



BANK OF ENGLAND  
PRUDENTIAL REGULATION  
AUTHORITY

# Annual Competition Report

## 2017

# Prudential Regulation Authority

## Annual Competition Report

### July 2017

This is the Prudential Regulation Authority's (PRA) second Annual Competition Report (*Report*). It has been produced in response to a request from the Government in 2015 that the PRA should publish an annual report setting out how it is delivering against its secondary competition objective (SCO). The PRA's SCO, as set out in Financial Services and Markets Act 2000 (FSMA), came into force on 1 March 2014 and states that:

'When discharging its general functions in a way that advances its objectives, the PRA must so far as is reasonably possible act in a way which, as a secondary objective, facilitates effective competition in the markets for services provided by PRA-authorized persons in carrying on regulated activities'.

In March 2017, the Government sent the Prudential Regulation Committee (PRC) the first recommendation letter<sup>1</sup> about aspects of the government's economic policy to which the PRC should have regard when considering how to advance its objectives and when considering the application of the regulatory principles set out in FSMA. Of particular relevance to this *Report*, the letter indicated that the Government is keen to see more competition in all sectors of the financial services industry, particularly retail banking. This includes minimising barriers to entry and ensuring a diversity of business models. Moreover, the Government wishes to ensure that the United Kingdom remains an attractive domicile for internationally-active financial institutions, and that London retains its position as the leading international financial centre. Finally, the Government is keen to see innovation in the financial services sector and how this can support the wider economy, through new methods of engaging with consumers of financial services and new ways of raising capital. This includes recognising differences in the nature and objectives of business models and ensuring burdens are proportionate.

There are two parts to this *Report*:

Part 1 sets out key policy areas in which the PRA has delivered against its SCO by facilitating effective competition. Examples include:

- changes to capital requirements to reduce the risk that capital standards are overly prudent for firms using the standardised approach (SA) for credit risk;

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<sup>1</sup> See s30B Bank of England Act 1998 (BoEA). Information about the PRC and HM Treasury's recommendation letter is available at [www.bankofengland.co.uk/about/Pages/people/prapeople.aspx](http://www.bankofengland.co.uk/about/Pages/people/prapeople.aspx).

- easing access to the retail banking market through the ongoing work of the New Bank Start-up Unit (NBSU);
- facilitating the development of the market for Insurance Linked Securities (ILS), which provides an alternative to traditional reinsurance products;
- making sure that stand-alone ring-fenced banks are not unduly burdened compared to those that form parts of universal banking groups;
- levelling the playing field across large banking groups with ring-fenced banks and smaller banks subject to structural reform through constraining the use of double leverage by large banking groups;
- mitigating the risk that the implementation of International Financial Reporting Standard (IFRS) 9 in January 2018 unduly penalises small firms through the impact on some credit portfolios; and
- a greater focus on competition in future stress tests.

Looking forward, the PRA will undertake a review of Solvency II requirements in areas where it has flexibility in implementation.

Part 2 summarises how the PRA has continued the process of embedding the SCO into PRA policy and supervisory decision making and responded to the recommendations made by the Bank's Independent Evaluation Office (IEO) in its 2016 review of the PRA approach to the SCO. It also provides a summary of the competition-focused research activity undertaken by PRA staff, which includes using a newly-created database of historical regulatory returns data to construct a series of measures of competition in the UK deposit-taking sector.

The PRA is committed to being open and accountable in the performance of its responsibilities and in the use of its powers. This *Report* is intended to help achieve this outcome.

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# Abbreviations used in this report

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<b>ABI</b>	Association of British Insurers
<b>BCBS</b>	Basel Committee on Banking Supervision
<b>BES</b>	Biennial Exploratory Scenario
<b>CMA</b>	Competition and Markets Authority
<b>CP</b>	Consultation Paper
<b>CEPR</b>	Centre for Economic Policy Research
<b>CRR</b>	Capital Requirements Regulation
<b>DP</b>	Discussion Paper
<b>EBA</b>	European Banking Authority
<b>ECL</b>	Expected credit loss
<b>FCA</b>	Financial Conduct Authority
<b>FPC</b>	Financial Policy Committee
<b>G-SII</b>	Global systemically important institution
<b>IEO</b>	Independent Evaluation Office
<b>IFRS</b>	International Financial Reporting Standard
<b>ILS</b>	Insurance Linked Securities
<b>IRB</b>	Internal ratings based
<b>LCR</b>	Liquidity coverage ratio
<b>LGD</b>	Loss given default
<b>NBSU</b>	New Bank Start-up Unit
<b>OSII</b>	Other systemically important institution
<b>PD</b>	Probability of default
<b>PPGD</b>	Probability of possession given default
<b>PRA</b>	Prudential Regulation Authority
<b>PRC</b>	Prudential Regulation Committee
<b>PS</b>	Policy Statement
<b>PSR</b>	Payment Systems Regulator
<b>RFB</b>	Ring-fenced bank
<b>SA</b>	Standardised approach
<b>SCO</b>	Secondary competition objective
<b>SIMR</b>	Senior Insurance Managers Regime
<b>SRPC</b>	Supervision, Risk and Policy Committee

# Part 1

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## 1 Application of the secondary competition objective in the work of the PRA

This part of the *Report* sets out the key areas in which the PRA has delivered, and intends to deliver, against the SCO including, for example, steps the PRA has taken to review its approach to internal ratings based (IRB) model applications from smaller firms, and policy measures that, by applying the principle of proportionality, facilitate effective competition.

