Questionnaire on the reappointment of John Taylor to the Prudential Regulation Committee, submitted 4th January 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 do not consider that I have any business or financial connections, or other commitments, that might potentially give rise to a conflict or perceived conflict of interest in carrying out my duties as an External Member of the PRC. In line with the PRC's Conflict of Interest Code, 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 (none of which I consider pose an actual or perceived conflict with my role on the PRC).

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?

   I have other non-executive commitments that I accommodate alongside the PRC. My total time commitment across all roles is approximately 3.5 days per week, so I have contingency should demands emerge at short notice.

The Prudential Regulation Committee and Prudential Regulation Authority

4. In your initial questionnaire, you stated that you would expect to make a particular contribution on the "oversight of the insurance sector; response to technological innovation within firms; retaining a focus on the implications for customers." Did you focus on those areas, and if so, how?

- What are your current concerns around these particular areas?
- What is your current view on the use, or potential use, of Artificial Intelligence by regulated firms, and by regulators?

As an External Member of the PRC, I have a responsibility for pursuing the PRA's objectives across all firms it regulates. I have, therefore, sought to contribute across banking and insurance but my insurance experience has meant that I have been particularly involved in insurance matters.

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

During my first term that has involved the following: reforms to Solvency II, insurance stress testing, the development of the bulk purchase annuity (BPA) market and the climate biennial exploratory scenario. I have also attended many Periodic Summary Meetings for insurance groups to achieve greater insight prior to the recommendations coming to the PRC. The areas that I highlight as worthy of ongoing focus for insurance are: maintenance of financial resilience whilst implementing Solvency II reforms in a challenging economic environment; the safe development of the rapidly growing BPA market; liquidity risk; climate and cyber risks. I elaborate on these later in the questionnaire.

Technological innovation has been most rapid in operational and customer service domains. One of the most marked shifts is the pace at which firms are placing data and services in the cloud.

Such innovation is having a transformational effect on business models, operations and relationships with customers. From a safety and soundness perspective, greater operational sophistication requires more focus on operational resilience particularly as it applies to supply chain management. Greater technological sophistication can also create vulnerability to cyber-attacks. As an illustration, the cyber-attack against the ION group in 2023 disrupted operations at over forty international banks.

This reinforces the work the PRA is undertaking on operational resilience in PS 6/21, encouraging each firm to carefully consider the resilience of its important business services. Whilst placing a responsibility on each firm is necessary, it became clear that this approach was not sufficient. The frequency with which certain third parties featured in the supply chains across multiple regulated firms was creating a systemic risk. As a result, the PRA published CP 26/23 with a view to mitigating the systemic risk posed by "critical third parties".

The adoption of Artificial Intelligence (AI) is likely to continue apace due to improvements in computational power and the greater availability of data. Customer interaction is being influenced by new technology: some firms deploy Large Language Models to enhance chatbot services; AI analyses data from new sources (e.g. wearables) to price new insurance contracts; claims underwriting is also being made more efficient through the use of AI.

On the prudential side, AI presents the opportunity for firms to better understand their risks and, therefore, make better pricing and capital allocation decisions. However, AI also poses risks in relation to safety and soundness. It could enable the following distortions: new forms of market manipulation; the creation of misinformation to destabilise markets; the amplification of market volatility through algorithmic trading. For the PRA, AI model governance is critical and regulatory expectations were set out in PS6/23. There are certain challenges that AI models pose in contrast to more established models:

- Explanation. The workings of some AI models, neural networks for example, can be opaque but it's imperative that senior managers remain accountable for their operation.
- Dynamism. AI models frequently recalibrate automatically, creating additional oversight challenges.
- Bias. Over-reliance on historic data creates a risk of unfairness and an underappreciation that the future may not resemble the past.

Even pricing and customer innovations from AI have the potential to create prudential risks. If, for example, a firm consistently misprices risk or is deficient in its claims underwriting, automation can amplify the impact. Also, the automation of aggregation services could increase the likelihood of the sudden termination of many bank accounts, creating a liquidity

risk for banks. In insurance, portals could see the channelling of particular risks to those providers who misprice those risks. These conduct-related risks with intermediary services exist in any case but AI has the potential to aggravate.

