

John Taylor, TSC Questionnaire – 5 January 2021

Personal

- 1. Do you have any business or financial connections, or other commitments, that might give rise to a conflict of interest in carrying out your duties as an external member of the PRC?**

A material conflict with other commitments seems unlikely. Each of my other commitments, Immediate Past President of the Institute & Faculty of Actuaries (IFoA) and Chair of Scottish Financial Risk Academy Group (SFRA), is more likely to support my PRC role rather than conflict with it.

In the unlikely event that a conflict arose, I would recuse myself from the relevant PRC business. I would always check with the Bank's Secretary if I had any concerns I could be conflicted.

- 2. Do you intend to serve out the full term for which you have been appointed?**

Yes.

- 3. Do you have, or do you intend to take on, any other work commitments in addition to your membership of the PRC? If so, how will you fit them alongside your commitments at the PRC?**

I'm currently Immediate Past President of the IFoA and Chair of SFRA. The time required for both roles is relatively light and I don't expect any significant challenges in accommodating my PRC obligations alongside these existing ones.

My intention is to immerse myself in PRC activities in the coming months and not to seek out other roles. Once I am established within PRC, I may consider taking on other roles during my PRC term(s) but only if they don't compromise my PRC responsibilities.

- 4. Please explain how your experience to date has equipped you to fulfil your responsibilities as a member of the PRC. To which areas of the PRC's work do you expect to make particular contributions?**

I'm familiar with the UK regulatory regime and insurance market, having spent much of my career working at PRA-regulated insurers, including as an Approved Person (regime prior to SMCR).

My experience of leading the IFoA contains number of relevant themes:

- The IFoA is itself a regulator, upholding a professionalism regime that has some parallels with SMCR: actuaries must act competently and with integrity; actuaries have a duty to "speak up"; actuaries must adhere to all relevant legal, statutory and professionalism requirements.
- Much of the substance of the profession's work overlaps with that of the PRA – eg risk management, selection of actuarial assumptions and use of models.
- I've approved the profession's response to a number of regulatory consultations, such as the PRA's consultation on stress scenarios for climate risk.
- The role has involved engagement with policymakers, such as the Minister for Pensions.

Technology has featured throughout my career, enabling me to innovate in the insurance market, most recently through the delivery of automated financial advice to consumers. I've also championed the adoption of data science within the actuarial profession. The experience should be beneficial in understanding current and future market developments by regulated entities as well as appreciating the opportunities the Bank has for greater adoption of technology.

I've a broad understanding of the long-term savings market, having worked in retail and corporate markets and with pension providers. This should assist me during my time on the PRC through greater understanding of consumer impacts and of issues beyond the regulatory perimeter (e.g. pensions).

My career has given me exposure to different prudential regimes and organisational cultures. I've experienced the various iterations of UK prudential regulation for insurance as well as the reserving requirements for UK pensions. My international travel with the IFoA has shown me how other countries have responded to the rise of Solvency 2. I also worked within the insurance division of a large banking group as it went through the Global Financial Crisis, so have some insight into the cultural challenges of that time. This gives me with a broad perspective on different approaches to prudential regulation.

At SFRA, I lead a combined group of practitioners from insurance banking and asset management along with academics as we collaborate to enhance capability in a number of key risk areas: credit scoring; using data in risk management; climate risk; consumer technology; cyber risk. This will provide me with one mechanism for staying current with market attitudes during my term on the PRC.

I also have some first-hand experience of working for a regulator when I was on secondment to FSA in 2001, supporting the development of a new conduct regime.

Overall, I hope ultimately to make a contribution across the full breadth of the PRC's remit, and I expect to make a particular contribution in the following areas: oversight of the insurance sector; response to technological innovation within firms; retaining a focus on the implications for customers.

The Prudential Regulation Committee and Prudential Regulation Authority

5. What is your overall assessment of the track records of the PRA and the PRC to date? In your opinion, what are the areas of most success and in which is there still the most work to be done?

The fundamental success of the PRA has been in re-establishing resilience of individual firms and the sector following Global Financial Crisis.

