

Treasury Committee

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

Wednesday 23 January 2019

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Members present: Nicky Morgan (Chair); Rushanara Ali; Mr Steve Baker; Colin Clark; Charlie Elphicke; Alison McGovern; Catherine McKinnell; Wes Streeting.

Questions 157-220

Witnesses

I: Sam Woods, Deputy Governor for Prudential Regulation and Chief Executive Officer of the Prudential Regulation Authority; Sandra Boss, External Member, Prudential Regulation Committee; David Rule, Executive Director, Insurance Supervision, Prudential Regulation Authority.

Examination of Witnesses

Witnesses: Sam Woods, Sandra Boss and David Rule.

Q157 **Chair:** Thank you very much indeed for being here this afternoon. Sam, I think we are going to see you again next Tuesday. I know you cannot stay away from the Treasury Select committee, so we might limit our conversations about Brexit this afternoon, which I think everyone will be deeply relieved about. I am going to ask the panel to introduce themselves and then we will get going.

Sam Woods: I am Sam Woods, head of the PRA.

David Rule: I am David Rule, executive director of insurance supervision at the PRA.

Sandra Boss: I am Sandy Boss. I am one of the external members of the Prudential Regulation Committee.

Q158 **Chair:** I wanted to start on diversity. Thank you very much for sending through the diversity data for November 2017 to November 2018. I know the gender pay gap is calculated by the Bank of England as a whole, so you are going to let us have those figures in due course. It was noticeable that the proportion of women in higher pay scales has increased by just 1% in that year, but in scale C plus, which I think is the highest grade, in terms of data, there has been a slight decline. Perhaps you could talk us through what is going on, in terms of women reaching the top of the PRA and diversity initiatives generally.

Sam Woods: Perhaps I could say a few words, and then Sandy, who has seen this in a lot of organisations, can provide that wider perspective. When I look at the PRA statistics, and particularly the senior ones, the organisation overall is 44% female and 56% male, and we are tracking towards 50% as our target. If you look at the more senior layers, obviously I am a man, but if you take the 10 people in the next layer down, so five people at David's level and five at the level below that, it is an even split. It happens to be two women at executive director and three men, and then three women and two men in the director layer. We have another director slot that is currently occupied on an interim basis, as it happens by a man and a woman in a job-share arrangement. As we sit here, we happen to be perfectly balanced at the top level of the PRA. That is not something one should aim for in such a small group, but I take some satisfaction from that and I like to have a balanced team of that kind.

I then look, though, at what we call scale C and up. Scale C is head of division. A division is really the working unit of the PRA and the Bank, so that is the bottom rung of senior management. That is 28%. We want to get to 35%. We have been doing quite a lot of things to try to move the dial on that, and it has tracked up over the last few years. I would make two comments on it. First, when you look at our data—and this is quite persistent, and it is not unique to the Bank or the PRA—you see that the male/female ratio tracks down as you go into the manager layer and the

senior manager layer, before, in other words, the one we are talking about here. This is the head of division layer. After that, it is flatter.

Some of the issues are around how those processes work into those levels and what the attraction is to women of going into those roles. We have done quite a bit in terms of taking gendered terms out of adverts, making sure we are enabling flexible working practices and working with specialist recruiters such as Capability Jane and those sorts of ones. We also have a good business reason to do that, because we can do it better than many of the financial services firms and it is a good way for us to compete.

I would mention one last thing that we have done recently. This is interesting, because it is an example of why there may be more things we can think of to do. This is quite a good thing. Sorry for the long answer, by the way. For that layer, the scale C layer, instead of the appointments being made individually, we have decided to pool them and appoint people in groups to individual roles, but do it at the same time for groups. That is a simple step we have taken. I think that is going to make quite a big difference on this score, because then we have some ability, which otherwise you do not for process reasons, to take account of the collective mix, while still appointing the best person to the best role. I am quite optimistic about that.

Sandra Boss: Sam gave quite a comprehensive review of the data, as well as some of the changes. I guess I would observe some things, like the women in finance report you did, and there has been a lot of research around the industry on how we move particularly gender diversity, but also ethnic diversity and other forms of diversity. The Bank has the advantage, relative to the private sector, of two things.

One is that we do not have the bonus culture, money game, that was discussed at some level in your report. It is a very different type of compensation structure. It is in lockstep around a relatively narrow increase band. Certainly, there would never be any of that negotiating for a bonus phenomenon. The commercial culture is completely different and that is advantageous.

The other thing is that this is a civil society. People join the Bank because they care about the Bank. They want to make a difference. They want to achieve something that is intellectually rigorous, that has impact on the financial services industry. Those are very selective criteria for having people enter this population. I have noticed this in my time at the Bank; it has been about five years. When I left my prior work in the private sector, at that point we had reached the awareness in the boardroom that perhaps it might be sort of a good idea to address this issue, but had not yet done the many things that are happening. That was pre-30% Club. That was before any of the other big steps that have been happening, with the UK in the forefront.

When I got to the Bank, I discovered that they were already causing change. There was no denial. No one was saying, "We do not have a problem". The things Sam mentioned have had a big effect. If I look at it,

it is now 13% part time. David is on a four-day week programme. A lot of the men are on four-day week programmes. Talking to someone I knew in the cafeteria, I learned today that at the HoD level a man has taken long-term paternity leave, and therefore a woman of colour has stepped into an acting management role. That was a choice the Bank made based on both merit and opportunity, but it could not have happened if both of them were not operating in a way that I would never have seen in banking.

I have been impressed by the actions and the commitment to change. I will not enumerate the ones Sam mentioned, but I think it is going in the right direction in the executive area.

Q159 **Chair:** Great, thank you for that. Yes, there is more to follow and the Committee will be following up on diversity generally. I wanted to move very briefly on to Brexit, because we are going to return to it next week, particularly on that SI about the no-deal powers. I just wondered if you could give us a brief update on the PRA's work, particularly around the number of EU or EEA firms that have been applying for authorisation, interest in a temporary permissions regime and any other discussions you are having with EU regulators.

Sam Woods: Broadly, we are on track. I will not go through the whole list of things we have been doing, which are broadly tracking as expected. One of the most important is the thing we are going to talk about next week, the transitional power SI. The temporary permissions regime was the single most important thing Parliament has done for us, in terms of managing the risk of a cliff edge. That is going pretty well.

We have expected for about the last 12 months now that the amount of firms we would have applying for that, split across banking and insurance, would be about 170. That number has not really moved. We are still expecting that number. We have had about 80 in so far. That is the number of applications for branch status. On the temporary permissions regime itself, for which people only need to notify, we have had 100 since it came in. But of those 70, if you have applied for branch status, that kind of automatically gets you notified.

The total number under the temporary permissions regime, as distinct from the 170, which are those we expect to want to stay here permanently as a branch, we will only find out in due course. It depends how many come out of the woodwork that we were not previously aware of because they are not currently within our bailiwick. That number is small at the moment but may get larger.

Chair: That is very helpful.

Q160 **Charlie Elphicke:** Good afternoon. Sam, the FCA data shows that technology outages increased by 138% in the year to October 2018. Why do you think that is?

Sam Woods: You can point to a more dramatic increase if you pull back the lens one yard and look at the difference between the full-year 2018 number from the FCA, which is 841, and what that number was three

years ago, which was 130 or so. Within that, part of it is a reporting issue. This piece of regulation, PSD 2, has come in in the meantime, and that accounts for 450 or so, maybe a bit more, of that 840. That is genuinely a new reporting stream. Even if you took all that out, you would be looking at something like a two or threefold increase over that slightly longer period, including the increase you just described, year on year.