The PRA has been considering for a number of years how AI can support its own work.[2] The most promising near-term application of AI to supervision is in the review of the large amount of text data received from firms. This includes internal MI packs, committee minutes, submissions like the Internal Capital Adequacy Assessment Process, the Internal Liquidity Adequacy Assessment Process, documentation for internal models, and many other artefacts. Large Language Models (LLMs) offer the potential to summarise such data rapidly. However, the PRA would need to ensure LLMs did not compromise data security and that LLMs' propensity to "hallucinate" was mitigated. Therefore, any live deployment of AI to aid supervision would require rigorous testing and mitigations to ensure an acceptable level of accuracy. In particular, an AI model would never be allowed to make a supervisory decision – a human supervisor would always make the decision, possibly using AI as a decision support tool.

You refer to my aspiration to consider consumer implications throughout my time on the PRC. My industry experience of dealing with customers helps me understand the inter-relationship between the prudential regime and customers. I have sought to bring that to the fore wherever relevant with one important instance arising during the discussions on the reform to Solvency II. As the PRC examined the feasibility of different technical options for better incorporating credit risk into the new regime and what it meant for probability of failure, I often invoked the consumer's perspective: the regime typically covers one of their most material assets and that the consumer was trusting an insurer to remains solvent over many decades. I believe this perspective contributed to maintaining an appropriate context around technical discussions of probability of failure.

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

The Solvency II reforms will allow us to move away from the "one size fits all" solvency regime of the European Union to one designed specifically for idiosyncrasies of the UK market. The PRA supported Government's three objectives for the review of Solvency II:

- to spur a vibrant, innovative, and internationally competitive insurance sector;
- to protect policyholders and ensure the safety and soundness of firms;
- to support insurance firms to provide long-term capital to support growth.

Mirroring the twin consultation paper approach taken by the PRA, I will refer to reforms under two themes: financial and broader governance. The financial reforms focussed on risk margin, matching adjustment and asset eligibility.

[2] https://www.bankofengland.co.uk/speech/2020/james-proudman-supervisor-centred-automation-speech

The original risk margin in Solvency II is widely agreed to have been over-calibrated and the PRC was part of a broad consensus that a significant reduction was appropriate. Using the assumptions contained in the Governor's letter to the chair of your committee dated 22nd February 2023, the aggregate risk margin for the industry will fall by 65% from £22bn to £8bn.

As you will be aware, the PRA's view was that this release should be partly offset by a strengthening of the Matching Adjustment rules. The PRC spent considerable time on this topic and held the view that the Matching Adjustment did not allow sufficiently for the credit risk premium. Ultimately, Treasury concluded that it would maintain the original design of the Matching Adjustment.

Taking these two conclusions together, it seems plausible that we will see a reduction in the industry's capital resources of up to £14bn, with firms potentially releasing the capital as dividends. In that case, it's self-evident that the risk of default within the life sector will increase. As the Governor observed in the same letter, the new regime may see the one-year probability of failure increase from 0.5% to 0.6%. Whilst in absolute terms these probabilities seem low, they become much more material when compounded over the multiple decades that many individuals will hold annuities.

However, Treasury has allowed additional measures that could mitigate some of the additional risk. Requiring each firm's CFO to attest that their Matching Adjustment appropriately allows for risk will focus minds. Similarly, the introduction of a published stress test for insurers may constrain firms from taking excessive risk. And finally, the finer graduation of credit notches will moderate the incentive firms currently have for seeking the highest yielding assets within each credit notch.

I anticipate a slight weakening of policyholder security as a result of these reforms but the extent will depend on the effectiveness of the above mitigations. We will all be better placed to assess the effectiveness of the regime when it is formally reviewed in 5 years.

Another key area of reform to the Matching Adjustment is the liberalisation of asset eligibility rules in two areas. Firstly, the ability to invest in assets with "Highly Predictable" cashflows rather than the more narrowly-defined "Fixed" cashflows is a material departure. Secondly, we are likely to see more investment in sub-investment grade assets now that they too become eligible for Matching Adjustment treatment. To support firms in exploiting these new freedoms, the PRA intends to give more clarity on eligibility of assets and to streamline the approval process for Matching Adjustment assets. In each case, these new assets are likely to bring more risk when used to back the (relatively) fixed cashflows of an annuity portfolio. As such, it is important these assets do not constitute an excessive part of a Matching Adjustment portfolio and are tightly controlled.

