Questionnaire on the reappointment of Antony Jenkins CBE to the Prudential Regulation Committee February 2024

Personal

1. **Do you have any business or financial connections, or other commitments, that potentially give rise to a conflict or perceived conflict of interest in carrying out your continuing duties as a member of the Prudential Regulation Committee?**

I have declared my assets and liabilities to the Bank and the Bank also maintains a public register of interests[1] which sets out relevant financial and non-financial interests, including the roles I hold at present outside of the Bank.

Notably the business I founded, 10x Banking, serves and is in discussions with banks around the world including some regulated by the PRA.

As a consequence, we have a system of recusals in place for specific organizations. There are also certain thematic subjects such as use of cloud services by banks where I have recused myself.

Finally, I have a close family member employed by a regulated firm. As a matter of prudence, I have to date recused myself from specific decisions/discussion concerning this firm.

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

Yes.

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

I do not plan to take on additional commitments at this time.

The Prudential Regulation Committee and Prudential Regulation Authority

4. In your initial questionnaire, you noted as a possible risk to the safety and soundness of firms "[…] the poor returns on equity in the industry which are a consequence of further adjustments required to the operating models of the banks particularly in the areas of cost management and technology". Does this remain a concern?

- **Do you have an optimal return on equity in mind when thinking about the**

[1] https://www.bankofengland.co.uk/-/media/boe/files/about/register-of-interests

safety and soundness of firms regulated by the PRA?

There is no doubt that the financial system is considerably safer than in the run up to the GFC principally due to higher levels of liquidity and capital. Indeed, given the complexity of business models within banking and the cyclical nature of these activities, appropriate levels of capital and liquidity are incredibly important protections.

One of the consequences of higher capital levels, all other things being equal is that return on equity declines. Although we have seen an improvement in return on equity during my service on the PRC, there remains work to do. This is important as banks need to be able to raise capital and shareholders deserve a fair return on their investment.

Return on equity should exceed cost of capital both of which will be unique to individual firms.

Also of concern is the fact that most of the large firms we regulate trade at a discount to book. This suggests that the market has concerns about the quality of assets on the banks' balance sheets and/or the sustainability of these returns over time.

I believe that having made considerable progress on re-regulation post the GFC which has been further advanced by the implementation of Basel 3.1, there remains work to do around return on equity.

As I commented in the original questionnaire this will require banks to examine carefully how they allocate capital and the revenues and costs associated with this allocation. This is captured in the overall business model. Significant opportunity for banks exists for them to improve these business models through more effective capital allocation and improvement of operational and risk costs. Technology will play a key role in this as banks can automate activities and process data more effectively.

5.What do you think the overall impact will be of the reform of Solvency II?

The short answer is that it is too soon to say and that the impact of these reforms will need to be closely monitored over the coming years.

As a result of leaving the EU, the UK had the opportunity to enact these reforms. At their heart is a set of potentially competing factors; the desire to improve productive investment particularly in infrastructure, policy holder protection and returns to shareholders.

Through an extensive dialogue between the PRA and Treasury, a series of reforms were agreed. As has been publicly stated, the view of the PRA is that risk has increased. As the Governor has said the one-year probability of failure has increased from 0.5% to 0.6% and whilst these numbers seem low, the cumulative impact over many years must also be considered.

Reflecting on the experience of the banking industry over the twenty years to the GFC, it was clear the regulatory change (sometimes referred to as "light touch" regulation in the UK) led to relatively reduced capital levels in the industry and consequent short-run improvement in returns for shareholders. When coupled with greater risk taking, this caused a situation that was near cataclysmic for the financial system.

Whilst I am not suggesting that Solvency II will lead to the same outcome, this experience does suggest very careful monitoring of the impact of these reforms on the PRA's statutory objectives is necessary. Some comfort can be taken from the attestation and stress testing components, but other metrics of import will be the increase in the amount of productive investment and the returns to shareholders via dividends and share buybacks.

I am confident that the PRC will be vigilant in overseeing these impacts.

6. What risks and benefits arise from Machine Learning and Artificial Intelligence?

- In your initial questionnaire, you noted that “Firms are challenged, on the one hand by fintech and on the other, big tech whilst firms’ legacy systems are often decades old.” How has this played out?

This is a vast and complex topic.

Machine Learning and Artificial Intelligence are not new capabilities, but it is true that the power of them is increasing at an increasing rate. However, it is also true, that as with much technology change, we have the tendency to overestimate the impact in the short term and underestimate it in the long term.