I saw what Andrew said to you about that and I agree. There is a mixture. There is likely to be a mixture of more outages but also higher awareness and better reporting in that way, a bit like the debate that always goes on about crime figures. Those numbers are high, and we all have a collective interest in them coming down. Some of the things that have gone wrong have been a real disaster and the Committee has taken a close interest in them.

Q161 Charlie Elphicke: Some bankers say to me it is all down to regulatory indigestion. The PRA demands one thing; the FCA demands something else; then along comes the Information Commissioner to demand something completely different. All these regulators are just like the utility companies, digging up the roads continually and causing complete chaos with the technology infrastructure in banks. That is what is causing these outages. Is that possible?

Sam Woods: As is often the case, members of some financial institutions may be expressing themselves more vividly than the facts support. The easiest way to express it is that a good chunk, say 20%, of those numbers is cyber. I can assure you that the PRA is not launching cyberattacks on any financial institution. Looking at the rest of them, take for instance the episode Lloyds had on Friday. It lost access to the faster payments gateway between 7.30 and 9.42 in the morning. It was nothing to do with what any regulator had done. It was something that occurred and they worked through it.

There is a grain of truth in what you have been told, in the sense that there is a lot of change. The biggest one we have driven from the prudential end is, of course, ring-fencing. To give the banks credit, that was a massive exercise. We may come on to it, I am not sure, in discussions. Perhaps I will not go into it too deeply, but that was achieved without any technological hiccups. That is to the credit of the people in the banks who work on these things.

Q162 Charlie Elphicke: Sandy, the regulators are always big on challenge, about how the non-executive directors should challenge the executive team. Have you challenged the executive team about this possibility of regulatory indigestion causing technological chaos? Also, from your previous experience of being an absolute specialist in investment banking and risk at what is possibly the leading company in the advisory sphere, do you think this is a possibility? Should there be a steering committee or clearing house to ensure there is not regulatory indigestion?

Sandra Boss: I would agree with Sam's assessment that, if you look at the menu of causes, it is mixed. With structural reform, Brexit and the restructuring associated with it, the anticipated changes in the payments

system, what is happening with Pay.UK, as well as what will happen with RTGS, there is a lot of change. There is no question that that creates a challenge.

Things are happening to try to manage that challenge. You are asking the question about what we are doing as non-executives. What we are not doing is saying, "PRA, you should stop agenda item XYZ because we think this is causing incremental indigestion". Instead, we are working with the PRA, and involving the FCA and the FPC, to ask, "How do we take a step back and think about operational resiliency more in the round?" There is a discussion paper that has come out. We were quite vocal, as external members, to say, even before that discussion paper came out, "This is an issue we need to be engaging more with our regulated firms about". That was one of the ways in which we said, "We need to step back".

However, we did not say, "This change should not occur". It would be difficult for us to not have done structural reform. It would be difficult for our firms not to get ready for Brexit. I can speak for my other role in RTGS. One thing we are doing is trying to develop an integrated map for how the payments system will evolve over the course of the next five years, specifically to address that point. That is something the payments industry is quite attentive to, but that is not relating to my PRC hat. I hope that begins to address your question.

Q163 **Charlie Elphicke:** Thank you. I appreciate that. Sam, the PRA assesses a candidate's fitness and propriety before allowing them to take on certain senior roles within a regulated firm. In what percentage of cases do you turn people down? Also, in what percentage of cases have you rejected a candidate due to a lack of cyber or technological expertise?

Sam Woods: I do not have the precise numbers with me. To give you a sense of how the process works, someone is put forward for an interview, which is a core part of the assessment. If we are concerned, from the interview, that they do not have the right skills, the way the law works is that they have the opportunity to come back for a second interview. In many cases, the firm and/or the individual at that point will decide to withdraw from the process. That is not always the case. Sometimes they will go through to the second interview and, in some of those cases, will get through.

That rather blurs the lines of what is a rejection, although I think overall that is a sensible process. It is a fairly regular occurrence and people typically prepare pretty thoroughly for their interviews with the PRA and the FCA.

Q164 **Charlie Elphicke:** How many rejections did you make last year?

Sam Woods: I do not have that number with me.

Q165 **Charlie Elphicke:** Did you reject anyone?

Sam Woods: I will come back to you to give you a sense of it. I will have to pull it out of the data, because I also want to give you a sense of the numbers of second interviews and withdrawals, because that gives a truer picture.

Coming to cyber and op in particular, I am not aware and I do not think we have rejected anyone on those grounds alone. However, we have made a point to a number of boards that we think they need to build up their expertise in this area, as indeed many other institutions and we ourselves are building it up. That is a concern about the degree of experience at the top of these institutions in that particular field.

- Q166 **Charlie Elphicke:** Okay, so you have not rejected anyone for lack of cyber or technological expertise. In other cases, will you give me a breakdown of how many people you have rejected and in what categories those rejections are? Will you be able to write to me?

Sam Woods: I will come back to you with the best we can do on it. I will need to check for GDPR compliance and things of that kind, but we will be able to put some flesh around the answer to that question.

- Q167 **Charlie Elphicke:** How critical is the resilience of cloud service providers to the safety and soundness of PRA-supervised firms?

Sam Woods: This is becoming ever-more important through time. The firms are moving more of their data and some of their processes to the cloud providers. We have recently instituted a new process within supervision in order to guide the supervisors as to whether something is important enough to require a deep inquiry from us, or whether it is a more routine thing that we can let go.

It is not necessarily a bad thing that firms are moving more stuff to the cloud. In some cases, there may be advantages to that. It may be that the cyber resilience of some cloud providers is higher than that of some individual firms. Nonetheless, it is a concern for us if that becomes too concentrated, which is a real risk.

I might just bring in David briefly, because this question of outsourcing to technology firms is not only a cloud question. There are some specific issues in insurance that David is looking at.

David Rule: The cloud can come in two ways. Either it comes directly or you outsource to an outsource provider that itself uses the cloud. In insurance, the use of cloud has mainly been for running the organisational activities like payroll, but there is a lot of outsourcing of key functions to outsource providers particularly by life insurance firms, but also by general insurance firms, and some concentration in that market.

We currently have a piece of supervisory work we are doing jointly with the FCA. We do most of this operational resilience work jointly with the FCA, given our overlapping objectives. In that work, we are looking at the resilience of some of the outsource providers that life insurers use and, in particular, if those providers were either to exit the market or to suffer technological problems, what the capabilities of the insurers to take the business back in house would be.

- Q168 **Charlie Elphicke:** As you will know, there has been quite a serious IT outage in TSB. There was meant to be a report published before Christmas. Correct me if I am wrong; a month on, no one seems to have

seen anything about this. Have they been talking to you and can you provide an update on the progress of your investigation into TSB's IT failure?

Sam Woods: Yes. First, we share—and I know Andrew and the FCA do as well—the Committee's concerns about what happened at TSB, which is a very severe operational failing. Unusually for us, that is why we are jointly investigating it with the FCA. A number of these failures, and it will be a high proportion of the 841 we just talked about, are bad in the sense that they are inconvenient for consumers, and some of them engage the FCA's objectives. There is a higher bar for it to get to a safety and soundness issue for us in the PRA.

This one certainly met that bar, and that is why we have put the investigation in place. It is ongoing. I do not want to tie myself to a timeline, but it is a priority one for our team and it is not affected by the timing of the Slaughter and May report, which they have commissioned themselves. Our investigation is separate to that.

