owner of that latter business, separately, because they were worried that they were constantly at the margin making investment decisions that were not optimal. That is how I understand it. I do not want to speak for them.

David Belsham: For Solvency II, the capital level is calibrated to a one in 200 level of failure over one year. When you convert that into a credit rating, it is the equivalent of something like a BBB level. Insurance companies all want a rating higher than BBB. Solvency II is pitched at a level where firms would want to hold more capital than that. As Sam said, really, a lot of these problems keep coming back to the risk margin. The capital requirement for annuities is not excessive in terms of the solvency capital. It is because the risk margin has effectively been

mis-calibrated and is too sensitive to low interest rates, which is why we are seeking to fix it.

- Q126 **Stewart Hosie:** I will come to mis-calibration in another series of questions, in a moment. You said, Mr Woods, that shareholders are doing quite well, but can we just talk about customers and the products available? How many new insurance companies have come into the market in the last few years, offering life and non-life policies with a long lead time?

Sam Woods: We authorised 28 new companies during the first 5 years of the PRA. That is on the insurance side; it is 37 on the banking side. I do not have with me the split of those that are annuity writers. It is true that a substantial number are London market firms. There is another way to look at your question, taking more of a customer perspective: has the arrival of Solvency II affected annuity pricing? We included a chart on this in the report that we sent to you. While we are on this, Chair, at some point I would like to make a correction to one number we have previously given to the Committee. Perhaps I could give that at the end of this answer, if I might.

If you look at the chart of what has happened with annuity pricing, you simply cannot see the introduction of Solvency II, and the reason for it is overwhelmingly driven by what is going on with risk-free rates and bond spreads. I do not think it is really having an impact there. Risk margin, if we cannot solve it, is a problem for the back book. For the front book, new annuities, what is happening is what David described, which is longevity being offshored. That is unhelpful from a prudential perspective, but commercially it is okay.

- Q127 **Stewart Hosie:** I am going to come to the offshoring in a moment, but can I just go back to your 28 new insurance companies? I understand very many of those are subsidiaries and spin-outs. They are not genuine new entrants, by and large, suddenly appearing and saying, "We have a whole wholen of capital and we want to go into this market". Is the system really encouraging genuinely new entrants to provide these services for customers?

Sam Woods: It is true that the new entrants to the market are not heavily stacked with brand new insurance companies. That is something we should have an eye to. Whether that changes, partly for reasons of fintech, is quite an open question. For the moment the big firms are staying ahead on that, but it is quite likely that we will see more in that space.

Stewart Hosie: I am sorry to be rushing, but I am conscious of time. There are a lot of questions in this area.

Chair: Do you want to give your correction?

Sam Woods: Could I possibly, just because it is important for the record? I am very sorry to intrude on questions. We should do it while we are on insurance. I regret to have to inform the Committee that we need to correct one number we have previously given

you. When David and I gave you evidence in February of last year, to inform your hearing on Solvency II, we gave you a number of £59 billion for the value of the matching adjustment. That number is correct. That was the correct number at the end of 2016. When I wrote to you, Chair, in January this year, I used the same number. The number is still correct. The end of 2017 number is £58 billion. Where we made an error was in our subsequent response to the Committee. On page 22 of the report, there is a different number of £66 billion. That is also in the footnote on page 24. This also arose in the correspondence between me and Mr Mann. I am afraid that was a calculation error. I do not think it changes the big picture, but I just wanted to put that on record. We have alerted the Clerk, and we will change the report on our website.

Chair: Thank you.

Q128 **Stewart Hosie:** That is helpful. In terms of offshoring, we know there has been a massive build-up of offshore reinsurers. There is nothing wrong with that as a business model, but what is the systemic risk involved in massive offshoring of reinsurance? What is the consequence if something out with your regulatory gamut does not work?

Sam Woods: My instinct is that it is a really bad thing. We have done the thing we can, which is to crawl over, in a thematic way, the contracts that firms have been using to achieve that, to assure ourselves that sensible things have been done on collateral, and all that. In most cases, that was the case. As always when you do these things, you find a few that need to be a bit sharper. We have answered the question in a narrow sense, but it is plainly an unintended consequence. It was not an aim of the risk margin to shove longevity offshore, out of the UK, into mainly the US, as far as we can tell. My whole instinct is that that is a bad thing long term. That is why we are going to need to fix this risk margin problem, which is stymied for what I hope will be a relatively brief period.

