BANK OF ENGLAND

Speech

Stylish regulation

Speech given by

Sam Woods, Deputy Governor for Prudential Regulation and Chief Executive Officer,
Prudential Regulation Authority

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I met recently with the head of a large foreign bank, who was in London following a visit to the continent. He had been advised by some of our EU colleagues that with the departure of the UK from the EU, the British public would become alarmed at the size of the financial sector relative to the size of the economy and would therefore demand ever-tougher financial regulation in order to assuage their sense of unease. Thus it was put to him that it would be sensible for him to move more of his operations to Paris, Frankfurt or Dublin, where things would be easier.

A noisy pro-Brexit demonstration taking place in the next door street seemed to support his case. But I told him that I thought it somewhat unlikely that the public would take much interest in the size of the financial sector unless it blew up again, and that ten years on from the financial crisis we have largely implemented the reforms and are moving into more of a business-as-usual phase. I said that we more often heard the opposite concern from EU officials in the context of Brexit – that having escaped the "shackles" of EU regulation we would embark on a course of weakening financial regulation in a way that makes the financial system less resilient. This, needless to say, would be anathema to the Prudential Regulation Authority and to all of us who have spent the last decade repairing the financial system.

So as far as the *stringency* of financial regulation goes, we at the Bank have a clear view of what would make sense for the UK in a post-Brexit environment: we should keep it calibrated roughly where it is now and have no desire whatsoever to weaken it. And despite inevitable tensions between regulator and regulated, my impression is that at the most senior levels most of the people running banks and insurance companies in the UK today would agree with that position, and that it also has support in the Government and Parliament. We need to keep pace with new developments and continually patch any weak parts of the regulatory system, but overall following 10 years of wrenching reform we should let the new architecture do its job.

But what about the *style* of regulation in a post-Brexit world?

Now I am always reluctant to talk about style, for good reason: my oldest child told me the other day how much she admires the persistence with which I prioritise comfort over fashion in my clothing choices. In a sense it is also much too early even to think about this question, given that the terms of the UK's exit from the EU, and its future relationship with it, are still far from clear. And this will of course be a question for the Government and Parliament to settle when the time comes. However, in its own way Britain can be pretty stylish so I and colleagues at the Bank have been spending a little time thinking about this issue, in order to be ready to offer views when the time comes.

We have begun, of course, with first principles. As I am a practical person I always approach first principles with a degree of caution, but nonetheless in principle at least it must be good to have principles. So here are a few, which I would argue should form the basis of any regulatory regime which aims to deliver safety and soundness and financial stability in a UK context:

1. Robust prudential standards. This one may be in the category of "so obvious why do you need to say it?" But I think it's vital that this is stated as the first and most important feature of any credible framework for prudential regulation. The goal is to ensure continuity in the supply of vital financial services to the real economy throughout the cycle, including after severe shocks. All other principles should be subordinate to this one.

2. Responsible openness based on international collaboration and standards. This principle is particularly relevant to the UK given the Government's policy of maintaining the UK as a leading international financial centre, which is itself rooted in a centuries-long tradition of London as a major global trading hub. In practice, what does this mean? It means three things: first, that we have a mandate to engage strongly in international standard-setting processes and make sure that we are at the forefront of implementing those rules in a thorough way; second, that we adopt practices and structures which promote strong collaboration with colleagues in other jurisdictions; and third, that we are open to hosting cross-border business in the UK – but only if it is appropriately controlled and governed. Our recent moves to ring-fence retail banking, and other expectations (some going back to 2014) that firms will subsidiarise material retail banking and insurance businesses, are a vital part of what enables us to take this approach safely.

3. Proportionality and sensitivity to business models, and promoting competition. We have, for better or for worse, adopted a system in which financial companies are privately or mutually owned and then regulated in the public interest in order to make them internalise costs which might otherwise be borne by others. An analogy is sometimes drawn with pollution: the factory is encouraged to generate wealth for its owners by employing people to make products that people want to buy, but it cannot have a free pass to pour waste chemicals into the river. It follows inevitably from this that there will be tensions and arguments between regulator and regulated. However, these frictions should not be bigger than they have to be – in other words, we should aim for a system in which the burdens on firms created by our regulation are no greater than they need to be to achieve the objectives set by Parliament. Part of this is about the ability to adapt regulation for different types of businesses, as given the enormous diversity of financial firms operating in the UK it is unlikely that one size will fit all in all cases. The other side of this coin is that we cannot run a zero-failure regime.