Overall, the reforms to asset eligibility create the conditions for firms to invest significant amounts in UK infrastructure. The extent to which that materialises will partly depend on how firms view competing asset classes. We are, for example, seeing growing interest amongst firms to place assets in offshore reinsurance vehicles.[3]

The Matching Adjustment is also being extended to encompass new liabilities as well as new assets. The inclusion of in-payment income protection and the guaranteed component of with-profits annuity products in Matching Adjustment portfolios could enable firms to use capital more efficiently. This could result in better pricing for customers and encourage innovation, contributing to the UK's long-term growth and competitiveness.

[3] https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/letter/2023/june/thematic-review-work-on-funded-reinsurance-arrangements.pdf

The second theme is broader regulatory reform to promote market dynamism and efficiency:

- Simplifications and process improvements to the calculation of the transitional measure on technical provisions.
- A new, streamlined set of rules for internal models (IM).
- Greater flexibility for insurance groups in the calculation of group solvency requirements to provide more flexibility in the development of group IMs and allow a better reflection of groups' underlying risks.
- The removal of certain requirements for branches of international insurers operating in the UK, to facilitate entry/expansion and competition and the international competitiveness of the UK insurance sector.
- The streamlining and removal of reporting requirements.
- A new 'mobilisation' regime to facilitate entry and expansion for new insurers.
- An increase to the size thresholds at which small insurers are required to enter the Solvency II regime, to increase proportionality for smaller or newer insurance firms.

The anticipated high growth in the BPA market is creating interest amongst potential new entrants and the above reforms should facilitate entry whilst also enabling incumbents to be more agile.

6. In your initial questionnaire, you noted that as you assumed your role on the Prudential Regulation Committee "… [your] own inclination [was] towards greater transparency." Have you been able to bring greater transparency to the work of the Prudential Regulation Committee, and where do you think there may be a case for greater transparency?

Throughout my time on PRC, I've sought opportunities to for us to be more transparent. I have learned during my first term just how much of the PRC's work needs to be confidential: from market-sensitive policy initiatives and firm-specific findings through to personal information relating to the conduct of Senior Managers and in applications for Senior Manager roles, and so most of the opportunities to be transparent would principally involve policy development.

Policy development is an area where the PRA is already very open. It's often the case that PRC discussions on policy are followed within a week or two of the publication of formal Discussion Papers or Consultation Papers. Beyond formal consultation, PRA staff give speeches highlighting thinking on topics that may subsequently require formal changes to regulation or supervision. There will be more opportunities to enhance transparency in these matters und the new regulatory framework as set out by the Financial Services and Markets Act given the rulemaking powers given to the PRA. I will continue to look for opportunities as and when they arise.

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

The new secondary competitiveness and growth objective (SCGO) is the first change to the PRA's objectives in nearly ten years and is already having a material effect on the operation of the PRC.

The PRC has been contemplating this objective since it was first mooted in 2022. The ultimate formulation as a secondary objective with reference to international standards gives the PRA a clear framework to consider when determining policy. This is helpful not least because it avoids a dynamic whereby a competitiveness and growth objective could have motivated a weakening of standards. In any case, the PRC's view is that strong, consistent standards promote growth in the medium to long term.

As broader context, the PRA has sought to be thoughtful in approaching this new objective. In particular, a conference held in September 2023 invited stakeholders to reflect on the new SCGO. It was illuminating on a number of fronts, for example on how the PRA might measure progress and the need to consider growth of the wider economy as well as that of the financial sector. This contributed to the open Consultation Paper explaining how the PRA will approach the new objective[4]. Perhaps of particular note to your committee, this consultation includes a suite of metrics that will enable you and others to hold the PRA to account for its advancement of SCGO.

In practice, PRC now formally considers SCGO whenever policy is under consideration. We are proactive and often discuss extensively how the SCGO should influence the policy. Our general approach is to seek out those policy options that maintain safety and soundness in a way that also advances the SCGO.