Q129 **Stewart Hosie:** That really brings us back to the beginning. Given that much of this reinsurance is indeed going to the US, one would have thought that our European friends would take a similar view, in terms of looking at the risk margin in a positive way, to pull back some of that lost reinsurance business.

Sam Woods: It is curious that we have been a little isolated on this topic, even though there is significant risk margin in other parts of Europe. The reason is that it bites particularly heavily for annuities, which is a product we have much more of here in the UK than in most other places. Secondly, it is because of a very obscure technical thing called the ultimate forward rate. There is a particular one for sterling, and when it comes together with this issue it makes it worse for our firms, but for that reason we have been a little isolated on it.

There are some signs that at least the industry in the EU 27 is becoming more energised about this topic, so it may be that it can be moved in a better direction.

David Belsham: Your point was explicitly made in the submissions from the PRA to EIOPA. I was concerned that we were putting our best foot forward on this and worked with the team, and we did raise that concern.

On a point of comfort, we have looked at concentration risk. The reinsurance at the moment is being spread across a large number of counterparties. There is an irony in that, up until fairly recently, the reinsurance market did not really exist for longevity. For many years, protection business has been reinsured globally. Longevity has been a long way behind that. Firms have retained enormous concentration risks themselves. A typical annuity company would have just two big risks: one longevity, one credit. When I used to be an actuarial function-holder, I recommended every year that we should be reinsuring more longevity risk, but there was not a market to do it.

There is a bit of time before the volumes of this get close to a systemic problem, because it is the new business that is largely being reinsured. However, it does mean that the risk margin needs to be fixed within a reasonable time. It is not a crisis as of today.

Q130 **Stewart Hosie:** I recall hearing similar arguments in 2007 and 2008, in relation to banking, that, because the risk was being spread more widely, that was taken as an argument to say, "There is nothing to worry about". I am glad there is a focus and I am glad there is an understanding that this could lead to a systemic risk. That is helpful.

Let me move on to equity release mortgages, and the Solvency II consultation paper published two weeks ago. We have received correspondence from Equity Release Council, which says that the proposals lead to excessive prudence for insurers holding ERMs, an allowance for risk equivalent to assuming a 25% to 30% immediate fall in property prices and no recovery. How would you respond to that?

Sam Woods: The first thing I would say is that this is a consultation, so we have put something out there; we are going to take views on it, and I am sure the Equity Release Council will not be shy in giving us those views. As a starting point, I do not consider what we have put out to be overly prudent. At the heart of what we are saying is that, for this product, which we think plays an important role, will play an increasingly important role and is a suitable investment for annuity writers as part of a diverse portfolio, there is a particular challenge in valuing a thing called the no negative equity guarantee. That is a thing that says to a customer, "You can put back the house on us, or your descendants can do it, if it turns out that the rolled up value of the loan is higher than the value of the house at that point".

You can immediately see that that is a very complicated financial instrument, and therefore there are a variety of views about how you should value it. Our particular focus is on making sure that the valuation of that does not leave out risks to which the insurance company is exposed, such as house price inflation above the risk-free rate. We regard that as a risk to which an insurance company is exposed, because, if those things are left out, the risk is that the matching adjustment on the other side of the balance sheet is too big, and

therefore firms do not have enough capital. That is what we are trying to get a handle on. There is going to be a vigorous debate.

Q131 Stewart Hosie: You say you are trying to get a handle on it, but I know you have been told the matching adjustment is not market consistent, so it is incompatible with the principles and formula proposed by you in CP13/18. It is a technical error, which I know has been explained, but the frustration we are told we are left with is that you know this, you have been told this, but nothing seems to have been done. Where are we with the industry saying you have got the matching adjustment wrong? Where are we with this?

Sam Woods: Well, we simply do not agree that it is wrong. The problem we have on equity release is that the position is insufficiently clear about how you should deal with this stuff in the Solvency II framework. As a result, there is a variety of practice in the industry. Another motivation for our consultation is a competition one, which is that we see that variety of practice and we are not sure there is a level playing field. I can tell you that, in my assessment, the calibration we have put forward is well within the span of current industry practice. The more sensibly prudent end of current industry practice is not different from what we are suggesting, but inevitably there will be some people in different positions, and those who are in a different one are likely to give us some forthright evidence in our consultation.