4. Dynamism and responsiveness. Sometimes these words – "dynamism", "responsiveness" and indeed "proportionality" above – are understood to imply weak regulation, which unsurprisingly we at the Bank are firmly against. So because of this danger of a whiff of weakness we have thought very carefully about whether it is important to have something like this as part of our list of principles. We have concluded that it is necessary for a simple reason: the financial system is an extraordinarily adaptive organism and is constantly changing. Sometimes this is for good reasons, for instance as it adopts new technologies in order to deliver a better product. Surely many of us would find it intensely irritating to go back to needing a laptop to check our bank balance rather than doing it through the app on our phones, or indeed – if we jump another generation back – to have to go into a branch to arrange a payment, although branches are still very important for many customers. Regulation should not block these advances, and should actively keep pace with them – for instance we need to have the ability to adapt the calibration of liquidity regulations if it turns out that app-based deposit outflows have a different shape from branch-based ones. And as new players emerge we need to make sure that our regulation is not creating unnecessary barriers to entry and thereby impeding healthy competition. But sometimes the system adapts for bad reasons – the profit motive drives firms to find the weaker parts of the system and channel business into them. We need to be sufficiently fleet of foot to respond to these shifts before they create serious problems – in short, regulation should be future-facing and keep fit for purpose.

5. Consistency. Firms and the public need to be confident that the regulatory framework is stable, that prudential rules are based on clear evidence, and that supervisory judgements are impartial and consistent. We need to ensure that the approaches of regulators are consistent across activities carried out by firms, and consistent across sectors where different types of firm happen to provide some similar services.

6. Accountability. This is particularly important in a system in which considerable discretion is provided to regulators, both to make rules and to supervise and enforce firms' adherence to them. There is a strong economic case for giving such responsibilities to an operationally independent regulator with clear statutory objectives defined by Parliament. Like monetary policy, prudential regulation faces a time-inconsistency problem. Governments may have incentives to boost credit cycles to increase short-term nominal growth, causing problems in the medium- and long-term – indeed these problems may be more acute for financial regulation than for monetary policy, given that the cost of regulation tends to impact financial services firms in the short-term but the benefits tend only to be visible in the much longer-term (hence the importance of cost-benefit analysis requirements being placed on regulators). Of course independent regulators can get it wrong too, and have in the recent past – but an independent regulator with a clear mandate for stability can more credibly commit to robust prudential standards. Counter-intuitively, it may also be the case that an independent regulator has more scope to be proportionate while maintaining confidence, because a government may actually need to over-regulate in order to establish its credibility. But – thankfully for all of us – we live in a democracy, and so a system of independent regulation can only work if the regulators are properly accountable, in particular to Parliament.

So much for principles. In practice, where might these lead to for a post-Brexit system of financial regulation in the UK?

One possibility is: nowhere! This could arise in several ways, but one comes immediately to mind – a scenario in which our future relationship with the EU takes a form that means we stick with a system which looks exactly like what we have today. There is no reason to be very alarmed by this prospect – it is not ideal but we have largely shaped that system through our membership of the EU and we make it work well currently. However, this would be undesirable if it came with the prospect of becoming a rule-taker in financial services with all the risks – both prudential, and as a matter of industrial policy – that entails.

But let us toy briefly with the idea that the Government and Parliament decide to adopt a style of financial services regulation built on the six principles set out above, or something like them. What, in practice, would this style look like?

To step back one pace, you can consider the style of different bits of financial regulation in the UK as being at different points along a spectrum[1]. Looking at the last two decades, at one end there is the original Financial Services and Markets Act[2] (FSMA) 2000 model, which gives most discretion to operationally independent regulators. Only statutory objectives and the general framework for rule-making (including obligations to "have regard" to particular matters) are set out in legislation, and regulators have wide powers to make rules which comprise the regulatory regime. At the other end of the spectrum is the way in which rules are made in the EU, which we have imported through the "on-shoring" process as part of Brexit. Under this approach a significant amount of technical detail, including calibrations, are set out in legislation.

In between these two, there are various other options, including in recent UK experience the approaches adopted for the Senior Managers and Certification Regime (SMCR) and ring-fencing. Both of these contain significantly less detail in legislation (rather than regulators' rules) as compared to the EU model:

- *SMCR.* Certain core aspects of the regime (e.g. the framework for regulatory approval processes and the fitness and propriety test, relevant offences, and introducing the concept of conduct rules and statements of responsibilities) are set out in legislation. But regulators were given considerable discretion in filling in the detail of the framework – including what functions required approval, the content of the conduct rules, and the detailed systems and controls requirements that apply to firms.

- *Ring-fencing.* The Act amended the PRA's objectives to incorporate ring-fencing, and set out the basic structural aspects of the regime (in particular about the scope of the ring-fence), while leaving much of the framework to be established via statutory instruments from the Treasury. The statute also detailed matters related to ring-fenced banks' governance and policies which the PRA should make rules about. The PRA also implemented further details of the regime (e.g. systems and controls requirements, capital requirements for ring-fenced banks, independence requirements, access to payment systems) via rules.

To be clear, I am not focused here on the question of whether or not the SMCR or ring-fencing are a good thing, about which people will argue for decades. Rather, I am focused on the legislative style which Parliament adopted in order to introduce them – how this style compares to other models, and which model seems to fit best the principles set out above for a future financial services framework in the UK.