The PRA's first major contribution to this outcome came through its substantial influence with supranational bodies, including the Basel Committee on Banking Supervision (BCBS) and European Insurance and Occupational Pensions Authority (EIOPA), as these bodies developed new regulatory regimes. Ensuring the new frameworks addressed the deficiencies of the previous regimes and recognised the peculiarities of the UK market was essential. The PRA has been relatively successful in achieving these outcomes as evidenced by, for example, EIOPA's adoption of Matching Adjustment provisions.

Thereafter, the PRA has been highly effective in supervising individual firms as they have rebuilt their capital bases and transitioned towards these new regulatory regimes. On

average, the Common Equity Tier 1 ratio for major UK banks was 15.8% in Q3 2020, more than double the minimum requirement.

The combination of the FPC's response to the pandemic (e.g. release of the counter-cyclical capital buffer), and the PRA's (encouraging firms not to be overly pessimistic on credit outlook, cancellation of dividends and bonuses) has enabled banks to use that resilience to support the real economy through the pandemic.

Beyond the financial aspects reform, the PRA has also played a significant role in the introduction of SMCR and a ring-fencing regime, ensuring that UK standards surpassed the global baseline. Both initiatives are necessary to build resilience within the sector.

In addition to nursing the established finance sector back to health, the PRA has also helped to stimulate competition from challenger banks. This has come in the form of specific units focussing on authorisation of new banks and insurers, and a proportionate approach to supervision. As the PRA recognises, there is more to do in ensuring challenger banks don't encounter regulatory hurdles as they grow.

A further aspect of the PRA's success is its standing within the UK market and abroad. As well as being regarded an exemplar in financial regulation, it is also seen as a thought-leader in climate risk. Nonetheless, such is the potential threat from climate change, that this is one area that Bank needs to develop further. (See Question 10.)

Another key area for the Bank to redouble its efforts is in relation to Cyber-risk. As we've been reminded very recently by allegations of foreign hacking into US government institutions, cyber-attacks are increasingly sophisticated and carry significant risk. Closer to home, UK banks have also proven vulnerable to cyber-attacks in recent years. It's imperative the PRA continues to set robust expectations in this area and ensures firms meet them.

Cyber-risk is a specific facet of a much broader source of risk and opportunity: technological change. Such is the pace of change, the PRA cannot afford to become complacent. This is driving rapid change within the financial services market as disruptive start-ups appear, some at or beyond the regulatory perimeter (eg peer to peer lenders). The Bank needs to continue its regular reviews of the regulatory perimeter to assess any implications for financial stability. Incumbents are also embracing technology such as Artificial Intelligence. It's vital the PRA remains vigilant to the potential impact on firms' soundness and the sector's stability.

Technology also brings an opportunity for the Bank itself. Operationally, there may be more scope to introduce technology to enable smarter, more efficient oversight.

Reflecting more broadly on the implications of the UK's departure from the EU, this presents a number of opportunities and challenges for PRA. The PRA has the opportunity to establish a regulatory regime that is more aligned to the characteristics of the UK market and is less prescriptive than the EU regime. (The Treasury consultation on Future Regulatory Framework elaborates on this.) I believe this will deliver a number of benefits to the UK without compromising on firms' soundness. (See Question 7.)

However, such a move will require cultural change within the PRA as well as the firms it regulates. Even with the current set of detailed regulations, PRA staff regularly exercise judgement and discretion. But the scope of discretion may increase significantly because of Financial Services Bill and the Future Regulatory Framework consultation. This will naturally pose a challenge for the PRA in ensuring such discretion is exercised expertly and

confidently; the PRC will need to ensure there's adequate consistency when discretion is being exercised.

Finally, as the pandemic has demonstrated, there may be unexpected but highly significant horizon risks to consider. (See Question 12.)

6. The PRC has a lower public profile and is less transparent than the Bank's two other policy-making committees (for example, it does not publish meeting records or minutes). How appropriate do you think this is, and do you think there is a need for the PRC and PRC members to promote greater transparency and public engagement?

FSMA requires regulators to "exercise their functions as transparently as possible". Much PRA work is public. But not minutes.

