BANK OF ENGLAND

Speech

Looking both ways

Speech given by
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I planned to deliver an abridged version of this speech at the BSA conference on 3 May but had to withdraw my participation due to election purdah. I am grateful to Kayleigh Guinan, Eric Engstrom, Nick Lock, Louise Oscarius and Alex Holmes for their assistance in preparing this text. I am also grateful to David Kynaston and John Fforde, on whose work I have drawn heavily.

The theme of the BSA's conference is the future – the challenges and opportunities that lie ahead for building societies and what it means to be a modern mutual. Now, being forward-looking is great and we have indeed built that into the most basic foundations of the PRA's approach. But *only* looking forward would be unwise, given history's ability to repeat itself. We need to look both ways.

In that context, I want to talk about supervision and why it matters - supervision, as distinct from regulation. The two terms are often used interchangeably, but they are quite different. Regulation concerns the framework of rules and legal standards which govern the way in which firms operate. Systems of regulation, even if self-regulating, have been around for a good number of years in a wide variety of sectors, from media to energy to education. Supervision, by contrast, is the dynamic pursuit of the relevant authority's statutory objectives, through oversight of firms' activities. To do this effectively, you of course need regulation – but one without the other in financial services would, in my view, be futile.

At the PRA, we have committed ourselves to a judgement-based, forward-looking supervisory approach. This means that we proactively take action to meet our objectives and we evolve our methods to reflect emerging developments. It also means that we rely heavily on the judgement of supervisors and get them to unearth and scrutinise the top risks at any given firm. This is delivered by a keen supervisory focus on business models and the prudential health of firms rather than a sole preoccupation with firms' compliance with regulation, important though that is. And because we rely heavily on judgements, the PRA has a central spine of decision-making committees, with the most important supervisory decisions reserved for the Prudential Regulation Committee (PRC).

But where did this approach come from? Most comparisons between the PRA's current supervision model and those that preceded it focus heavily on the differences between the PRA's approach and that taken by the FSA before the global financial crisis. But the truth is that the practice of supervision in the U.K. has evolved slowly over time; indeed, the roots of supervision lie much deeper and can be traced back over the past 100 years or so.

In this speech, I will take a whistle-stop tour through the twentieth century to examine the increasing role that supervision has played in the regulation of financial institutions and why it remains an essential ingredient of the regulatory framework here in the UK. This is especially true in the context of regulatory arbitrage and, of course, Brexit – themes to which I will return later in this speech. First, though, I will consider the three main roots of supervision during this period, namely the individual regimes of oversight relating to banks, building societies and insurers[1]. I will proceed in alphabetical order in the hope that this will avoid offending any sector, even if (regrettably) it means the bankers get in first.

[1] My colleague Mark Yallop has given an excellent speech in similar terrain.

Banking Supervision

Let's begin in 1890. Our scene is Cannon St and an establishment which printed a weekly chronicle that went by the name of *The Statist.* Hot off the press is a headline: "Messrs Baring Brothers' Issues". Then follows a well-informed, highly sceptical article which questioned the quality of much of the foreign business being embarked upon by what was, at the time, considered by many to be the most respectable house in the City of London[2]. I particularly like this story because my very first job after university, here in London, involved sitting in Barings and trying to work out quite how much money Nick Leeson had lost.

What then prompted such a critical article, almost exactly 100 years before I found myself involved in the clear-up after the Leeson episode? Barings, at this point, was responsible for about one quarter of the considerable funds flowing into Argentina – a very attractive investment at the time – and a man by the name of Revelstoke was pivotal to its success. He managed to secure the flotation of the Buenos Aires Water Supply and Drainage Company and, "with his propensity for double-or-quits, decided against the increasingly common custom of having the issue fully underwritten"[3].

The flotation flopped in 1888 and, to make matters worse, a combination of financial maladministration and political turmoil in Argentina left Barings over-exposed, with capital locked down in its various South American holdings. This, coupled with the policy of the Russian government of steadily withdrawing its large-scale deposits from the house, left Barings in a precarious position by 1890.

Rumours began to circulate that the firm might not have any surplus left after payment of its liabilities. The Governor was alerted given the "almost unthinkable consequences should Barings go down: not only would the failure of the City's leading accepting house inevitably bring down a host of other firms… but the very status of London would be threatened and thus the pre-eminence of the City as an international financial centre"[4].

Amidst much to-ing and fro-ing between the Bank of England (hereafter "the Bank"), the Treasury and Downing Street, it was becoming apparent that the crisis at Barings was one not only of liquidity but also of solvency, and that there was now a palpable loss of confidence in the institution throughout the City. The Bank alone could not afford to act as lender of last resort so eventually the Governor of the day – Lidderdale – announced the establishment of a guarantee fund for Barings; within half an hour, the City's top institutions rushed to contribute – the likes of Raphaels (£250,000), Antony Gibbs and Brown Shipley (£200,000 apiece) and Smith Payne & Smiths, Barclays, Morgan and Hambros (each contributed £100,000). Indeed, the

[2] Kynaston, David. *City of London: the history*, London, Vintage Books, 2012, pp130-131
[3] Ibid, p.131
[4] Ibid, pp.133-134

leading joint-stock banks had put themselves down for £3.25m and by mid-afternoon the fund was up to £10m and climbed further to £17m by the following week[5].

Barings was saved. But the crisis revealed something about the relationship between the state and industry at the end of the nineteenth century. Indeed, the institutional set-up explains quite a lot about the approach taken towards the oversight of financial institutions at this time.

The Bank of England was still a private entity. The leading partners from each trading house sat on the Bank's Court of Directors. This was a world of gentlemen's agreements and moral suasion, or "what a later generation would know by shorthand as the Governor of the day raising his eyebrows"[6].

One reason the Bank developed a supervisory interest in the clearing banks was to protect its balance sheet given its role as banker to the banks but it was, at most, *primus inter pares,* and banks were largely self-regulating. Indeed, the crisis at Barings was ultimately one of solvency not liquidity and so the Bank would not devote its own resources to a recapitalisation.

Instead, the rescue of Barings Bank relied on the collective action of its industry peers and some co-ordination by the Bank rather than any formal supervisory role. This is in contrast to later crises of liquidity during which, in line with Bagehot's theory, the Bank extended credit at a penal rate to solvent but illiquid banks and became lender of last resort.

Following the Barings episode, banks were required to publish their balance sheets on a monthly basis; whilst this heightened awareness of competition between the banks, ultimately it did little to change the role of the Bank in overseeing the sector. The Bank's interaction with firms continued largely unchanged and the system of regulation relied on the Bank's soft power (partly derived from its position as defender of the gold standard) and willingness to intervene in a crisis as the lender of last resort (or at least coordinate such a response).

During the first half of the twentieth century, the status of the Bank (as a private institution with semi-public responsibilities and lack of statutory powers) explains in part why the system of regulation relied on a high degree of self-regulation and a light supervisory touch throughout the early decades of the 1900s.