### 1.1 Facilitating market entry and expansion

#### Smaller firms and the internal ratings based (IRB) approach

To address the competitive disadvantage faced by firms using the standardised approach (SA) in the residential mortgage lending market, the PRA undertook a review in 2016 of its approach to IRB credit risk model applications from smaller banks and building societies. The findings showed that many of the specific issues raised by IRB aspirants were linked to an overarching perception that the PRA did not welcome IRB applications from smaller firms. This, together with the significant challenges of implementing IRB, had discouraged some boards from approving investment in IRB projects. The following themes have contributed to this perception: process and PRA interaction; lack of clarity about regulatory requirements for IRB model approval; and data inadequacies, particularly for residential mortgage lending. In response to these issues, in last year's Annual Competition Report<sup>1</sup> the PRA made the following high level commitments:

- Process enhancements – make more PRA resource available for the pre-application phase and the initiation of a new approach aimed at delivering improved interaction between firms and the PRA; and make the application process more transparent by moving to a module-based assessment, with indicative timescales for response and regular feedback to applicants.
- Provide greater clarity of PRA expectations in respect of certain IRB regulatory requirements highlighted by firms.

Box 1 summarises what the PRA has done to deliver against these high level commitments.

#### **Box 1: Facilitating IRB model applications from smaller firms**

Subject to meeting minimum prudential standards and obtaining permission from the PRA, the IRB approach allows a firm to use its own estimates of parameters to calculate a risk-weighted capital requirement for credit risk. Therefore, an IRB model should more closely reflect the firm's assessment of the risks in its lending compared to firms using the SA, where risk weights are based on regulator-set parameters which typically will be less risk sensitive.

The PRA published the results of its review of the approach to IRB model applications from smaller firms in last year's Annual Competition Report. In response, the PRA has sought to reform its approach in those areas outlined above without compromising prudential soundness, although it should be made clear that the PRA has not developed a separate IRB regime for smaller firms. Permission must be granted for an applicant firm to use the IRB approach only if the PRA is satisfied that an applicant is compliant with the

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1 [www.bankofengland.co.uk/publications/Documents/annualreport/2016/compreport.pdf](http://www.bankofengland.co.uk/publications/Documents/annualreport/2016/compreport.pdf).

IRB requirements set out in EU law.

The reforms will be relevant to all firms regardless of size and are not specific to any type of firm. In practice, however, they are likely to be most relevant and beneficial to smaller and newer firms that wish to assess the appropriateness of IRB permissions for their business model. They should also signify that the PRA is 'open for business' if a firm believes it meets the IRB requirements and wishes to proceed with developing an application.

(a) Process enhancements

The PRA has made two IRB-related process enhancements, which will help improve the quality and transparency of communications with firms:

(i) Pre-application engagement with IRB aspirants

The design principles are:

- greater engagement across a range of issues;
- a consistent approach across aspirants;
- the PRA can highlight areas of non-compliance with IRB requirements;
- pre-application engagements will not constitute a technical model review nor will the PRA act as a consultant;
- a firm can discuss potential compliance and idiosyncratic issues prior to application; and
- any feedback to the firm will be based on supervisory judgement at the time and will be non-comprehensive, non-binding, and non-definitive.

(ii) A new modular and transparent application process

The key features are:

- a briefer scoping phase, including communication, to ensure the firm understands what will be delivered in the future and identifies progress in the application process;
- an indicative work plan that includes timescales for each module and internal sign-off;
- a review of modules based on categories of IRB requirements in the Capital Requirements Regulation (CRR);
- feedback at various points so the firm can undertake remedial work during the assessment; and
- an updated, clearer application pack that links documentation requirements to each module.<sup>1</sup> This also includes self-assessment forms for Sequential Implementation plans and Permanent Partial Use, which should improve understanding in these two areas.

(b) Consultation Paper (CP)

CP5/17 'Internal Ratings Based (IRB) approach: clarifying PRA expectations' was published on 28 March 2017 and proposed changes to Supervisory Statement (SS) 11/13 'Internal Ratings Based Approach'.<sup>2</sup> The measures proposed in the CP should enable firms that wish to obtain IRB permissions to understand better the PRA's expectations for IRB applications, and therefore enable firms to take investment

1 'Internal Ratings Based Approach CRR Permission application pack' is available at [www.bankofengland.co.uk/pr/Pages/authorisations/crr/applying.aspx](http://www.bankofengland.co.uk/pr/Pages/authorisations/crr/applying.aspx).

2 [www.bankofengland.co.uk/pr/Pages/publications/cp/2017/cp517.aspx](http://www.bankofengland.co.uk/pr/Pages/publications/cp/2017/cp517.aspx).

decisions with greater confidence.

The PRA has sought to clarify its expectations in respect of the specific requirements of the IRB approach, including those outlined in last year's *Report*. The CP focused on the more significant aspects of the IRB Framework, specifically:

- how firms can demonstrate that they meet the requirements of the CRR on 'prior experience' of using IRB approaches; and
- the use of external data to supplement internal data for estimating Probability of Default (PD) and Loss Given Default (LGD) for residential mortgages.

The CP also proposed the setting of two Probability of Possession Given Default (PPGD) reference points (PPGD is one of the main drivers of LGD). This is in response to the difficulty in building up default and loss data for residential mortgages as a result of prudent lending practices and/or the economic environment. These are reference points from which a firm with limited data and the PRA can begin the assessment of an appropriate margin of conservatism in the firm's PPGD estimates.

Where external data are used, the PRA would expect firms to apply additional margins of conservatism. This can be expected to limit the reduction in capital requirements that can result when moving from the SA to the IRB approach for residential mortgages. Over time, however, firms can be expected to build up additional internal data that may justify a lowering of the level of conservatism and a consequent reduction of their capital requirements.

The PRA will consider the feedback received during the consultation period and aims to publish an update of SS11/13 in October 2017.