The following initiatives have been influenced by the SCGO:

- As in Answer 5 above, the PRA consulted on a package of Solvency II that should create meaningful efficiencies for firms through rationalisation of data collection, streamlining of the model approval process, simplification of the transitional calculation together with a reduction in the risk margin to be implemented earlier than originally anticipated.[5]
- A number of proportionality initiatives will enable simpler liquidity and disclosure rules for smaller banks and building societies and simpler remuneration rules for small firms. These are intended to increase the ability of these firms to compete and thus contribute to more efficient capital allocation in the economy, investment and growth.[6]
- Removing the bonus cap that had the effect of increasing fixed pay and reducing the ability of internationally competitive firms to attract talent.[7]

In addition, the competitiveness and growth considerations feature prominently in our ongoing discussions on the development of our policy approach to "Basel 3.1".

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

First and foremost, the PRC has been mindful of the impact that changes in these macroecomonic variables can have on the safety and soundness of regulated firms.

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[4] https://www.bankofengland.co.uk/prudential-regulation/publication/2023/december/pra-approach-to-policy-consultation-paper

[5] https://www.bankofengland.co.uk/prudential-regulation/publication/2023/june/review-of-solvency-ii-adapting-to-the-uk-insurance-market

[6] https://www.bankofengland.co.uk/prudential-regulation/publication/2023/december/strong-and-simple-framework-policy-statement

[7] https://www.bankofengland.co.uk/prudential-regulation/publication/2023/october/remuneration-ratio-between-fixed-and-variable-components-of-total-remuneration

We have been most vigilant in relation to credit impairments on banks' balance sheets as a result of the changing interest rate environment. Due to most mortgages having a two or five-year guarantee period, the impact on mortgage books has been spread over a period of time. Moreover, mortgage performance has remained robust for a number of reasons: the affordability rules; increases in wages and house prices; the Government's mortgage charter. We are alive to emerging signs of deterioration and continue to assess firms' capital levels and operational readiness to support any increase. We have also been alert to credit risks manifesting in other lending, such as against commercial real estate where values have declined significantly both in the UK and abroad.

Of course, higher policy rates have supported balance sheets through widening the "net interest margin" (NIM). Conduct regulation has curtailed banks' ability to generate excessive NIM and, so, we scrutinise the reliance firms place on NIM under stress to ensure it remains realistic in light of regulation and competition.

Sudden changes in interest rates can also have financial stability impacts which also interact with the balance sheets of banks and insurers. One of the most dramatic examples of this was the rapid increase in long-term interest rates that prompted the LDI episode, discussed in Question 10 below. Another notable impact was on Silicon Valley Bank in the US whose demise can be traced back to its holding of long duration bonds, the value of which declined rapidly during 2023. In general, UK banks are not exposed in this way because the capital regime disincentivises and capitalises such positions. Despite that, we continue to monitor instances where there is some exposure to long-term interest rates, both for UK regulated firms and for overseas parents.

In general, insurers tend to closely match the duration of their assets and liabilities, meaning that solvency is typically resilient to changes in long-term interest rates. However, the increase in these rates will have a less immediate but profound impact on insurers. Many Defined Benefit pension arrangements have seen their solvency positions improve significantly because liability valuations have dropped as their discount rates have risen in line with long-term interest rates. Consequently, many more can now afford to insure their liabilities with an insurer via a BPA. The BPA market is now projected to grow dramatically. The PRC is alive to the risks that such rapid growth could pose to safety and soundness.[8]

The effect of inflation is to put pressure on costs, often exacerbated by supply chain shocks, and some classes of business are seeing claims costs rising faster than general – e.g. via litigation outcomes; some medical insurance. Most insurers can manage this impact by creating efficiencies and/or increasing charges, the increase in motor insurance premiums being a notable example. The stress is often greatest for those insurers with long-term liabilities where they have accepted a fixed premium some years ago and are now facing costs in excess of those anticipated at the time of pricing. This is unlikely to manifest in a solvency event but we continue to monitor stresses. More generally, large premium increases have the potential to create protection gaps and, therefore, affect the functioning of the broader economy.