Nonetheless, in the rushing about at Threadneedle Street to deal with the Barings crisis more than a century ago I can clearly discern people doing what I and colleagues have had to do at various times when firms have been under stress over the last decade – it is called supervision.

[5] Ibid, p.137
[6] Ibid, p.148

A number of factors began to change the nature of supervision in the UK. First, the Bank's nationalisation in the 1940s moved it onto a different footing as a truly public institution. The relationship between the Bank and banking sector was no longer one of equals, though the Bank's approach did not alter course overnight.

The Bank of England Act 1946 subsequently granted the Bank a range of powers, including the ability to issue directions to firms. A further legislative development – the Companies Act 1948 – conferred privileged status on some institutions (recognised banks or discount companies) which resulted in the Bank granting exemptions to these institutions by virtue of their status as a bank[7]. For the first time, we see evidence of some differentiation of treatment between banks and regular companies.

Meanwhile, the Accepting Houses Committee[8] – a collection of merchant banks with accounts at the Bank – had by this point grown in stature as an association that represented banks of good standing with the implicit backing of the central bank[9].

During the 1950s, and in exchange for the extension of this privileged status, the banks accepted a measure of consultation in order to reassure the Bank that their name was still good. This often took the form of a monthly meeting with the Governor to discuss the firm's balance sheet, and it was in this setting that the Bank formed an idea of the level of hidden reserves (or excess capital in modern parlance), something that would otherwise go undisclosed in the firm's public accounts.

The Bank had some guidelines on the metrics it would tolerate - for example, there was an expectation that about one-third of deposits plus one-fifth of acceptances[10] should be matched by liquid assets. And the Bank showed willing when it came to enforcing this, though notably only through moral suasion rather than any formal sanction.

The Governor would sometimes meet the prospective leader of a bank should there be a change in leadership, and he would expect to be notified of any significant transactions, a fact that Samuel Montagu (whose business is part of HSBC's private banking arm today) was sharply reminded of in 1957 when he reportedly neglected to update the Governor on a potential M&A deal[11].

Overall though, much of this interaction was based on courtesy rather than any expectation that the Bank's approval was a pre-requisite or necessary. There was a relationship to be sure but it was all very informal; the terms supervisor and supervised would have sounded out of place. There were no hard and fast requirements and the approach was minimalist in style.

[7] For example, through the granting of waivers on the publication of balance sheet data.
[8] Originally set up in 1914 to manage difficulties in payments between countries at the start of World War One.
[9] Fforde, John. *The Bank of England and Public Policy: 1941 -1958,* Cambridge, Cambridge University Press, 1992, p.750
[10] A short-term debt instrument issued by a company that is guaranteed by a commercial bank, often used to facilitate trade.
[11] Fforde, p.755

And yet, as in the 1890 Barings episode, you can see in this activity elements which persist in supervision today. For instance, while I do not wish to offer any formal comment on the state of Mark Carney's eyebrows, in my experience a meeting with Mark is always a useful way to focus the mind.

It is worth remarking that during this period there was a genuine window of opportunity to extend the boundaries of banking supervision undertaken by the Bank and legislate accordingly[12]. However, after a year's negotiation, it came to nothing and instead of a Banking Act 1957, the banking sector would have to wait until 1979 before the Bank involved itself more formally in the affairs of firms and, crucially, on a statutory basis.

In the period up to the 1970s, there had been 'no recent case of depositors losing their money. There was little public interest in the subject and there had been no troubles that might have led to a demand for the Bank's help'[13]. This set of circumstances changed abruptly when the secondary banking crisis engulfed the City in the period 1973-5. In short, very rapid and uncontrolled growth in the fringe (i.e. not primary) banking sector came home to roost when the first oil shock hit in 1973, delivering a blow to the economic prosperity enjoyed by the UK since World War II, reducing the value of bank assets and revealing a significant mismatch of borrowings and lending that resulted in a liquidity, and subsequently solvency, crisis. The secondary banks were especially affected, having been able to expand their balance sheets rapidly using wholesale markets[14], much as Northern Rock did just over thirty years later.

The number of affected banks surpassed fifty[15] in total and the Bank coordinated a significant effort – the so-called 'Lifeboat' operation – to assist the troubled institutions, whether through shareholder support, marriages to stronger banks or support directly from the Bank. The most important revelation, however, was that these institutions had been allowed to go effectively unsupervised by the Board of Trade in the first place.

Such a circumstance arose due to something seemingly quite simple – the lack of a definition of a "bank" in UK law. Under Schedule 8 of the aforementioned Companies Act 1948, certain firms could be exempted from publishing their accounts in full on the grounds that they were banking companies. On this basis, certain banks – in almost all cases, the well-established ones – were subject to Bank oversight. By contrast, there was a population of 133 deposit-takers – the so-called "section 123" companies – that were identified as such by the Board of Trade, a body that did not possess the requisite powers of supervision over the institutions concerned[16]. A gap therefore emerged in the regulatory perimeter with significantly limited oversight. The consequences for the Bank were profound.

[12] Ibid, p.777
[13] Ibid, p.760
[14] Gardener, Edward (ed). *UK Banking Supervision: Evolution, Practice and Issues,* London, Allen & Unwin, 1986, p.87
[15] Ibid, p.100
[16] Ibid, p.102

The total lent during the Lifeboat operation exceeded £1.3bn at the peak – equivalent to just over £10bn in today's money[17] – and there was "a growing realisation that the Bank of England supervisory system was not rigorous enough for the more demanding era heralded by the events of the early 1970s"[18]. Indeed, Gardener notes, presumably in relation to the secondary or "fringe" banks, that "there are other cases where, in dealing with a few of our newer charges, there must remain a question whether gentlemanly discussion and exhortation to observe prudent practices will on their own always produce the desired result"[19].

Moreover, the crisis, at least in part, encouraged the European Economic Community (EEC) to introduce a requirement that deposit-taking institutions ought to be licensed. And in the UK, the experience of the crisis created a swell of opinion that legislative updates to the Banking Act were necessary and, significantly, that banking supervision should be undertaken by the Bank on a statutory basis for the first time.

This was not necessarily a welcome development for the Bank. George Blunden, head of Banking Supervision at the time, felt the key characteristics of the Bank's approach – flexible, personal, progressive, participative – were highly desirable, and he was keen not to have these eschewed by the forthcoming legislation. The Bank prided itself on its flexible approach, its recognition of the role of the market and its consensual mode of supervision – and was determined not to lose this as its oversight of the banking sector inevitably took on a more formal tone. In large part, the Bank achieved its aim – the 1979 Banking Act was more evolutionary than revolutionary and written in such a way that "clear scope was preserved for the continuance of the Bank of England's particular supervisory style"[20]. Indeed, "the legislation was designed to interfere as little as possible with what was regarded as good in what had come before and only to add to the earlier arrangements new features where the previous system had been found wanting"[21].