#### (c) Additional communication

On 24 February 2017, the PRA held a seminar for smaller banks and building societies that set out the elements of the PRA's IRB regime that are particularly relevant for this population. The 18 firms in attendance had previously indicated an interest in submitting an IRB application in the future. The content of the seminar included the suite of clarifications of PRA expectations in respect of specific IRB regulatory requirements, and process enhancements relating to the PRA's pre-application engagement and the nature of the application process. Firms were also offered the opportunity to take part in a Q&A session with specialists from the PRA. This fulfilled the commitment that was made in last year's *Report*. The PRA will re-run this seminar at a future date should it be required. However it is envisaged that this content can be provided to firms through the new pre-application engagement model. In addition, Martin Stewart, Director of Banks, Building Societies and Credit Unions, gave a speech on 3 March 2017 that outlined the PRA's work on refining the standardised capital regime.<sup>1</sup>

#### Update on the New Bank Start-up Unit: continued progress

The New Bank Start-up Unit (NBSU) was established in January 2016 as a joint initiative from the PRA and Financial Conduct Authority (FCA) with the aim of giving information and support to firms thinking of becoming a bank or building society in the United Kingdom. This includes information on an alternative route to becoming a fully operational bank or building society – 'mobilisation' – introduced as part of 'A review of requirements for firms entering into or expanding into the banking sector: one year on'.<sup>2</sup>

1 "Harrowing the ploughed field" – Refining the standardised capital regime': [www.bankofengland.co.uk/publications/Pages/speeches/2017/965.aspx](http://www.bankofengland.co.uk/publications/Pages/speeches/2017/965.aspx).

2 July 2014: [www.bankofengland.co.uk/pru/Pages/publications/reports/2014/reviewrequirements.aspx](http://www.bankofengland.co.uk/pru/Pages/publications/reports/2014/reviewrequirements.aspx).



During its first year the NBSU provided regular information and support to prospective and newly authorised UK and international banks in pursuit of its aim of helping to smooth the process of obtaining authorisation and establishing a bank in the United Kingdom.

The NBSU has three principal outputs: (i) a dedicated website; (ii) the provision of periodic seminars; and (iii) a single point of contact.

- (i) The focal point of the NBSU is a dedicated website<sup>1</sup> which outlines in detail the authorisation process, providing applicant firms with a step-by-step guide. The website sets out the factors prospective banking applicants should consider when preparing an application to become a UK authorised bank. It also confirms how any application will be assessed, and what life will be like as a newly authorised UK bank or building society. The NBSU continues to update and refresh the website to ensure it provides the up-to-date information necessary to smooth entry into the UK banking market.
- (ii) In 2016 the NBSU hosted two heavily oversubscribed seminars. Delegates heard from a variety of speakers including representatives from the PRA, FCA, and the Payment Systems Regulator (PSR), as well as from newly authorised firms themselves. Feedback has been positive and suggests that the seminars are an effective mechanism of communicating relevant information to participants, whatever business model they are considering. The most recent seminar was held on 9 June 2017, and it is expected that seminars will continue to be hosted periodically.
- (iii) A dedicated helpline and email address remain in place for firms. This is in addition to the case officers from both the PRA and FCA assigned to each firm once its application is in train to provide formal and informal support on applications.

The NBSU has assisted several authorities from other countries who have been keen to learn more about the UK regulatory approach to the authorisation of new banks and building societies.

By way of summary, since the PRA was formed in April 2013, the PRA has authorised 25 new banks, fifteen of which are UK banks, with the remainder being subsidiaries or branches of overseas banks. Of those fifteen, four had a 'FinTech' business model based on providing retail banking services to customers entirely digitally. There continues to be a healthy pipeline of potential new entrants with interest from about 35 firms that have started the authorisation process, eight of which have formally applied to become a bank. Since its launch, the NBSU website has had over 37,000 page views.

### Developing the market for Insurance Linked Securities (ILS)

Insurance Linked Securities (ILS) provide (re)insurers with an alternative form of risk transfer to traditional, well-established reinsurance products. They constitute a growing and innovative sector of the insurance market and the development of a regulatory regime that is both transparent to firms and proportionate to the risk they represent should facilitate new entrants to the market.

As part of HM Treasury's initiative to develop ILS business in the United Kingdom, the PRA consulted (jointly with the FCA)<sup>2</sup> on its regulatory approach to the authorisation and supervision of insurance special purpose vehicles (ISPVs), the vehicles central to the ILS market. The CP proposed a framework that the PRA would follow in assessing ILS authorisation applications and when delivering ongoing supervision, consistent with the requirements of Solvency II.

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1 [www.bankofengland.co.uk/pranbsu/Pages/default.aspx](http://www.bankofengland.co.uk/pranbsu/Pages/default.aspx).

2 CP42/16 'Authorisation and supervision of insurance special purpose vehicles', November 2016: [www.bankofengland.co.uk/pranbsu/Pages/publications/cp/2016/cp4216.aspx](http://www.bankofengland.co.uk/pranbsu/Pages/publications/cp/2016/cp4216.aspx).

Feedback to the consultation has been received, including views on the implications for the PRA's competition objective. This feedback will be considered with a view to issuing final policy during 2017.

## 1.2 Implementation of Solvency II

As at Q4 2016, the PRA had issued around 150 reporting waivers for quarterly Solvency II reporting. This amounts to over 70% of solo and over 50% of group quarterly reporting waived for small insurers. The PRA will continue to evaluate the use of these waivers through its review of submitted returns. This will focus primarily on the expansion of the eligibility of these waivers to medium-sized insurers.

In March 2017, Sam Woods, Deputy Governor for Prudential Regulation and Chief Executive of the PRA, provided evidence to the Treasury Committee as part of its inquiry into Solvency II.<sup>1</sup> He set out his preliminary views on several areas where the UK industry has raised concerns about undue burdens, including areas where further work will be considered. Some areas are particularly relevant to the SCO such as the work on undertaking an assessment of reporting requirements where the PRA has flexibility in implementation.

## 1.3 Increased proportionality

In its work to develop and implement prudential policies, both domestic and international in origin, the PRA has been proactive in identifying areas where a more proportionate approach, that facilitates effective competition without compromising prudential standards, could be adopted.

### Domestic regulation

The PRA has proactively applied the principle of proportionality to the design and implementation of domestic policy resulting in material changes to policy outcomes and beneficial impacts on effective competition.