Q169 **Charlie Elphicke:** Sandy, have you been looking at this as well? Obviously, you are very expert in risk.

Sandra Boss: Thus far, we have gotten live issues reports on the incident. In the PRC, one of the first things we do at every meeting is to engage on what the active issues are. That is always a very important thing. We participate in the discussion as to whether that should be opened as an investigation. Those decisions are typically taken quickly by the executive when they need to be, and then there are times when we will engage on whether an investigation should be opened. We were apprised of the decision to open the investigation, supportive of that decision, and we will look forward to the subsequent solution to this.

It is also quite important that we have been kept apprised of the consequences, in part on the customer's side, because we mind about the customer impact, even though that is not our primary objective. We have also been kept apprised of the prudential implications, because the PRA makes very important decisions around financial resources, some of which involve payments that go between the local entity and the parent. Some decisions are ours; some are not ours, but we need to know how that is being handled. That is something we have been very engaged on.

Q170 **Charlie Elphicke:** Are there any initial learnings on this?

Sam Woods: I want to wait until the investigation comes out, but I will point to one, which I think is a positive one. There may well also be negative ones for us coming out of the investigation. As I say, our focus is on safety and soundness. I think the primary issue for the Committee has been the enormous inconvenience and distress suffered by many customers of that institution, but we also have to worry about the impact on safety and soundness. Part of that is customer reaction, but it is also about capital. In this case, our team was well engaged with them on the programme and put in place an extra capital requirement—

Chair: We are going to vote, but finish your sentence.

Charlie Elphicke: Keep going.

Chair: Then we will go and vote.

Sam Woods: —precisely to cover an unspecified possibility of it going wrong. I can tell you, now that it has gone wrong, it has proved very expensive. It is a very good thing we have that capital requirement in place. That is one learning for us: that we should always do that where firms have a big programme of this kind.

Sitting suspended for a Division in the House.

On resuming—

Q171 **Wes Streeting:** I want to ask about credit unions. You will have followed the parliamentary debate around credit unions and will understand the political, moral, practical attraction of credit unions in the context of household indebtedness. However, nine credit unions failed in 2018. From your vantage point, what do you think makes credit unions so susceptible to failure?

Sam Woods: Some of it just comes down to size. Some of them are very small and therefore easily knocked over by quite small things. To put the nine in perspective, the number of credit unions failing per year over the last decade has ranged between four and 10. As it happens, the year before last was the four, so if you take the two years together this is running at more or less the normal rate.

What was unusual last year, though, was that one of those nine was a credit union called Dial-A-Cab. It had a balance sheet of £23 million. That is three times bigger than the next biggest failure we had, and that came about because of a fraud.

Briefly, the bigger picture for credit unions is that they are consolidating. If you wind the clock back five years or so, there were 572 credit unions. As we sit here today, there are 448. At the same time, the value of the assets in the sector has gone up, from £2.1 billion to £3.3 billion, and the number of members has gone from 1.4 million to 1.8 million. The sector is doing okay, but it is consolidating. That is quite a natural phenomenon.

Q172 **Wes Streeting:** Do you carry out reviews of collapsed credit unions to establish what went wrong and what could have been done differently in individual cases?

Sam Woods: We do, but to varying degrees, depending on how much return there is in it. In the case of the one I just mentioned, we are doing a full investigation, together with our colleagues at the FCA, because we were very concerned about what had happened there. If it has happened in a more benign way, which, frankly, is often the case, there may not be a big return to investigating it.

It also may be worth saying the way we supervise credit unions is quite different for most of them than what we do for the rest. There are basically 16 at the top end that have a balance sheet above £40 million, which we categorise as category 4, out of five categories, 1 being big banks and insurance companies and 5 being very small credit unions and

insurers. We treat those 16 like small building societies: annual stocktake, scoring, all that kind of stuff. Once you get into the next layer down, that starts to taper off. For a large number of credit unions, our focus is on orderly failure: if they fail, can they pay everybody out within seven days?"

Q173 **Wes Streeting:** Beyond that, does the PRA provide credit unions with support to stop them getting into financial difficulty in the first place?

Sam Woods: To a limited extent, but it is limited just because of capacity. Our team on credit unions is 8.3 people. That is adequate for the job, but you can easily see across 450 credit unions they are spread reasonably thin. For those smaller ones, we have to rely on the data to lead us to those firms that are in difficulty through their reg returns. We have developed a program that is a profiler of credit unions, which can help the team identify ones that are in trouble. It will sometimes be the case, unlike with building societies and banks, that we learn quite suddenly that one is in trouble. Then we ask the questions: "Is the single customer view file good? Can we just pass it to the FSCS?" The great thing about credit unions is that, in almost all cases, their failure can be managed in a very smooth way and people can move to another provider.

Q174 **Wes Streeting:** Finally, the Kensington & Chelsea Credit Union was the most recent to collapse, in October. Have you looked at that case and can you say if the collapse was linked to the Grenfell fire?

Sam Woods: I personally have not. I will come back to you if there is a linkage to the Grenfell fire, to let you know. That was a more normal size of credit union failure. The one I focused on was the other one, because it was larger and the events that led to it seemed to be pretty egregious.

Wes Streeting: I would appreciate that.

Chair: If there is any update, if you could let us know, that would be appreciated.

Q175 **Catherine McKinnell:** I wanted to ask a few questions about the senior managers regime and how you think it is bedding in. I can be more specific. In the annual report, in the foreword, Mark Carney says, "Senior managers are increasingly focusing on building cultures of risk awareness, openness and ethical behaviour". If that is a statement you agree with, what are the pointers towards that? Where is the evidence?

Sam Woods: I agree with that in the simplest sense, in that the regime has now been in place for banks for the best part of three years. We rolled it out more fully to the insurers in December just past, although we had managed to cobble together something quite like it before that. The effect of it has been that the most senior people in all the banks and insurance companies now have clearly defined responsibilities, which we specify. We say, "Here is a prescribed responsibility that someone in the firm has to own". That is then distributed among the senior management functions, which we also specify. We say, "You have to have certain significant management functions".

I think that will have the effect of avoiding the problem Parliament was concerned about in the first place. We will know for sure, I guess, 10 years down the track. As you remember, this came out of the Parliamentary Commission on Banking Standards. When things turned bad, suddenly any bad decision was the responsibility of a diffuse committee and no individual was responsible. The idea of this is to avoid that happening. All the evidence so far suggests to me it is going to work.

Q176 Catherine McKinnell: Some considerable concern was expressed about the message sent by Jes Staley at Barclays receiving only a fine rather than a ban for his repeated attempts to unmask the identity of a whistleblower. Do you have concerns about the message that the FCA/PRA punishment decision has sent to the industry, given there are very longstanding concerns about practices and cultures within the industry?

Sam Woods: First, whistleblowing is incredibly important to us, both as a prudential regulator and to our colleagues at the FCA. It is a vital safeguard and we have quite a lot of whistleblowing coming in to us directly, as well as what goes on in firms. We have done a number of things since 2015 to make sure firms take this seriously.

Coming directly to the case of Mr Staley, he made a very significant and egregious error in what he did in that case. We launched the investigation with the FCA as a priority and conducted it pretty quickly by the standards of these things. I think the team got to the bottom of what happened there, and that is laid out in the decision notice. In effect, the judgment was that this was a breach of the conduct rule for due skill and care. The correct response to that was the one we gave, which was a fine and a public censure for Mr Staley. I think that has been a major setback for him. I do not think he is at all happy about the trail of events there.