The introduction of the Act did, though, formalise some of the basic supervisory activities carried out by the Bank as well as introduce some new conditions, not least the requirement for the Bank to authorise deposit-takers. In fact, the Bank did indeed withdraw licences and wind up deposit-takers on at least two occasions following the Act's introduction[22].

In addition, there was an increased focus on the fitness and propriety of individuals running the banks, and an acknowledgement that "this emphasis on qualitative assessment has been born of experience, as management problems and inadequacies have typically provided the first sign of difficulty"[23]. Moreover, the Bank now received and reviewed on a quarterly basis returns which included a more detailed breakdown of assets and liabilities as well as profitability. The Act also contained powers for the Bank to commission third party expertise to review aspects of a firm's business, a commonly-used tool by the Bank in a bid to make

[17] http://www.bankofengland.co.uk/education/Pages/resources/inflationtools/calculator/default.aspx
[18] Ibid, p.74
[19] Ibid, p.96
[20] Ibid, p.77
[21] Ibid, p.86
[22] Ibid, p.107
[23] Ibid, p.104

the most of its resources – something akin to a modern-day section-166. On the heels of this a different dialogue began to emerge between the Bank and those institutions it supervised, with the Bank pointing out deficiencies to the firm, the firm coming up with a remedial action plan and subsequent close monitoring by the Bank to ensure delivery[24].

By this point, the Bank was supervising almost 600 institutions: 291 recognised banks and an equal number of licensed deposit-taking institutions – all serviced by an 80-strong division within the Bank. This resulted in a two-tier system in which recognised banks enjoyed a superior status and a lighter supervisory touch. Whilst this did not rub especially well with the licensed deposit-takers, there was scope for them to progress to the lofty heights of "bank" status, and at least the new set-up had the advantage that all deposit-taking institutions were now subject to Bank oversight.

It is fair to say that the new focus on supervision was not solely driven by domestic developments. Indeed, the importance of supervision was enhanced by the increasingly international flavour of the City, following the Big Bang and a wave of overseas investment (particularly from the US). The Basel Committee was established in 1975 and the US and UK were the first to cooperate on the 'US/UK Accord', which laid the foundation for a common assessment of firm capital in both countries[25]. The collapse of Banco Ambrosiano in 1982 and the difficulties at Johnson Matthey Bankers in 1984 brought the risks inherent in the system into sharp relief once more, and there was a renewed push to establish consolidated supervision across borders[26].

Through its participation in international fora, the Bank sought "to promote close supervisory co-operation, to influence supervisory developments and to enhance the effectiveness of its own supervisory effort through obtaining clearer pictures of the nature of the business operations engaged in by the institutions it supervises and of the methods and operations of its international counterparts"[27].

The idea of a level playing field began to emerge in the international setting as well as the importance of supervisory convergence in an increasingly globalised sector; this, alongside crises, motivated the evolution of regulation and supervision to a large extent during the latter decades of the twentieth century. In addition, the increasing size (including in the present day) of the financial sector and its contribution to UK GDP underscored the importance of maintaining stability in the financial system, and a more active type of supervision began to emerge.

Meanwhile, the Bank had established a Board of Banking Supervision 'to advise the Governor on supervisory matters and oversee the implementation of the (reformed) Banking Act'[28] and the supervisory

[24] Hall, Maximilian, J.B. *Handbook of Banking Regultation and Supervision,* Hertfordshire, Woodhead Faulkner, 1993, p.75
[25] Ibid, p.95
[26] Kynaston, p.79
[27] Hall, p.77
[28] Ibid, p.23

function was further expanded. And this brings me back to the collapse of Barings Bank in 1995, following which a report into the existing supervisory arrangements was commissioned from the (now also-collapsed) Arthur Andersen, which in 1996 set out recommendations to overhaul the Bank's supervisory approach.

What you can see in all this is that supervision is not a static game, and has to move with the times. But there are also some constants. In particular, although we have moved a very long way from the supervisory practices (and hairstyles, other than the resurgence of beards amongst male supervisors) of the 1970s, we have maintained the view of our predecessors that supervision cannot be a narrow, tick-box, compliance exercise, and that judgement plays a key role.

Building society supervision

The merchant and trading banks of the City of London were no doubt significant in the world of wholesale international finance. But there was another group – the building societies – that served a critical function in servicing the UK economy, particularly retail customers. Indeed, up until 1980, building societies accounted for approximately 80% of UK residential mortgages and over 40% of retail deposits[29].

The first building society was established in 1775. It was known as Ketley's, the name of the landlord in whose pub the society met (despite the tavern's formal name *The Golden Cross*). Perhaps it is a shame your boards don't meet in pubs any more, but I'm afraid it probably would result in a capital scalar if you did. The original purpose of the societies was for members to pool resources to finance the building of houses; these homes would act as collateral for additional finance and enable more houses to be built. The societies were underpinned by a mutual structure.

Over the next 60 years, some societies chose to register under the Friendly Societies Act 1793, but the remainder had no clearly defined legal standing. This was addressed in the Building Societies Act 1836 which provided a legal standing for building societies and, among other things, required their rules to be certified by a barrister. The certifying barrister became, under the Friendly Societies Act 1846, the Chief Registrar of Friendly Societies, and the Chief Registrar remained the regulator of building societies until 1986. I think it pays to have a bit of humility in life, so here in passing, and as the CEO of a regulator only 4 years old, I doff my supervisory cap to an outfit which survived in this hazardous line of work for 140 years.

A series of Building Societies Acts between 1836 and 1962 set out the statutory framework under which building societies could operate and gave increasing powers to the Chief Registrar (hereon the "Registry"). Unsurprisingly, and in common with other financial services regulation, these additional powers were often introduced as a result of scandal or crisis in the sector.

[29] BSA Building Society Fact Book 1984

By 1960, the Registry had the power to call for an inspection of a society, to prevent it from taking deposits and to prohibit it from advertising. During this period, the Registry operated a legalistic framework; indeed, it was a statutory requirement until the late 1970s that the Chief Registrar and the two Assistant Registrars were lawyers.

Only following the failure of Grays Building Society in 1978 (where all societies made good the losses that would otherwise have been suffered by Grays' retail depositors) did we see the first appointment of a non-lawyer as Chief Registrar. With that, a new approach to supervision was adopted, comprising more frequent visits to societies, the receipt of more regular, better quality information from societies, and the recruitment of additional staff to undertake these enhanced supervisory activities.

The role of the Registry also evolved to reflect the market conditions of the day. One of its key functions was to oversee inter-society mergers, which became a frequent occurrence as the number of building societies reduced (largely through merger) from around 2,200 in 1900 to 480 in 1970[30]. By this point, Registry staff were examining societies' annual returns and seeking to identify weaknesses in capital and liquidity; indeed, there was a keen focus on the latter when, in 1976, building societies started to submit a monthly liquidity return. I am told that at that time, the Registry had one electronic calculator to which the three building society teams each had access for half a day each week. History does not relate what the calculator did for the other three-and-a-half days – perhaps it was resting.