### Refining the PRA's Pillar 2A capital framework

The PRA published a CP3/17 on 24 February 2017 proposing refinements to the Pillar 2A capital framework.<sup>2</sup> This approach seeks to address concerns over the differences between SA and IRB model risk weights. Proposals in this CP would allow supervisors to exercise judgement and reduce variable Pillar 2A add-ons for firms using the SA for credit risk where appropriate. In assessing capital needs, supervisors will take into account the greater degree of conservatism that may apply to risk weights derived under the SA compared to those from IRB models for certain types of exposure, using so-called IRB credit risk benchmarks. These are average risk weights for different types of exposure across firms that use IRB models.

It is proposed that PRA supervisors will also take into account a range of additional factors including: the outcome of the PRA's existing Pillar 2A methodologies for capitalising different types of individual risks; firms' own assessments of the amount of capital they need to maintain given the risks on their balance sheets; firms' overall business model and risk profile (including the quality of risk management and governance); and peer comparisons. This should help to reduce the risk that capital standards are overly prudent for firms using the SA for credit risk, essentially by looking at capital requirements in the round rather than assuming that a simple 'sum of the parts' approach will necessarily deliver the right answer.

The consultation closed on 31 May 2017 with a target implementation date of 1 January 2018.

## Structural reform

1 [www.parliament.uk/business/committees/committees-a-z/commons-select/treasury-committee/inquiries1/parliament-2015/eu-insurance-regulation-16-17/](http://www.parliament.uk/business/committees/committees-a-z/commons-select/treasury-committee/inquiries1/parliament-2015/eu-insurance-regulation-16-17/).

2 'Refining the PRA's Pillar 2A capital framework': [www.bankofengland.co.uk/pr/Pages/publications/cp/2017/cp317.aspx](http://www.bankofengland.co.uk/pr/Pages/publications/cp/2017/cp317.aspx).

In July 2016 the PRA published its second policy statement on the implementation of ring-fencing covering prudential requirements, intragroup arrangements and use of financial market infrastructures.<sup>1</sup> One issue raised by respondents to the consultation was how the PRA's ring-fencing rules and related policies will apply to UK banking groups with no excluded-activity entities. In particular, respondents asked whether the PRA would permit the ring-fenced bank (RFB) to treat other members of its group as if they were members of an RFB sub-group in such cases. Certain PRA ring-fencing requirements and related policy do not apply between members of an RFB sub-group.

In response to the consultation, the PRA amended SS8/16 'Ring-fenced Bodies (RFBs)'<sup>2</sup> to clarify that, where an RFB sub-group is not established, an RFB could apply to the PRA for a modification to the PRA's ring-fencing rules so that requirements (and the PRA's related policy) are applied to the RFB's UK consolidated group level as if it were an RFB sub-group. This is important for those firms that may exceed the threshold for ring-fencing of £25 billion in core deposits (broadly retail and SME deposits) but that do not own material investment or international banking businesses and which consequently do not intend to form RFB sub-groups. Allowing entirely retail-focused banks to treat other members of their group as if they were members of an RFB sub-group puts them on a level playing field with the RFB sub-groups of universal banks that undertake similar activities.

This demonstrates that the PRA will be applying its ring-fencing policy in a manner it considers to be proportionate to achieve the outcomes set out by the group ring-fencing purposes of FSMA, while also taking into consideration the variety of business models and legal entity structures that exist across firms that will be subject to structural reform.

As part of its proposals on the implementation of ring-fencing, the PRA proposed to take account of 'RFB group risk' when assessing capital adequacy at the consolidated group level under Pillar 2 (CP25/16).<sup>3</sup> These proposals reduce the incentive for firms to use 'double leverage'<sup>4</sup> when prudential requirements are set at both the RFB sub-group and the consolidated group level. The PRA's assessment is that this proposal could have a beneficial impact on competition. This is because large groups tend to make greater use of double leverage than smaller groups.

### Implementation of IFRS 9

IFRS 9 is a new set of accounting rules for financial instruments issued as part of the post-crisis reforms, effective from 1 January 2018. A major change for banks is the introduction of a forward-looking approach to the assessment of the impairment of loans, in response to concerns that the current incurred loss approach is 'too little, too late'.

In addition, as part of the refinements to its Pillar 2A capital framework outlined above, the PRA is also consulting on proposals to consider the extent to which the expected credit loss (ECL) approach in IFRS 9 may already be covered by the Pillar 1 capital charge for firms using the SA for credit risk. Any potential overlap between ECL and the Pillar 1 capital charge would inform the setting of Pillar 2A capital, so that smaller firms using the SA are not unduly disadvantaged.

In addition, in February 2017 the PRA ran a seminar for medium-sized and smaller UK banks and building societies affected by the ECL requirements under IFRS 9. 89 firms were represented in total, which corresponds to the vast majority of the affected firms. The purpose of the seminar was to discuss the implementation of this accounting standard and, in particular, how this can be done in both a

1 PS20/16 'The implementation of ring-fencing: prudential requirements, intragroup arrangements and use of financial market infrastructures': [www.bankofengland.co.uk/pr/Pages/publications/ps/2016/ps2016.aspx](http://www.bankofengland.co.uk/pr/Pages/publications/ps/2016/ps2016.aspx).

2 February 2017: [www.bankofengland.co.uk/pr/Pages/publications/ss/2017/ss816update.aspx](http://www.bankofengland.co.uk/pr/Pages/publications/ss/2017/ss816update.aspx).

3 'The implementation of ring-fencing: reporting and residual matters', July 2016: [www.bankofengland.co.uk/pr/Pages/publications/cp/2016/cp2516.aspx](http://www.bankofengland.co.uk/pr/Pages/publications/cp/2016/cp2516.aspx).

4 'Double leverage' (also known as 'capital upgrading') refers to situations in which a parent company funds investments in the regulatory capital of its subsidiaries by itself issuing capital or other funding instruments of lower quality.

proportionate and consistent way. A number of speakers from the PRA and the major audit firms, as well as from banks and building societies, talked about the key issues for the latter and how they might deal appropriately with the practical challenges presented by the standard. The speakers also held a panel session enabling firms to ask questions. It is the PRA's intention to have a follow-up seminar later this year which will discuss progress made and practical implementation issues that remain.

