BANK OF ENGLAND

Speech

Seven awkward questions

Speech given at a roundtable to mark the fifth anniversary of the PRA's Secondary Competition Objective

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Thank you all very much for coming to our event today, and in particular to our panellists for agreeing to take part.

Indeed, I speak on competition with a degree of humility in front of this panel – and particularly in front of Sir John because my first real engagement with these issues took place under his chairmanship when I was working for the Independent Commission on Banking back in 2010.

For that reason, and in view of the expertise of this audience, you will be relieved to hear that I am going to avoid giving you a fifteen-minute-long list of all the things we've done over the last 5 years to advance our secondary competition objective. Of course I have to do a bit of that or I'm not doing my job! But I'll just pick out a few items and keep it brief. Nor will I focus too much on some of the hardy perennials of this debate such as low switching rates, because I'm sure others on the panel can do better on those if we want to get into them.

Instead, I'd like to focus on some of the more awkward questions which confront us as a regulator with prudential and competition objectives. Five years on from the introduction of our competition objective it's a natural moment to do this.

But before turning to those questions, I have to ask you to indulge me for a few moments in picking out what to me are the most significant things we have done to advance our secondary competition objective during the first five years of its existence. I will limit myself to three:

- First, the structures we have put in place to encourage the entry of new banks: our New Banks Unit, which engages with prospective new entrants and provides a nursery for newly authorised banks; our 'mobilisation phase' which allows new banks to get going in a live environment but before being released into the wild; and our 'wind-down' approach to setting PRA buffer requirements for new banks in order to avoid penalising early stage growth. I don't think it's a coincidence that we've authorised 17 new UK banks in such a short period.[1]

- Second, bank capital. I have long been troubled by the difference between some standardised and modelled capital requirements, particularly for mortgages. And there are remaining tensions on capital which I will come back to. But we have done a lot to lean against this – most importantly our holistic approach to Pillar 2A, our success in getting Basel to lower very significantly the standardised risk-weight for lower-LTV mortgages, our introduction of the modular approach for IRB applications and the introduction of a leverage ratio into our regime.

[1] Besides these 17 new UK banks, the PRA also authorised new banks to meet ring-fencing requirements and overseas banks. The total of all banks authorised by the PRA since its formation in 2013 is 39.

- Third, related moves that we have made on the insurance side including a New Insurers Unit, our proportionate Non-Directive Firms regime for small insurers outside the scope of Solvency II, our active use of what flexibility there is in Solvency II to lower the administrative burden for smaller firms, and our new regime for insurance-linked securities.

My aim in mentioning these things is not to bore you, though I can see I may have succeeded in doing that, but to illustrate the simple point that the PRA has been very active in advancing its competition objective over the first five years of its existence. The objective has had a significant impact already: I would argue that, with the exception of the leverage ratio, we simply would not have done any of the things I've just mentioned if we did not have a competition objective.

Let me now turn to seven more awkward questions for us.

First, how do we square the principle of proportionality with the steeper slope of regulatory requirements this inevitably causes for growing firms? This arises in many ways, where we take a softer approach for smaller firms but this has to be withdrawn as they grow. One example is the steps in our Systemic Risk Buffer regime, which we've debated with Sir John in the past – it's true these could be smoothed to some extent by greater granularity and/or an 'income tax' approach, but the basic problem of gradient remains. This issue also arises on the resolution side, which is of course outside the scope of the competition objective – it must be right that we exempt small firms from bail-in debt, but this inevitably leads to a moment when successful firms stop being small and need to start issuing.

Second, and related to the first, although we have in my view been pretty successful in encouraging new entrants, it is so far notable that no small bank has successfully become a large bank. Perhaps this will change through time, and it may have much more to do with behavioural stickiness of current accounts than regulation, but it would be complacent to be relaxed about it. As an aside, there may be lessons to be learned here from the general insurance market: it is notable that some of today's largest GI firms started as small challengers within the last 20-30 years. Of course one way firms can get larger is through mergers and acquisitions, for which PRA approval of the 'change in control' is required. A natural question to ask is how our secondary competition objective plays into these situations. The law is actually very clear on this point: when considering whether to approve the change in control, we are required to disregard the competitive impact and to limit ourselves to a consideration of the appropriateness of the new controller. Assessing the impact on competition falls instead to the CMA.