I hope it will be as obvious to you as it is to me that many of these practices have shaped the PRA's approach to supervision today, just as much as our heritage from the Bank on the banking side. This is partly because as the prudential supervisor of banks, building societies and insurers we must of course draw in full on our heritage across all three sectors. But it's also because some of our wisest staff have been here all the way through – most obviously Eric Engstrom who was, I understand, born in Ketley's pub in 1775.

Indeed, the general approach that started to emerge for building societies in the early 80s was forward-looking and judgment-based, though nobody at the time would have described it in such terms. By this point, the Registry had introduced inspection teams to undertake on-site supervisory work. One target of this more invasive approach was the New Cross Building Society, which was closed down in 1983 following a detailed investigation of its business that uncovered non-compliance with key provisions of the Building Societies Act. The Registry concluded that if the present management and existing policies continued, there was a distinct risk of a crisis in this rapidly growing society and that it would then not be able to repay retail depositors in full.

[30] BSA Building Societies Yearbook 1998-99

A weakness of the legislation as it stood then was that the only hard power available to the Registry was to force the closure of a building society. In most instances, the threat of such action was sufficient to achieve the Registry's aims – but in the case of New Cross, the most radical option had to be pursued.

The Building Societies Act 1986 aimed to improve this and handed enhanced powers to the newly-formed Building Societies Commission (BSC), which was tasked with enforcing tougher prudential requirements in respect of capital, liquidity, systems of control and governance – and all on a statutory footing (you will note here the parallels with developments in banking supervision). Indeed, in its first report to Parliament, the BSC made clear that it would complete the shift in supervision (already underway at the Registry) from a reactive approach "to the more positive and forward-looking approach"[31].

In practice, all societies were visited at least once a year (4 or 5 times for the larger ones). There was an annual review meeting with the board; a report would be prepared with the supervisor's assessment; a letter would be sent to the board outlining actions to be taken forward by the society; management information and strategy documents were reviewed, regulatory returns monitored, and mergers scrutinised.

Insurance supervision

The other major part of the PRA's supervisory responsibility is the oversight of insurers. Here our heritage, as for building societies, is from outside the Bank. Indeed, despite the practice of insurance extending all the way back to the era of Babylon, it is only in the past four years that the Bank has played any role in supervising the sector. I will cover this more briefly, only because I have already given a speech devoted entirely to this topic[32].

Up until the 19th century, insurers were largely self-regulating and bound by the principle of "freedom with publicity", the idea that regulation was unnecessary as long as some element of disclosure existed to encourage market discipline. This all changed when the Albert Life Assurance Company went under in 1869 and, in response, the Life Assurance Companies Act 1870 was introduced.

The Act ushered in strict new rules, including a requirement for those looking to set up an insurance company to place a £20,000 deposit with the Accountant General. Financial information across insurers was to become standardised and independently valued at least once every five years. The Act also introduced conditions around takeovers and mergers, requiring that consent be sought from both the courts and shareholders[33] – a process alive and well today in the form of Part VII transfers. Whilst the Accountant General could hardly be characterised as an active supervisor, the Act did at least lay down some

[31] Annual Report of the Building Societies Commission 1986-87
[32] http://www.bankofengland.co.uk/publications/Pages/speeches/2017/967.aspx See also: http://www.bankofengland.co.uk/publications/Pages/speeches/2016/877.aspx
[33] Tapp, Julian. 'Regulation of the UK insurance sector', in Finsinger, Jorg. and Pauly, Mark V. *The Economics of Insurance Regulation: A Cross-National Study,* London, Macmillan, 1986, p.29

requirements for life insurers for the first time. In 1909, these were extended to all other classes of business in existence with the exception of motor and marine insurance, and by 1930 motor insurance was also subject to this level of oversight.

During the early part of the 20th century, British society underwent a stark change as the invention of the car transformed people's everyday lives. It also made for a lucrative line for insurers, not least as motor cover was compulsory, though the period was also marked by a good number of insurers that failed. In response to this, the Cassell Committee on Compulsory Insurance was established in 1937. With its recommendations temporarily stalled by the onset of the Second World War, which understandably diverted Parliament briefly from the noble topic of insurance supervision, they were implemented somewhat belatedly in the form of the Insurance Companies Act 1946.

Crucially, the Act strengthened the powers of the Board of Trade (later the Department of Trade and Industry, or DTI) and introduced solvency margins, with the amount being set as the greater of £50,000 or a tenth of premiums[34]. In addition, insurers had to have at least £50,000 in paid up share capital and the Motor Insurers' Bureau was established to fulfil claims for victims of uninsured drivers, funded by a levy on the motor insurance industry.

Despite these reforms, nine motor insurance companies failed in the period 1966-67. In typical fashion, a new piece of legislation was enacted in response. The Companies Act 1967 further strengthened the hand of the DTI, which was now empowered to refuse authorisation, impose conditions on a firm's operation and prevent control of the company from those individuals not deemed fit and proper[35]. Thus, we see elements of a supervision regime begin to emerge which persist in the PRA to this day. All was not rosy, however, and shortly thereafter in 1971 the failure of Vehicle and General revealed the importance of producing timely and accurate financial information, as well as the need to set aside adequate reserves for expected pay-outs.

The Insurance Companies Act 1982 insisted on the appointment of an actuary and periodic investigations, as well as the power to compel firms to provide additional information to supervisors, and even a power to prevent companies writing new business. Despite this expanded toolkit, however, the DTI's approach did not encourage much of it to be used. Indeed, "if the company is behaving in a responsible manner and produces all the information required of it, there will be no interference with its behaviour by the DTI[36]" – in short, the style of supervision was pretty light touch.

[34] Ibid, p.32
[35] Ibid, p.33
[36] Ibid, p.41

It all comes together

The Gower Report, published in 1984 with a focus on firms undertaking investment activity, noted the myriad of self-regulating agencies to whose method, in principle, he was not opposed. However, Gower also recognised 'the extent to which firms have come to undertake a full range of financial services… the present system of legal regulation has not fully adjusted to this and neither have the present professional associations'[37].

Gower put forward the pros and cons of much supervision continuing to be undertaken by the DTI (in practice, largely self-regulating) or the establishment of a self-standing commission. His recommendation at the time was that the DTI continue in its role, allowing the firms to self-regulate, until such a time that 'it is apparent that a substantial volume of day-to-day Governmental regulation and supervision will have to be undertaken… [at which point] a self-standing Commission answerable to the Secretary of State should be established and the Governmental role undertaken by it'[38].

The debate about the most appropriate institutional setup for the supervision of financial services in the UK continued to rage on. Fast-forward to 1997 and the responsibility for insurance supervision was being passed to the newly-created Financial Services Authority (FSA). Around the same time, the Government announced that it would transfer full operational responsibility for monetary policy to the Bank of England, ably supported by my colleague Sir Jon Cunliffe in his former mandarin incarnation, and – as part of that change – the supervisory function for the banking sector was transferred to the FSA.