### Senior Insurance Managers Regime (SIMR)

As explained in this *Report* last year, the PRA introduced new rules requiring insurance firms to take reasonable steps to obtain (and correspondingly to provide) regulatory references for all their managers responsible for a senior management function or other significant functions. These rules are intended to inhibit the opportunity for individuals with a history of business misconduct from moving readily from one financial services firm to another regulated firm.

The PRA is consulting in CP8/17 on some proposed new rules for the optimisation of the SIMR,<sup>1</sup> and is planning to consult on the extension of a certification regime to insurers. It is envisaged that the application of a number of these proposed new rules will differentiate between smaller and larger firms. This will help to ensure that larger insurance firms and groups operate under comparable governance standards to one another, which, together with a more streamlined approach for smaller firms, should ensure a proportionate approach is adopted.

### International regulation

The PRA has continued to exercise its influence internationally to progress effective competition through the proportionate design of regulations. In line with the expectations of the Competition and Markets Authority (CMA), the PRA argued for a significant lowering of the standardised risk weight for low loan to value (LTV) mortgages when negotiating revisions to the SA for credit risk being considered by the Basel Committee on Banking Supervision (BCBS).

### Liquidity reporting requirements

In March 2017 the European Banking Authority (EBA) published its guidelines on liquidity coverage ratio (LCR) disclosure,<sup>2</sup> which is intended to improve the transparency and comparability of firms' liquidity risk management. The guidelines specify common disclosure templates and tables that contain firms' LCRs, and other key liquidity risk management-related information. There is a template for systemic firms and a simplified template for non-systemic firms.

The PRA supported a proportionate approach to the guidelines through the specification of a simplified LCR disclosure template for non-systemic firms (ie institutions that are not defined either as global systemically important institutions (G-SIIs) or as other systemically important institutions (OSIIs)). The simplified template includes only the LCR ratio, the firm's liquidity buffer and its net outflows. The rationale for the differentiated approach, set out in the guidelines, is that the impact in markets that such firms' disclosures may trigger are expected to be very different, given their non-systemic classification and liquidity risk profiles, compared to systemically important institutions.

### Proposed amendments to the CRR

Proportionality is also an important part of the November 2016 European Commission proposals to amend prudential requirements for banks and investment firms.<sup>3</sup> The PRA supported proposals aimed to achieve proportionality on remuneration, reporting and disclosure. In line with the Bank's response to the Commission's Call for Evidence on the EU Regulatory Framework for Financial Services,<sup>4</sup> the PRA is

1 'Strengthening accountability in banking and insurance: optimisations to the SIMR, and changes to SMR forms', June 2017: [www.bankofengland.co.uk/pr/Pages/publications/cp/2017/cp817.aspx](http://www.bankofengland.co.uk/pr/Pages/publications/cp/2017/cp817.aspx).

2 [www.eba.europa.eu/-/eba-publishes-final-guidelines-on-lcr-disclosure](http://www.eba.europa.eu/-/eba-publishes-final-guidelines-on-lcr-disclosure).

3 [ec.europa.eu/transparency/regdoc/rep/1/2016/EN/COM-2016-850-F1-EN-MAIN.PDF](http://ec.europa.eu/transparency/regdoc/rep/1/2016/EN/COM-2016-850-F1-EN-MAIN.PDF).

4 [www.bankofengland.co.uk/financialstability/Pages/regframework/response.aspx](http://www.bankofengland.co.uk/financialstability/Pages/regframework/response.aspx).

supportive of measures to introduce greater proportionality in prudential requirements for smaller, less complex firms. The measures set out in the Commission proposal are subject to negotiations and likely to evolve as discussions proceed among Member States, and within the European Parliament.

The proposed amendments to the EU Capital Requirements Regulation (CRR II) would introduce new approaches for calculating risk-weighted capital requirements for trading activities carried out by banks, building societies and investment firms – the market risk and counterparty credit risk frameworks. The proposals include a more proportionate approach to the way in which smaller firms have to implement the rules. For market risk, smaller firms would be allowed to use a simplified approach to calculate capital requirements that does not rely on them developing models to estimate risk, and for the smallest firms there would also be the option to calculate capital requirements under the credit risk framework rather than creating separate systems to implement the market risk rules. For counterparty credit risk, smaller firms would also be able to choose to apply a simplified approach to calculate capital requirements.

A proposed amendment to CRR II envisaged that the EBA should produce a report on the proportionality of reporting requirements and the financial impact on firms of complying with these requirements. CRR II also included a proposal for a new category of small institutions (those with total assets below €1.5 billion) which would be subject to reduced reporting requirements. Finally, another proposed amendment would see new categories of institutions (large, small and other, including non-listed) with disclosure frequency and other requirements varying according to category of firm.

### Implementation of IFRS 9

With respect to the implementation of IFRS 9, the PRA is also engaging at the European level to ensure that the bank capital framework is adjusted to give firms transitional capital relief in response to the effect of implementing IFRS 9. This should help to address the PRA's concern that the impact on capital ratios may be greater for firms using the SA rather than IRB approach for credit risk. The PRA is also engaging internationally at the BCBS to begin to discuss whether and how it might be appropriate for the capital framework to be adjusted in response to IFRS 9 in the longer term.

## 1.4 Stress Testing

### 2017 biennial exploratory scenario (BES)

The 2017 stress test scenarios and guidance were published by the FPC and PRA on 27 March 2017.<sup>1</sup> In addition to the annual cyclical scenario, for the first time the Bank is running an additional exploratory scenario, which includes an increase in competitive pressure as a potential source of stress over the long term. Further information is set out in Box 2.

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<sup>1</sup> Key elements of the 2017 stress test (March 2017) is available on the Bank of England website at [www.bankofengland.co.uk/financialstability/Pages/fpc/stresstest.aspx](http://www.bankofengland.co.uk/financialstability/Pages/fpc/stresstest.aspx).

## Box 2: The 2017 stress test – biennial exploratory scenario

The 2017 stress test includes two stress scenarios. Alongside the annual cyclical scenario, the Bank is running an additional exploratory scenario for the first time. The aim of the 2017 exploratory scenario is to consider how the UK banking system might evolve if recent headwinds to bank profitability persist or intensify.

