Independent Evaluation Office

Evaluating the PRA's approach to its Secondary Competition Objective

March 2016

BANK OF ENGLAND

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Foreword from the Chairman of Court

The Court of Directors (the Bank of England's Board) oversees the performance of the Bank, including the performance of the Prudential Regulation Authority (PRA). An important aspect of this oversight role is to ensure that the Bank is following the spirit, as well as the letter, of its statutory duties. Court gains assurance about the Bank's approach in a number of ways, including from in-depth assessments by its Independent Evaluation Office (IEO).

In March 2014, the PRA gained a new statutory requirement in relation to competition — the Secondary Competition Objective (SCO). The SCO requires that when making policy in pursuit of its primary objectives of safety and soundness and insurance policyholder protection, the PRA does so in a way that facilitates effective competition, as far as reasonably possible. This new statutory duty necessitated a material change of gear.

In February 2015, Court commissioned the IEO to evaluate whether the requisite change was taking place. The IEO employed a number of analytical techniques to assess whether the PRA's emerging competition framework was on course to deliver an appropriately proactive approach. This analysis, together with the IEO's findings and recommendations, is laid out in this report.

As the report sets out, and as we have discussed at Court, there are plenty of positives. Competition is gaining airtime and traction at all levels of the PRA, and there are numerous instances where competition considerations have influenced policy outcomes. While those developments are encouraging, there remains the need to ensure that the requisite cultural shift has taken root throughout the institution. This is fully recognised by the PRA's management team, who have set in train a number of initiatives accordingly.

Delivering lasting cultural change is a challenge in all organisations. The IEO's recommendations therefore seek to build on the efforts of the PRA's management to ensure that the institution is embedding an appropriately proactive and positive approach towards its duties to facilitate competition.

I am pleased that the PRA Board is in the process of implementing all of the recommendations contained in this report. Court will continue to monitor progress in this important area.

Anthony Habgood, Chairman of Court
March 2016

The Bank of England's Independent Evaluation Office can be contacted at independentevaluation@bankofengland.co.uk

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Executive summary

In March 2014, the Prudential Regulation Authority (PRA) was given a statutory secondary objective to act, so far as is reasonably possible, to 'facilitate effective competition' when making prudential policy to advance its primary objectives.(1) This Secondary Competition Objective (SCO) requires the PRA to take a more proactive stance towards competition than had been the case for the Financial Services Authority (FSA), the PRA's regulatory predecessor. In early 2015, the Bank of England's Court of Directors asked its Independent Evaluation Office (IEO) to undertake an assessment of the PRA's approach to the SCO, with a view to facilitating Court oversight of the strategy adopted.(2)

This report sets out the findings of the IEO's evaluation, which was primarily conducted between April 2015 and October 2015. The evaluation drew on three different workstreams: a review of changes made to the PRA's policymaking framework in light of the SCO; case studies of major PRA policy initiatives; and linguistic analysis of papers sent to the PRA's policy committees. Emerging themes from the IEO's work were discussed at the October 2015 Court, and a draft report at the February 2016 Court.(3) The PRA Board also discussed emerging themes from the project, and the draft IEO report; it approved a management response in March 2016.

Important context for this evaluation, and for the PRA's SCO more generally, is the post-crisis focus of public policy both on reshaping the regulatory framework for prudential supervision and on improving competition in financial services (Section 1.1).

In the aftermath of the crisis, the failings of the pre-crisis approach to prudential regulation were widely acknowledged. Those included the difficulties of entrusting a single financial services regulator with both prudential and conduct supervision, as well as the shortcomings of a culture of 'light touch' supervision. Alongside this debate on prudential regulation was an emerging consensus on the importance of competition in the sector — specifically that the crisis had had an adverse impact on competition in financial services, and that there would be benefits for consumers, and also for wider system stability, from a renewed focus on 'effective' competition. Effective competition can be thought of as competition where suppliers offer customers a choice of products and services on terms that are both attractive and sustainable, where customers have the confidence to make informed decisions and where firms enter, expand and exit from the market.(4)

This public policy focus both on ensuring that firms were robustly supervised from a prudential perspective, and on improving competition in financial services, informed the design of the PRA's SCO in a number of ways (Section 1.2). The Government explained that its intent in introducing the SCO was that the PRA 'be proactive in looking for ways to support competition', while the formulation of the SCO also recognised the limits to what the PRA can achieve given, for example, its primary objectives, the tools at its disposal, the remits and powers of other regulatory bodies with competition responsibilities and the requirements of European law. These considerations also informed the design of this assessment, which was, by construction, a 'process' evaluation rather than an 'impact' evaluation,(5) and focused specifically on prudential policymaking at the PRA (the only area of the Bank which has a statutory competition objective).

(1) The PRA's primary objectives are to promote the safety and soundness of its regulated firms and to contribute to securing an appropriate degree of protection for insurance policyholders. The Secondary Competition Objective is contained in s2H of the Financial Services and Markets Act; see Section 1.2 for a fuller description.
(2) More details on project governance are provided in Section 2.4.
(3) The evaluation was conducted by an IEO team of Lea Paterson, Alice Carr, Will Holman and Felicity Thomas, with supplementary analytical and administrative support provided by a number of areas of the Bank. The analysis contained in this report, together with any errors herein, are the sole responsibility of the IEO, and not of the Prudential Regulation Authority, nor of the wider Bank.
(4) The concept of effective competition is explained more fully in Dickinson *et al* (2015).
(5) A process evaluation focuses on how a policy is implemented and delivered, rather than the impact that a given policy has on market outcomes; for more see Section 2.1.

In carrying out its work, the IEO made use of criteria drawn from established practice for policy evaluation, and informed by the statutory framework for the PRA. Specifically, the PRA's emerging strategy and approach to its competition objective were assessed against whether these were clearly articulated, proportionate, consistent, proactive and influential (Section 2). We used these evaluation criteria in all three of our workstreams (Sections 3 to 5). Our findings and recommendations drew on common themes emerging, as summarised below and described more fully in Section 6.

Overall, our work found numerous positives. The PRA has invested in its approach to the SCO, with positive results for the flow of new policies; the PRA also delivered substantive reforms to authorisations policy to address potential barriers to entry into banking ahead of the SCO coming into effect. Competition issues appear to be receiving airtime, and gaining traction, at all levels of the organisation, including via regular discussion at the PRA's policy committees. Most key aspects of the SCO are well understood across policy staff, and the PRA's approach supports the consistent treatment of competition issues in different types of policy initiative, as well as a broadly appropriate degree of prioritisation. We also found evidence of proactivity. For example, although the SCO does not require the PRA to conduct *ex-post* reviews of existing regulations on competition grounds, the PRA has conducted exercises of this nature, and this is suggestive of proactive intent. Similarly, the PRA has also signalled its intention to take a proactive stance in international negotiations in the prudential policy sphere.

Nevertheless, we also found residual misgivings in some parts of the institution about the compatibility of the competition objective with the PRA's primary objectives; this may have slowed the PRA's progress in embedding and communicating on the SCO to a degree. The wider context here is important: there is a valid debate, as evidenced in the academic literature, about the degree of synergy between competition and financial stability. In addition, PRA staff are very aware of the risks inherent in the insufficiently focused culture of prudential regulation that prevailed in the pre-crisis period. That all said, some of the questions surrounding the potential compatibility of the PRA's primary objectives with the SCO were addressed by the objective's precise formulation, recognising as it does the limits to the PRA's powers and the need to facilitate 'effective' competition (rather than a competitive 'race to the bottom'). Moreover, practical experience to date suggests that there may have been a greater degree of synergy between the SCO and the PRA's primary objectives than initially envisaged, in part reflecting the nature of the post-crisis reform agenda (which has focused on addressing market and regulatory failures, and as such is likely to have advanced safety and soundness as well as effective competition).

Our work suggests that articulating the PRA's framework and intended approach more fully is one way in which any undue misgivings about the compatibility of the SCO with the PRA's primary objectives could be usefully addressed (it should be noted that the PRA paused some of its planned initiatives in this area pending the outcome of this evaluation). More generally, we found scope to embed the SCO more firmly into PRA processes, thereby helping to maintain a consistent and appropriately proactive approach to the objective throughout the organisation. We additionally identified opportunities to ensure that competition is sufficiently influential by strengthening governance and demonstrating consistent compliance with the SCO, as well as to refresh the PRA's strategy on external liaison and communication on competition issues.

Our recommendations, as detailed in the table below, are organised around the 'inputs', 'supporting infrastructure' and 'outputs' of policy that are generally in scope of any IEO evaluation of a policy function. They are aimed at building on the continuing work of the PRA's management team to ensure an appropriately proactive and positive approach to the SCO that complements delivery on the PRA's primary objectives. When making our recommendations, we recognise that the PRA's framework for, and approach to, its competition objective is continuing to evolve, in part based on the institution's reasonably positive practical experience with the SCO over the past two years.

As well as supporting the work of the PRA in embedding the SCO fully into its processes, our evaluation should also help to establish benchmarks against which future progress can be evaluated. This, in turn, should facilitate oversight by the Bank's Court of this important area of the institution's work. And by putting our evaluation into the public domain, we hope to facilitate external comment and debate of the IEO's approach and methods. We welcome feedback.(1)

(1) The Bank's Independent Evaluation Office can be contacted at independentevaluation@bankofengland.co.uk.

Summary of recommendations

Inputs into policy decisions	**1 Identification and prioritisation of competition issues**	• Refine processes to ensure competition issues are consistently identified early in policymaking, including by: – developing 'trigger' questions to help identify where detailed competition analysis is merited; and – strengthening existing horizon-scanning exercises. • Ensure research focuses on the questions the PRA needs to answer, including on the relationship between the PRA's primary and secondary objectives. • Keep the adequacy of existing specialist competition resources under review.
Infrastructure supporting policy decisions	**2 Clear articulation of the PRA's approach to the SCO**	• Ensure sufficient clarity among policy staff on the statutory requirements of the SCO, and the PRA's intended approach to delivering those. • Improve internal dissemination of recent thinking on the SCO, including potential synergies with the PRA's primary objectives, and interpretation of 'effective' competition. • Accelerate 'learning by doing' by consolidating what is known about competition issues that commonly arise in prudential policymaking.
	3 Embedding the SCO into policymaking	• Update internal guidance to stress the SCO is relevant throughout policymaking, not just in cost benefit analysis, and that where reasonable it implies developing policy options that facilitate competition. • Use internal guidance to reinforce the intended proactive approach to the SCO when influencing the development of prudential policy in domestic and international fora.
	4 Governance	• Enhance the effectiveness of the six-monthly updates to PRA Board, including through more systematic reporting on policy initiatives. • Demonstrate consistent compliance with the SCO across internal and external policy materials.
	5 External co-ordination with competition regulators	• Build understanding of the PRA's remit, and invest further in co-ordination with relevant competition regulators.
Outputs of policy decisions	**6 External communications**	• Use forthcoming communication vehicles (eg new Annual Report on competition) to set out more fully the PRA's recent experience and evolving thinking towards the SCO. • Find opportunities to communicate the PRA's approach to the SCO to a suitably wide set of stakeholders.