- a. Because the PRC does not publish such information, it will be difficult for this Committee to assess your contribution to the PRC. Do you intend to give speeches, or be visible in some other way?**

In line with the PRA's legislative duty to be transparent as possible, it communicates extensively in many ways through, for example, speeches and consultations. However, the PRC minutes are not published and I understand this has been an area of interest to the Treasury Select Committee.

As I assume my role at the PRC, my own inclination is towards greater transparency. Indeed, my own experience at the IFoA has been to publish minutes for key governance meetings. I certainly found this a healthy discipline. Such an approach is "on trend" with general developments in governance across many settings.

And the likely future direction of the PRA is relevant. The Financial Services Bill empowers the PRA to become more of a "rule-setter" than it was within the EU. Moreover, the Treasury's "Future Regulatory Framework" consultation envisages the PRA moving away from detailed, prescriptive rules in favour of a more principles-based approach. With greater discretion, accountability and transparency become even more important. Where the PRA sets new rules in the new framework, it should continue to use consultations, discussion papers and supervisory statements to ensure it is acting transparently and taking into account views from firms and other external stakeholders.

The important consideration that militates against openness is the confidential nature of much of the PRC's deliberations. Some discussions will be market sensitive and, where they relate to new authorisations or conduct of authorised individuals, may also contain personal information. Moreover, it's important that firms and individuals feel able to maintain an open dialogue with the PRA, one that's unconstrained by concern of subsequent publication.

As I become more accustomed to the PRC's business, I intend to reflect on whether the Committee could become more transparent without undermining its function.

In terms of the Treasury Select Committee assessing my contribution, I note that it's common practice in corporate boards for the chair to conduct an annual assessment of each board member's contribution. I understand there are analogous review mechanisms within the Bank: the Chair of the Court reviews the functioning of the PRC with each member individually, each year. In addition, the PRC holds occasional "away days" to review its own functioning. It would be worth exploring whether the conclusions from these meetings could be shared with the Treasury Select Committee.

I've enjoyed public speaking engagements throughout my career, particularly the many I've undertaken as President of the IFoA. I'd be delighted to support the profile of the PRA/PRC

through participation in public events provided this complemented the contribution currently being made by the PRA's public speakers.

7. The current remit letter from the Chancellor recommends that the PRC have regard to six aspects of the Government's economic policy: competition, growth, competitiveness, innovation, trade and 'better outcome for consumers.' As a PRC member, what will be your approach to balancing these against the PRC's statutory objectives?

I don't see my role as seeking a "balance" between these two priorities, at least not in the sense of compromising statutory objectives to support government policy. Rather, my obligation is to assist the PRA in meeting its statutory objectives, and I will seek to do this in a manner that supports the stated six aspects of government policy.

With an EU-specified rule book, the PRA's room for manoeuvre in supporting both priorities was very limited. The repatriation of the regulatory rule book gives the PRA more discretion as to how it fulfils its statutory objectives. Such discretion will not be unfettered due to, for example, equivalence considerations. Nonetheless, the PRA's discretion will be substantially greater than in the recent past. I will be advocating for those mechanisms that are better aligned to government policy whilst simultaneously maintaining prudential standards.

For example (and as the PRA already recognises), the Risk Margin component of the Solvency 2 insurance regime poses specific difficulties for insurers of longevity risk, with the result that significant volumes of UK longevity business are reinsured outside of the EU. The Treasury's review of Solvency 2 may identify alternative formulations for the Risk Margin that will allow the PRA to meet its statutory objectives without posing the same difficulties for insurers.

Having spent much of my career serving retail customers, I'm passionate about the final government objective: "better outcomes for consumers". And, fundamentally, being able to rely on the security of providers who accept savings and provide insurance is critical. It gives consumers confidence to save/insure in the first place and then peace of mind that their savings/insurance can be called upon when needed.

However, the PRA needs to ensure that new prudential regulation considers the needs of consumers, which could be frustrated by overly-burdensome rules. This can happen if prudential regulation creates a significant burden for those providers offering products that mitigate consumers' financial risks. The consequence can be withdrawal of such products or a dearth of product innovation. As a result, the market may not offer the risk-mitigating solutions wanted by consumers, with the result they bear more financial risk than they'd prefer.