That should send a message to everybody at the top of a bank or insurance company that whistleblowing is a live rail and you touch it at your risk. I think that is the message we have sent, but I appreciate from what you say that there is a mixed view on that.

Q177 Catherine McKinnell: You say he is not happy about the trail of events, but he instructed Barclays Group security to attempt to obtain CCTV footage of the purchase of the postage for the letter from the whistleblower, which is highly morally questionable, is it not? In seeking to obtain the footage, Barclays misled the US Postal Service into believing it was investigating a criminal matter, rather than a whistleblower. Has Mr Staley ever been asked what he would have done had he identified the whistleblower, which he failed to do, despite his efforts? Taking into account his persistence, do you think it is sufficiently accounted for? Do you think it gives sufficient reassurance that whistleblowing and the ability to whistleblow confidentially is being fully respected and that confidence is being given?

Sam Woods: Clearly not, in this case. We have sought to apply the correct censure in order to send the right message about what had gone wrong in this case. To go to what happened, the key mistake that Mr Staley made was not to recognise very early in this process that he had a

potential conflict in relation to the issue and he should not have been involving himself at all. Everything else then followed from that decision. The question for us was whether it was a choice between a breach of the integrity conduct rule and the due skill and care conduct rule, or whether it was both.

Really, that came down to a judgment we had to form. This is set out in the decision notice. Did Mr Staley deliberately, and knowing this was a whistleblowing case, pursue the series of actions you have just described, or had he allowed himself to become confused about whether it was a whistleblowing case, failed to recuse himself, as he should have done, and therefore pursued it in that way? When you look at the detail of the events, it is far more plausible that it is the latter explanation. I personally agree that that is the explanation. It would have been very difficult to reach the legal test for proving the former. That being the case, we took the sanction we did. Had we reached the different view, breach of integrity, the censure would have been more severe.

Q178 Catherine McKinnell: In December, Barclays Group was fined \$15 million by the New York state over this matter, which is significantly more than the fine that was levied by the PRA FCA decision, significantly. Do you think that fine is a fairer reflection on what took place, and a fairer reflection on how seriously whistleblowing is taken and how much confidence whistleblowers should have in the processes?

Sam Woods: The view we took was that the fault in this case was mainly with the individual, with Mr Staley. That is why the focus of our enforcement action was on him as an individual.

Q179 Catherine McKinnell: As the chief executive.

Sam Woods: As the chief executive, but as an individual he had individually breached our rules.

Q180 Catherine McKinnell: I find it interesting that you are talking about him as an individual, rather than as the chief executive.

Sam Woods: It is a fair question. Separately, if I can just complete the point, we imposed, for the first time, a set of whistleblowing specific reporting requirements on the firm. We thought that was a better way to go, to fine and censure the individual, then take the action on the firm to prevent this happening again. The NYDFS has a different set of responsibilities and imposed a fine on the firm. One can debate quite what the relative translation is between a \$15 million fine on a very large bank and a £1 million cost to an individual.

Q181 Catherine McKinnell: Have you assessed what kind of impact this whole episode may have had on the confidence of whistleblowers? Do you share concerns that it may well have had a negative impact on the confidence of whistleblowers to come forward?

Sam Woods: That was precisely one of our concerns about it, as well as the things that had actually gone wrong in the firm.

Q182 Catherine McKinnell: How is that being assessed?

Sam Woods: It is difficult to track those things precisely. There are a number of ways you can do it. One of them is of course that the rules we impose on firms require them to have their own procedures, but also to alert their employees to the fact that they can whistleblow to us in the PRA. We publish those numbers in our annual report. For the last year, 141 came to us, of which we think about 116 were relevant to our objectives. We can track those through time.

There are also things that the firms do, some of them with the Banking Standards Board, looking at surveys of staff of how well able they feel to speak up and things of that sort. That is another way that it can be tracked. We try to keep across this but, unlike capital and liquidity, it is not something you can pin down precisely.

Q183 **Catherine McKinnell:** Are you confident that the PRA itself treats whistleblowers correctly and inspires confidence in whistleblowers to come forward?

Sam Woods: I am absolutely confident about that, in two respects. One is how we deal with the whistleblowing that comes into us from the outside. Of course, where we have whistleblowing cases of our own, we always handle them very carefully. In my experience, these are not easy cases to handle, particularly the ones you have within your own organisation. I think our processes are good, and of course we have applied to ourselves the requirements under the senior managers regime. The chair of the audit committee of the Court of the Bank of England is our whistleblowing champion, or has those responsibilities under the senior managers regime.

Q184 **Alison McGovern:** On a different regulatory issue, if I could bring you to the ring-fence, we are 10 years on from the financial crisis now and ring-fencing has been completed. Do you think there are regulatory reforms left from the financial crisis, of which the ring-fence is the most famous but not the only one, and you have also been talking about the senior managers regime, that are yet to do?

Sam Woods: Big ticket, on the prudential side, the answer is no. We are basically done. The ring-fence was the last big piece to come in. Accountability was another piece. The drive-up of capital was the third and the fourth will be the introduction of new resolution arrangements, including bail-in debt. Some of those things have a bit further to run, particularly on the resolution side, but in terms of big changes we are, at this point, largely done.

Q185 **Alison McGovern:** Specifically in relation to the ring-fence and more broadly, do you think there is any risk that there will be a walk-back from the new regulatory environment?

Sam Woods: This is always a question for us: will the pendulum swing against strong financial regulation? To be honest, I worried about that a bit in the context of some of the debate we were having around Solvency II, where it was in play. In the UK so far, there has not been a huge pressure to come back the other way. That may partly be because many of the people leading the banks at this point were involved in the events

that led up to the crisis, experienced it, and therefore have quite a lot at stake, having rebuilt it.

In relation to the ring-fence narrowly, of course you in Parliament have equipped us with this. It is called the electrification power. If we start to become concerned that there is wicked burrowing going on underneath the fence, we can use that to push back the other way.

Q186 **Alison McGovern:** How will you know if you want to pull your electrification lever? What are the tests?

Sam Woods: To give you a sense of it, we had about 100 people in the PRA building the ring-fence from our perspective. One of our management challenges at the moment is winding that group down. We are going to have what I tend to colloquially call the border patrol, of about 30, to patrol the fence going forward. I do not want to sound too much like—I shall not continue that thought.

Chair: Yes, we are not talking about borders. Do not go there.

Sam Woods: I will not go there. What will they be doing? They will be looking at whether the ring-fenced banks meet the tests that are laid out for them. Do they have the ability to form a view on things independent of the group? Are they capitalised and do they have liquidity consistent with the risks they run, but within the ring-fenced bank? Do they have any improper dependence on other parts of the groups that are carrying out prohibited activities? Are the exposures of the ring-fenced group to other parts of the group within third-party limits and done on an arm's length basis? We will be testing all those things and others. We will provide an annual report to Parliament, the first one this year, on how we are feeling about this.

Q187 **Alison McGovern:** Compare and contrast the ring-fence in the UK to the US and the EU more broadly.

Sam Woods: The EU is not doing much. It looked at whether to do this. It had a report, the Liikanen report, which recommended it do a very similar thing, but there was not the same momentum for it in the wider EU. As an aside, I think the reason is that it is a huge business to unscramble this omelette and separate out these bits of banks. It has been a £4.4 billion programme here in the UK. It makes sense to do it if you are a medium-sized country with an enormous trading centre, where you do not want to have your domestic system completely comingled with it. That is why we are on a different basis from the EU.