1 Context for the SCO

The introduction of the PRA's Secondary Competition Objective (SCO) in March 2014 was part of a far broader set of reforms to the UK regulatory landscape in the wake of the financial crisis. These included the creation of the PRA itself in April 2013 as a subsidiary of the Bank of England, and an associated wholesale reshaping of the regulatory approach to prudential supervision. These post-crisis reforms provide important context for both the nature of the PRA's SCO, and the scope and structure of this evaluation. This is discussed further in Section 1.1, while Section 1.2 provides more detail on the nature of the SCO itself.

1.1 Context for the PRA's SCO

In April 2013, the new regulatory arrangements for the financial services industry came into being, with the PRA and the Financial Conduct Authority (FCA) replacing the FSA. The PRA is responsible for the prudential regulation of banks, building societies, and credit unions (referred to as 'deposit-takers' in this report), insurers and major investment firms. It was given both a general objective to promote the safety and soundness of PRA-authorised firms and an insurance objective to contribute to securing an appropriate degree of protection for insurance policyholders (these are the PRA's 'primary' objectives). At the forefront of these changes was the widespread recognition of the failings of the pre-crisis regulatory arrangements, where the FSA had been responsible for both prudential and conduct supervision, and a culture of relatively 'light touch' supervision.(1)

From the outset, the PRA's regulatory approach was grounded in the need for forward-looking, judgement-based supervision.(2) And although no additional requirements were set initially for the PRA in relation to competition, a series of other post-crisis initiatives were in train — both domestically and internationally — that were likely to improve the nature of competition in the UK financial services sector. Improving competition in financial services, particularly retail banking, was identified as a public policy priority in a number of post-crisis reviews, including the Independent Commission on Banking (ICB) (2011) and subsequently the Parliamentary Commission on Banking Standards (PCBS) (2013).(3) Both Commissions concluded that engendering more competition in financial services could be associated with positive outcomes.

The ICB and PCBS reports summarised the state of competition in the UK banking sector in the immediate wake of the crisis. They set out that while there had been some gains over the preceding decade, including through the activity of 'challenger banks', the crisis had resulted in a partial reversal of these gains as challenger banks left the system (including by being absorbed by larger rivals). Furthermore, some competition in the pre-crisis period, occurring as it did in the context of inadequate regulation and insufficient private market discipline, may have contributed to system instability. Banks which were considered 'too big to fail' (TBTF) may have enjoyed lower funding costs, thereby placing them at a competitive advantage to smaller rivals, incentivising risk-taking by these entities and encouraging the lowering of standards by smaller firms trying to win market share. In this context, the ICB drew a parallel between regulation and pollution noting that 'If pollution control is too lax, polluters will gain business from cleaner firms as they are able to produce at a lower cost, unless the cleaner firms also reduce their costs by lowering their standards and polluting more (a 'race to the bottom').'

Against this backdrop, wider institutional reform of the United Kingdom's arrangements for competition in general, and in the financial services sector in particular, were under way. The Competition and Markets Authority (CMA) was established in April 2014 as the United Kingdom's primary competition and consumer authority with economy-wide responsibilities and powers to promote competition and to ensure that markets worked well for consumers, businesses and the economy.(4) From its inception, the FCA was given an operational objective to

(1) See, for example, the Prudential Regulation Authority and Financial Conduct Authority (2015).
(2) For an overview of key features of the PRA, see Murphy and Senior (2013).
(3) The Treasury Committee (2011) provides a stocktake of competition issues in the banking sector, and some recommendations for change.
(4) The CMA took over many of the functions of the Competition Commission and the Office of Fair Trading.

promote 'effective' competition in regulated financial services in the interests of consumers and a duty to promote competition when advancing its other operational objectives for consumer protection. From April 2015, the FCA became a concurrent competition regulator for financial services after being given some of the same competition powers as the CMA. Finally, the Payment Systems Regulator (PSR) was established in April 2014, with an objective to promote effective competition in the markets for payment systems and services underpinned by concurrent competition powers. More detail on these wider institutional arrangements is included in Box 2.

Amid these wider reforms to the regulatory landscape, there remained for some, including the PCBS (2013), a concern that the initial formulation of the PRA's statutory objectives could lead the regulator to neglect competition considerations. The PCBS reported evidence suggesting that regulators were risk-averse, could be sceptical of new entrants and business models, and might have too much faith in the power of regulation over market forces such as competition. At its inception in April 2013, the PRA had inherited from the FSA a so-called 'have regard' requirement for competition — specifically, the requirement to have regard to the need to minimise any adverse effect on competition in the relevant markets that may result from its prudential policy. This was seen as inadequate by the PCBS, which concluded that:

> 'A 'have regard' to competition simply does not go nearly far enough. As the experience of the FSA shows, a 'have regard' duty in practice means no regard at all. With only a 'have regard' duty given to the PRA, the risk is high that it will neglect competition considerations. This would be of great concern, given the potential for prudential requirements to act as a barrier to entry and to distort competition between large incumbent firms and new entrants. The current legislation strikes an inadequate balance in this area.'

The Government agreed with the PCBS recommendation, setting out that it would introduce an amendment to the Financial Services and Markets Act (FSMA) to provide the PRA with a Secondary Competition Objective. The Government stated that it was fully supportive of the 'need to ensure that the regulators understand and champion the need for competition in the financial sector' and in relation to the PRA specifically, that the proposed reform would 'strengthen its role in ensuring banking markets are effective and deliver good outcomes for consumers'. The PRA's SCO subsequently came into force in March 2014.

The formulation of the PRA's SCO — discussed further below — reflects the various constraints on the PRA's ability to influence competition outcomes. These include that in many circumstances the PRA is implementing policies set by third parties (both domestic and international) with differing policy objectives and statutory frameworks. For example, many policy initiatives are set at the EU level, where policymakers do not have competition objectives directly equivalent to the PRA's (including because the priority for the EU is competition across Member States).

The formulation of the SCO also reflects the debate over the degree of compatibility between system stability and competition, a consideration that is tackled in, among others, the ICB report (2011). This discussion is echoed in the academic literature, where the relationship between prudential regulation and competition is relatively complex and not well understood. As summarised in Dickinson *et al* (2015), some studies have concluded that there are synergies between competition and stability, while others have found that there are trade-offs.

After considering the concerns raised about the compatibility of stability and competition, the ICB concluded that it would be wrong to draw the conclusion that such uncertainties provided cause to deny consumers the benefits of competition (saying in relation to the regulation/pollution analogy, '[t]he solution is not less competition but proper pollution control'). The ICB stressed the importance of separating out 'good' forms of competition from those with undesirable characteristics. Consistent with this conclusion, the post-crisis requirements on the FCA and PSR as sectoral competition regulators, as well as the PRA's SCO, all reference 'effective' competition, discussed further below.

1.2 Nature of the PRA's SCO

The PRA's SCO, which is deconstructed in Box 1, 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-authorised persons in carrying on regulated activities.'(1)

As the SCO exists to guard against the unnecessary consequences of prudential regulation for competition, it applies only when the PRA is making prudential policy to advance its safety and soundness and insurance policyholder protection objectives. The PRA is not required to seek out, nor does it have powers designed to address, competition issues unrelated to its own prudential regulation; this responsibility falls to the CMA, the FCA and the PSR as competition regulators for the sector (see Box 2). Reflecting this, the PRA is not required to conduct periodic reviews of existing regulations solely on competition grounds, and the SCO applies only to 'general functions' such as rule-making rather than to firm-specific supervisory decisions.(2)

The SCO does, however, create an important requirement on the PRA to consider whether its new prudential policy initiatives can be designed in a manner that also facilitate effective competition, which the Government described as 'turn[ing] the negative duty to avoid harm to competition into an active secondary objective'. As considered in this report, it may be that in many cases, the PRA will be able to identify policy options which simultaneously advance both its primary and secondary objectives. In other cases, it may be that within the range of options available to the PRA, there may be some which would deliver greater benefits to competition and others which would deliver greater benefits to safety and soundness or policyholder protection (or may do so on different time horizons or in a different way on a firm-specific and system-wide basis). The SCO means that the PRA should consider (but is not necessarily required to adopt) those options which deliver greater benefits to competition.

That a wider set of factors determines competitive conditions in relevant markets, and that other regulatory authorities are tasked to identity and mitigate wider obstacles, is why the PRA is required to 'facilitate' rather than 'promote' competition. As noted above, the reference to 'effective' competition recognises that some forms of competition have undesirable characteristics and that the PRA is only expected to support competition consistent with 'good' outcomes. While the legislation does not define the concept of effective competition, the PRA view is that a market will tend to demonstrate effective competition if, as set out in Dickinson *et al* (2015), it displays the following aspects: suppliers offer customers a choice of products and services on terms that are both attractive and sustainable; customers have the confidence to make informed decisions; and firms enter, expand and exit from the market.

Overall, the SCO creates a need for the PRA to consider how best to meet the expectations set out by the Government in its annotations to the amendment introducing the objective, namely that the PRA is expected 'to embed competition considerations within the workings of the organisation and to be proactive in looking for ways to support competition'.

Since the SCO was introduced, there have been a number of other developments which are directly relevant to the PRA's approach to its SCO. In particular, the HM Treasury (2015) productivity statement set out that:

- 'the PRA and FCA have agreed to establish a joint New Bank Unit to help new, prospective banks to enter the market and to support them though the early days of full authorisation' and that the two regulators would undertake a review of the effectiveness of the Unit after three years 'to ensure it is working in the best interests of new banks'. A New Bank Start-up Unit was subsequently launched in January 2016 by the PRA and FCA.