David Belsham: The key thing is this no negative equity guarantee, because that is effectively a put option on residential housing, or, in fact, for a customer on their individual house. You have firms effectively writing put options. Some of them are very good at it. They recognise it as a put option; they will value it as a put option, so they will use Monte Carlo techniques and stochastic models, or they will use a variation on the Black-Scholes formula with market-consistent assumptions. The difference between that and the matching adjustment is that the matching adjustment is available for the way that firms can earn a liquidity premium on fixed interest assets. It is reasonable to capitalise that liquidity premium, because on a corporate bond the coupons are fixed and the maturity value is fixed. You can anticipate in advance exactly what cashflows you are going to get and, insofar as you are being paid for the liquidity premium, it is reasonable to capitalise that upfront. This is how the industry has worked, and we have accepted that approach. Where you have a property, you are fully exposed to the falling property value. If the residential market drops, there is not a pull to par that automatically says, "By the time it reaches the maturity date, there will be a redemption".

You have a fundamental difference between a corporate bond with fixed cashflows, where the matching adjustment was designed to be available, and an equity release mortgage, where it has a no negative equity guarantee. If the loan to value is very low, then the no negative equity guarantee is not onerous and it very much resembles a fixed-interest asset. On mortgages where the loan to value is material, it will then roll up throughout the life of the loan at maybe a 5%, 6% or 7% interest rate that is being charged to the customer, so you have an option that is

moving closer to the money throughout its life. That is the concern, really: that this needs to be properly recognised by firms and effectively all firms brought up to a suitable minimum level. We are not moving them all. It is within the range of what firms decide to do.

Q132 **Stewart Hosie:** Your argument, fundamentally, would be that the regulations you have put in place are not dreadfully onerous; they are simply recognising the risks that exist, which some of the firms perhaps will downplay.

David Belsham: Yes. I would refer you back to the Equitable, in a way. They gave onerous guarantees. They valued them on a realistic assumption. If you value onerous guarantees on a realistic assumption, they will not cost much. If you value guarantees properly, recognising you are giving an option, then you hold a market-consistent cost of that guarantee. If the Equitable had held market-consistent costs for its guarantees, there would not have been a problem with that firm.

Q133 **Stewart Hosie:** One final question is on dynamic volatility adjustments. I know you have a consultation out at the moment. Can you give the Committee an update on this issue, given that, as we have already discussed with the last two technical issues, there is a divergence between some of the industry and the regulator. Where are you, or where are we, with DVAs?

Sam Woods: I should say, more broadly, it has been great to have the Committee's interest in this topic. It is particularly timely in terms of when we brought in Solvency II. On DVA, we have moved our position to the same position as the industry. We did not think the regulation was designed to allow this, but it became plain that a number of our colleagues around Europe had taken a different view. In the end, we concluded it was not sustainable, once EIOPA had had a look at it, to say that we needed to be an outlier, so we are moving.

Q134 **John Mann:** Just clarifying previous information you have provided, on the capital requirements for the insurance industry—Mr Woods, I believe you gave us previously a figure of £126 billion.

Sam Woods: Yes, the latest is £120 billion.

Q135 **John Mann:** You, Mr Belsham, gave us a figure of £80 billion.

Sam Woods: Yes, that was for the life industry.

David Belsham: I was probably talking about the life sector. If this was in relation to matching adjustments, it is the life sector that is largely using the matching adjustment, because they are the ones with the long-dated liabilities.

Q136 **John Mann:** The amount of capital created by matching adjustment you are now putting at £59 billion.

Sam Woods: The latest is £58 billion.

Q137 **John Mann:** If we look at the solvency of companies taking out matching adjustment, there are players in the market that would be insolvent if they could not use matching adjustment.

Sam Woods: To be more precise, they would be south of their capital requirements. It is a very large benefit in relation to the capital requirement of the industry as a whole, and it is true that the industry as a whole—which is currently at 55% above its capital requirement—would be in aggregate below it, if it was not for that instrument.