The US has two things. It previously had something a little like our ring-fence, which has somewhat faded now but is still present in the regulation in a softer form. More recently, it added a thing called the Volcker rule. That drew the line in a different place, basically somewhere in the middle of trading, between prop trading and trading for clients. We thought that would not be such a useful place to draw the line and that it would be very hard indeed to draw that line. So far, history is on our side in the choice of where we have put it.

Q188 **Alison McGovern:** I would agree with you that there was a risk, certainly in the political debate over the past year, that there might be some resiling from the ring-fence, specifically around competitiveness. Will the PRA monitor the impact of the ring-fence on what some people call competitiveness?

Sam Woods: Yes, we will. There is, of course, a cost to the ring-fence. The ongoing cost is relatively small in the context of the overall size of the banks. You could think of estimates of maybe £300 million to £600 million, but that is obviously not a small number. As far as the ring-fenced banks' competitiveness among themselves goes, as a result of ring-fencing, competition in the mortgage market has intensified pretty significantly. Our view is that strong competition is, in the end, good for competitiveness, because you have firms that are fit in their own market and will be better able to compete elsewhere.

As far as UK banks' competitiveness more broadly goes, as we just discussed, there are slightly different arrangements in different jurisdictions and different firms will have to accommodate them. I do not think any of the banks would argue that the level we have here in the UK, overall, is higher than what they have had in recent years in the US.

Q189 **Alison McGovern:** Could you talk through the channel and how it has fed through to the mortgage market?

Sam Woods: One of the main effects of ring-fencing is to trap retail deposits in a narrower set of assets, so they can be used for less. Specifically, you can no longer use retail deposits to fund trading as a principal. That is what the whole thing is about. Some of that was going on before, and the point of the reform was to change that. Therefore, those deposits have to be channelled into something, and one of the places they are going is into mortgages. How much of the price war in mortgages is driven by this phenomenon I do not know, but I think every single banker out there in the retail market thinks it is a significant factor. I think there is some truth to that.

Q190 **Alison McGovern:** Might you try to find out?

Sam Woods: I am not sure it is analytically possible to specify how much of it, because you have so many other things going on, but it is a material factor. That is a good thing, within balance.

Q191 **Alison McGovern:** I have one final question. Last November, James Proudman, who is an executive director of the Bank, stated that ring-fencing could lead to a reduced supply of sterling surpluses, increasing the price of sterling funding for banks that have relatively few retail deposits. Would you agree or disagree?

Sam Woods: Yes, that is a reasonable point to make, but, unlike the effect on the mortgage market, that is not something we can see in the data at the moment. I think it will be a few years before we have a really good sense of how this quite radical restructuring of the banking system is going to play out in all respects, but that will be one to watch.

Q192 **Alison McGovern:** You mentioned your annual report to Parliament. I know I speak on behalf of all parliamentarians when I say we are very much looking forward to it. At some point, will there be some sort of programme of analysis, not just of the change over one year but over a greater period?

Sam Woods: Yes, there certainly will be. One thing that we have to do but also wish to do is, before the end of 2021, start a full review of how it has gone. The annual reports will be informative but will be quite a lot about whether it has come in; to the extent there is any non-compliance, where it is; whether we are worried about that; what waivers we have granted, those sorts of things. That 2021 review is probably the time to have a wider look.

Q193 **Alison McGovern:** It would be helpful to have an economic review as well as a compliance review; that would be my suggestion.

Sam Woods: Okay. Why do we not wrap that into the work that we have going forward?

Q194 **Chair:** Sandy, I noticed you nodding there. As an external member of the committee, I presume this is something the committee has been following very closely.

Sandra Boss: Yes, we have been very involved. We had a choice along the way with ring-fencing as to how much the Prudential Regulation Committee wanted to take active decisions in taking the big banks through the process, versus deferring it to the executive and keeping track. We decided that this was one of the biggest changes that had happened in the UK in multiple decades, in terms of the structure of banking, and that it was our duty therefore to be actively engaged. That meant going through all the policy, which we would have done anyway, because that group always makes policy, but also, at the individual firm level, going through what the planned structures were, what the issues were, what was happening up to the point of getting the approvals in the courts for the part VII transfers.

We also got a regular update on all the MI around red, yellow, green status on the programme. It was quite important to us because, as Sam mentioned earlier, this was a massive programme of change. There was £4.4 billion of spend by the banks. Relatively little of that was our spend. It was by the banks. They managed to get through that in a very orderly fashion, not at the last minute, but almost all the banks set and held themselves to a six-month window of technical completion before they were required to be compliant. As a committee and as external members, we were impressed by the process they went through to get there. We look forward to the reviews. I suspect that will be one of our subjects in the next couple of years.

Q195 **Rushanara Ali:** Good afternoon. I have a question, first on all, in relation to the senior managers regime, and then I will come on to competition in banking. You will be aware of the Credit Suisse scandal and the US prosecutors recently going after a \$2 billion case following the tuna bonds and hidden loans scandal in Mozambique. That happened

some time ago. Do you think the new regime will mitigate against these sorts of activities?

Sam Woods: The allegations that have been made in relation to that case are pretty severe and in the financial crime sphere, and, as you were discussing with Andrew Bailey the other day, include allegations under the Bribery Act. The reason I want to give you a cautious response is that, if you have an individual who is prepared to engage in criminal activity, and I am not making any prejudgment on where that case will go—and there are some other prominent cases that seem to have a similar flavour—I question to what extent a regulatory regime, the senior managers regime, will put them off.

It is likely that the senior managers regime will play an important and very useful role in enforcing normal behaviour but, if someone is going to be an outright criminal, in a way they have jumped that trace and jumped the law. That may be too cautious a reading. The senior managers regime should help in terms of risk and controls, and preventing these things happening, but in relation to the individuals I would have that as a question mark.

Q196 **Rushanara Ali:** Isn't the whole point of the senior managers' remit to prevent such activity within their institutions? Is there a risk that, in cases like this, given what you are saying, senior managers in these institutions will still have a way to pass the buck and say, "Criminal action has taken place and we cannot really control for that"? Perhaps I am misunderstanding what you are saying.

Sam Woods: We will be better equipped, as I was saying to Ms McKinnell a moment ago, to hold people to account for the controls within the organisation. These are the sorts of things we look at in these cases. The only caveat I am offering, and I have probably made too much of the caveat, is in relation to outright criminality. Obviously, that is not something we want to see in the financial system, and it is one of the FCA's objectives to avoid it, but I do not want to claim that a regulation of itself would be a bigger disincentive than law.

Q197 **Rushanara Ali:** Is there basically a problem in the UK of a failure to join up? On the one hand, we have the Bribery Act. We have the FCA. As Andrew Bailey mentioned, there are issues about pursuing criminal activity and how that is done. Then there is this regime. In the totality of these instruments that we have, you are not inspiring confidence that we would be able to stop these sorts of things happening in the future. As a consequence, if there are many more examples like this, that is surely not going to inspire confidence in the system.

The consequences are also dire, where it is emerging economies and developing countries, in terms of being unable to access IMF finance and the rest of it, and being heavily indebted because of corruption. The consequences are just as serious, and they add up to further problems, if there is not joining-up and an assurance that this new regime will prevent these sorts of things happening. If it is not enough, what should be done to make sure these sorts of issues do not come up in the future? It is billions of dollars.