(1) Section 2H1 of the Financial Services and Markets Act (FSMA).
(2) Although, as and when the PRA decides to launch periodic reviews of the existing stock of regulations, this is regarded as exercising its 'general functions' and the SCO is consequently engaged. See, for example, sections 2F and 55M of FSMA.

Box 1
The Secondary Competition Objective explained

The diagram below deconstructs the statutory requirements that the Secondary Competition Objective (SCO) places on the Prudential Regulation Authority (PRA).

> *'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-authorised persons in carrying on regulated activities'.*
>
> The PRA's SCO, s2H(1) FSMA.

'When discharging its general functions in a way that advances its objectives…

➔ The SCO applies when the PRA makes prudential policy to advance its primary objectives of safety and soundness and insurance policyholder protection; the competition objective is not directly relevant to firm-specific decisions.(a)

…the PRA must so far as is reasonably possible act in a way which, as a secondary objective…

➔ Where the SCO applies, the PRA must seek to facilitate effective competition where it can; the PRA is not required to act in a manner inconsistent with its primary objectives but nor is it expected to pursue those without constraint. That there may be other binding constraints on the PRA (eg domestic or EU law) is recognised.

…facilitates effective competition…

➔ Use of 'facilitates' indicates that the PRA can help to create the conditions for effective competition; by contrast, the competition regulators are expected to 'promote' effective competition. The reference to 'effective' competition confirms that the PRA is only expected to facilitate competition associated with 'good' outcomes.

…in the markets for services provided by PRA-authorised persons in carrying on regulated activities'.

➔ The objective has relatively broad scope, extending to any market in which one or more PRA-authorised firms provide regulated services, whether those markets are domestic, foreign or international, although what is reasonably achievable will differ depending on the context.(b)

(a) Relatedly, EU law specifically precludes the PRA from considering the 'economic needs of the market' (ie competition) when deciding whether to approve a change of control.
(b) PRA-authorised firms include the activities of UK-authorised firms' overseas branches, the local activities of firms passporting in from the EEA and branches of third-country institutions.

- the PRA and the FCA would publish annual reports on how they are delivering on their respective competition requirements; these would '…set out clearly the steps being taken to drive more competition and innovation and to help ensure that the right incentives exist for new banks to enter the market'.

- the Government intended to issue a remit letter to the PRA and FCA in order to highlight those aspects of government economic policy most relevant to their duties. It was elaborated that: 'Both regulators have a duty to have regard to the desirability of sustainable economic growth in the medium to long term. These new remit letters will outline the government's priorities for increasing competition and innovation in financial services, for ensuring that the UK remains an attractive location for financial services businesses, and for securing London's role as the leading international financial centre'.

Box 2
The wider institutional arrangements for competition in financial services

- **Competition and Markets Authority (CMA)**: Since April 2014, the CMA has been the United Kingdom's primary competition and consumer authority with economy-wide responsibilities and powers to promote competition and ensure that markets work well for consumers, businesses and the UK economy. It took over many functions of the Competition Commission and the Office of Fair Trading. Specifically, the CMA is responsible for enforcing consumer protection legislation as well as for conducting market studies and investigations to identify where there may be competition and consumer problems to address. The CMA is expected to co-operate with sectoral competition regulators, including encouraging them to use their own powers and considering references and appeals made by these regulators.(1)

- **Financial Conduct Authority (FCA)**: In addition to its other responsibilities, the FCA is a competition regulator for financial services having had, since April 2013, both a competition objective and a duty. One of the FCA's three operational objectives is to promote effective competition in regulated financial services in the interest of consumers. A competition duty requires that the FCA promotes effective competition when advancing its other operational objectives for consumer protection and market integrity (see FCA (2015a)). The FCA is able to use its powers under FSMA to advance all of its objectives, including the competition objective. Those powers were subsequently expanded to include some of the same powers to enforce competition legislation as are available to the CMA.(2)

- **Payment Systems Regulator (PSR)**: Established as a subsidiary of the FCA in April 2014, the PSR has an overriding goal of promoting competition and innovation and ensuring that payment systems are operated and developed in the interests of those that use them. One of the PSR's three objectives is 'to promote effective competition in the markets for payment systems and services — between operators, payment service providers and infrastructure providers'. The PSR's regulatory remit and powers extend to eight payment systems.(3) The PSR also has some of the same competition powers as the CMA and FCA.

The concurrency arrangements mean that any of the CMA, FCA or PSR can enforce competition law, conduct market studies or make market investigation references (for the FCA, in relation to financial services; for the PSR, in relation to payment systems). The FCA can also conduct market studies under its regulatory powers. CMA market investigations may, among other measures, result in it issuing recommendations and advice to any authority, including the PRA, on actions that should be taken to address identified market problems. Both the FCA and PSR can take action in relation to firms regulated by the PRA or payment systems overseen by the Bank of England; the legislation establishing the PSR includes a power under which the Bank and PRA may exercise a veto in certain circumstances.

(1) The CMA is also responsible for: investigating mergers that could restrict competition; bringing criminal proceedings against individuals who commit cartel offences and enforcing consumer protection legislation to tackle practices and market conditions that make it difficult for consumers to exercise choice.
(2) See FCA Finalised Guidance documents — FG15/9: 'Market studies and market investigation references', July 2015; www.fca.org.uk/your-fca/documents/finalised-guidance/fg15-09, and FG15/8: 'The FCA's concurrent competition enforcement powers for the provision of financial services', July 2015; www.fca.org.uk/your-fca/documents/finalised-guidance/fg15-08.
(3) Currently Bacs, CHAPS, cheque and credit, FPS, LINK, NICC, MasterCard and Visa.

2 Approach to the evaluation

The IEO's approach to its evaluation of the PRA's SCO drew on established principles of policy evaluation in both UK government and international institutions.(1) Specifically, we: defined the purpose and remit of the project at the outset; set out our 'evaluation criteria' in the early stages of the work; determined our methodological approach and data sources, drawing on a variety of different approaches; and agreed a project framework and governance approach. This section sets out the details of the approach used. The evaluation itself is detailed in Sections 3 to 5.

2.1 Purpose and remit of evaluation

A core objective of the IEO is to support the Bank's Court (the institution's Board) in its duties to keep the performance of the Bank, including the PRA, under review. The IEO's focus is on the inputs into, infrastructure supporting, and outputs of the Bank's policy areas and its strategy. The IEO reports directly to the Chairman of Court, who determines the work programme and remit of the office, typically in consultation with other Court Directors. For the SCO evaluation, the high-level terms of reference were set out by the Bank's Court in its February 2015 meeting. Specifically, Court endorsed 'a proposed assessment of the PRA's approach to its new competition objective, to be undertaken by the Independent Evaluation Office. The aim would be to facilitate Court oversight of the strategy adopted, using appropriate metrics and monitoring tools'.

The statutory framework for the SCO was a central consideration in project design. By statute, the SCO only applies to a subset of the PRA's activities, and is secondary to the institution's primary objectives to promote the safety and soundness of firms and to ensure an appropriate degree of protection for insurance policyholders. That statutory framework influenced the design of the IEO project in the following ways:

- As the PRA is the only part of the Bank that has an explicit secondary objective to facilitate effective competition, this project focused solely on the work of the PRA, rather than on that of the Bank's other policy committees. Our work did consider the interaction between the PRA and other Bank policy committees insofar as these committees are a possible source for policy initiatives that the PRA is required to implement. When examining interactions between the PRA and other areas of the Bank, however, we did so solely from the perspective of the PRA and its obligations under the SCO.

- The SCO is only engaged when the PRA is carrying out its so-called 'general' functions such as rule-making, setting supervisory policy and preparing and issuing codes (see Section 1.2). Individual supervisory decisions are out of scope of the SCO, and hence of the IEO project.

- The project did not seek to provide commentary or judgement on individual policy decisions made by the PRA. Competition is only one of a number of factors that the PRA takes into account when reaching policy judgements. Specifically, when making policy, the PRA has to ensure that it is meeting its primary objectives to promote the safety and soundness of firms and protect insurance policyholders. In addition to its obligations under the Secondary Competition Objective, the PRA is also required to take into account a number of other considerations, including proportionality, and the need to use its resources in an economic and efficient way. Consequently, commentary or analysis by the IEO of the PRA's approach to its competition obligations in any individual policy decision should not be taken as commentary or analysis of the overall soundness of the PRA's policy judgements.

(1) See, for example, OECD (1991), UNEG (2005) and HM Treasury (2011).

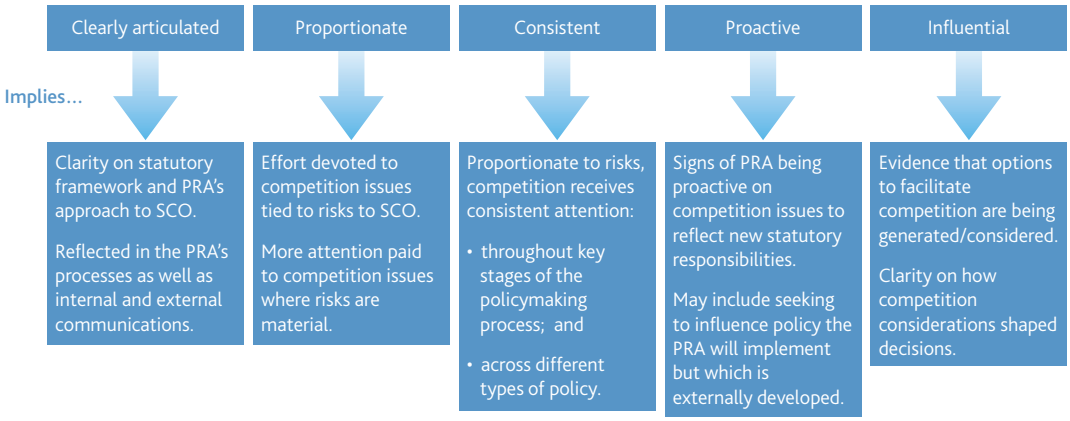
When formulating criteria against which to assess the PRA's approach to its competition considerations (see below), we were mindful of the fact that there are limits to what its prudential regulation can achieve in terms of competition outcomes. The PRA is only one of a number of agencies whose actions potentially impact upon the degree of effective competition in financial services. As set out in Section 1.2, three concurrent regulators — the CMA, FCA and PSR — have a primary duty to promote competition in financial services, and a range of tools to help them achieve those goals. And there are limits to what any regulatory agency can do to influence the structural characteristics that tend to determine the ultimate level of competition in the market place — for example the nature of fixed costs and the ability and propensity of customers to switch providers. There are also likely to be considerable lags between any actions that regulatory agencies take, and the ultimate impact on the degree of effective competition; in this context, it is notable that the PRA's Secondary Competition Objective only came into force in March 2014.