Overall, the PRA cannot itself achieve those six aspects of government policy; it is the firms themselves who will compete, grow, innovate, trade and better serve consumers. This emphasises the imperative for the PRA to consult industry with a view to determining how to configure the regulatory regime. I will, therefore, be particularly mindful of credible industry feedback when exploring alternative ways of meeting the PRA's statutory objectives.

Regulatory and policy issues

8. What is your assessment of the risks to the safety and soundness of the firms and sectors regulated by the PRA arising from Coronavirus? How well has the PRA dealt with the situation to date, and what future challenges could emerge?

As mentioned in Question 5, much of the PRA's contribution came in advance of the pandemic itself, in ensuring the sector was well-capitalised prior to the pandemic. The PRA's rapid response at the beginning of the pandemic has helped supply liquidity to many corporates and individuals.

Operational resilience of the sector has also proved impressive. Whilst very few (if any) envisaged the current pandemic, more general risk preparations have meant firms have coped well from an operational perspective. Prior exercises in disaster recovery and technological resilience have enabled firms to embrace remote working.

The single most significant ongoing risk relates to credit risk for lending institutions. Should the economy (or sectors within it) perform below expectations, there is a risk of significant impairments to bank balance sheets and drying up of liquidity. A key challenge for the PRA is to ensure that individual firms remain prudent in their financial management without the whole sector becoming over-cautious.

From an insurance perspective, the most significant risk relates to claims exposure of general insurance firms. Significant exposure to, for example, Business Interruption claims beyond that which firms intended in their policy documentation could pose material solvency risks. (Any failure to communicate such intent clearly to customers further increases potential liability.) Similarly, Coronavirus means the potential liability for other vital insurance products, such as Directors & Owners Insurance, has increased sharply, with a corresponding impact on prices.

Ironically for a disease with a significant impact on mortality, the effect on life insurers is relatively modest. Coronavirus predominantly affects older lives, a group that typically has little need for life insurance when compared to younger lives. Older lives are, however, more likely to have annuity contracts and so any increase in mortality for these ages may actually benefit insurers. All insurers nevertheless have had to manage the extreme volatility in asset prices caused by the pandemic.

Information Security and Cyber risks are heightened given that firms are operating on a distributed basis on infrastructure not designed to be used at scale indefinitely. Moreover, many operators are working in unsecure environments.

From a longer-term perspective, I consider the key Coronavirus issue to be one of opportunity rather than risk: a revised regulatory environment could enable firms to support long-term economic recovery. For example, more permissive rules on investment might facilitate greater investment in infrastructure. (See Question 7.)

9. What is your assessment of the remaining and future operational challenges and risks to the safety and soundness of the firms and sectors regulated by the PRA arising from Brexit?

One of the biggest issues relates to the new financial services regulatory framework the UK wishes to adopt. Taking advantage of the freedoms available in leaving the EU may be constrained by the desire to have the UK regime recognised as equivalent.

A key consideration in this regard is the ongoing relationship between regulators in the UK and EU. A dialogue will need to be maintained to ensure each domestic regulator is aware of relevant developments where they are placing reliance on foreign regulators, be that in relation to the development of rules or the soundness of individual firms.

One would hope that further dialogue with the EU in these areas will result in the UK regime being accorded equivalence by the EU in the near future.

The equivalence agreements that have been reached on market infrastructure and Central Security Depositories have obviated some of the greatest potential disruption at the end of the transition period. However, the criticality of these instruments and the temporary nature of the equivalence agreements means this will need ongoing attention until a more enduring settlement is reached.

The UK will also need to reassess its approach to engagement with supranational bodies. Without formal representation in European fora, the UK will still need to engage with and influence these bodies. The more direct channels for the UK to remain at the forefront of global standard setting will increasingly be through international bodies such as the BCBS and G20.

Further down the track, if the UK's recognition of the equivalence of the EU regime does end at some point, there may be a considerable operational challenge for the PRA in having to directly authorise and supervise the many organisations that operate in the UK but whose primary regulatory relationship is currently in the EU.