Q138 **John Mann:** There are outriders, are there not? Those outriders are significant. When it comes to what is prudential to define as capital, there are some outriders that are relying on matching adjustment to keep in the game.

Sam Woods: Firms that are concentrated in annuities are naturally more reliant on the matching adjustment. If you are a London market firm, you do you not have the matching adjustment. What you say follows in that respect. That is why we think we need to be very careful about it, and that is why we are focusing on this equity release issue, because we are concerned that, if not very carefully handled, too much matching adjustment could be claimed. That is precisely the worry.

Q139 **John Mann:** There is a suggestion, is there not, that some people have based their business model on creating a false, rosy picture of their strength, purely by using matching adjustment to mask some inherent weaknesses?

Sam Woods: This is all a question of degree. The matching adjustment as a construct is absolutely fine. The reason for that is that there is a very clear prudential benefit, particularly if you are an annuity writer, if you can invest in assets that clearly match what you are going to have to pay out on the other side. Indeed, many other jurisdictions have not managed to achieve that matching, and they are much more exposed to changes in various things. That is a good thing. But it is a very large benefit, and we need to be extremely careful about it, particularly where the ways in which you value and think about these assets—equity release is the current example—are subject to debate and a certain degree of uncertainty. That is why we think we need to tighten up around that.

David Belsham: The fundamental point is that these annuity companies are buy and hold investors. They are buying a corporate bond, typically, and the spread on that corporate bond yield can be split into an amount for credit and an amount for liquidity risk. On the liquidity risk, you are being paid for that in case you become a forced seller. If an insurance company has annuity liabilities running out 20 or 30 years, and it is going to hold the corporate bond and just take the cashflows for 20 or 30 years, it is not exposed to the risk of being a forced seller in adverse market conditions, when spreads might have widened.

That is why the matching adjustment is allowed. It is why the matching adjustment has been used—previously, it was just called the liquidity premium, which is what it is—for many years by firms to enhance the

annuity rates they can give to their customers. They have recognised economically that illiquidity has value, and they can pass it on to customers. Having done that, it seems reasonable to factor it into the capital calculations as well. But they do need to be buy-and-hold investors, and that is the underlying risk in here, that for some reason in the future they become forced sellers.

Q140 John Mann: They are removing the risk element, in reality, in how they are pricing risk. That is a risk. If I take some 2016 figures, there is one company that with matching adjustment has a solvency ratio of 162.5%. Without matching adjustment, it is minus 56.9%. That is quite staggering.

Sam Woods: It is perfectly true.

John Mann: And it is risky.

Sam Woods: It depends on your view of the matching adjustment. We think that needs to be very tightly controlled, for the reasons you give. We think it is genuinely safer for annuity writers in particular to match their assets so that they cannot be caught out if the markets move in a different direction. We think, broadly, that equity release mortgages are a suitable asset for that purpose. However, that needs to be very carefully controlled. That is why we are focusing on that asset.

Very briefly on that asset, this is still relatively small in the big scheme of things. There is £20 billion of this stuff on insurance company balance sheets at the moment, which is around 1% of total insurance assets, or perhaps it is better to think of it as 8% of matching adjustment assets. That is probably a more relevant way to think about it. We think now is the right time for us to be making an intervention that clarifies how firms should treat that asset, because it is growing at three times the pace of other mortgage assets, and given the demand that there is for such an asset, for all sorts of wider reasons, one can expect that to continue.

Q141 John Mann: Going back to 2008, the outriders did not all survive - Northern Rock. It would seem to me that, in the evidence you have given to the Committee, there is a danger that you are underplaying the risk of outriders whose business plan is different, who are over-relying on matching adjustment as their business plan, and that those outriders are therefore at significantly greater risk of a potential change, which has therefore some comparators in what happened and how some people behaved in the run-up to 2008.

Sam Woods: If I may make two comments on that, it is true that more concentrated business models have particular risks associated with them. That is an argument sometimes used by very large companies to declare themselves safe and, having been through RBS, Lloyds and the rest, I am reluctant to accept that. My view is that companies of all shapes and sizes can go bust, and we need to be paranoid about them all, to some degree.