Together, these considerations suggest that the value to the Bank's Court of a so-called 'impact' evaluation of the PRA's competition strategy would be limited. Instead, we conducted what is commonly referred to in the evaluation literature as a 'process' evaluation.(1) Specifically, a process evaluation looks at how a policy is implemented and delivered, focusing on, for example: whether a policy is being implemented as planned; what is and what is not working well; and whether a policy is delivering expected outputs and outcomes (where a relevant outcome might be the degree of effect that competition considerations are having on PRA policy judgements).

2.2 Evaluation criteria: what does good look like?

A core element of process evaluation is to establish at an early stage the criteria against which a policy or approach will be evaluated. We therefore developed a set of five criteria against which the effectiveness of the PRA's approach to its Secondary Competition Objective could be judged. These drew on a number of sources, including: external guides to policy evaluation; statutory requirements on the PRA, including the Government's intentions when formulating the PRA's SCO; and views of policymaking practitioners. Our evaluation criteria are summarised in **Figure 2.1**.

Figure 2.1 Evaluation criteria



(1) Impact evaluations look at the difference a policy makes — an impact evaluation of the PRA's competition strategy, for example, would assess the likely effect of PRA judgements on the degree of competition in the relevant markets for financial services. For more discussion on different types of policy evaluation, see HM Treasury (2011).

A central evaluation criterion was the degree to which the PRA's approach to its Secondary Competition Objective had been **clearly articulated**, in both internal guidance and in external communications. It is essential for effective and appropriate policymaking that staff involved in policy design within the PRA and, where appropriate, the wider Bank(1) are clear about the PRA's statutory obligations under the SCO, as well as the PRA's emerging framework and approach for considering competition issues in the context of prudential regulation.

When evaluating this aspect of the PRA's performance, we were mindful of the fact that the SCO is a relatively new statutory objective for the PRA; as such, one would expect the degree of internal guidance and communication to be less developed than for the PRA's primary objectives. Nevertheless, reasonable elements of an appropriate internal articulation of the SCO at this early stage of its life might include: clarity about the PRA's statutory obligations under the SCO; a consensus at senior levels about the emerging framework and approach; and a cascade of this consensus to core policymaking staff.

As well as internal communication, we also considered external communication when assessing performance under our 'clear articulation' criterion. Effective communication is a core component of successful policymaking in the context of central banking.(2) Moreover, external communication of the PRA's strategy and approach to the SCO provides clear evidence of deliberation and agreement among internal stakeholders.

A second evaluation criterion was that of **proportionality**, of which there are a number of aspects. In legal terms, proportionality in the context of public policymaking is the principle that a burden or restriction should be proportionate to its benefits. As a public body, the PRA is required by administrative law to consider proportionality when making policy. It is also a principle to which the PRA must have regard under the Financial Services and Markets Act (2000) (FSMA).

In this evaluation, we used the concept of 'proportionality' to additionally capture aspects of efficiency in policymaking. The PRA is required by statute to have regard to the need to use its resources in the most efficient and economic way.(3) And 'efficiency' is identified by both the OECD (1991) and the UN Evaluation Group (2005) as a core criterion of policy evaluation. In the context of our evaluation, therefore, we defined proportionality as the need to ensure that the effort devoted to competition issues by policymakers was proportionate to the risks to the PRA's SCO, with more attention paid where the risks to effective competition were likely to be more material.

The **consistency** of consideration of competition issues formed our third evaluation criterion. The PRA Board, and its supporting committee, the Supervision, Risk and Policy Committee (SRPC) take a large number of decisions each year. To support coherent and consistent judgement-making in that context, the PRA produces and maintains detailed guidance for supervisors and for policymakers. Consistency in consideration of competition issues is therefore an important criterion for this evaluation to consider. Specifically, we considered consistency of competition discussions:

- throughout key stages of the policymaking process (in staff analysis prior to consideration by policy committees, at SRPC and at PRA Board); and

- in different types of policy, for example when comparing policy primarily affecting the banking sector with that primarily affecting the insurance sector, or when comparing policy initiated by external parties (eg the EU) with that initiated by the PRA.

In putting forward amendments to the legislation introducing the SCO, the Government explained that its intent was that the PRA should take a more **proactive** stance on competition, saying that: 'This Government amendment… turns the negative duty to avoid harm to competition into an active secondary objective. … The amendment is intended to require the PRA to embed competition considerations within the workings of the organisation and to be proactive in looking for ways to support competition'.(4)

(1) The Bank's Prudential Policy Directorate, which has a dual reporting line to the Deputy Governor for Financial Stability and the Deputy Governor for Prudential Regulation, typically takes the lead in policy design, drawing on wider Bank expertise as appropriate.
(2) As discussed, for example, in Warsh (2014).
(3) See Sections 2H(2) and 3B(1)(a) of the Financial Services and Markets Act 2000.
(4) See https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/245791/Annotated_Clause_-_PRA_Competiton_Objective.pdf.

Given this legislative background, a core aim of the IEO evaluation was to provide Court assurance that the requisite 'change of gear' had occurred when moving from a 'have regard' approach to competition (as practised by the FSA and in the very early days of the PRA) to a statutory Secondary Competition Objective. In our assessment, we looked for evidence of proactivity in competition issues when the PRA was engaged in prudential policymaking, which in this context could mean testing the boundaries of where the SCO was engaged, or seeking to influence policy originating from outside the PRA (such as in international fora).

Our final evaluation criterion was the need for competition considerations to be **influential** in prudential policymaking. Evaluation criteria endorsed by the OECD (1991) and the UN Evaluation Group (2005) include the need for initiatives to be effective and have impact; the PRA is also required by statute to have regard to the need to use its resources in the most efficient and economic way. It therefore seemed important to assess whether consideration of competition issues were making a meaningful difference to the policy judgements of the PRA. Specifically, during the course of our evaluation, we looked for evidence that the PRA was successfully generating options to facilitate competition, and for clarity on how competition considerations were shaping decisions.

2.3 Methodology and data sources

As is commonly practised in the evaluation field, we combined a number of different approaches and techniques when forming judgements about the PRA's approach to its competition objective. Combining insights in this way (an approach known as 'triangulation') recognises that any individual approach to a research question has its limitation and drawbacks; combining different approaches and looking for common themes or findings should improve the robustness of the results (as discussed, for example, in HM Treasury (2011)).

Specifically, our evaluation project had three complementary workstreams: a review of the strategy and framework for competition that the PRA had put in place; six in-depth case studies that looked at consideration of competition issues for key policy initiatives; and linguistic analysis of competition discussion in materials sent to the PRA's policy committees.

For the first of these workstreams, the '**framework review**', we conducted a desk-based assessment of the framework and supporting processes that the PRA had in place to embed the SCO into its policymaking, organised under 'inputs', 'supporting infrastructure' and 'outputs'. This desk-based review was supplemented with structured discussions with a wide range of prudential policy staff.

Our second workstream, the '**case study review**' assessed the attention that competition issues received in practice in relation to number of key policy initiatives. We selected the case studies using so-called 'purposive sampling', in that the studies were selected to represent characteristics thought to be relevant to our research questions, rather than to provide a statistical representation of the research population.(1) Specifically, we sought to identify case studies: where competition issues were likely to be reasonably material; which encompassed both the banking and insurance sectors; which included PRA-initiated policy as well as externally driven policy; and which covered new policies as well as updates to existing ones.

Our third workstream ('**linguistic analysis**') was conducted in conjunction with the Bank's Advanced Analytics area, and sought to use linguistic analytical tools to evaluate discussion of competition issues at the PRA's policy committees (PRA Board and SRPC). We used simple linguistic tools to analyse the amount, and type, of attention paid to competition issues during the policymaking process. The aim of this strand of work was to provide preliminary quantitative indicators to support the emerging themes from the first two workstreams, which were by design more qualitative in nature.

Of these three approaches, it was the first two (the framework review and the case studies) which had the most impact on our conclusions and recommendations. Although our third approach (the linguistic analysis) provided a variety of useful supporting material, there were a number of known constraints to the exercise (including that the Secondary Competition Objective had been in force for a limited period of time, that materials drawn up for

(1) See HM Treasury (2011) for further discussion of sampling techniques.

the policy committee had a large number of different authors and styles and that the exercise necessarily involved a series of subjective judgements) that meant we were cautious of the risk of overinterpreting the results.

Ideally, our evaluation would have included an assessment of how the PRA's approach to its competition objective compared with that of peer organisations. However, the nature of the PRA's SCO is, as far as we could ascertain, unique in the regulated community. Competition considerations feature in the objectives of numerous other regulators in the financial services industry and beyond, both at home and abroad. But the precise formulation of the PRA's obligations for competition — a statutory secondary objective whereby the PRA is obliged to facilitate, rather than promote, effective competition — is not one that appears to have been replicated elsewhere. By way of contrast, for example:

- The FCA has competition as a primary objective, and is required to 'promote' rather than 'facilitate' competition, a deliberate choice of phrase designed to reflect the differing remits of the two agencies.(1)

- The duty to 'promote' competition (rather than the PRA's obligation to 'facilitate') also features among the statutory requirements of other UK regulatory agencies, such as Ofgem, the energy regulator and Ofcom, the communications regulator.

- Overseas regulators are typically governed by very different statutory frameworks to those of UK regulatory bodies; although competition may feature in their objectives, it is difficult to find any clear analogue to the statutory framework of the PRA.

Although there were no directly relevant peers against which to conduct an in-depth comparison, we nevertheless sought to include relevant aspects of external best practice when conducting our work. For example, when considering the PRA's approach to competition issues when formulating policy, we referred to HMT guidance on policy design (HM Treasury (2013a)). And when assessing PRA policymakers' assessment of the materiality of competition issues, we referred to guidelines on 'competition impact assessment' issued by the Competition and Markets Authority (CMA (2015)). We also benefited from discussing emerging themes from our work with members of the PRA's Practitioner Panel(2) and colleagues in the FCA.