Sam Woods: Believe you me, I completely share your concern about what has happened in some of these cases. It is just a question of which part of the authorities is responsible for which bit of it. Essentially, for us, with a remit of safety and soundness, and with the senior managers regime, once something gets into the criminal zone there may sometimes be a role for the FCA, but usually it is over to the police, the Serious Fraud Office or the National Crime Agency. Between those bodies, this stuff is very well on the screen. That has an international aspect too, with the DoJ involved.

Q198 **Rushanara Ali:** It just exposes the fact that we are still not there yet, in terms of joined-up working. I know that is quite often a challenge with many institutions, but I wanted to leave that for you to consider how we can deal with the remaining gaps. I have raised this with three individual institutions that have come before this Committee already. This is the third time I have raised it, and it feels very siloed, in terms of how such problems are addressed together, as they emerge in the future and might grow.

On to competition, the six largest lenders in the UK control 85% of the UK's current accounts. Do you think there is a glass ceiling in the UK beyond which lenders struggle to grow?

Sam Woods: That is the market to worry about most, the personal current account market. The latest number I have is 87%, but it is obviously close to yours. If you look at the other product lines, they are significantly concentrated but a big step down, so more like 70% for mortgages, for instance, or another 10 points down for something like unsecured loans.

How has that changed through time? It has been relatively flat through time, which illustrates your point about the glass ceiling. It has not been completely flat. That number on the metric I am using was up at 92% immediately after the crisis, so the share in this of non-big six has gone up from 8% to 13%. It is a relatively small change from the point of view of the big six. It is actually quite big change from the point of view of the challengers.

I gave a speech about the issue we have last week. I imagine the Committee members had other things on their minds.

Rushanara Ali: Sorry. I have read extracts.

Sam Woods: That is probably a wise approach to my speeches. We have done a tonne of stuff on barriers to entry, and I will not bore you with it all, or I can if you wish. We have really exerted ourselves very strenuously in that field. The more difficult question for us is the proportionality one, which I think goes directly to your point of a glass ceiling.

Sorry to go on, but just to explain the point briefly, where we are taking steps in order to encourage new entry and encourage small firms, that means giving a lower requirement on various things for small companies. As they become successful and become larger companies, evidently at some point they need to move to the big firm standard. That means, as

they grow, the slope of regulatory requirements is steeper than if they were already at that high level. There is not an easy way around that, but that is a topic that we, the firms, and perhaps the Committee, should be increasingly focused on in this next period. In a way, it is more difficult than the thing we have done in the first five years about new entry.

Q199 **Rushanara Ali:** Would anyone else like to add anything to that?

Sandra Boss: I like Sam's idea of the review. We have been taking a nice list of piecemeal stuff, so the new bank entry but then all the changes around the RWA requirements for small banks. Each time we implement a new policy, the Bank thinks about, in the resolution directorate, how deep the MREL requirements should go. We think about proportionality and, similarly, we think about OCIR, which is the resilience in the context of operational continuity in resolution. When we do that, we say, "Everyone needs to be prepared but the requirements and the reporting requirements that will come in with resolution are different for larger banks".

In each case we have thought about it, but it would probably merit us stepping back, looking in the round and asking, as we get to each step function, "Where are those plateaus? Where are the hills? What is the slope? Are there places that could be smoothed or adjusted?"

Q200 **Rushanara Ali:** Are there particular UK-specific characteristics that make it harder? How successful is the new bank start-up unit?

Sam Woods: A dominant and big factor here has been the stickiness of current accounts, so people's unwillingness to move their current accounts. Regulation may also play a role, but it is a secondary factor. On the new banks side, we have been very successful. We have authorised 39 new banks in five years. To break down that number for you, 17 of those you could think of as new UK banks of the sort that we probably have in mind. That is a lot. The question is whether any of them can break through.

It is notable to me that, at the moment, we have one or two purely digital new entrants. They are making bigger inroads faster into the current account market than we have typically seen before. One of the questions for us is whether that is a sign of a change in behaviour.

Q201 **Rushanara Ali:** I have one final question. What would you consider to be a success in, say, 10 years' time? Where would you like to see the figure go to if it is 87% at the moment? What would be a good balance between new entrants and this expectation that there should be fewer large lenders that hold the country to ransom, as happened 10 years ago? What can we expect to see that will redress that imbalance?

Sam Woods: Obviously, a lot of what we have been doing is trying to avoid the hold-to-ransom problem, so the ring-fencing is one example to give us more options next time around. I do not have a target number. Does 87% seem very high? It does. The CMA has been very concerned about it. Do the levels we see in other markets, 70%, 60%, seem like more reasonable numbers that you might expect to have in a market like ours? Yes, I think so.

Rushanara Ali: It is 60% or 70%.

Sam Woods: If you look at where the CMA's greatest concerns have been, they have been about the market you are asking about and the SME market, which is heavily concentrated in a similar way, although concentration is only one measure of this. It has been less concerned, say, about unsecured loans, which is at 60%, and indeed, rightly, about mortgages, where competition is pretty fierce, where the stock is at 70% but the percentage of the flow of net lending of non-big six firms is about 37%. To me, those markets look livelier. There is more change. They are more dynamic. If personal current account concentration was down at those levels, a lot of the concerns about this would probably fall away. Whether that will happen is a completely open question.

Sandra Boss: The only thing to add is that open banking has just come in. That may see some change. It has not taken off fast. The banks have now implemented what they are required to implement, and we have a lot of new business models that are starting to take off. It is a change. Obviously, there were other things that were done after the CMA review, but that is the biggest change we will see. I have some positive hope that that could start to shake things up. The FCA has also been quite active in the overdraft market. That is another place where you can see really meaningful movement. Like Sam, I cannot predict the market share in PCA, but we need small banks to take share.

Q202 **Rushanara Ali:** Not so much a prediction, but it was more a question of what would be desirable.

Sandra Boss: Do you have a different number?

David Rule: You want a competitive market where people can move around and do move around. I am not sure saying what the number is is the right answer to that.

Q203 **Rushanara Ali:** What would be the right question?

David Rule: It seems to me that the model of cross subsidy that we have with free-in-credit current accounts is not helpful to that competitive market, but shifting away from that is very difficult.

Chair: We touched on that last week with the FCA.

Colin Clark: You will be glad to hear that I have the last set of questions.

Chair: You do not, actually.

Colin Clark: Sorry to disappoint you.

Sam Woods: I enjoyed it for a brief moment.

Chair: We have to bring Mr Rule in, at some point, properly.

Q204 **Colin Clark:** In the PRA's annual report, you stated that not one of the large banks needed to improve their capital position as a result of the 2017 stress test, a feat that was repeated in the 2018 stress test. Has there been a similar improvement among smaller banks in their internal capital assessments?

Sam Woods: The overall capitalisation of the banking system, both across big and small—obviously not in every single case—has been very significant. This goes back to the question Ms McGovern was asking a moment ago. We have been building up capital over the last 10 years. We are now approaching more of a steady state, and that is what you are seeing in the stress test results. It is the intention that the stress test is dynamic. For instance, if there was enormous increase in house prices, one might expect us to apply a more severe downturn in our stress test for house prices. Leaving aside that cyclical point, we have been going up, and now we are more in a state that we want to hold where it is.

Q205 **Colin Clark:** Royal Bank of Scotland is no longer considered as a global, systemically important bank by the Financial Stability Board. Will that lead to a cut in its capital requirements? Should we be concerned if it takes the opportunity to reduce its capital buffer, in that it is now a smaller bank?