It is therefore important that we consider risks and benefits from the perspective of the firms we regulate and the PRA itself.

We must also consider the fundamental requirements for the deployment of ML and AI. These include very large data sets to train the algorithms and algorithms that are capable of self-adaptation. The combination of these requirements can inject risk around bias because of the training data used and the nature of the algorithms themselves where it can be opaque as to how decisions are made.

If we turn to the application of these technologies within firms the most common uses are currently automation of customer service (e.g. chatbots), back and middle office automation (e.g. data collection from customers for operational purposes) and automation of technology operations (e.g. coding productivity can be increased by up to 30% and similar gains can be seen in testing). Firms are also experimenting with the use of these technologies in areas such as fraud, AML/KYC and credit decisioning.

For the PRA itself, the most obvious areas are data analysis and technology productivity.

The benefits for both parties include lower operating cost, better use of human capital and faster speed to deliver new services.

It is an open question as to how these benefits are shared between the organizations deploying them and their “customers.”

On the downside there are the risks of bias and poor outcomes where decisions are made by an algorithm which does not fully account for all the relevant factors. The protection against this is that human oversight must be maintained at critical points to ensure that the benefits are garnered, and the risks minimized.

It should also be stressed that it is very early in the development of these technologies, and it is important that the human capital of the organization is developed so that these tools can be properly used and managed.

Regarding my earlier comments, we have seen a continuation of trend where some Fintechs have gained significant market share. This has pressured the legacy banks in certain areas, for example the competition for deposits as interest rates have risen. Of course, this is largely beneficial for customers themselves.

The big tech firms continue to increase the intermediation of the financial system. For example, the use of ApplePay or GooglePay for payments or offering point of sale financing (often provided by banks).

My expectation is that these trends will continue to accelerate in the coming years.

7. How has the PRA's secondary competitiveness and growth objective affected the work of the Prudential Regulation Committee?

As the PRA has stated, we see this objective being driven by three things. Firstly, maintaining trust in the PRA and the UK prudential framework. Secondly adopting effective regulatory processes and engagement and thirdly adopting a responsive approach to UK risks and opportunities.

As such this objective has a very broad impact on our work and is routinely considered in the course of the work of the PRC. Some examples in the public domain include the removal of the cap on bankers' bonuses where the PRA position was also that this policy was counterproductive to our objectives. Another example would be the strong and simple regime for smaller institutions.

At its heart strong and effective micro prudential regulation is the bedrock of the attractiveness of the UK as a place to do business. The more attractive we are, the more we can attract investment and businesses to drive growth.

These themes are very much reflected in the day to day work of the PRC, for example in the oversight of the effectiveness of the PRA in SMF authorization approval times.

8. How have rising interest rates, and inflation, affected the work of the Prudential Regulation Committee?

Within the PRC we have considered the impact of rising interest rates and inflation very broadly.

From a micro prudential perspective, raising interest rates have the ability to stress the cashflows of individuals and businesses where they have obtained financing at previous lower rates and which needs to be refinanced at the now, higher, prevailing rates. Likewise, inflation can increase the cost of living and thereby stress the finances of businesses and individuals.

There are other consequences of these factors, for example property prices could fall if interest rates increase causing the possibility of negative equity for some.

Examples of how these trends are addressed in the PRC include supervisory oversight of individual firms, sector wide analysis and of course stress testing.

We have also been careful to think broadly about impact. For example, we are now approximately 15 years away from the last major economic downturn. This means that many of the people who had experience of such downturns have now moved on or retired.

A significant downturn creates significant demand in areas such as customer service and collections as customers reach out for help. Ensuring that sufficient trained capacity is available to meet this demand is key for firms. We have been working hard with PRA colleagues to ensure they are asking the right questions of firms in this regard.

9. What do you regard as the major lessons from the failures of SVB and Credit Suisse?

There are three major lessons from these bank failures.

a. Despite much higher levels of capital and liquidity in the system, banks still fail when confidence weakens. This is an inherent feature of maturity transformation and fractional reserve banking.

   However, unlike the GFC the presence of social media can significantly accelerate the collapse of confidence and the ability to move money electronically can increase the pace at which the institution loses liquidity.

b. Subsidiarization - while helpful - is not a perfect protection against a failing parent.

c. Business model matters. Although SVB had a relatively simple business model, they were caught by the significant and unexpected rise in interest rates. Likewise, the higher risk business model of Credit Suisse caused depositors to withdraw money at pace.