Further details of our methods and data are contained in Sections 3 to 5 and Annexes 1 to 3.

2.4 Timing, quality control and governance

Most of our analysis focused on the period dating from March 2014 (the formal adoption of the SCO) up until October 2015 (when we presented our preliminary findings and recommendations to the Bank's Court of Directors). We took a flexible approach, however, and on more than one occasion considered material produced by the PRA in advance of the formal adoption of the SCO if we considered this to be informative for our work.

Best practice evaluation guidelines stress the need for internal transparency and communication in evaluations, both to assist with quality control, and to increase the likelihood of an evaluation contributing to the wider learning culture in an organisation.(3) HM Treasury (2011) suggests that the use of a steering, or advisory, group is one way to achieve good communication and exchange of ideas with stakeholders.

In this project, a senior-level advisory group helped provide quality assurance, as well as helping ensure that recommendations from the project were likely to be effective. This group was constituted on a purely advisory basis; the evaluation itself was conducted by a seconded team based in the IEO, reporting directly to the Chairman of Court. The membership of the advisory group was designed to bring in views from across the Bank, and not solely from within the PRA, and also included two members who were employed by the PRA in an independent capacity (the PRA's senior advisor on competition and a non-executive director of the PRA Board) to

(1) For further discussion, see Section 1.
(2) The Practitioner Panel is an independent statutory panel required under the Financial Services and Markets Act 2000 to represent the interests of practitioners. See www.bankofengland.co.uk/pra/Pages/practitionerpanel.aspx.
(3) As set out, for example, in UNEG (2005).

ensure that an appropriately diverse range of views were brought to bear.[1] In addition to this senior-level advisory group, the IEO team met regularly with the PRA's in-house competition experts, who provided comments and feedback on the emerging themes and recommendations of the work.

A founding principle of the Bank's IEO is its independence: its work is conducted at arm's length from local business areas, and it reports directly to the independent Chairman of Court. This is in line with established best practice on evaluation functions (see, for example, UNEG (2005)).

(1) Full membership of the advisory group was: Andrew Bailey (CEO of the PRA), Sandy Boss (non-executive director of the PRA Board), Professor Paul Grout (senior advisor to the PRA on competition and Professor of Political Economy at the University of Bristol), two Executive Directors of the Bank (Alex Brazier and Sam Woods), Sasha Mills (Director in the Bank's Prudential Policy Directorate), Martin Stewart (Director of Supervision for smaller banks, building societies and credit unions) and Rob Price/Vivienne de Chermont of the Bank's Legal Directorate. The advisory group was chaired by Lea Paterson, IEO Director.

3 Evaluation — PRA's framework for the SCO

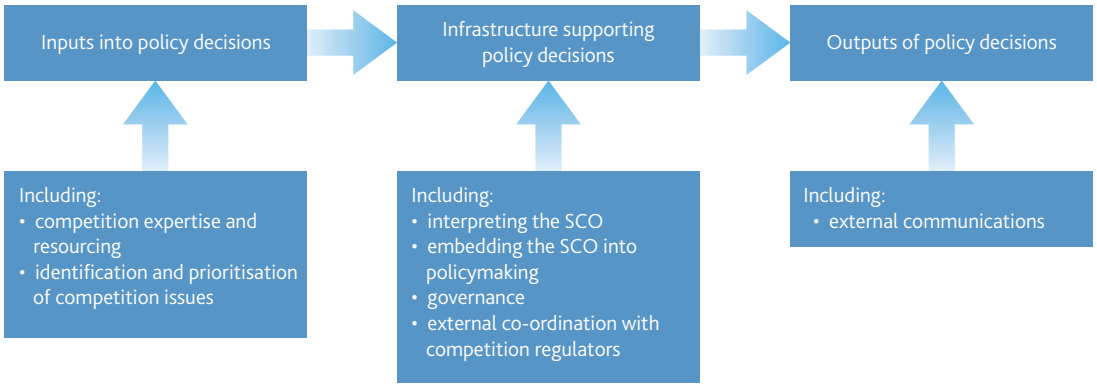
As set out in the preceding section, our analysis consisted of three workstreams: a framework review, a case study review and linguistic analysis. This section of the report briefly sets out the framework employed by the PRA to fulfil its responsibilities under the SCO (Section 3.1), before evaluating the approach adopted with reference to our five evaluation criteria (Section 3.2).

3.1 The PRA's approach to the SCO

The 'framework review' workstream considers the framework and supporting processes that the PRA has in place to embed the SCO into its policymaking, organised under 'inputs', 'supporting infrastructure' and 'outputs' to policymaking (**Figure 3.1**).(1) It is based on a desk-based evaluation of internal briefing and guidance materials, and of relevant external communications, supplemented with structured discussions with a range of staff from the PRA and the wider Bank. The material reviewed primarily covers the period March 2014 (when the SCO came into effect) to October 2015.(2) As one might expect, the PRA's approach to the SCO has evolved during this period; where relevant to the evaluation we have noted the nature of any significant changes.

As noted in Section 2, there are no directly comparable peers against which to benchmark the PRA's approach. Where relevant, however, we considered best practice for policymaking and competition impact assessment (in particular, HM Treasury (2013a) and Competition and Markets Authority (2015); the relevant CMA guidelines are also summarised in Annex 1). Box 3 provides an overview of some of the key features of the PRA's general approach to prudential policymaking.

Figure 3.1 Aspects of the PRA's approach to the SCO in scope of the IEO evaluation



(i) Inputs

Core inputs into the PRA's approach to competition include its dedicated competition resources, and the way in which it identifies and prioritises competition issues.

In terms of resources, a small dedicated team, based in the Bank's Prudential Policy Directorate, acts as a centre of expertise on competition and impact assessment upon which staff leading on prudential policy design can draw, with a small number of additional staff being recruited after the SCO came into effect. Following the adoption of the SCO, Professor Paul Grout was appointed as the PRA's Senior Advisor on Competition to bring external

(1) This aligns with the IEO's remit to focus on the inputs to, the infrastructure supporting, and the outputs of the Bank's policy areas and its strategy.
(2) We additionally included key external communications that were published after October 2015, but were being formulated during our evaluation period, such as the 2015 Q4 *Quarterly Bulletin* article on the PRA's Secondary Competition Objective (Dickinson *et al* (2015)).

perspective and experience from competition regulation and academia as well as to provide independent advice and challenge.(1) As well as the dedicated competition resources, other areas of the PRA also have a strong interest in, and input into, competition matters. These include the teams responsible for authorising new firms and for supervising small and medium-sized banks.

Identification and prioritisation of competition considerations is supported in a number of ways, including by research into relevant aspects of competition. As indicated in the February 2015 One Bank Research Agenda (OBRA), Bank research will explore the impact of prudential regulation on competition as well as the wider relationship between competition and stability.(2) It is expected that, in turn, this will help the Bank better understand the impact that micro and macroprudential regulation may have on competition.

The PRA's dedicated competition team closely tracks the flow of forthcoming policy initiatives to help them to identify policies likely to raise material competition issues. At the time of the IEO evaluation, a plan was in place to adopt a more systematic approach to horizon-scanning that would engage senior management in the prudential policy area, but this plan had not been put into practice.

(ii) Infrastructure

Much of our framework review focused on the infrastructure that has been developed (or is in the process of being developed) to support consideration of competition issues during prudential policy design. Core features of this infrastructure include:

- **Interpretation of the SCO.** At the time of the IEO evaluation, there was no single 'go-to' document setting out the PRA's interpretation of its SCO (we note that plans to revise the PRA's 'approach' documents, that lay out its approach to prudential regulation, were put on hold pending the outcome of this evaluation). But we gained insight from reviewing internal materials, external communications and from discussions with PRA staff. We found that most of the key features of the SCO were widely understood, including that the SCO requires consideration of the competition effects of prudential policy, and that where appropriate the PRA should consider policy options that facilitate effective competition. It was also understood that the PRA is required to think about the competition effects of its prudential policy across all of the markets for regulated activities in which PRA-authorised persons operate (taking into account what can reasonably be achieved in those different markets).

  At the same time, we encountered some uncertainties about what being a secondary objective implied, along with a residual tendency among some policy staff to assume that facilitating competition would rarely be consistent with furthering safety and soundness. To a degree, these uncertainties and residual concerns were reflected in the drafting of some of the documents reviewed (particularly the older material). As the IEO evaluation progressed, and as the PRA's approach to the SCO continued to evolve, some of the more up-to-date material reviewed reflected the nature of the SCO more accurately (for example, see Dickinson *et al* (2015)).

  An important characteristic of the SCO is that it requires the PRA to facilitate 'effective' competition as far as is reasonably possible. We observed that the concept of effective competition had been considered in some detail by the PRA's dedicated competition team, at a senior level at the PRA's policy committees, and subsequently discussed in the Bank's *Quarterly Bulletin* (Dickinson *et al* (2015)). This thinking had not been disseminated across the policy area more widely, however.

- **Embedding the SCO into policymaking.** PRA staff leading on a policy initiative are responsible for ensuring that policy options are consistent with the SCO, and are encouraged to draw on the technical specialists to understand the effects on competition, particularly where these appear to be material, complex or precedent-setting. Policy (and supervisory) staff were briefed on how they were expected to meet the requirements of the SCO in an initial round of training in early 2014. As the PRA is also responsible for

(1) Paul Grout, Professor of Political Economy at the University of Bristol, additionally served as a member of the Advisory Group for this evaluation; see Section 2.4.
(2) See www.bankofengland.co.uk/research/Documents/onebank/discussion.pdf.

implementing policy developed by others, we noted that guidance to policy staff encourages proactive engagement in international policymaking initiatives and close co-ordination with the Financial Policy Committee (FPC).

In the main, we found that the approach to competition assessments and policy design was in line with established practice elsewhere in the UK regulatory sphere. For example, formal guidance encourages PRA policy staff to initiate impact assessment (in the form of economic analysis) early in the policymaking process, to build up to a more detailed cost benefit analysis (including competition assessment), and to summarise the results in internal papers to policy committees and in externally published consultation papers. We observed, however, that this formal guidance did not explicitly steer staff involved in policy design to develop options to facilitate competition; nor did the guidance state that if material effects on competition were identified then there may be a need to revisit the options being considered.