One of the key features of the 2017 exploratory scenario is an intensification of competitive pressure from smaller banks and non-bank businesses. The scenario also incorporates weak global growth, persistently low interest rates, stagnant world trade and cross-border banking activity and a continuation of costs related to misconduct. The test will have a seven-year horizon.

### Why is competition featured in the 2017 exploratory scenario?

In recent years, there has been substantial competitive pressure in many UK retail lending markets. Since the start of 2013, spreads on new mortgage and personal loan lending have fallen by nearly 200 basis points and nearly 300 basis points respectively. While much of this has been driven by the strengthening of major banks' balance sheets following the financial crisis, restoring their capacity to supply credit, small lenders' share of gross new UK retail lending has risen by 10 percentage points since the start of 2010, from 28% to 38%. Their presence has contributed to both a loss of market share for the major banks and competition in pricing and other terms and conditions in these markets.

On the corporate side, there has been a migration of larger companies in particular towards market-based finance and away from bank credit.

Additional competitive pressures may come from developments in regulation and financial technology. Initiatives from the CMA and the FCA to increase transparency on current account fees could boost competition, as could greater use of mobile banking applications. These developments could make it easier for customers to switch their deposits, leading to a reduction in major banks' brand power, and a rise in the deposit rates paid by these banks.

### How is competition incorporated into the 2017 exploratory scenario?

In light of the above, in this scenario banks face a trade-off between maintaining margins and retaining market share.

In retail banking, market-wide lending spreads fall while deposit spreads rise. The net impact is around a 40% fall in the spread between market retail deposit and lending rates relative to current levels. There is also a reduction in the share of household savings held as retail deposits as households increasingly invest in products offered by non-banks.

In corporate lending, in addition to the demand for credit being subdued, private non-financial corporations increasingly opt to issue market debt rather than borrow directly from banks. The growth of bank lending to corporates turns negative in the second half of 2017 and remains that way for the rest of the scenario. As a result, the aggregate stock of corporate loans on banks' balance sheets falls significantly (by 21% from 2016 Q4), leading to a loss in fees and cross-selling revenues associated with these loans.

## Part 2

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In the first Annual Competition Report, the PRA recognised that there was more to be done to embed the SCO, in particular with respect to implementing the recommendations of the Independent Evaluation Office (IEO) published in March 2016.<sup>1</sup> Since then, the PRA has completed a programme of work designed to ensure that the resources and processes developed during the last two years are always used by PRA staff responsible for developing prudential policy.

As part of the ongoing implementation of the SCO, the PRA is committed to deepening its understanding of how competition affects firms' safety and soundness, policyholder protection and financial stability. To this end, the PRA has undertaken, and is undertaking, a number of research projects on the relationship between prudential regulation, financial stability and effective competition, with the ultimate aim of helping build the evidence base to support and influence policymaking, both domestically and internationally. Further, in order to motivate and engage with external researchers in this important area, the PRA has launched a programme of regular academic conferences and seminars focussed on various aspects of the relationship between competition and financial regulation.

## 2 Implementing the SCO

This section sets out the programme of work completed by the PRA to embed the SCO in response to the recommendations of the review undertaken by the IEO.

### 2.1 Effective processes

A core element of the PRA's effort to embed the SCO in its policymaking process is the identification and prioritisation of policies most likely to have an impact on competition. This meant making better use of management information (MI) to monitor competition-relevant policies both on a forward-looking basis and retrospectively. Regarding the former, a new tool based on the PRA's regular quarterly MI has been developed to take a more strategic approach towards horizon scanning of planned policy work and to identify those areas of policy which may require more detailed competition assessment. Regarding the latter, based on a new tool developed internally, competition-focussed MI can now be generated in order to monitor, record and report the extent to which competition discussions take place as appropriate at governance forums within the PRA. This allows the delivery of more systematic updates to the PRC on how competition considerations are influencing policy development.

### 2.2 Research agenda

In line with one of the IEO recommendations, the PRA is committed to maintaining a flow of policy-oriented research projects aimed at deepening its understanding of the complex relationship between prudential regulation, financial stability and effective competition. Since the first publication of this *Report* last year, two research projects have been completed with the publication of corresponding Staff Working Papers. These two research projects focussed on: i) the impact of IRB models on the pricing of mortgages;<sup>2</sup> and ii) developing indicators of effective competition in the UK deposit-taking sector.<sup>3</sup>

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1 [www.bankofengland.co.uk/about/Documents/ieo/evaluation0316.pdf](http://www.bankofengland.co.uk/about/Documents/ieo/evaluation0316.pdf). See also the PRA's response to the IEOs evaluation, March 2016: [www.bankofengland.co.uk/about/Documents/ieo/preresponse0316.pdf](http://www.bankofengland.co.uk/about/Documents/ieo/preresponse0316.pdf).

2 Staff Working Paper No. 639 'Specialisation in mortgage risk under Basel II' January 2017: [www.bankofengland.co.uk/research/Pages/workingpapers/2017/swp639.aspx](http://www.bankofengland.co.uk/research/Pages/workingpapers/2017/swp639.aspx).

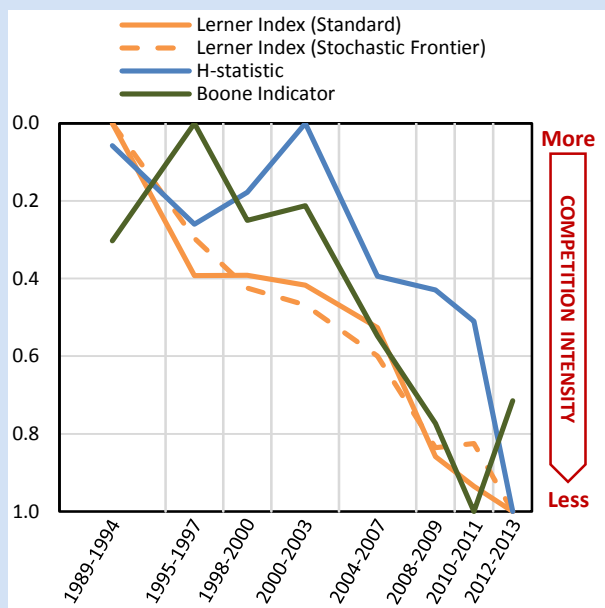
3 Staff Working Paper No. 631 'Measuring competition in the UK deposit-taking sector' December 2016: [www.bankofengland.co.uk/research/Pages/workingpapers/2016/swp631.aspx](http://www.bankofengland.co.uk/research/Pages/workingpapers/2016/swp631.aspx).