The second point is on outriders. The outriding that really worries us is when firms are making outriding assumptions or calibrations, and doing

things that seem to us to be aggressive or out of line with a sensible view. That is when we become most concerned, and the difficulty in the equity release area is that it has not been totally clear where a sensible line is. We are drawing a line, or consulting on where we should draw a line, at the moment, but it is very important that we draw that line somewhere.

David Belsham: The other thing we pursue is stress testing. Because these are buy and hold investors, the risk is that they are no longer able to hold their assets when markets become riskier or credit starts to worsen. In the course of the next year there will be some stress testing done on the life industry, and that will effectively explore the quality of their assets. Two firms can have exactly the same published solvency margin. One could be backing its solvency margin with gilts; another could be with a matching adjustment; another could be with the value of its Hong Kong business, say. Solvency II is an economic valuation regime, so it values all the future profits from whatever source. Stress testing is important because that teases out how those assets behave in stressed circumstances. We are alive to the issue.

John Mann: Good.

Q142 **Mr Jack:** Let us turn to the TSB, the Trustee Savings Bank. Before the TSB migration, what did the PRA do to assess—you need to be sober to say this—the potential prudential risks and their mitigations?

Sam Woods: The single most important thing we did was in 2014, when we put in place an extra capital requirement for that bank, specifically to cover the risks that the IT migration might go wrong. We increased the level of that requirement in the middle of 2017, because of the delay that there was. I have the number in my head and can give it. I prefer not to; I think it is better if the firm talks about those numbers, but my current expectation is that that will be enough to accommodate the financial aspect of this. However, the prudential aspect of this is far from the worst aspect.

Q143 **Mr Jack:** I agree. To what extent have the events at the TSB made you consider further supervisory action on the outsourcing of financial services?

Sam Woods: We are doing a number of things. First, as I referred to before, we have an investigation going on jointly with the FCA into what happened at the TSB, which plainly has been an absolute disaster, and we need to understand better how that came to pass. This, of course, is an unusual case where they were extracting themselves from an existing system. We are separately, bearing in mind the lessons of this, looking at outsourcing arrangements and in particular—I will be very brief, but I can say more if you want—outsourcing to the cloud, which we are seeing ever more of from both banks and insurance companies. We are doing some work on ways in which that can be safe and ways in which it can be unsafe.

Q144 **Mr Jack:** They relied on an attestation process, did they not? Do you think that is a useful way of providing assurance?

Sam Woods: It is useful, in the sense that it pins accountability more clearly on individuals, which is the aim of the senior managers regime. The strategic way in which—

Q145 **Mr Jack:** Mr Elphicke in a previous session referred to the senior managers regime as “a paper tiger”. You do not see it as that.

Sam Woods: I would not agree with Mr Elphicke on that characterisation. I think it focuses the mind very considerably if you are a senior manager with a specific responsibility. The key thing, coming out of a recommendation from the PCBS, which was closely associated with this Committee, is to avoid what happened in the last crisis, when just about everybody was able to say, “Well it wasn’t me, guv, because it was some committee of folks, we all did it together and somehow none of us are responsible”. That is obviously dreadful.

The senior managers regime is designed not to get rid of committees—we have loads ourselves—but to be clear that, when it comes to the crunch, individuals are responsible and can be held to account. I think that is going to work well for us.

Q146 **Mr Jack:** Do you have confidence in the senior management, the executive members of the board of the TSB and their ability?

Sam Woods: It would be wrong for me to front-run the investigation that we have going on. It is clear at this point that it has been a disaster, it has had a terrible impact on TSB customers and the communications around the incident have been pretty poor, certainly in the early stages. You can understand the desire to put a brave face on things, but my personal opinion is that that early communication in particular exacerbated what is already a difficult issue.

Q147 **Mr Jack:** A lot of banks use legacy IT systems. Just how detailed is the PRA’s understanding of the state of the IT systems used at the moment?

Sam Woods: To be honest with you, it varies from one firm to another. As David mentioned, we have a growing team looking at these operational resilience issues, and the team David referred to is in our risk specialist division, which looks at operational risk and is now 42 people. We are equipping supervisors with more tools to look at these sorts of things.

Q148 **Mr Jack:** So you are getting your own expertise in.