In terms of the analytical framework for the competition assessments, PRA's approach is broadly in line with guidelines set out by the Competition and Markets Authority (CMA) — see Annex 1. A key difference was that while the CMA guidelines suggest use of a checklist to help identify whether there are likely to be competition issues that then merit in-depth consideration, PRA practice is that the depth of the competition assessment should be determined by the overall rating assigned to the policy.(1)

- **Governance.** The PRA Board (PRAB) has requested that it is updated once every six months on efforts to embed the SCO, as well as on how competition considerations are influencing policy development. More generally, the PRA's policy committees (both the PRAB and its supporting committee, the Supervision, Risk and Policy Committee (SRPC)) frequently discuss the impact on competition of individual policy initiatives. Internal guidance sets out that papers for these policy committees should include the views of the Legal Directorate on their consistency with the PRA's statutory objectives (including the SCO), and also reflect the views of the in-house competition specialists, where appropriate. Increasingly, the PRA's senior advisor for competition also attends relevant SRPC and PRA Board discussions with a view to providing independent advice and challenge on competition issues arising.

- **External co-ordination with competition regulators for financial services.** As described in Section 1.2, there are numerous regulatory bodies with responsibilities for competition in financial services (namely the Competition and Markets Authority (CMA), the Financial Conduct Authority (FCA) and the Payment Systems Regulator (PSR)). PRA staff regularly engage with the CMA and the FCA at working level on competition issues of mutual interest; engagement with the PSR is at an early stage. While the PRA and FCA have agreed an approach to co-ordination on policymaking, as described in their bilateral Memorandum of Understanding (MoU), it is not currently specified that this extends to co-ordination on competition issues of mutual interest.(2) The Bank, PRA, FCA and PSR are under a statutory obligation to co-ordinate with one another in the exercise of their respective functions in relation to payment systems and have entered into an MoU; the sections of the MOU relating to co-ordination on competition do not extend to the PRA.

(iii) Outputs

Our review of outputs largely focused on key external communications vehicles such as the PRA's 2015 *Annual Report* (which provided greater detail on how the PRA understood its new objective) and speeches by policymakers (for example, Bailey (2015), which identified competition as being one of three areas where the PRA intended to focus its efforts).

(1) As described in Box 3, each PRA policy is assigned a rating from 1 (a policy likely to have a high impact on firms) to 5, with these ratings informing resource prioritisation and the decision-making process.
(2) At the time of the evaluation, the April 2013 version of the PRA-FCA MoU was being updated to include a factual reference to the PRA's SCO. See the Memorandum of Understanding available at www.bankofengland.co.uk/about/Documents/mous/prastatutory/moufcapra.pdf.

Box 3
Overview of the PRA's approach to prudential policymaking

This box sets out key features of the PRA's approach to policy design, and in particular how it approaches the various aspects of the policy 'life cycle'. It also summarises key features of the infrastructure and processes that support policymaking at the PRA.

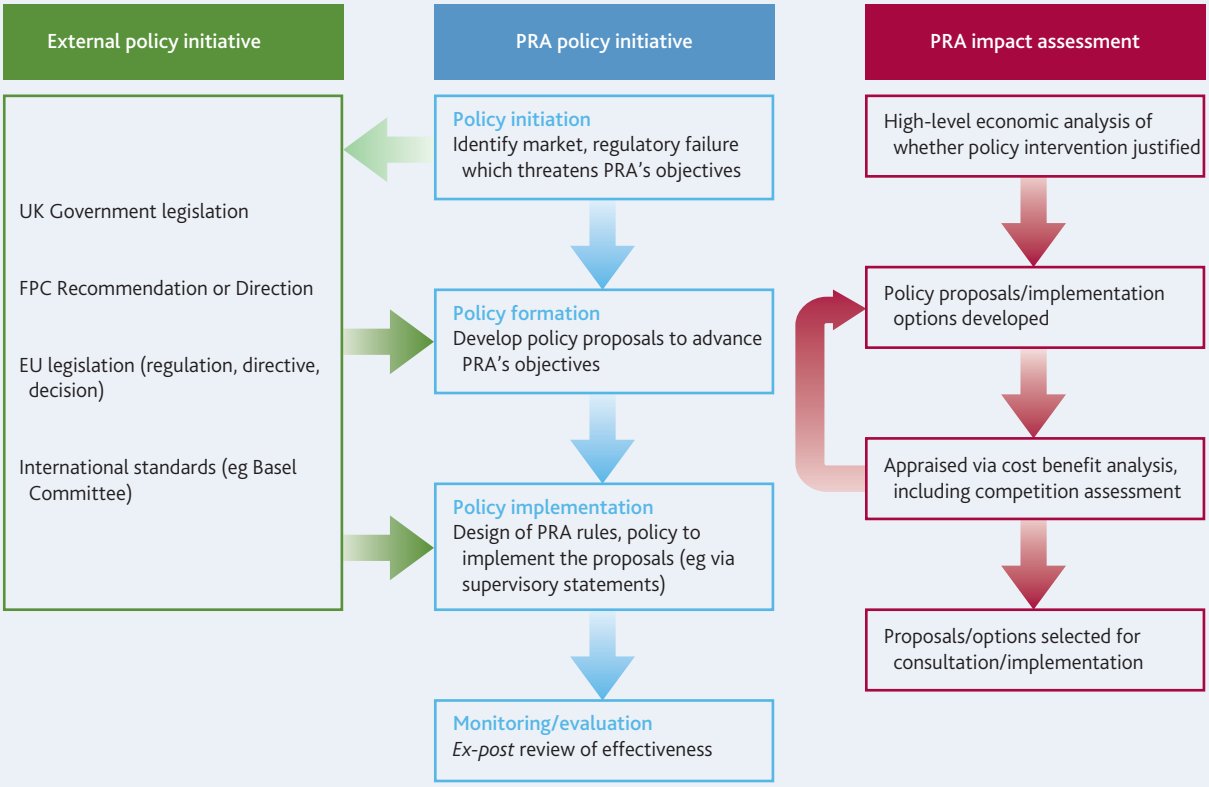
Policy 'life cycle'

PRA policymaking can be divided into four key stages as per the middle 'blue' column of the figure below. The first is policy initiation whereby the PRA identifies market or regulatory failures which might be detrimental to safety and soundness and insurance policyholder protection. Then the PRA considers how to address the issues identified so that the net effect of any reform — whether a new or modified prudential policy — advances the PRA's objectives, including the SCO, as well as meeting other statutory obligations outlined below. This is policy formation.

The PRA is responsible for implementation not only of its own policy but also that which originates with other — domestic or international — policymakers as shown in the 'green' column of the left of the figure below. In such cases the PRA would still consider the rationale for the policy and how consistency with its own objectives might be achieved, with a view to supporting proactive engagement in domestic and international policy debates as appropriate (represented by the pale green arrow).

Alongside advancing its statutory objectives, the PRA has regard to a number of regulatory principles including that the benefits of its requirements should be proportionate to the costs, the desirability of sustainable UK economic growth in the medium or long term, and differences in the nature and objectives of authorised persons. As indicated by the 'red' column on the right, to improve the quality of policy and to meet legal requirements, the PRA routinely conducts impact assessment which studies impact of its policy initiatives on regulated firms and the wider economy. This is, in theory and practice, an iterative process starting with a

Figure A Stylised policymaking process



Note: Adapted from HM Treasury (2013a) and guidance to PRA policymakers.

high-level assessment at the policy initiation stage through to the carrying out of more detailed cost benefit analysis (CBA) once policy options have been developed.

Supporting infrastructure and processes

Whether the PRA is responsible for a policy throughout its life cycle, or for the implementation of a policy developed externally, policy staff with expertise in the relevant area (capital, liquidity etc) lead the work, drawing on technical — including competition — experts within the Prudential Policy Directorate and often seeking input from supervisors.

Each PRA policy is allocated a rating — 1 for policies likely to have a high impact on firms, the system or PRA objectives through to 5 for those likely to have limited effect. These ratings inform resource prioritisation and the decision-making process. Higher-impact policies are initially considered at a senior-level committee — the Supervision, Risk and Policy Committee (SRPC) — whereas lower-impact matters are delegated to management. The PRA Board is involved in the most important decisions on general policy and must approve all rules.

The PRA has a statutory duty to consult when introducing new rules and a public law duty to consult widely on any other measures that significantly affect firms, including consulting with the PRA Practitioner Panel and FCA. Typically, the PRA publishes a consultation paper on its website and, after determining its final approach, communicates this in a policy statement.

3.2 Evaluation of the PRA's framework against criteria

This section considers the PRA's approach to the SCO against the five criteria outlined in Section 2.2: clearly articulated, proportionate, consistent, proactive and influential.

(i) Clearly articulated

Effective policymaking requires clarity among staff involved in policy design about the statutory requirements of the SCO, as well as about the PRA's emerging framework and approach for competition issues. A complicating factor is that, as explained in Section 1, there are genuine uncertainties about how prudential regulation affects competition and how, in turn, competition interacts with safety and soundness. Given the PRA's need to understand these relationships more effectively, further research seems to be an important investment in embedding the SCO. It seems appropriate, therefore, that the initial focus of planned research is on better measuring and understanding levels of competition in financial services, given that this provides a basis from which to explore the effect that prudential regulation can have on overall levels of competition. The challenge is that even within the field of PRA's particular area of interest, there is a relatively long list of uncertainties to explore and a need to prioritise future work given resource constraints.

Across the policy area, we found a relatively high degree of understanding of key aspects of the statutory requirements of the SCO (including that the SCO applies when the PRA is making policy to advance its primary objectives and creates an obligation on the PRA to consider policy options that facilitate effective competition where possible). At the same time, as outlined in Section 3.1, we encountered uncertainties among some staff about some aspects of the legal requirements, as well as on the PRA's intended approach where the framework affords discretion. Structured discussions during the IEO evaluation helped to clarify some of these issues, and so there is scope to update guidance and training for policy staff accordingly.

Another area where there may be value in providing greater clarity to staff is on the PRA's obligations where policy is developed externally, including where it takes the form of EU legislation. This would help to mitigate the risk that focusing on potential constraints to action may inadvertently discourage staff from efforts to influence policy being developed externally or to consider scope to address competition effects in implementation (as considered further under 'Proactive').

Given that we encountered some residual concern among policy staff about the compatibility of the PRA's primary and secondary objectives, there would be value in ensuring that recent work on how to interpret

'effective competition' (eg as set out in Dickinson *et al* (2015)) is actively disseminated among staff in the policy area. This would not only help to ensure familiarity with the framework as it stands, but also to assist in developing thinking further.