The PRA itself is not immune to the cost pressures caused by inflation. Accordingly, we've had to make some challenging prioritisation decisions as part of the annual planning process, such as paring back resource in areas such as Climate Risk.

[8] https://www.bankofengland.co.uk/speech/2023/april/charlotte-gerken-speech-bulk-annuities-conference

9. What do you regard as the major lessons from the failure of SVB?

As you would expect, PRA has reflected on the failure of SVB prompting discussion at the PRC on how to improve supervision in light of the lessons learned.

First of all, it's worth reiterating the point Andrew Bailey made to your committee on 28th March 2023, that SVB UK was "a well-capitalised subsidiary, and it had strong liquidity". The PRA's policy that required SVB UK to subsidiarise was instrumental in achieving this solid foundation.

What caused the UK subsidiary to fail was not any failure in its financial management (or supervision) but a dramatic run prompted by the collapse of its US parent. The nature of the run was unprecedented: social-media spread concerns amongst a tight-knit community of depositors who were able to quickly transfer money out of SVB UK. The unprecedented speed and scale of this run saw approximately 30% of its deposits withdrawn on a single day, a rate of withdrawal that even a well-capitalised, liquid subsidiary could not sustain[9].

There are six key lessons I would highlight here:

Understanding of overseas parent. There may be scope for the PRA to improve its understanding of the overseas parent of a UK subsidiary. Given the PRA's risk-based approach to supervision, it mainly considers overseas regimes as they apply to the biggest banks. As was the case with SVB, smaller banks can be subject to a different regime and the PRA could be more cognizant of this. More generally, the PRA is enriching its data to improve its understanding of intra-group relationships.

Strategic importance of firms. As one would expect, the PRA focuses its resources on systemically important organisations. SVB UK was not considered systemically important, but the PRA was aware of the sectoral importance of the bank and its strategic relevance to UK innovation. It's worth reflecting on whether the allocation of supervisory resource should place more weight on firms with similar strategic importance.

Resolution process. Resolution is typically conducted over a weekend because financial markets are closed, enabling more time to execute the chosen option. The Bank continues to reflect and refine its approaches to maintaining a resolution toolkit that is at all times fit and ready. (That's mainly for the Bank as Resolution Authority to lead on, rather than PRA.)

High growth firms. SVB had grown rapidly both in the US and UK. The PRA needs to consider whether such rapid growth is an indicator of prudential risk. Firstly, it's reasonable to question whether rapid growth has been achieved due to weaker underwriting controls. Secondly, the PRA should ascertain whether a firm's control framework has kept pace with the growth of the firm. (In the case of SVB UK, its rapid growth prompted PRA to request subsidiarisation ahead of thresholds being met.)**Focus on liabilities**. More generally, a key lesson is for banks and supervisors is to develop a greater understanding of risks inherent on the liability (deposit) side of the balance sheet as well as those on the assets side (loans). This involves understanding the extent of any liquidity risk:
- what proportion of deposits can be moved electronically?;
- what proposition might be deemed "at risk" by depositors because they exceed depositor protection limits

- are a material proportion of deposits held via deposit aggregators?
- what mitigations are in placed (e.g. daily withdrawal limits) to limit outflows?

[9] https://edu.bankofengland.co.uk/-/media/boe/files/letter/2023/letter-svb-uk-hearing.pdf

Reforms to the resolution toolkit. Greater confidence in this backstop could quell run dynamics. As noted by Andrew Bailey, new proposals are being explored. Any revised approach will, of course, need to strike a balance between depositor protection, moral hazard and cost. [10]Monetary and financial stability: lessons from recent times - speech by Andrew Bailey | Bank of England

It's not clear that these lessons would necessarily prevent another failure resembling SVB but they are likely to contribute to a more resilient sector as a whole.

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

The Liability-Driven Investment (LDI) episode was notable for the threat it posed to UK financial stability but it was the latest in a series of examples where leverage in the wider financial system has stressed the core system. As such, I highlight five lessons here, some of which are specific to LDI whilst others have broader relevance.