10. What is your assessment of the risks to financial services arising from climate change and what the PRA is doing to ameliorate those risks? What role can and should the PRC and PRA play in promoting the transition to net zero carbon emissions?

a. Do you think a revision needs to be made to the PRC's objectives or Chancellor-set remit in order to allow it to promote the transition to net zero?

Climate risks are very material to financial services. Most obviously, physical risks are already manifesting for general insurers through increased claims from extreme weather events and greater exposure to flood risk.

Given the international consensus and the UK government's own commitment to mitigate further climate risk, there is likely to be a significant transition away from a high carbon economy. Such a transition itself creates risk for financial institutions, not least in relation to their investments.

It's necessary for all firms to actively manage their exposure to transition risk. Insurers in particular manage their investments over decades, during which transition risks are likely to manifest. Mitigations include divesting from some high carbon stocks and active engagement to encourage the transition of others. The PRA's postponed stress tests on climate scenarios, now likely to take place in 2021, will show how effective current mitigations plans are.

As well as these long-term stresses, it may also be beneficial to think about shorter-term transition "shocks". It's conceivable that consumer sentiment could turn sharply against high carbon users, and that governments could introduce carbon taxes. With these possibilities in mind, firms might want to consider their asset portfolios more immediately, not just in the longer-term.

As important as it is for financial institutions to be prepared for climate risk, the implications for capital allocation in the real economy may be even more powerful in affecting change. Persistent high carbon users may find that the financial institutions penalise their behaviour and reward that of “greener” organisations, thereby providing a powerful engine for change within the real economy.

I anticipate an explicit climate risk reference in the PRC remit would be helpful, not least in sending a signal to the market and in reinforcing the Bank’s dialogue with firms. Having said that, ensuring firms are resilient in the face of risk is the PRA’s *raison d’être*. Climate risk is one of the greatest risks to society and the financial sector is not immune to that. Accordingly, it’s integral to the PRA’s current remit to ensure firms have effective mitigation plans for climate risk.

11. What assessment have you made of the impact that the Senior Managers and Certification Regime has had on culture and accountability in the sectors regulated by the PRA?

I believe SMCR has made a significant contribution to increasing the culture of accountability. From discussions with peers, I know how seriously many take this. It has driven greater clarity of accountability, with explicit mapping of accountabilities across executive teams; processes for ensuring delegations are managed effectively. As further evidence, the PRA’s own requirement that firms have a senior manager accountable for operational risk has itself driven significant change. Moreover, the possibility of personal risk has focussed minds of many senior managers.

There is an important question of perception, however. Following the Global Financial Crisis, there have been very few instances of senior individuals being held to account for failure, and this can undermine credibility in the regime.

However, the regime has also to be seen as fair and proportionate by those who work in it. One objective of the regime is to ensure that influential positions are held by conscientious, risk-aware individuals. Were such individuals deterred from assuming those positions because the regime was seen to dispense exemplary punishments on thin evidence, that could undermine the underlying objective.

12. Apart from the issues highlighted above, would you highlight any other emerging or possible risks to the safety and soundness of firms in any of the sectors regulated by the PRA?

The pandemic has illustrated the importance of considering horizon risks. It’s possible to identify some of these in advance (the “known unknowns”) but others will remain genuinely unknown until they manifest (the “unknown unknowns”).

Individually, each such risk may have a very small probability of occurring over a period of, say, up to five years. It can, therefore, be tempting for managers within firms to be complacent about such risks. Yet, history has shown that one horizon risk or another manifests with concerning frequency.

In light of the pandemic experience, it might be worthwhile to revisit the National Risk Register (NRR) to assess the potential implications of each event on the financial system. (For example, most firms had identified Disaster Recovery sites as part of Business Continuity plans but few had anticipated that distributed working would be necessary.) There may also be other events outside of the NRR scope that could pose a risk to the financial system. For example, developments in quantum computing could have significant implications on trading algorithms and threaten widely-used encryption protocols.

No matter how much work is undertaken to identify potential horizon risks, some will remain obscure to us. The PRA and firms need to consider how to mitigate these, with one potential route being more creative application of reverse stress tests.

The Treasury Committee will publish your answers to this questionnaire.