As the PRA becomes increasingly familiar with the requirements of the SCO, there seems scope to invest further in explaining to external stakeholders how it interprets and intends to approach competition issues. This might usefully include a fuller articulation of how the PRA's responsibilities fit into the wider landscape for competition in financial services. An overview of this was included in Dickinson *et al* (2015), and there may be scope for the PRA to say more on respective responsibilities and the agreed approach to co-ordination as the post-crisis institutional arrangements bed down. This, in turn, should help to mitigate the risk that the PRA is expected to act outside of its remit or that co-ordination is sub-optimal.

(ii) Proportionate

Ensuring that the efforts devoted by policymakers to competition issues are proportionate to the likely risks to the SCO is important in ensuring that the PRA is efficient and effective. It is positive, therefore, that under the PRA's current framework, staff involved in policy design are encouraged to consider whether initiatives are likely to raise competition issues at an early stage of the policy life cycle. Furthermore, the planned horizon-scanning exercises — to be conducted by the in-house competition team with a view to identifying policies with a potentially material effect on competition — should act as an important cross-check on the work of staff leading on design of individual policy initiatives. Coupled with the requirements on the PRA to consult widely, the existing framework is likely to be reasonably effective in identifying where the PRA should focus its efforts in relation to competition.

At the same time, our evaluation identified a number of ways in which the existing framework could be strengthened to support more effective prioritisation by the PRA of its competition work. Keying the effort devoted to competition assessment off the overall 'impact' rating assigned to a policy (see Section 3.1) may not be optimal as there may be cases where the scale of the competition issues raised by a policy are higher (or lower) than the overall impact of that policy might imply.

There additionally seems to be scope to build on the planned process of horizon scanning by the in-house competition team. This could include ensuring that it has sufficiently broad scope, and draws on the views of an appropriately wide set of stakeholders. Horizon-scanning exercises could have greater impact if there were a clearer feedback loop to policymaking — for example, by consistently informing senior decision-makers of the results of the exercise and ensuring that policies identified as raising material competition issues are flagged as such as they make their way through the PRA's policy committees.

(iii) Consistent

One aspect of consistency is ensuring that a material competition issue arising receives attention irrespective of the sector to which it relates (eg banking or insurance). And so it is positive that the same framework and processes support prudential policymaking across all PRA-regulated entities. (The case study review in Section 4.2 provides insight into the attention competition has received in practice to policies relating to the banking and insurance sectors.)

Another aspect of consistency is ensuring that as a statutory objective, competition issues receive attention throughout the policymaking life cycle. Internal guidance sets out that staff involved in policy design should consider the potential effects on competition from policy initiation through to implementation. At the same time, positioning the competition assessment as part of the cost benefit analysis (CBA) of an initiative, as is currently the case, carries the risk that policy staff may see their responsibility as being primarily about estimating the impact on competition of policy options which have already been developed. Indeed, in practice, as explored further in our case study work in Section 4.2, CBA tends to be carried out once there are policy proposals to assess, and detailed competition analysis (particularly the relatively thorough analysis envisaged by the PRA's guidelines) may come relatively late on in the policy life cycle.

(iv) Proactive

The PRA has stated its intent, both publicly and in internal guidance to policy staff, to be an active and persuasive participant in international negotiations on policy (see, for example, PRA (2014a)). A relevant recent example is

the PRA's October 2015 submission to the European Commission consultation on the impact of the new capital regime. This set out that a more differentiated approach to implementing CRR/CRD IV in the European Union might have been beneficial for financial stability and effective competition.(1)

At the same time, internal guidance to policy staff does not set out clearly that a similarly proactive approach should be taken where policy originates from domestic sources (for example, the UK Government or other parts of the Bank such as the Financial Policy Committee (FPC)). Doing so would provide support for what seems to happen to some extent already in practice, which is for PRA policymakers to flag any material competition issues that might arise in relation to prudential policy being developed domestically, such that the external parties (such as the Government, FPC or other parts of the Bank) can take that information into account (noting that in turn, their approach to considering and addressing such issues would be determined by their own policy priorities or statutory objectives).

That the PRA has also stated publicly an intent to carry out 'periodic reviews of existing rules to identify areas where changes would facilitate greater competition without compromising the safety and soundness and policyholder protection objectives' (see, for example, Dickinson *et al* (2015)) is a further sign of proactivity; although the PRA may carry out reviews of this nature, it is not strictly required to do so under the formulation of the SCO (see Section 1.2).

(v) Influential

It appears that the six-monthly discussions of the SCO, which occur not only at PRA Board but also SRPC, play an important role in helping to ensure that senior policymakers regularly take stock of the PRA's approach and efforts to embed the new objective. To that end, there may be scope to enhance further the effectiveness of these discussions by providing regular updates across all of the key elements of the PRA's approach (as considered in this evaluation), as well as on the status of those policies where material competition issues had been previously identified.

An important aspect of ensuring that competition issues receive a sufficient degree of attention — and hence are influential in policymaking — is creating the conditions for challenge internally and externally. Increasingly, the PRA's senior advisor for competition and its in-house competition experts are playing this role, both through their involvement in policy design and impact assessment, as well as by feeding in views when policies are brought to SRPC and PRA Board. Additionally, it is common practice to involve supervisors in policy development, and those who supervise small and expanding firms are often well-placed to flag potential competition issues. Guidance encourages the setting out of competition issues in external consultations also, which in turn helps expose proposals to external scrutiny. Nevertheless, and as a further check that competition considerations are getting sufficient traction, there may be scope to further stress to policy staff the importance of inviting internal and external challenge on competition matters.

(1) Available at www.bankofengland.co.uk/pra/Documents/crdiv/responsecrrcrdivbankfinancing.pdf.

4 Evaluation — case study review of policy initiatives

As set out in Section 2, our analysis consisted of three workstreams: a framework review, a case study review and linguistic analysis. This section of the report briefly outlines the policy initiatives which formed part of the case study review (Section 4.1), before assessing the approach taken against our five evaluation criteria (Section 4.2).

4.1 Approach to case studies

In our second workstream, we assessed the attention that competition issues received across six major policies. After identifying the most material PRA policies(1) we selected a subset of those where competition issues were present and which displayed other characteristics thought to be relevant to our evaluation.(2) The case studies chosen included policies from the banking and insurance sectors, as well as both PRA-initiated and externally-initiated policies. The case studies spanned the full period from the PRA coming into existence, and included both new initiatives and those revising existing policy.

The six case studies identified through this process are summarised below (and in **Table 4.A**); more details are provided in Annex 2:

- The June 2014 FPC Recommendation to the PRA to limit high loan to income (LTI) ratios in residential mortgage lending. This allowed us to consider the PRA's approach to the SCO when making rules designed to implement macroprudential policy.

- A 2014–15 PRA-initiated review of the approach to bank-specific Pillar 2A capital requirements, aimed at creating a more risk-sensitive and consistent approach to setting Pillar 2A capital. The ICB (2011) identified that competition issues could arise in relation to setting capital requirements for credit and concentration risk; our case study therefore focused on revisions made to methodologies for these risk types in particular.

- Implementation of transitional measures to smooth the move to new, higher financial resource requirements for insurers under the EU-wide Solvency II Directive (this came into force in January 2016). The PRA had identified potential for competition issues to arise in relation to transitional deductions from technical provisions (TDTPs); we therefore considered the PRA's approach to implementation in the context of maximum-harmonising EU legislation.

- A 2014–15 PRA initiative to review the competition effects of rules which would appear in the PRA Rulebook in the context of a wider project to update material inherited from the FSA.(3) Motivated by the SCO and to meet other statutory requirements, the PRA sought to identify areas where changes would facilitate greater competition without compromising its primary objectives.

- The PRA's implementation, beginning in 2014, of UK Government legislation for structural reform of the banking sector ('ring-fencing'); these reforms stemmed from recommendations from the ICB (2011) designed to improve stability and competition.

- Bank/FSA reforms to authorisations policy for new banks which were announced in 2013 just before the new regulatory arrangements establishing the PRA and FCA came into effect. The case study allowed consideration of revisions to existing policy to address barriers to entry as identified by the ICB (2011) among others.

(1) In other words, those ranked 1 or 2 on the PRA's policy rating — see Box 3.
(2) As described in Section 2.3 this technique is known as 'purposive' sampling.
(3) The FCA and PRA inherited the FSA Handbook in April 2013, when the new regulatory framework took effect.

Each case study began with an initial document review that sought to gain insight into the policy process from inception to communication of final policy decisions. Staff papers to the PRA's SRPC and Board were considered as well as relevant external materials (consultation papers, policy statements etc). This was supplemented with structured discussions with policy staff and competition experts (including Professor Paul Grout, the PRA's senior advisor on competition) to explore further the competition issues arising and how they were addressed.

Table 4.A Key characteristics of the six case study policies

Case study	Source	New policy?	Why chosen?
FPC Recommendation on high loan to income (LTI) ratios	Domestic — FPC	Yes	First time PRA made rules to implement an FPC Recommendation; competition issues identified in consultation process.
Updates to Pillar 2A capital requirements (particularly credit, concentration risk)	Domestic — PRA[(a)]	No — review of existing policy	ICB had identified competition issues arising from Pillar 2A requirements; PRA review offered opportunity to address those.
Solvency II — transitional deductions from technical provisions (TDTPs)	EU — maximum-harmonising Directive.	Yes	Wider Directive and transitional arrangements had competition effects; case study allowed consideration of PRA's approach in context of maximum-harmonising EU legislation.
Competition review of PRA Rulebook rules	Domestic — PRA[(a)]	No — review of existing rules	To consider the PRA's approach to reviewing existing rules, but in a case where no specific competition issues had been identified *ex ante*.
Structural reform (ring-fencing)	Domestic — HMT	Yes	Major new policy initiative with roots in ICB recommendations (2011) designed to advance financial stability and competition.
Reforms to authorisations policy for banks	Domestic — PRA[(a)]	No — review of existing policy	High-profile initiative aimed at tackling potential barriers to entry into banking in a way consistent with the PRA's primary objective; authorisations policy in the context of barriers to entry raised by a number of external reports, including ICB (2011).

(a) The three policies whose source is 'Domestic – PRA' are also influenced by EU law, given that the PRA's policy remit is shaped by EU law.