In particular, the latter project looked to measure the intensity of competition in the UK deposit-taking sector, providing empirical evidence of competition intensity over a long period of time and context for historical developments. The novelty of this research is twofold: i) four different measures of competition have been used, thus providing greater confidence in the conclusions where measures coincide; and ii) a new dataset is used that spans a 24-year period (from 1989 to 2013) and includes both banks and building societies to see how competition evolved over time in the sector. The findings of this research suggest competition intensity declined in general over the period of the study, with firms earning increasing market rents. The decline in competition intensity in the period before the financial crisis suggests that the relationship between competition and financial stability is not straightforward. Box 3 provides more detail.

### Box 3: Measuring competition in the UK deposit-taking sector

Accurate measures of competition intensity are important in understanding the influence of the deposit-taking sector on the wider economy. Ineffective competition in banking can have negative consequences for productive efficiency and the cost of finance, with implications for consumer welfare and economic growth.

In new research, an approach using four measures of competition (the Lerner Index, the stochastic frontier Lerner Index, the H-statistic, and the Boone indicator), along with a new regulatory dataset of UK deposit takers covering a 24-year period, was used to explore how competition intensity in the United Kingdom evolved over time.



The four measures used in the study are shown in the chart which shows that competition intensity, while generally strong over the period 1989-2003, deteriorated in the period ahead of the financial crisis and remained at a lower level. There are a number of factors that have driven this trend historically.

First, competition was strong in the 1990s and early 2000s as firms adapted to a new landscape for competition. Financial market reforms of the 1980s (eg removing the bank 'corset', the 'Big Bang' reforms, and the 1986 Building Societies Act) changed the regulatory landscape, allowing banks and building societies to compete more directly with one another. A number of large banking groups emerged from this process, encouraged by the desire to compete effectively with large foreign

banks and from a desire by regulators to promote financial stability.

Second, the trend changed after the last big pre-crisis merger in 2001 (the creation of HBOS) with competition weakening noticeably from 2000-03 to 2004-07. During this period, firms earned increasing market rents up until the 2008 financial crisis.

Finally, in the post-crisis period (2010-13) the picture is less clear. Differences in the trend may reflect the various direct interventions in markets undertaken in response to the financial crisis (eg Bank Recapitalisation Fund, Special Liquidity Scheme, and government loan guarantees) which drove outcomes away from purely market-driven outcomes.



Overall, the measures estimated show that competition intensity between deposit takers was generally positive in the 1990s as firms adapted to the newly deregulated environment, but weakened in the years immediately ahead of the financial crisis. Interestingly, this outcome is not consistent with the hypothesis that financial stability is enhanced by less competition, and suggests that the relationship between competition in the deposit-taking sector and financial stability is not straightforward.

These research findings have been taken forward in a new project as part of the ‘One Bank Research Agenda’,<sup>1</sup> that looks to expand more on the relationship between competition and financial stability using: i) a number of different measures of financial stability which are common in the literature; and ii) different empirical techniques such as regression analysis and causality testing.

Another ongoing research project undertaken within the ‘One Bank Research Agenda’ looks to understand and monitor the extent to which the ‘stickiness’ of retail deposits may change in response to the Open Banking Standard, which was mandated by the CMA.<sup>2</sup> This remedy is ultimately aimed at lowering consumer search and switching costs by empowering the usage of so-called ‘aggregators’ – apps that allow consumers to compare prices and product characteristics on the basis of individual spending behaviour and usage profiles, and to manage multiple accounts seamlessly. While this is likely to be a positive development from a competition, consumer and innovation perspective, the increased movement of retail deposits between deposit-taking institutions facilitated by the use of aggregators could have a number of prudential implications for retail banks’ business models.

### 2.3 Internal and external communication of the PRA’s approach to the SCO

As part of the PRA’s efforts to improve awareness and understanding of its SCO amongst its internal and external stakeholders, the PRA hosted a conference on competition and regulation in financial markets in February 2017, organised jointly with the Centre for Economic Policy Research (CEPR). The conference attracted a number of leading practitioners in the field and included: i) contributions from Sam Woods (Deputy Governor for Prudential Regulation and Chief Executive of the PRA) and Andy Haldane (the Bank of England’s Chief Economist); ii) keynote speeches by Mathias Dewatripont (at the time Director at the National Bank of Belgium) and Tommaso Valletti (Chief Economist, European Commission, Directorate-General Competition); iii) a policy panel discussion on competition and regulation featuring Franklin Allen (Imperial College), Thorsten Beck (Cass Business School), John Thanassoulis (Warwick Business School), and Huy Nguyen Trieu (CEO, The Disruptive Group); and iv) a presentation of recent papers on competition and regulation from Eva Schliephake (Harvard University), Valeriya Dinger (Osnabrück University), and Giancarlo Spagnolo (Stockholm Institute of Transition Economics - Stockholm School of Economics).