Third, there is a tension for us arising from the efforts we make to encourage new and smaller players. My involvement in this line of work really began with the collapse of the largest, and apparently well-diversified, bank in the world right here in the UK. And I have been involved in and observed numerous other episodes of big banks getting into trouble. So I will never believe that there is something inherently safer about larger banks. But nor do I believe the opposite, and there are plenty of examples of smaller banks getting into trouble, in some of which I've been heavily involved. So it is perfectly natural that with our safety and soundness objective in mind we should take a close interest in small firms as well as large, particularly when they are fast-growing, heavy users of central bank funding schemes, concentrated in higher-risk niches and/or untested in a downturn. Bluntly I think we wouldn't be doing our job if we didn't do this – but at the same time the competition objective requires us to ride both horses at once. This is doable but it is tricky. It also raises an interesting question about the relative costs of supervising smaller firms versus higher FSCS levies to cover failures, which would merit further study.

Fourth, how is technology going to affect all this? This is obviously a huge topic in its own right, and others here will touch on it so I will make only two brief comments. One, in my view the jury is still out on whether Open Banking and/or PSD2 are the gateway to a bigger change. Two, it is notable that some digital banks are making material inroads into the current account market – is this the leading edge of a bigger change, or not?

Fifth, might Brexit create opportunities to move further on proportionality for smaller firms? I've already talked about the way in which we make the regime tougher for larger firms. This is entirely appropriate, but is not the same as saying we should have a weak prudential regime for smaller firms – indeed, I think that is the last thing we need both from a safety and soundness and a competition perspective. However, there may be a reasonable case that a simpler (simpler, not weaker) regime for small firms would advance both our safety and soundness and competition objectives. We have often argued in Europe for simpler approaches for small firms, but the differing legal traditions across the EU27 and the desire to harmonise regulation and supervision are powerful forces in the opposite direction. It is impossible to know at this stage, but under some Brexit outcomes we might have room to revisit this question for small domestic firms. It is notable that both Switzerland and the U.S. are taking quite radical steps in this area; while I am cautious about the leverage-ratio-only capital regimes they are working on, and small British firms might be cautious about a 9% leverage ratio requirement, we are taking a close interest.

Sixth, there is the debate – which came up most recently in the context of the Treasury Select Committee's inquiry into Solvency II – about whether our competition objective would be better cast as a primary objective. I have a number of reservations about this idea. One is purely practical: with the FCA and CMA already having primary competition objectives, do we really want a third regulator doing this for the financial services sector? It strikes me as a recipe for bureaucratic overlap. Another is that the sort of referee role the PRA often plays, making sure that firms are competing fairly and not by running excessive risks with policyholders' and depositors' funds, is itself the most important contribution we make to competition. And finally, I do worry about diluting overly the focus of the prudential regulator, which was I'm sure one element of what led to the financial crisis. The same logic applies to a competitiveness objective, which surprisingly often gets confused with our competition mandate.

Seventh, five years on, I am slightly worried about a looming political economy problem. We have I think taken quite an expansive view of our secondary competition objective, by which I mean that we have been vigorously prowling all parts of the PRA's terrain actively looking for things we can do to advance the objective. But our terrain is not limitless, so the flow of new initiatives will I think slow, and we will have to spend more time tangling with more difficult questions of the sort I have discussed today. I am worried that people may infer from a lower volume of announcements a reduced commitment to our secondary competition objective. There is no such reduction in commitment – we are simply implementing our commitments thoroughly. Those taking an interest should hold us to account for that, and press us on what we can do in the next five years about the more awkward questions which now confront us.

So to sum up: in my view the competition objective has had quite a profound impact on the PRA's activities and approach over the last five years. We've done a lot, and our commitment to drive through the changes we've brought in is undimmed. But that's not enough, and as we enter the second five years I'd like to stir up a vigorous debate about the next set of questions, some of which are really very awkward. I'm sure I can rely on the small bank lobby to do some vigorous stirring as well, and between us we will make further progress.