Sam Woods: We are, but I would offer a couple of riders. First, an important subset of this is cyber. Obviously the TSB thing is totally self-inflicted, but on cyber we are staffing up. We need to leverage ourselves by docking with the National Cyber Security Centre, which is part of GCHQ. It is a big unit. They will always be better than us. We are using that relationship in that context. The only other rider is that there are quite a lot of IT migrations and IT changes that go okay. I do not want to defend the banks or the insurance companies, but the most recent example, which we have been very focused on and I was very concerned about, was 1.3 million sort code migrations for ring-

fencing. There was a lot of hard work by IT people within the banks to make that go smoothly.

Q149 **Mr Jack:** Presumably the majority, when banks are upgrading their IT, go okay.

Sam Woods: Precisely, so of course we see the ones that go wrong.

Q150 **Mr Jack:** In this day and age, banking IT is not a new thing. How could the TSB get it so catastrophically wrong?

Sam Woods: That is a very good question, and we will not know the answer until we have done the investigation. It is surprising how very badly it has gone wrong. There are only two I can think of that are comparable. The first is a different issue. The Co-op spent, as I recall, something like £300 million on an IT system, which it then had to write off. That never became a consumer thing, but it was a major prudential problem. Then there was the famous RBS episode, which was a patch that went wrong. We will get to the bottom of that in our investigation. I am sure we will be discussing that here again.

Chair: I have a couple of broad questions. I know Rushanara has too. You had questions from Alister and Stewart about the two particular relationships with the different sides, the insurance and banking industries. Earlier on, I was asking about the binding technical standards and the consultations that will need to be run on that. As you know, there is a lot of detail in the technical standards that the sectors will have a lot of vocal opinions about: the packaged retail insurance-based investment products, where the technical standards set out the detail of the key information document; the bond transparency requirements in MiFID II; the risk-free rate in Solvency II. That all comes from technical standards, which you as a regulator will need to consult on and the industry will want to hear about. I took your point earlier on about this Committee having a role to play in getting opinions.

However, there is a view that the industry is having its say when asked, in consultation papers launched by the PRA, but that say is not actually getting anywhere in the sense of being taken on board. In response to Mr Hosie, you talked about the Equity Release Council having a difference of opinion. How are those differences of opinion then dealt with, so that the person who has taken the time to respond to the consultation understands why there is that difference of opinion?

Sam Woods: There is a wide publication process around our decision-making, and that is quite voluminous. Where we could do a better job, if I am honest, as has been highlighted to me by the proceedings in this Committee in relation to Solvency II issues, is in explaining the technical decisions we come to in more accessible language, for a wider audience within the insurance sector. Sometimes it gets to an incredibly technical level, where it is very difficult for people to follow.

We are trying to do that better. Funnily enough, a recent example, which may or may not have been successful, judging from what you have reported to us, is on equity release. We have a very

techy consultation paper, but then David Rule, who is Sarah's and my colleague in charge of insurance, did a two-side letter to boards and just said, "This is what we are trying to do". The aim of that is to make it more accessible.

The other thing we are doing, and this is very live, was a suggestion that David Belsham made to me, which is that we are establishing a new panel on the insurance side, a sub-committee of our practitioner panel, which will only focus on insurance issues. The first meeting of that, I believe, will be this Monday. That is intended to be another forum where we can have a bit more of this debate and give a bit more feedback. I sense, given the degree of aggravation we have relative to the underlying issues, that we are not getting that quite right.

Q151 **Chair:** That is good to hear. Mr Belsham, the PRC came into existence in April of this year. As the external member here before us today, I wanted to ask you this. I know you only started on 1 May; is that right?

David Belsham: I started on 1 May 2015, and then renewed on 1 May 2018.

Q152 **Chair:** In terms of the PRC, how is that going as an external member? How aware are you of the issues being discussed? You have just highlighted an example of where you have been able to offer some advice on how things might be done differently. Do you feel that decisions are often presented as a bit of a fait accompli, or are you able to be influential as an external member?

David Belsham: We have six external members, who come from a wide range of backgrounds, and that allows us to all contribute based on our knowledge of the financial sector and of how firms work. I focus mainly on Solvency II, but in other areas people look at remuneration, for example, and how remuneration can be used more in supervision. As another example, we had the DP we just talked about on operational resilience, something the external members had been pressing for. We asked for more asset quality reviews on small banks. One of the external members was a chief executive of a small bank previously, or a smaller bank, and could direct activity. Each external member who comes with a different background or different skillset can challenge in their own way, and collectively we work together and swap notes. We also meet up with the FPC externals periodically, again to swap notes on what we are seeing.