In a statement to the House of Commons on 20 May 1997, Gordon Brown noted the "strong case for bringing the regulation of banking, securities and insurance together under one roof"[39], noting that firms by this point managed their businesses on a group-wide basis and that the new regulatory structure would reflect the increasingly integrated financial markets of the day.

Looking back, it seems inevitable that the increasing breadth of financial activities undertaken by single firms would create an impetus for increased consolidation in the oversight of such activities.

Of course this was the view in the late 1990s. At other points in time, indeed just over a decade after the FSA was created, it was decided that the most appropriate way to structure supervision was along separate prudential and conduct lines – the so-called "twin peaks" model. Moreover, some supervisory authorities like the PRA sit within the central bank given (in the case of the UK) the Bank's longstanding interest in overseeing the banks that settle in its money – the clearing banks – out of which was born a system of supervision over banking and payment systems.

[37] Gower, L.C.B. 'Review of Investor Protection', *Presented to Parliament by the Secretary of State for Trade and Indutstry,* January 1984, p.13
[38] Ibid, p.25
[39] Hansard: http://hansard.millbanksystems.com/commons/1997/may/20/bank-of-england-and-financial-regulation

Beyond the UK, we can observe many different types of institutional arrangements. In the United States, the organisation of supervisory agencies reflects the federal system of government with supervisors at both central government and local state level. Another difference lies in the fact that many US state commissioners are publicly elected, unlike other countries where supervisors are unelected. Indeed, undertaking a stint as an insurance supervisor at the DTI during the 1980s was just another rotation for those enrolled on the government-wide civil service scheme. And in China today the authorities have a model split between the central bank and separate banking, insurance and securities regulators, but are looking afresh at these arrangements.

My point here is that, while I personally happen to favour the current UK set-up and think it is working well, the sheer variety of institutional arrangements over the past 100 years in the UK, and internationally today, suggests to me that there is no one institutional set-up which outshines the rest.

In sum, nine regulatory agencies[40] came together to form the FSA on 1 June 1998. From the outset, it was "clear that it was not a takeover by any one [body] but the creation of something new", and the following years were spent defining the new supervisory approach and encouraging the passage of the Financial Services and Markets Act (FSMA) 2000, which transferred regulatory powers from predecessor agencies to the FSA and granted the FSA its statutory powers.

The FSA was a unified regulator for the financial services industry, with responsibility for 29,000 firms[41]. Although the responsibility for supervision now rested in one place, the FSA's supervisory approach was far from unified to begin with. Michael Foot, Managing Director at the FSA since its inception, described it as "a mishmash":

> *the banking supervisors spent a great deal of effort in understanding the strength and weaknesses of a group containing a large bank. In contrast the asset management regulators had no real concept of consolidated or group supervision and looked primarily at each legal entity in a group by itself. A small building society would be visited by staff from the Building Societies Commissioner every six months, while the insurance regulators' norm for a company with far greater assets than that small building society would be one visit every three years[42].*

Through a series of public papers, the FSA therefore embarked on defining a common approach towards all of the institutions it supervised. It defined its interactions with firms into 5 broad activities: authorisation; baseline monitoring; thematic work; specific risk mitigation; and work once a risk has escalated or crystallised.

[40] *Building Societies Commission (BSC);Friendly Societies Commission (FSC); Insurance Directorate (ID) of HM Treasury; Investment Management Regulatory Organisation (IMRO); Personal Investment Authority (PIA); Registry of Friendly Societies (RFS); Securities and Futures Authority (SFA); Securities and Investments Board (SIB); Supervision and Surveillance Division (S&S) of the Bank of England*
[41] FSA website: http://www.fsa.gov.uk/about/what/approach
[42] Foot, Michael. 'The FSA: The first six years', *Journal of Financial Regulation and Compliance*, Vol. 12 Issue. 3, (2004), pp. 201-205

The extent of the FSA's interaction with firms was defined by its assessment of two factors: a firm's probability of failure and its likely impact upon failure. Based on this assessment, firms were split into categories varying from high to low impact and supervisory activity was derived from this categorisation. Most supervisory attention was focused on the institutions with the highest potential impact, on the basis that whilst only 1% of all firms were classified as high impact, they accounted for 64% of market share and 98% of traded market volumes[43].

A risk assessment framework – the Advanced Risk Response Operating frameWork or 'ARROW' (sounds better than "ARROF", I suppose) – was used to organise supervisory activity and, on the basis of risks identified by supervisors through on-site visits and off-site investigations, would create a Risk Mitigation Programme (RMP) including actions that firms should undertake to mitigate identified risks.

This style of supervision went unremarked upon for the most part, though of course much has been said about the FSA's model since the global financial crisis. Countless speeches have summarised the crisis and its fallout – so I will not dwell on the crisis itself too much here. Instead, I will consider its aftermath and what it meant for supervision.

The Turner Review was one of the earliest reports critical of the FSA's way of doing things. In particular, the FSA was criticised for: focusing on individual firms rather than the system as a whole; placing too much reliance on senior management and boards of firms to make decisions about the appropriate balance of risk and return; focusing more attention on conduct of business than on prudential strength; assessing 'approved persons' based on probity in the past rather than their competence for a specific role going forward; and relying on unfettered wholesale markets to provide appropriate levels of customer protection[44].

During this time, the FSA embarked on a Supervisory Enhancement Programme (SEP) to remedy perceived weaknesses, such as being "light touch" and "reactive". But a change in government set the wheels in motion for a significant overhaul of the architecture of financial services regulation when George Osborne announced the abolition of the FSA in his maiden speech at Mansion House in June 2010,[45] and a new supervisory approach was ushered in a few years later with the establishment of the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA).

[43] FSA website:
http://www.google.co.uk/url?sa=t&rct=j&q=&esrc=s&source=web&cd=4&ved=0ahUKEwjSvKz71pnTAhUHIMAKHUvtAzYQFggrMAM&url=http%3A%2F%2Fwww.icmacentre.ac.uk%2Ffiles%2Ffinra_reading_list%2Fsupervision_oversight_sep08%2Fsupervison_and_oversight_fsas_approach_to_supervision_and_risk.pdf&usg=AFQjCNFpZ5SdEn1o5BNy8Dxh5tbTyP-eng&bvm=bv.152174688,d.ZGg

[44] Turner review:
http://www.google.co.uk/url?sa=t&rct=j&q=&esrc=s&source=web&cd=1&cad=rja&uact=8&ved=0ahUKEwiXmqjw15nTAhXKB8AKHUW5CC8QFggcMAA&url=http%3A%2F%2Fwww.fsa.gov.uk%2Fpubs%2Fother%2Fturner_review.pdf&usg=AFQjCNFEP-0NiS2fGmuePCRj3o0GLtZgGA

[45] Osborne, George. Speech by the Chancellor of the Exchequer, Mansion House (16 June 2010):
https://www.gov.uk/government/speeches/speech-by-the-chancellor-of-the-exchequer-rt-hon-george-osborne-mp-at-mansion-house

Today's supervisory challenge

As I outlined at the start of this speech, the PRA's model of supervision rests on a forward-looking, judgement-based approach to the supervision of banks, building societies and insurers. We are focused, given our prudential remit as laid out in our statutory objectives, on the most material risks within firms, spending most time on those that pose the greatest risk to the stability of the UK financial system and the protection of policyholders.