[1] See Annex 1
[2] The 2000 Financial Services and Markets Act (FSMA) established the current domestic UK framework for financial regulation

To my mind, if we look across the four main legislative styles adopted by Parliament in the last couple of decades – those for delivering FSMA, SMCR, ring-fencing and the EU model – the one that fits the principles best is the approach used for SMCR:

1. *Robust prudential standards*. It's a tough regime which enables us to hold the top brass to account when things go wrong.
2. *Responsible openness based on international collaboration and standards*. The approach taken works with the grain of the international financial system, and other countries have already borrowed heavily from it.
3. *Proportionality and sensitivity to business models, and promoting competition*. The regime has left us room to tailor it so that it fits a small insurance company as well as it fits a huge bank.
4. *Dynamism and responsiveness.* The framework gives us room to adapt it as needed. To give you one recent example: in view of the increased importance of operational resilience at firms, and particularly at banks given the programme of branch closures and the rapidly-growing dependence of their customers on digital channels, we last year introduced a new Senior Manager Function (SMF 24) for operations – so that it is clear who is accountable when things go wrong. This simply wasn't as high a priority when the SMCR was first brought in in 2016, but had become more important since – and the framework is flexible enough to allow us to respond to this change.
5. *Consistency.* There is enough of the regime in legislation to ensure consistency across activities and through time.
6. *Accountability*. We are regularly asked about the regime in Parliament, and have imposed it on ourselves.

The other attraction of using the approach taken for the SMCR for future regulation is that it has been the preferred approach adopted by Parliament most recently when not constrained by EU regulation (for the roll-out of the SMCR to insurers, which occurred in December 2018). This is an important consideration at a time of heightened debate, in a Brexit context, about so-called "Henry VIIIth" and "Cardinal Wolsey" powers. Although it is uncertain quite what those gentlemen's views would have been on the output floor in Basel 3.1, my point is that making use of an approach recently chosen by Parliament seems to me to have considerable attractions relative to choosing something completely new and untested.

Would it not, though, be easier and better simply to stick with the EU model through which we have recently imported a large volume of rules? This approach is radically different from the approach the UK has taken when left to its own devices. Indeed, the EU model, with a large body of technical rules set out in the equivalent of primary legislation, is quite different from how most of the world does it. For example, the EU and Switzerland were the only two members of the Basel Committee on Banking Standards where Basel 3 was implemented through primary legislation rather than the prudential authority's rule-making powers – in major economies like the US, Australia and Canada the regulators did the implementation. Even within the EU, where directives are used to implement Basel 3, some member states opted to allow regulators to implement these directives. Another example is on the insurance side, where some extremely detailed and highly technical actuarial material has ended up in EU legislation as part of Solvency 2 rather than being left to regulators. And in general the EU approach contrasts with that of the UK, where Acts of Parliament are usually used for overarching changes to the institutional framework and many of the details are then delegated to regulators, who are vigorously held to account for their activities by Parliament. Another place in which this bites is in relation to smaller firms, which are often subject to the entire rulebook when in some cases safety and soundness might be better served by a simpler (simpler, not weaker) approach. None of this is to advocate a wholesale re-write of existing, on-shored rules and regulations – to my mind the question is more about what style we adopt for future regulations.

Why is the EU approach different? Many others have provided answers that question[3]. Emphasis is sometimes put on the differing legal traditions in EU countries, which – it is sometimes argued – in aggregate tends to lead to a norm of greater and more detailed specification in EU legislation than tends to result from the UK's approach. But from my experience as a practitioner I think it derives in the main from another factor: the goal of harmonising regulation and supervision across 28 countries. It is entirely natural that this latter point should lead to a system in which a greater volume of the detail gets locked down in legislation as opposed to regulators' rules. It is also entirely natural to ask whether such an approach would make sense for the UK once outside the EU.

This question for Government and Parliament will also need to take into account the issue of EU market access, which could in some scenarios lead to greater alignment. Alternatively, we could adopt a hybrid approach which doesn't replicate either of the pre-existing EU or British approaches. Once you open this box the possibilities are legion. For instance, one could imagine a 'design vs calibration' split (design in legislation, calibration in rules), or a wholesale/retail split with more of the wholesale framework in legislation in order to keep closer to the EU.

Conclusion

At some point in the Brexit process, the question may arise for the Government and Parliament: what framework for financial regulation do we want to have in the UK? What style do we want to adopt? As for *stringency*, we can assure foreign banks' chief executives that we have no plans to upgrade our regulatory dress code to white-tie-only, and we can assure our colleagues in the EU that we have absolutely no desire to take off our clothes! But what will be the British *style* in this area? The PRA and the wider Bank stand ready to support this debate if and when it begins. I would urge all those involved to give serious consideration to the principles set out above, and to using an existing British approach, in the form of the model adopted for introducing the SMCR, to deliver them.

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[3] See for instance Andrew Bailey's speech: https://www.fca.org.uk/news/speeches/future-financial-conduct-regulation

ILLUSTRATIVE

Annex 1: Illustration of different approaches to financial regulation, by degree of discretion granted to regulators