Liquidity Management The episode further underscores the need for liquidity. One of the ironies of the LDI episode is pension schemes saw LDI as a prudent method for managing solvency. And balance sheets did improve as long-term interest rates rose but that did not prevent a liquidity crisis. The stress manifested as demand for liquidity to fund margin calls against derivative positions. As they ran short of cash, many pension schemes resorted to selling their next most liquid assets: gilts.

The most obvious lesson is that institutions need to maintain sufficient liquidity for a sudden, severe stress. PRA has begun to explore enhanced liquidity reporting for insurers with the potential for insurers and other non-bank financial institutions (NBFIs) to access central bank liquidity in times of severe stress.[11] The recent intervention of the Pension Regulator is particularly welcome in setting clear expectations for LDI funds.[12] For the Bank, the episode reinforces the benefit of not relying only on historic data but also using expert judgment when calibrating severe but plausible stress scenarios.

[10] https://www.bankofengland.co.uk/speech/2023/april/andrew-bailey-remarks-at-the-institute-of-international-finance

[11] https://www.bankofengland.co.uk/speech/2023/september/andrew-hauser-speech-at-market-news-international-connect-event.[11]

[12] https://www.thepensionsregulator.gov.uk/en/document-library/scheme-management-detailed-guidance/funding-and-investment-detailed-guidance/liability-driven-investment#resilience

Beyond the perimeter. The LDI episode largely emanated outside the PRA's jurisdiction, in LDI funds predominantly managed overseas and in UK pension schemes. Despite that, there were significant consequences for PRA-regulated entities and the core financial system. Therefore, it's another reminder for the PRC to remain alert to risks arising outside the PRA's perimeter and to consider how regulated firms can mitigate these. That observation is the inspiration behind the Bank's first system-wide exploratory stress scenario which will enable us to better understand the inter-relationship between PRA-regulated entities and the wider financial system.[13]

Understanding of operational and governance arrangements. LDI funds can be bifurcated into segregated mandates (run for the benefits of individual schemes) and pooled funds (where several pension schemes share the investments). The segregated mandates were often able to move more swiftly and obtain support from sponsoring employers to meet early margin calls. By contrast, the pooled funds struggled to move quickly enough and some clients took advantage of limited liability provisions, enabling them to walk away and forcing the funds to sell more gilts. This demonstrates that the PRA and firms themselves need to appreciate not only the financial dynamic but also associated operational and governance arrangements.

Margining practices. Margining for derivatives should avoid this "wrong-way risk", whereby falls in asset values prompt liquidation of the same asset class. Also, international work is underway with the BCBS-CPMI-IOSCO margin group publishing its report on margin reforms.[14]

Counterparty exposure. To the extent that banks supply funding to LDI schemes, or for that matter any other leveraged NBFIs, it's critical they understand counterparty risk. That means understanding when margin calls are likely to arise and the liquid resources of their counterparties. To do that effectively, they will need to understand the aggregate exposure of a counterparty. The international financial community is taking steps to facilitate such an understanding. [15]

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 default risk component of Internal Ratings-Based (IRB) models has been a priority for PRA throughout 2023. Indeed, in the annual letter to UK bank CEOs sent on 11 January 2023, David Bailey (ED of UK Deposit Takers) highlighted Model Risk as one of six priorities for the PRA's supervision of the sector, stating: "….for Internal Ratings Based models (IRB), we will continue to focus on three key workstreams: the implementation of IRB Hybrid mortgage models; the IRB Roadmap for non-mortgage portfolios; and IRB aspirant firm model applications."[16]

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[13] https://www.bankofengland.co.uk/financial-stability/boe-system-wide-exploratory-scenario-exercise
[14] https://www.bis.org/bcbs/publ/d537.pdf
[15] https://www.iosco.org/library/pubdocs/615/pdf/Bank%20of%20England.pdf
[16] https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/letter/2023/uk-deposit-takers-2023-priorities.pdf

The PRC has taken a keen interest throughout 2023 in the implementation of IRB hybrid models. Hybrid models are intended to ensure the probability of default component of an IRB model contains features of both a point-in-time model (i.e. a responsiveness to prevailing economic conditions) and of a through-the-cycle model (i.e. a stability that dampens pro-cyclicality).[17]

The implementation of such models has proved challenging, and there are lessons both for firms and for the PRA. In considering how to help firms meet regulatory requirements in light of these lessons, PRA management informed PRC in September that it wanted to examine its approach to IRB applications more broadly.