From these lessons we can draw several implications for the regulators. These include being constantly attuned to the external reputation of firms in order to be able to respond quickly when confidence starts to wane.

Critical evaluation of the business model of firms needs to be conducted and where concerns are identified, boards and management need to be held to account to address these concerns.

Whilst the FSCS limit is widely known, in practice there was no expectation that this cash was in anyway at risk.

Certainly, there was no return provided for that risk and as a practical matter it would be almost impossible to spread these businesses' cash across a sufficient number of banks to benefit from depositor protection.

Consequently, regulators need to think hard about how to ensure that this cash is always available to customers in the event of a bank failure.

10. What do you regard as the major lessons from the Liability-Driven Investment episode?

This episode was caused by a confluence of short and long term factors. These include the desire of Defined Benefit pension plans to match long term assets and liabilities, the excessive use of leverage, concentration in the providers of these facilities and an abrupt and unexpected increase in interest rates and thus a fall in gilt pricing.

Whilst the PRA does not regulate pension funds, the gilts market was severely disrupted, which had a financial stability impact that was of concern to the Bank and the FPC. This also in turn affected the funds' counterparties including banks.

There are a number of important lessons to be learned here.

Firstly, we must try as best we can to understand the totality of the parties involved in financial transactions whether directly regulated by us or not.

Secondly, we should be skeptical that statistical modelling will accurately reflect all risk, particularly the tail risk of extreme moves in for example interest rates.

Thirdly, we need to be aware of the international connectedness of and the need for international coordination.

These lessons apply broadly across our work.

11. Are you content with the rules related to, and the PRA resources devoted to, the approval of applications by banks to use an internal ratings-based approach to credit risk?

The use of IRB models for credit risk has the potential benefit of allowing the idiosyncrasies of individual books to be better reflected for capital allocation. There is also the potential for moral hazard where these models are used too aggressively by firms with the sole purpose of reducing the capital allocated.

There are also a number of practical matters affecting firms in the use of such models. They include having sufficient clean longitudinal data, modelling capability inside firms and institutional memory to provide context to the model.

For the regulator, sufficient quantity and quality of resource needs to be available to effectively review the models and approve them or provide feedback to the firms as required.

Overall, I believe that the rules are clear but that the process could be improved for both parties. This would include the PRA providing more clarity as to our expectations and having sufficient resources to do the work.

Likewise, the firms need to have the appropriate human and technology resources to complete the work.

Internally, we periodically review the progress to date on IRB and seek to learn lessons for improvement where appropriate.

12.In your initial questionnaire, you said that "The work of the PRC in the regulation of individual firms requires a high degree of confidentiality for obvious reasons". However, you told us you looked forward "[…] to representing the work of the PRC in whatever general way is considered appropriate." How have you publicly represented the work of the PRC in your first term?

Since joining the PRC, it has become even more apparent that what we do can be highly confidential and on occasion market sensitive.

I have sought to represent the PRA where possible, by explaining our work to wider segments of the industry – these have largely been technical audiences.

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

I would highlight three important areas of risk that the PRA needs to consider.

a) Geopolitics. There has been much discussion about the level of instability in the world at present including most prominently conflict in the Middle East and Eastern Europe. What is striking about these conflicts is the speed at which they have arisen and consequently the shocks to the global economy. Significant global inflation was triggered by the Russian invasion of Ukraine for example. This in turn led to rising interest rates and some of the issues described in question 8.

b) Economic macro trends. These include sustained low economic growth in some developed world economies, aging/shrinking working populations, the weakening of globalization and move to net zero. Any and all of these trends could create material stress in the UK economy and thus affect the performance of the firms we regulate.

c) Technology. There are many forms of technology challenge from the upgrading of legacy technology to the impact of new technology discussed in part in question 6. The consequences for firms include greater risk of fraud and cyber attack, increasing customer demand and challenge to business model.

What is notable about the above risks are that they are both highly significant and highly unpredictable. Whilst we can take some comfort from the fact that we have not seen a recurrence of the problems experienced by the sector during the GFC, we should acknowledge that there has been substantial fiscal and monetary support through various times of crisis since then.

As a regulator we cannot count on this to always be the case. Therefore, we need to constantly factor these environmental risks into our policy making and supervisory activities and then be constantly vigilant.

Please provide a full CV when returning this questionnaire. The Treasury Committee will publish your answers to this questionnaire alongside your CV. All documents should be provided in Word and PDF. Please provide these documents by midday 13 February 2024.