Sam Woods: It does directly lead to a reduction in RBS's capital requirement. That is how the framework is meant to work: extra capital requirements if you are particularly big, because if you blow up there is more collateral damage for everyone else. I think that is logical. In their case, they slipped just below the threshold for coming out of it in the previous year. In discussion at the Prudential Regulation Committee that Sandy was a part of, we thought that it would be better to wait until they were clearly and sustainably below. We took the view that this year the metrics suggested that they were. I do not think you should be concerned about that; that is about that bank coming back into a more normal shape. As a corollary to this question, when it was the biggest bank in the world and it blew up, that was a big problem for us all.

Q206 **Colin Clark:** Focusing on the same bank for a second, should we be relaxed about the fact that, according to the *Financial Times*, the likes of RBS and Barclays have lower leverage ratios now than they did in 2006? RBS's has fallen from 7.2 to 3.6, and Barclays's from 4.8 to 2.5. If their assets are measured using market valuations rather than book valuations, should that be—

Sam Woods: You make the crucial point in your last comment. Should we look at the capitalisation of banks based on our regulatory metrics and what we think the assets and liabilities are worth, or should we base it off where they are trading in the market? I take a close interest in the price-to-book ratio of UK banks; I look at it every morning, because it tells me about sentiment. We have done quite a deep analysis of whether the current low price-to-book ratios—about 0.7 for the banks as a whole—is telling us something about asset quality or about the low returns that banks are making. If you plot it on a chart, it is very clear that it is low returns and low expected returns that are driving that position. It would be very dangerous for us to use those market indicators for assessing the actual capital position, because they can be very pro-cyclical. I would argue that they were massively overvalued before the crunch, and that is what explains the difference you describe.

Q207 **Colin Clark:** How does the PRA mitigate the risk that risk-weighted asset books could be engineered to make capital ratios easier to reach? We

read in the evidence that Professor Anat Admati said that it encouraged innovations. Cynics would suggest that people are—I am not going to say “cooking the books”, but I think I just did.

Sam Woods: There is, of course, an enormous risk of that in our line of work. That can be true both in insurance and in banking. We mitigate it in two ways. First, we have our teams crawling all over those models to make sure that they are telling us the right thing. Indeed, we have had a recent discussion in the Prudential Regulation Committee about the way that mortgage risk weights are developing and whether the slight downward drift in recent years is justified. That is one way.

The other way, which is equally and, in my personal view, possibility more important, is the leverage metric that we use, which just ignores all that. On that metric, to go back to your previous question, before the crisis banks were 40 to 50 times levered. Now they are running at about 20 times levered; they have a 5.5% leverage ratio. That is healthier. That is a vital control. The system that we had before the crisis, where we only had the risk weights and a lot of modelling, is a profoundly dangerous system for exactly the reason that Professor Admati touches on.

Q208 **Colin Clark:** To bring it right back up to date—we cannot have a series of questions without mentioning Brexit—to what extent has Brexit affected the risk-weighted valuations of UK banks’ assets and, consequently, their capital requirements? How might they be affected by an orderly or disorderly Brexit? There you go; there is an enormous question.

Sam Woods: That is an enormous question. I also assume we will do some of that next week.

Chair: Yes.

Sam Woods: So far it has not affected the risk-weighting requirements in any very significant way. The reason is that the nature of the exposures has not yet changed. Where it has had an impact for them is where they are restructuring, in some cases, across the border and therefore need to hold capital in more than one place, more than they did before. In that separation of capital pots, there are some inefficiencies for the banks, and that has led to a small increase for them, but it is entirely manageable. The issue that I am sure we will come on to next week is this: what happens if there is a disorderly, cliff-edge exit with no agreement, and it is all just sheared off? One of the ways in which that would create a problem for us—it is highly relevant to the transitional power—is that the way risk weights are treated within Europe is different from how they are treated with third countries. Banks will have to—and this is correct, but it is a question of the speed at which they do this—move EU 27 exposures and risk weights on to a different basis once we exit the EU. That is fine if it is done relatively slowly; it is not fine if it is done in the course of a day.

Q209 **Colin Clark:** We heard from Mark Carney that the financial system is robust in a stress test of a 10% drop in GDP, which is pretty dramatic. Would you agree with him?

Sam Woods: Our test is appropriately severe. It is meant to be severe but plausible, so a nasty meltdown.

Q210 **Colin Clark:** It is a stress test, not a—

Sam Woods: It is a stress test, exactly, not a prediction. I think Dr Carney was also talking about the Brexit scenarios that we have run. We discussed that in December. We discovered that, looking at the various ways it could play out, through the relatively narrow lens of bank capital, we could not find a disruptive hit that was worse than the thing we do in our stress test. That is not very surprising because our normal stress test is a UK meltdown, a global meltdown—including a hard landing in China—and a massive conduct hit, all rammed together. It is not very surprising that, even if you look at quite a severe UK meltdown, it does not exceed what we call the “triple whammy”.

Q211 **Chair:** You mentioned the CMA earlier on, and in one of our last sessions we talked about audit of large banks and complex financial services firms. You will know that the CMA is currently conducting a consultation on improving competition in the audit sector. Have you inputted into that? Have you met the CMA to discuss that?

Sam Woods: Yes, we have been engaged on that. We are taking a close interest. I have discussed it informally with the chair of the CMA, who is well known to this Committee. It goes much broader than financial services and our patch, but we have a specific interest, which is around the topic we debated when I was here in the summer of last year, in the degree of concentration that now exists in the supply of audit to large firms. That is a genuine problem. We are pretty interested in that review and some of the ideas in there sound, to me, quite promising.

Q212 **Chair:** Sandy, has the PRC discussed this issue about competition in the audit sector for firms that you regulate?

Sandra Boss: This has not yet been a PRC issue, but we have had updates on it. It is important to make a distinction. For the PRC, we would be interested in the quality of audit, but we do not take an active interest in the competitive structure of the market. We are prepared to take the findings of the reviews, to work with HMT or you, to understand our role in the process going forward, but I do not think the PRC will likely take a decision. We will be more in receiving mode, working with the recommendations and, ultimately, with whatever changes there are.

Q213 **Chair:** But if proposals came up, as a guess, for mandatory joint audits—because, outside the Big Four, they might not be big enough to take on complex firms—and you felt that would impact the quality of audit of the firms you regulate, that is the kind of thing that the PRC would then take an interest in.

Sandra Boss: That is right.

Q214 **Chair:** Are you concerned that the PRA is reliant on auditors ensuring that banks adhere to prudential regulation?

Sam Woods: It is different across the banking and the insurance sides. On the banking side, we take the audited numbers, but we then make a

whole series of adjustments to them to put them on to a more prudent basis for the purposes of our regulation. For instance, there are various things that are allowed to count for capital in the accounts but that we deduct because we are not sure they are going to be loss absorbing if the bank gets into distress. That is how we approach it in banking. On the insurance side, interestingly, it does not plug in at all: we have a separate set of regulatory accounts, and it happens in a parallel stream.

Notwithstanding that, across the piece—as Sandy mentioned—we have a strong interest in audit quality, and this issue that the firms have had about the lack of diversity of supply when they come to rotate their auditor is a genuine problem. I am very interested to see what the responses are to the CMA about the joint audit proposal, which seems to me, personally, to be one quite plausible way to improve the supply. It seems to work in France, and at a first blush—one would want to take a view after one had seen the responses—I do not see why that could not be a useful addition here.

Q215 Chair: You also said in a letter to me that the PRA sees “no reason why mid-tier audit firms cannot be considered suitable candidates to carry out audits of PRA-regulated firms”, but they have to demonstrate skills, experience and competence. Without wishing to go into named firms, is there a concern that mid-tier audit firms, at the moment, are not able to demonstrate—or that there are concerns about—their skills, experience and competence?