The level of support we get is very good. We attend all the PRC meetings. The papers we get are of very high quality. They are really very good, and the quality of the information in them genuinely allows you to challenge them. They are not rubber stamping; there is good analysis there. Often, there are options presented. We are also given the opportunity to meet the people who prepared the paper in advance, which we often do, especially with all the complexity of this. It can be either a teach-in or just an opportunity to have a longer chat, if there is not time at the meeting.

We meet up with the team. We meet with Sam monthly, the deputy CEO monthly. In the nature of those conversations, you are talking about different things from the business of the committee. We meet up with the executive directors, such as Sarah, on a quarterly basis. We meet with the Governor quarterly for a general chat about what is on his mind and what is on our minds. We meet up with the internal audit head on a quarterly basis. We meet up with the head of the supervisory oversight function, which is like a second line of defence. Basically, we have the run of the building, and we take advantage of that. We go and talk to the team; we find out what is going on and what issues they are seeing. I think we get good insight into what is going on there.

Q153 **Chair:** Having been a PRA board member previously, what is the difference?

David Belsham: The difference is relatively small. We used to be non-execs of a subsidiary, so we had to produce the report and accounts, and we were concerned with operational aspects. It was a company, so we had all the responsibilities of a company director. On the PRC, we are effectively the senior decision-makers on regulatory matters. The report and accounts are no longer of interest to us. The delivery of operational matters is not of interest to us; that is a matter for the Court. But we are still interested in the resources we have. We are still responsible for running a supervisory framework for UK business, so we are concerned about whether we have the right quality of people, the right mix of people, the right systems. The changes, though, are relatively minor, so we have carried on much as before.

Q154 **Chair:** Ms Breeden, from your point of view as an internal member, being a full-time PRA employee, how does it work having the external members?

Sarah Breeden: They are a fantastic resource for us to go and access. The way David framed it was in terms of challenge. From my point of view, it is about the support they give us as well. They bring a perspective and a set of experiences that can help us put better proposals together. We quite often seek out their views positively before our proposals are finalised.

Q155 **Chair:** Mr Belsham, you mentioned there the FPC and the relationship with it. What input do the external FPC members have into the competition and the research agenda generally of the PRC?

David Belsham: The PRC external members do not get involved in the research side of it. That is simply down to the FPC side. The FPC and the MPC, as I understand the position, do far more research within the Bank. The PRC external members do not do research; we spend more of our time talking to the outside market, talking to firms, gathering external views to feed into the decisions of the PRC.

Q156 **Rushanara Ali:** One of your objectives is to secure an appropriate degree of protection for those who are or may become policyholders. It is a bit of homework, I am afraid, but I was particularly interested for you to come back, after some discussion perhaps with Mr Andrew Bailey, on

where we are at with protecting older policyholders, in terms of access to insurance for travel and other kinds of insurance that they require, including people with long-term conditions, such as mental health conditions, pre-existing conditions, cancer and so on. It is an issue that is coming up among MPs, in their inboxes and their constituencies. One of my concerns is, first of all, how much work has been going on between the PRA and the FCA. What else needs to be done?

There is a tension around how to deal with what in effect is a market failure, if the premiums need to be high, but the result is that a lot of people are not going on holiday, are not getting the right kind of insurance, are discovering things they are not covered for that are still in the small print. There has been improvement, but it is still not good enough. What has been done, what do we know, and what else do we need to know?

Sam Woods: Shall I take that away and liaise with Andrew? Then we will come back to you jointly or singularly depending on what we make of the issue.

Rushanara Ali: That would be great. My colleagues outside this Committee would really appreciate it as well. Thank you.

Chair: That would be a genuinely interesting point to cover, and of interest to MPs more broadly. Thank you very much indeed for your time this afternoon, as ever. I am sure there will be further sessions. If there is anything coming out of this afternoon that you want to write to us about, to clarify or add to, you can always please feel free to do that. For now, thank you for your time.