More recently, I am aware that PRA is responding to oral evidence your committee heard in early December on the topic of "SME Finance" where concerns were raised about PRA's resourcing to support firms' IRB applications. I expect the PRC will take this evidence into account when it reviews the aforementioned paper.

That same evidence session also questioned PRA's position in relation to the "SME Support factor" as part of Basel 3.1 implementation. The PRA has been exploring its position on this and related aspects of credit risk for some time. As mentioned in PS 17/23 published on 12 December, PRA will publish its "near final policy statement" on this topic in Q2 2024. [18]

As it determines its position in the intervening months, the PRC will reflect on the implications for PRA objectives:

- Safety and soundness, recognising the appropriate capital required in light of actual default risk.
- Secondary Competition Objective, particularly how capital differentials between IRB firms and those using the standardised approach may affect competition.
- Secondary Growth and Competitiveness Objective, with reference to the international standard as set by the Basel Committee for Banking Standards and its implementation in relevant jurisdictions. The PRC will also consider evidence on the relationship between prudential standards and the terms under which debt finance is made available to industry.

12. 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?

History has taught us that it's not always possible to predict the cause of the next crisis. Therefore, one of the most effective mitigations is to ensure that firms remain capitalised to withstand severe but plausible stresses. Nonetheless, I offer the following eight risks as meriting particular attention.

[17] https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/publication/2020/ss1113update-jan-2022.pdf

[18] https://www.bankofengland.co.uk/speech/2022/december/phil-evans-speech-at-uk-finance-on-basel-3-1-consultation

Economic Deterioration The most obvious transmission mechanism for an economic downturn to affect the financial system is through loan defaults. We remain alive to risks in relation to mortgages, commercial real estate and private debt. Some of these stresses could originate outside the core banking system but still have a material impact on it.

Cyber risk Cyber-attacks are an ever-increasing challenge for all players in the financial system, be they regulated firms, suppliers or regulators. There is, of course, an additional risk for providers of cyber insurance, potentially exacerbated by lack of contractual clarity. As with Business Interruption insurance during the pandemic, it's important for insurers of cyber risk to understand how the courts might interpret their policy documents.

Conduct of business Laws and regulations relating to conduct of business can impact safety and soundness. For example, we are seeing some firms having to adapt their business models in light of the new Consumer Duty. And, as we saw with Payment Protection Insurance, there is always a possibility that sales practices can result in remediation of a magnitude that's material to balance sheets.

Crypto currencies This is an area of rapid innovation that could cause prudential risk. Although small relative to the core banking system, the volatility of crypto-currencies could have an impact on the core banking system.

Digitalisation of assets Central Bank Digital Currency (CBDC) could if not implemented thoughtfully, create a different type of prudential risk, whereby account holders liquidate accounts in favour of CDBC at times of stress. This risk is, of course, recognised and mitigations proposed in the digital pound Consultation Paper.[19]

Geopolitical risks Geopolitical events can create prudential challenges given the interconnectedness of the financial system, the global nature of many firms and of supply chains. Even before prudential risks manifest, it's conceivable that jurisdictions could inhibit access to data in a way that prevents effective supervision.

Climate risk Adaptation and transition risks remain relevant to the financial system's safety and soundness in the medium to long term. As explained in May 2022 when PRA published the results of the Climate Biennial Exploratory Scenario, there is more for firms and the regulator to do to develop mitigations. Climate also poses near-term risk to firms with, for example, general insurers having to consider their exposure to climate litigation through the provision of long-term Directors & Officers cover.

Quantum computing Whilst not posing an imminent risk to financial services, it's conceivable that quantum computing could mature to become highly disruptive within, say, the next five years. One of the more obvious challenges is that quantum computing could undermine the standard methods for encrypting data, a possibility that's prompting the exploration of more secure ways of encrypting data ("post-quantum cryptography").

John Taylor's CV

[19] https://www.bankofengland.co.uk/-/media/boe/files/paper/2023/the-digital-pound-consultation-working-paper.pdf

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 4 January 2024.