Sam Woods: It depends on the part of the market. The mid-tier firms are perfectly active with many of the smaller firms we supervise. Where it starts to become more difficult is for the very largest firms, and that is simply because the smaller firms do not always have the degree of expertise in quite specific things—say, derivatives valuation—that is required to do an audit of some of those firms. That is not a place you can leave the debate. We have an interest in it moving on, and that is why, to my mind, this joint audit thing is interesting. It seems to me to provide a way in which firms can build skills through time. Interestingly, though, there seems to be a mixed view among those second-tier firms as to whether it is a good idea.

Q216 Chair: Mr Rule, I want to bring you in on equity-release mortgages. But, on that last point, about audit of insurance companies, is there anything you wanted to add, from an insurance perspective, about the size of auditors and the competition in the market?

David Rule: It is a similar analysis for insurers as for banks. The only other thing to say is that we have some groups that are global in their span, Prudential or HSBC, and there are some particular challenges about wanting a common view across their operations. If you had a different auditor for every single entity in that group, that would not give you the overall view of the group-wide controls that can be very useful for us.

Q217 Chair: Moving on to equity-release mortgages, the PRA made an announcement in December on this issue, and the shares of one of the insurance companies, Just Group, rose by more than 20% in response to that announcement. Have you analysed why the market response was

favourable to Just Group? The announcement was described as “industry friendly”. Is that a fair description?

David Rule: I am not going to get too much into one firm, but the reason their share price was particularly responsive reflects the fact that they have the biggest concentration of their business in equity-release mortgages. To take a step back, our key objective with our changes was that insurers are adequately reserved and hold appropriate capital against the risks. If they understate the risks, they would hold too little reserves. The key risk here, in our view, is the “no negative equity” guarantee, which is very beneficial for a borrower, in that it says the borrower will never repay more than the value of their home, but it exposes the insurer to property/house risk, over potentially a very long period. We have set out a common framework that sets a minimum standard for how insurers assess that risk and what reserves they then have to hold against it.

The key issue for us is that insurers should not be able to assume the risk away, effectively, by modelling it and assuming house price inflation in excess of the risk-free rate, because that is a risk to which they are exposed. If house price inflation is lower than their assumption, they will be exposed. The matching adjustment, in effect, delivers day-one profits, so it goes into capital and can be dividended away. It should never reflect risk to which firms remain exposed.

If I go back to why there was that stock price reaction, it was largely to do with a slightly arcane issue around the transitionals in Solvency II. The equity-release mortgage market is about £20 billion. Around £13 billion of that was written before Solvency II was introduced, a significant chunk, although the market has grown very rapidly over the last three years. Part of our interest in this market is that it has grown so rapidly and more firms have come into it. But there was a sizable chunk that pre-dated Solvency II and was therefore being reserved on our previous regime, under Solvency I.

Part of Solvency II is that, if you have lower reserves under the predecessor regime than Solvency II requires, you can transition that increase in over 16 years, and it runs off at one 16th every year. We had taken the view that we wanted to apply the same approach under Solvency II that we applied under Solvency I, when we consulted, because we took the view that the Solvency I regime was still a living regime, and we could update it if we saw the risks as changing. Therefore, it would not be eligible for that transitional.

Following the consultation, we were persuaded that a better legal interpretation of the Solvency II transitional is that it relates to the actual way that Solvency I was being applied by the firms just before Solvency II was introduced. If we were to change the interpretation under Solvency II, it would be eligible for the transitional. For firms, including Just, including Aviva, that had quite large back books, the impact on them was much less, because that transitional is now being recognised by us.

Q218 **Chair:** You mentioned house prices. Just Group had assumed a house price growth of 4.25% a year. Again, you might not want to comment on their particular assumption, but there are others. We were just talking earlier on about house price growth having slowed, particularly in London. Is that something that the PRA keeps an eye on, the house price growth assumptions that companies like this are making?

David Rule: Yes, that is the key thing that we are targeting here. Effectively, if your risk is the level of house prices in 20 years' time, if you assume 4.25% a year increases, you are assuming house price growth in excess of the rate that the borrower accrues interest, so the risk does not exist in your model. If you do as we require, which is to assess, now, that house prices do not grow any faster than risk-free rates, you recognise that you are at risk. That does not mean that you are assuming that that is what will happen, but it recognises that house price growth is a risk to which you are exposed and therefore that you should not be taking the future profits of that business straight into your day-one capital; you should be reserving against that risk. Fair enough, if house prices do increase, you will not be exposed on the "no negative equity" guarantee, and you will be able to make profits in the future. But you should not assume those on day one. That is the key part of our reform.

Q219 **Chair:** You gave a couple of speeches on this, one in July 2017 and one in April of last year. In the first speech you signalled that equity release mortgages, commercial property and infrastructure financing can be a good match for long-term annuity liabilities. You mentioned a couple of companies that think this is good business and, given where we are in terms of the demographics and an ageing population, this sector is going to grow. Would you agree with that? Does that mean the PRA is going to be putting more resources into this, as you can see, potentially, the appetite among homeowners growing in this market?

David Rule: Yes, we think it will grow. To put it in context, though: although it has grown quite rapidly, it is still relatively small in the context of insurers' overall books. It is about £20 billion out of about £500 billion of business that they write where they are at risk, excluding unit linked. It is only about 1.4% of the overall mortgage market, so it is still small in the general scheme of things. Part of the reason we wanted to tackle this now—and it has been very controversial in the industry—is that we wanted it to grow on a properly reserved basis going forwards.

We also wanted a level playing field, because we saw firms making different assumptions and, from a competition objective perspective, we thought that was distorting the market. Part of this was about having a level playing field across the firms in the market. We do see it growing, and we do think it is appropriate to back annuities, because it is a long-term asset suitable to back a long-term annuity book, as part of a diversified portfolio with other assets: infrastructure, corporate bonds, government bonds. We think that is right. These things have to be restructured to meet the Solvency II requirements for the matching adjustment. That is a complexity that we somewhat regret, but that is part of Solvency II. They have to be restructured to create fixed cash flows through internal securitisation.

Q220 **Chair:** Where are you with that? You put the document out, and you made the announcement. Is that it? Would you expect to be making further announcements, looking at the matching adjustment that you have talked about? Is this an area that you might expect to return to, or do you think that things are set up for the time being, given how the sector is developing?

David Rule: On equity release, the new approach phases in, so it will be fully implemented at the end of 2021. We also have some further pieces that we need to give clarity on to the industry, particularly around how often they should update these valuations. Some of the parameters that we set we think should vary if there are significant moves in interest rates. We will set out how that will work. We also need to set out how firms should model the risks on these things for their capital. So far we have focused on reserving, not capital.

More generally on matching adjustment, this is a key part of our supervisory work for annuity writers. Insurers are taking a lot of the defined benefit pension risk out of corporate pension schemes into the insurance sector, so they are growing largely for that reason. There are still some individual annuity businesses, but the large growth is coming out of the corporate sector, with pension scheme liabilities moving to insurers. We need to focus on the assets backing those risks, because the annuity business is a high-impact business, and on the operation of the Solvency II regime matching adjustment under which that business is reserved.

Chair: Thank you very much indeed. My apologies for the Division having interrupted and kept you waiting. We are very grateful to you for your evidence. As Alison said earlier, we look forward to your latest annual report landing on our parliamentary desks in due course and, Mr Woods, we look forward to seeing you next week. Thank you for now.