The papers presented at the conference covered a wide range of highly relevant topics which included: i) optimal capital regulation when banks compete with non-bank lenders; ii) the signalling effects of seasoned equity offerings; iii) the disciplining effects of rewarding whistleblowers; iv) the implications of common ownership; and v) the prevailing competitive strategies adopted by ‘FinTech’ start-ups. There were attendees from a number of different institutions, for example: the FCA; the PSR; CMA; the British Banking Association; the Building Societies Association; the Confederation of British Industry; the Bank for International Settlements; the European Central Bank; the EU Commission; the Organisation for Economic Co-operation and Development; the European Free Trade Association Surveillance Authority; the European Bank for Reconstruction and Development; the Bundesbank; Norges Bank; the National Bank of Belgium; the Spanish Competition Authority; and from senior managers from economic

1 More detail at [www.bankofengland.co.uk/research/Documents/onebank/summary.pdf](http://www.bankofengland.co.uk/research/Documents/onebank/summary.pdf).

2 The Open Banking Standard was a key remedy that came out of the CMA’s retail banking market investigation. See, CMA press release ‘Open Banking revolution moves closer’ February 2017: [www.gov.uk/government/news/open-banking-revolution-moves-closer](http://www.gov.uk/government/news/open-banking-revolution-moves-closer).

consultancies such as Charles River Associates, Oxera and PricewaterhouseCoopers. The PRA intends to hold this event on an annual basis.

Another element of the PRA's approach to its competition-related communications is its efforts to invite prominent speakers to give competition-themed public lectures. To this end, the first of a series of Flagship seminars with a focus on competition was delivered in December 2016 by Hal Varian, Chief Economist of Google, in which he discussed how digitalisation has disrupted business models in general, and how economic regulation should adapt in light of this paradigmatic shift. A second seminar by Glen Weyl of Yale University and Microsoft is planned for later in 2017.

Continuing the theme from the first edition of this *Report* on how the SCO aligns with the PRA's primary objectives, a forthcoming Bank Staff Working Paper, co-authored by Paul Fisher (Deputy Head of the PRA and Executive Director for Supervisory Risk and Regulatory Operations until 2016), and Paul Grout (the PRA's Senior Advisor on Competition) explores this subject, as explained in more detail in Box 4 below.

#### **Box 4: The relationship between facilitating competition and the primary objectives**

The SCO requires the PRA to act, subject to achieving its primary objectives, in a manner which facilitates effective competition. This statutory requirement for the PRA to facilitate competition, in addition to prudential and financial stability objectives, is believed to be unique, hence the interpretation and implementation of the SCO, and its interaction with other objectives, is of considerable interest. As indicated in the text, here we summarise the results of a working paper which seeks to analyse the interaction of competition and prudential regulation and, using this analysis, identify how the SCO should be interpreted and implemented.

The general conditions under which multiple objectives, which are not perfectly independent, can be achieved in the medium term (when delegated to different agencies), requires the set of targets given to different regulatory agencies to be compatible with overarching government policy and there needs to be as many sufficiently independent instruments as targets, otherwise the objectives cannot all be achieved. The use of secondary objectives is not common internationally but such objectives can play a critical role. Good policy should require that instruments and objectives are allocated across the relevant agencies in a manner that ensures policy effectiveness and stability and enables co-ordination. The allocation of secondary objectives to agencies can ensure that, as each seeks to achieve its primary objectives, they also minimise spillovers that would hamper other agencies in achieving their primary objectives, ie secondary objectives can play a central role in ensuring efficient co-ordination. The absence of provision of specific competition powers to the PRA when the SCO was introduced and the requirement that the PRA facilitates, as opposed to promotes, competition nevertheless helps ensure that in pursuing safety and soundness the benefits of competition are not ignored and that the actions to promote competition by other agencies (eg the FCA and CMA) are supported where possible by PRA policy. The flexibility to do this comes from the PRA's ability to vary the application of regulation - for example, in the timescales of regulatory action.

The much discussed conflict between competition and stability can arise, in theoretical models, if there is poor or no prudential regulation, but it is unlikely that there is a conflict between stability and competition in one market without a complementary relationship between stability and competition arising in other markets. However, once one recognises the co-ordination of policies, ie policy to facilitate competition can be set at the same time that the regulator changes its policy to achieve safety and soundness, then the conflict between stability and competition tends to disappear. Indeed stability and facilitating competition are often complementary (the simplest and most obvious example being removal of the 'too big to fail' subsidy to large banks). Any tendency to consider using a limit on

competition to achieve optimal safety and soundness will generally be relegated to the margins. The paper concludes that the historical concern for safety and soundness when pursuing competition is misplaced, hence the PRA can be proactive in seeking to facilitate competition and vigilant against policies that are not proportionate.

The meaning of effective competition in the sphere of banking and insurance is also analysed, and it is argued that the requirement to facilitate effective competition provides a separate argument for the complementarity of the PRA's objectives. The timeframe can again be relevant. Policies to facilitate effective competition should aim to facilitate those competitors that can survive in the market in the long run when meeting the costs of risk shifting to society. Hence, the focus on facilitating effective competition should, for example, be seeking to ensure that the smaller banks pay no more than the appropriate price for risks that they may shift and benefits they bring. Hence any long-run conflict between policies that promote safety and soundness and those that promote effective competition may raise doubts about whether such policies are proportionate and whether a sensible concept of effective competition is being pursued.

## 2.4 Working with external stakeholders

The PRA is committed to building on the strong and effective working relationships it has developed with competition regulators, in particular the FCA and CMA. The PRA and FCA co-operate effectively, not only within the ambit of the formal PRA-FCA Memorandum of Understanding,<sup>1</sup> but also with respect to the NBSU, a joint initiative between the PRA and the FCA.<sup>2</sup>

As reported last year, the PRA assisted the CMA with its retail banking market investigation, in particular in relation to the CMA's work on the impact of the capital requirements regime. The CMA concluded its retail banking market inquiry in August 2016. The CMA confirmed the provisional finding that prudential rules do not give rise to an adverse effect on competition. The CMA also called on both HM Treasury and the PRA to give due consideration to competition when developing and negotiating policies.

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1 [www.bankofengland.co.uk/about/Documents/mous/prastatutory/moufcapra.pdf](http://www.bankofengland.co.uk/about/Documents/mous/prastatutory/moufcapra.pdf).

2 See the 'Update on the New Bank Start-up Unit: continued progress' section on page 7 of this Report.



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