In the period since 2008, we have been steadily implementing the post-crisis reforms, both in banking and insurance. This has been a busy time but it is clear to me that this period is now drawing to a close, with the major remaining implementation tasks now narrowed to ring-fencing and bail-in debt. Instead of designing and implementing reforms, the job of supervisors becomes one of guarding them and holding the line. We are living through a vital moment in supervision and today I'd like to talk about three live challenges in turn: Brexit, an uptick in risk appetite and regulatory arbitrage.

Brexit

A year ago, the UK voted to leave the EU. Although the negotiation is still in its early stages, changes to the trading relationship between the UK and the EU may require firms to alter their operations and the services they provide. Now that the Government has triggered Article 50, we expect firms with cross-border activities between the UK and the rest of the EU to undertake appropriate contingency planning for the UK's withdrawal from the EU.

I want to make clear that whilst the UK's withdrawal from the EU will change many things, it does not change the PRA's statutory objectives. With that strongly in mind, supervisors will maintain the normal supervisory approach and focus on the biggest risks at each firm. For some businesses, Brexit will be a key risk and will, justifiably, warrant supervisory attention – we must not lose sight of risks as structures and business models change, or as activities move around or adapt.

Equally, firms' management should remain focused on the full spectrum of risks that they face. As we would any other identified risk, we expect to have discussions with firms about their contingency plans as part of our regular interaction. But in terms of how supervisors go about their day-to-day business, we remain focused squarely on the task in hand – safety and soundness of all firms and policyholder protection for insurers.

Returning to the punchbowl?

As well as a determination to inform our approach to current risks by having regard to lessons learned in the past, PRA supervisors are forward-looking and pay close attention to emerging trends and potential future risks. I would like to take this opportunity to highlight some issues of particular relevance for building societies.

We observe that net interest margins at societies are coming under increasing pressure, and, although they are still well above levels seen in 2010, the trend seems to have turned downwards. Squeezed margins are mainly a function of increased lending competition in core building society markets, both from existing large banks that are rebuilding their market shares, and from new "challenger" banks that are seeking to carve out their own competitive niches. Squeezed margins at building societies are exacerbated when pitted against the mutual pricing strategy many have adopted to protect members in an era of low rates – and so, building societies seek to source new lending that earns higher than average rates.

This combination of circumstances is what led a number of societies to broaden their lending appetites in the mid-2000s. I do not intend today to re-hash the full set of warnings about lending quality, assessing affordability and undertaking new business lines that John Tiner, as CEO of the FSA, set out to attendees of the 2004 BSA conference – if you want to remind yourself, his speech is still available to read on the archived FSA website![46] However, I would observe that part of the reason why only 44 societies are attending this conference rather than the 60+ that came to its equivalent in 2004 lies in the fact that many of those societies were unaware of, or failed to control, the risks they were taking.

As survivors, societies here today ought to be well aware of the warning signs, but I'm conscious that corporate memories can be shed surprisingly fast. So I do want to emphasise that a key part of our supervisory approach is to be alert to emerging risks that may not seem as relevant when you are at the lending coalface as they appear to be when aggregated and analysed on a supervisor's desktop.

I know that many of you will be familiar with our Supervisory Statement 20/15 on building societies' lending and treasury operations (commonly known as "the Sourcebook", reflecting its origins as an FSA document). This document sets out our expectations as to how society boards and management should achieve adequate risk controls over the business that they choose to undertake. These expectations have not emerged from a vacuum, but are informed by what we saw happening in the run-up to the crisis of 2008. The Supervisory Statement does not seek to stop boards from developing new strategies and lines of business, but it does articulate supervisory expectations as to how this activity can be done safely, in line with the PRA's objectives.

Across the wider market, we are observing – not from all firms, but definitely from a few (and some of them building societies) – a shift in credit risk appetite as lenders compete with each other to find ways of widening the pool of available borrowers, increasing the size of loans available to them, or reducing the credit premium

[46] http://www.fsa.gov.uk/library/communication/speeches/2004/sp176.shtml

charged for inherently more risky loans. This search for marginal borrowers is a normal function of competitive markets, and does not imply that all resulting loans will turn out to be poor quality.

The FPC's concerns about the rate at which consumer lending is growing have been well-flagged already and, very recently, the PRA published the findings of its review of consumer credit lending, focusing on asset quality and underwriting practices for credit cards, unsecured personal loans and motor finance – and the issues it wants firms to address[47]. I'm aware that, other than in a minority of cases, such lending is not undertaken by societies. The regulatory requirements following the Mortgage Market Review have also rightly put affordability at the heart of mortgage lending decisions but, as with any rules or regulations, complying with the spirit as well as the letter of the law is important.

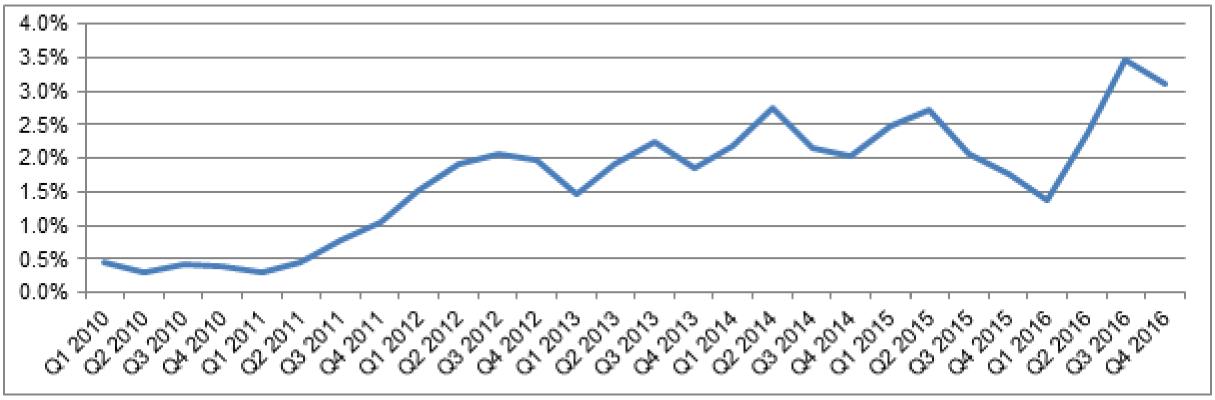
By way of example, I would highlight a recent trend in increasing loan terms: where 25 years might once have been the normal maximum term for a mortgage, now 35 years or even longer seems to be increasingly common. Of course, increasing the term reduces the level of each monthly instalment and makes the loan more affordable in the short term; however, it also increases the total amount of interest paid over the life of the loan quite significantly, and it increases the possibility that the final instalments may have to be met from post-retirement income. That should not be a problem if lenders can be confident about the availability of such retirement income, or about the scope for the borrower to downsize and use the sale proceeds to pay off the balance of the loan.

But if lenders become too narrowly pre-occupied with the profile of the loan in the first 5 years (in line with MMR affordability rules), this could store up a problem for the future. Since this type of lending seems to be on the up, we have included expectations on lending into retirement in the updated version of the Sourcebook and the information we have been receiving as a result demonstrates the extent to which societies, over a short period, now engage in such lending.

There is also evidence that some societies are searching for yield by creeping up the risk curve in prime residential mortgages. High LTV lending (over 90%) has increased to 4.5% of new lending in Q4 2016, from 2.8% in Q4 2015. High/high lending[48] was 3.1% of new lending in Q4 2016, up from 1.8% in Q4 2015. Most medium/small societies have mortgage indemnity insurance, so are partially protected against this risk.

[47] http://www.bankofengland.co.uk/pra/Pages/publications/statement040717.aspx
[48] See chart 1. High/high lending is over 90% LTV and over 3.50 LTI for single income or 2.75 LTI for joint income. Small societies fall below the FPC threshold for controlling high LTI lending.

Chart 1: New high/high building society lending (% of all residential lending)



Notes: High/high lending is defined as over 90% LTV and over 3.50 LTI for single income or 2.75 LTI for joint income.
Source: Mortgage Lenders Administration Return (MLAR)

I should make clear that I am not unduly focusing on building societies in making these examples - what we are seeing is a market-wide trend. But I did want to take this opportunity to emphasise that the some parts of the sector face a number of strategic risks beyond those outlined above, including legacy issues relating to commercial lending and pension risk. Operational resilience is a key issue for societies, particularly where IT systems are outsourced, and we have stepped our supervisory efforts up a gear this year. Meanwhile, the finalisation of a number of key reforms (IFRS9, Basel III, MREL) will warrant a significant implementation effort that delivers, for example, genuinely robust (non-merger) recovery plans for societies.

We make our assessments of societies' business models and future plans in light of our judgements about the broader market context and extent to which risks can be appropriately managed and governed. In light of the challenges I have outlined, supervisors will continue to keep a close eye on the effects of these issues on the viability of business models and future strategy for building societies.

Regulatory arbitrage

I have spoken extensively about the steps we have taken, especially over the past few years, to build a robust regulatory framework and maintain a fit but lean army of supervisors to ensure it is implemented. It is worth noting here that we are not pig-headed about the specific way in which all elements of the regulatory framework fit together. Where we see something is not working as well as intended, we are prepared to make adjustments as long as we do not jeopardise financial resilience as a consequence.

Take the modification the PRA made last year, in which central bank reserves were excluded from the exposure measure in the UK leverage ratio. This change was made to ensure the effective transmission of monetary policy was not impaired and was recently followed up with a proposal to increase the minimum leverage ratio requirement from 3% to 3.25% to maintain the resilience of the standard overall. Where it makes sense to make a design improvement to better align with policy intent, we will do so. But on the whole, my sense is that we have the right shape of regime. So with reforms to the regulatory framework almost complete, how do we as supervisors remain vigilant in defending it?

I mentioned that the PRA's supervisory approach relies on a healthy dose of judgement. This is important because, even though we might think that our rules and regulations are now in much better shape, history tells us that the commercial incentives of firms will create pressures to find ways to minimise the impact of those rules.

I am especially mindful that financial institutions will always be able to innovate faster than we are able to modify the prudential rulebook. In order to remain fit for purpose, the prudential regulatory framework must be responsive to changes in the behaviour and structure of the financial system and identify any gaps, faults or incoherence that can lead to perverse behaviour. This is why we need well-informed rule-makers and alert supervisors, who together can smell when something is off and decide what to do about it.

And this is one reason, in my view, why supervision will be particularly important in the coming phase. The financial services industry that we regulate is highly developed, highly innovative and highly sophisticated. But, stripped bare of this complexity, it remains a business in which individuals need to exercise judgement, skill and care. The role of the supervisor is to observe this behaviour and form judgements about the extent to which the firm – and the individuals running it – meet the intention, as well as the letter of, the regulation.

Some innovation by financial institutions in response to regulation will be intended by regulators, or, if not intended, at least benign. For example, the current capital rules incentivise firms to reduce the volumes of outstanding derivative transactions on their books, as this reduces the capital charge applied. This is achieved by ”tearing up” or closing out unwanted trades. While it is not the primary intended consequence, some of this activity also makes firms simpler and more resolvable which should, in turn, reduce risks to financial stability.

However, some innovation is pure regulatory arbitrage – that is, action taken by firms to reduce specific regulatory requirements without any commensurate reduction in their risk. Let me share with you a few recent examples of behaviour that might be problematic, even if they comply with the specified rules.

Off-balance sheet leverage. The leverage ratio requires all on-balance sheet assets to carry a minimum level of capitalisation regardless of their risk. Off-balance sheet transactions are also captured in the leverage ratio, but if an on-balance sheet transaction can be restructured into an economically similar off-balance sheet transaction, it may not always attract the exact same capital charge. We have noticed that some institutions are now moving on-balance-sheet financing to off-balance-sheet formats using special purpose vehicles, derivatives, agency structures or collateral swaps.

Some of these structures might meet the detailed requirements for calculating a specific financial ratio whilst others may have a harmless motivation. But we have noticed that some carry material credit risk which escapes the detailed aspects of the capital framework. When setting up these transactions, firms should be prepared for questions from supervisors about the substance, as well as form, of their proposals.

Treatment of liquid assets. Similarly, the letter of the regulation allows firms to account for the value of the liquid assets in their liquid assets buffer on a "hold to maturity" basis rather than on a trading basis, under which their reported value would be updated daily in line with market conditions. This is an important concession for firms who do not have a trading book but it means that market value gains and losses on the portfolio remain undeclared until the assets are sold.

This practice raises the risk that – especially if gilt yields should rise – market price movements in liquid assets buffers could lead to unrealised losses. If this were to happen then the firm may be unwilling or unable to sell the assets. For which firm would want to sell liquid assets and declare unrealised losses at a time of liquidity stress? If the firm has access to the repo market, it may be able generate liquidity through repo. But there may be limited liquidity available in the repo market, so the liquidity of the liquid assets buffer would be impaired.

Of course, if the assets in the liquid asset portfolio concerned carry very low risk, and their possible market value changes are small, "hold to maturity" accounting should not be of any concern to a well-run firm or a well-informed supervisor. The appropriate level of risk is something we are currently discussing with firms.

Liquidity horizon. Finally, we are aware of banks seeking out funding that matures just beyond the time horizon used to calculate regulatory liquidity requirements. These include the Liquidity Coverage Requirement’s (LCR) 30-day window.

If a firm subject to the LCR accepts a deposit that can be withdrawn by giving less than 30 days’ notice, it has to hold a certain amount of high-quality liquid assets as insurance against the deposit being withdrawn during stress. As yields on high-quality liquid assets are relatively low, this can drag down profitability. But a bank can evade this by obtaining a deposit that matures after 30 days, since these deposits generate no requirement for counterbalancing high-quality liquid assets.

I recently saw a term-sheet for an evergreen 35-day call account. In previous times, the market-standard notice period was one calendar month. Why the shift from one-month to 35 days? The traditional one-calendar-month call account is only sometimes LCR-friendly – during a 31-day month – whereas the new 35-day product always is.

But how much additional liquidity has been obtained by extending the funding profile by five days? And how strong is liquidity risk management beyond the narrow requirements of the LCR?

Extending the term of a deposit by a few days to mature exactly just after the boundary of the liquidity risk measure is compliant with the letter of the regulation – but the overriding principle of safety and soundness must be considered.

Firms should expect supervisors to ask these questions and they should be prepared to defend their compliance, not only with the letter of the regulation, but also with our principles of prudence, effective risk management and adequacy of financial resources at all times.

Indeed, our approach has been to bake the spirit of the law into the letter of the regulation, via our Fundamental Rules. These rules define broad principles which firms must respect in addition to their compliance with the detail of any particular requirement. The Fundamental Rules require firms to act prudently, to conduct their business with skill, care and diligence, to have effective risk management as well as adequate financial resources, and to be open and co-operative with the regulator. The Fundamental Rule requiring firms to maintain adequate financial resources is supplemented by the overall financial and liquidity adequacy rules[49]. These provisions require firms to look at their financial resources in the round, not limiting their assessment to the specific financial ratios set out in the regulation.

Moreover, they are backed up in statute[50] by the PRA's Threshold Conditions for authorisation of deposit-takers and insurers, which stipulate that firms should have adequate financial resources and adequate non-financial resources at all times. The statute's definition of non-financial resources specifically mentions human resources – that will likely include many of you here today – and we have reflected this emphasis in our Senior Managers Regime to give specific responsibilities to key individuals in firms for the implementation of the prudential framework.

Whilst we, as supervisors, may identify issues that warrant further investigation, we will not spot everything. Ultimately, it remains the responsibility of senior managers and Boards of Directors to identify and mitigate the risk that firms are not complying with the spirit of the regulation. Indeed, we hold industry to account for its compliance with the Fundamental Rules and Senior (Insurance) Managers Regime, just as much as we hold it to account for its compliance with the detail of our regulations.

Solvency II contract boundary. Turning to an insurance example, Solvency II has introduced some changes to the way insurance companies calculate the reserves for their insurance products. In particular, the rules defining the 'boundary' of an insurance contract means that firms cannot recognise future premiums on

[49] Individual Capital Adequacy Assessment 2.1 and Individual Liquidity Adequacy Assessment 2.1
[50] Financial Services and Markets Act 2000, http://www.legislation.gov.uk/uksi/2013/555/article/2/made

unit-linked savings policies that do not include any insurance cover or financial guarantee of benefits. Under Solvency II valuation rules, this business is usually profitable and provides a boost to a firm's balance sheet; no credit for future premiums therefore reduces the recognition of expected future profits and leads to a lower solvency ratio.

In response to this, some firms have sought to amend existing insurance contracts in order to extend the contract boundary and recognise more future profit. The most common example is the addition of free marginal insurance benefits that are of questionable value to policyholders and which are (arguably) not economically discernible.

Some amendments might meet the letter of the regulation, but they are designed to circumvent the spirit. The PRA will continue to scrutinise proposals by firms which seek to strengthen their balance sheets but which pay little attention to the additional risks they carry.

Keeping across these issues, and leaning against any risks they create to our objectives, will require us to make good use of the full range of the Bank of England's intelligence and analytical techniques. The new strategic plan that we have just adopted for the Bank ('Vision 2020') is exactly in this spirit and I'm delighted that my beady-eyed colleague Vicky Saporta will lead some horizon-scanning work in this area.

Conclusion

Today I have provided a potted history of how banks, building societies and insurers have been supervised in the UK over the past 100 years. Despite the considerable pressure of day-to-day events, I think stepping back in this way occasionally and looking both ways is a good idea, in order to maintain a sense of perspective and learn from the efforts of our forebears.

The supervisory approach for banks, building societies and insurers in the UK has meandered down different paths, at different times – and each at a different pace. Indeed, even when regulation has been laid down in statute, each supervisory agency has taken time to develop and embed its own approach. For example, supervisors of building societies and insurers both received statutory responsibility around the same time – but my sense is that the building society supervisors were notable for their vigour and enthusiasm in implementing a more intrusive supervisory regime.

All have in common that enhanced powers for supervisors often came in response to a crisis – and even when new systems of regulation have been developed internationally, these have often been based on the experience of domestic institutions going under and reinforced by the emergence of new failures. The most recent example of this is undoubtedly the huge swathe of reforms instigated following the 2008 global financial crisis.

The average supervisory toolkit in each system of supervision is strikingly similar. It is clear that, regardless of whether you are a bank, building society or insurer, the three basic questions most regularly asked by a supervisor are: Is the firm financially sound? Does it have a sustainable business? Are the people running it competent, open and honest?

With that in mind, the types of activity undertaken by supervisors became well-established, particularly as supervisory approaches evolved, and indeed began to conform, in the latter half of the twentieth century. This evolution has laid the groundwork for the supervision that we undertake at the PRA today, with some obvious exceptions such as cyber risk which calls for innovation in our approach.

It would be hubristic to condemn and discard all the regimes of the past, or to insist that our approach is, for the first time in supervisory history, perfect. But I am confident that we have distilled the best (often basic) elements of supervisory practice from our mixed heritage – forward-looking, judgment-based, focused on the key risks – and combined these with a healthy dose of common sense to deliver the PRA's approach.

So what conclusions should we draw from the evolution of supervision over the past 100 years?
Will a supervisor in 2117 look back and say the PRA had the best way of doing things? I doubt it – supervisors of the future will surely identify ways to improve on various elements of our current supervisory model. Our approach here at the PRA is a good one but we would be wise to have some humility about it. But one thing that is clear if we look back over the twentieth century is that our predecessors were tackling many similar challenges, often with a strikingly similar response and for that reason I think that the core of the PRA's approach will endure.

Finally, it is clear to me that supervision – as distinct from regulation – is vital if we are to ensure that the framework of regulation operates effectively and as intended. Supervisors have an important job to do – defending the reforms put in place following the most recent crisis and, just as importantly, keeping their eyes peeled and their ears to the ground in pursuit of a safe and sound system over the next 100 years.

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