4.2 Evaluation of the case studies against criteria

This section sets out key findings from the case study reviews. It is important to note that in terms of the scope of the exercise, we were, for each case study, seeking to assess the approach taken by the PRA against our evaluation criteria (clearly articulated, proportionate, consistent, proactive and influential). This is a different exercise from one which seeks to assess the wider impact of PRA policy judgements on competitive outcomes (the latter would constitute an 'impact' evaluation rather than the 'process' evaluation conducted by the IEO; see Section 2.1 for details). More generally, as competition is only one of a number of factors that the PRA takes into account when reaching policy judgements, commentary or analysis by the IEO of the PRA's approach to its competition obligations in any individual policy decision should not be taken as commentary or analysis of the overall soundness of the PRA's policy decisions.

(i) Clearly articulated

Across most of the case studies considered, policies developed to advance the PRA's safety and soundness and insurance policyholder protection objectives seem also to have been consistent with the SCO. Indeed, more often than might have been anticipated, prudential policy designed to address market and regulatory failures posing a threat to safety and soundness seemed to facilitate effective competition as well (**Table 4.B**). For example:

- by ensuring that capital add-ons are set in way that more accurately captures the risks that individual firms face, thereby increasing consistency across the system, the PRA's revised Pillar 2A policy should improve resilience to shocks and reduce incentives for regulatory arbitrage, while also helping to level the playing field between smaller more concentrated firms and their larger diversified rivals.

Table 4.B How the policies considered advanced the PRA's objectives

Policy	Overarching aim of the policy initiative	Advances safety and soundness and/or policyholder protection because…	Facilitates effective competition because…
FPC LTI	Provide for an insurance policy against a scenario where lenders extend a higher proportion of loans at high LTIs than is desirable from the perspective of system-wide stability.	By improving system-wide resilience, the policy helps to contain risk of a shock with a feedback loop to the banking system.	Implemented in a way that secures macroprudential aim, without having disproportionate effect on the ability of small niche firms to compete.
Pillar 2A (deposit-takers only)	To ensure that firm-specific add-ons more accurately reflect the risks posed by each firm's business activities and are more consistent between firms.	Better risk capture and mitigation helps improve resilience to shocks and reduces incentives for regulatory arbitrage.	Reduces potential for unintended differences in capital requirements which could disadvantage new entrant and small firms with more concentrated business models relative to larger diversified rivals.
Solvency II TDTP (insurers only)	Smooth the transition to new, higher financial resource requirements (for technical provisions) under Solvency II for insurers who had written long-term books of business under existing (and robust) regulatory requirements.	Avoids a sudden change in technical provision requirements, potentially triggering widespread capital raising and other management actions with negative consequences for policyholders and safety and soundness.	Should avoid a scenario where firms with substantive books of long-term insurance are unable to compete for new business on equal terms with new and recent entrants.
Structural reform (deposit-takers only)	Ending cross-subsidy between retail and more risky wholesale activities and removing implicit subsidies enjoyed by TBTF institutions by requiring greater loss-absorbency and improving resolvability.	Removal of subsidies coupled with greater loss-absorbency improves resilience to shocks but also the prospects for orderly failure.	Alongside other measures to address TBTF, including resolution arrangements, structural reform should contribute to levelling the playing field between the largest banks and their smaller rivals.
Authorisations (banks only)	To remove unnecessary barriers to entry and expansion, while maintaining common minimum standards to support safety and soundness.	Gains for safety and soundness may be over a longer horizon, as new entrant firms bring benefits of greater competition, which helps create incentives for efficiency across the system.	Lowering barriers to entry and expansion, while maintaining common minimum standards, should help facilitate effective competition and is likely to be positive for supply.

Note: The Rulebook case study is not included in this table because ultimately no material competition issues were identified.

- PRA implementation of UK legislation for structural reform should help to reduce the implicit subsidy received by 'too big to fail' (TBTF) banks and the associated funding advantages that smaller, less systemically important firms may not have enjoyed.

- Measures to smooth the transition to new (higher) Solvency II requirements for insurers' technical provisions should help to mitigate the risk of substantial capital raising and other management actions which could have negatively affected insurance policyholders and wider stability as well as the pricing and supply of new policies.

Furthermore, the case studies include one (Authorisations) where the PRA sought to adjust an existing policy designed to advance its safety and soundness objective to address unintended barriers to entry and expansion. And in another — the FPC LTI Recommendation — the PRA's aim was to implement a macroprudential policy in a manner that was as consistent with its own objectives as possible, including mitigating potentially adverse effects on small firms specialising in high LTI lending. Specifically:

- with its Authorisations reforms, the PRA successfully addressed some barriers to entry and expansion (for example, capital scalars previously applied because a bank was new), while maintaining common minimum standards in line with its safety and soundness and effective competition objectives (such standards may give retail consumers the confidence to move between regulated firms).

- in implementing the FPC LTI Recommendation, the PRA identified that setting a '*de minimis*' threshold to exclude firms extending fewer than 300 loans each year would help to ensure that niche, typically small, lenders would not be disproportionately affected.

The apparent synergies between the PRA's primary and secondary objectives in the Pillar 2A, Structural Reform and Solvency II case studies, as well as the policy choices made in the Authorisations and FPC LTI examples, were perhaps surprising given that conversations with some policy staff, and some of the materials reviewed, indicated ongoing doubts about the compatibility of PRA's objectives.

Generally speaking, policy staff were familiar with the fact that, as described in Section 1, the wider academic literature is somewhat inconclusive on the nature of the relationship between stability and competition. At the same time, there seemed to be a relatively low level of awareness that the PRA is only expected to facilitate 'effective competition'; it was noticeable that the concept was rarely mentioned as a concept in internal or external materials relating to the policies in the case study review.(1) Indeed, it was more common for policy staff to rely on familiar concepts such as 'proportionality' when developing policy options.

Our work also suggested that the PRA's external communications had not always expanded on the competition aspects of the case study policies as fully as they might have done given there were generally positive stories to tell. For example:

- In communicating on the likely effect of its Pillar 2A reforms, the PRA explained that these could affect competitive conditions through 'a redistribution of capital requirements, with higher total Pillar 2A requirements for systemically important firms and lower total Pillar 2A requirements for smaller firms and new entrants' (PRA (2015a)). It was not mentioned, however, that in so doing the PRA was addressing one of the competition-related recommendations made by the ICB.

- Although the PRA had considered consistency with all of its objectives in relation to the Solvency II TDTPs, in its external communications it stressed that as a maximum-harmonising Directive, the PRA had limited scope to act with regards to competition specifically (see, for example, PRA (2015c)). That one of the wider motivations for the common standards being introduced under Solvency II was competition was not mentioned in policy materials.(2)

By way of contrast, the first consultation paper (CP) on structural reform did set out how legislative provisions for ring-fencing might be expected to impact on competition(3) and the second CP included a relatively full description of the specific competition effects of the PRA rules that were the subject of the consultation. This likely reflected sustained input during policy development from the competition experts and growing familiarity with the SCO among some policy staff (see 'Proportionate' below).

Finally, two case studies revealed scenarios where the PRA, while implementing policies with broad application, needed to consider competition issues arising from market participants with specialised business models:

- in implementing the FPC LTI Recommendation, the PRA's volume-based '*de minimis*' was designed with niche lenders in mind; and

- in the Pillar 2A reforms, specific allowances for smaller firms were made, both in terms of the capital calculation methodology (eg excluding residential mortgages from the geographic concentration risk methodology) and in explicitly acknowledging the role of supervisory judgement in determining capital add-ons.

At the time these policies were being developed, it is not clear that policy staff realised they were grappling with a similar issue and one that is likely to arise repeatedly in the context of broad scope policies being applied to multiple markets and diverse participants.

(ii) Proportionate

As we set out to consider major policy initiatives where competition issues were thought to be present, it is perhaps not surprising that competition received a relatively high level of attention across the case studies.

(1) Except where the materials were quoting the SCO.
(2) There were no explicit references to this in PRA (2015c) or PRA (2015d), although it was discussed in Dickinson *et al* (2015).
(3) Ring-fencing rules are expected to improve effective competition by helping to reduce cross-subsidies between core activities inside the ring-fence and the more risky activities beyond it, as well as reducing the implicit subsidies enjoyed by TBTF entities.

Although internal PRA practice ties the depth of the competition assessment to the PRA's overall policy rating, in practice the trigger for considering competition varied across the case study policies. For example:

- Ahead of the SCO coming into effect, the ICB and then HM Treasury had suggested a review of Authorisations policy to address any unnecessary barriers to entry and expansion.

- ICB (2011) had initially flagged the competition issues that might arise from existing Pillar 2A requirements, although in practice supervisors of small firms played an instrumental role in drawing attention to the issues relating to credit and concentration risk.

- The potential effect on small niche lenders of the intended approach to implementation of the FPC's LTI Recommendation was identified in the process of external consultation, when a significant number of lenders raised concerns.

- That implementation of structural reform could raise unintended competition issues was proactively identified as part of horizon-scanning by the PRA's competition experts.

Given these various triggers, and that the PRA's overarching policy rating seeks to capture a wide range of factors such that there is no reliable relationship with the materiality of the competition issues, there appears to be scope to ensure that policies with potentially material effects are consistently identified early in the policy process. This would also help to ensure that the PRA uses its resources efficiently where no obvious competition issues are present: in this context it is noted that the PRA carried out a relatively thorough review of the competition issues arising in rules destined for the PRA Rulebook. This reflected the policy rating allocated to the initial phase of the wider Rulebook project, but there may have been potential to deprioritise this work when it became clear it was yielding few results.

(iii) Consistent

In terms of when, during the 'life cycle' of a policy, competition receives attention, there were differences across the case studies. Clearly, the Authorisations reforms were designed to address known competition issues, and so how best to address barriers to entry and expansion was relevant throughout. Competition issues received a high degree of attention throughout the Pillar 2A reforms also, including due to the early and sustained involvement of the small firms' supervisors who were aware of the sensitivities around credit and concentration risk.

At the same time, conversations with policy staff, as well as the FPC LTI and Structural Reform case studies, indicated that more generally competition issues continued to be seen as most relevant in the context of cost benefit analysis (CBA). Although policy leads are expected to take an iterative approach to impact assessment, beginning at the policy formation stage, in practice CBA tends to occur when policy options have been developed and there is a policy to assess. So, other things being equal, tying consideration of competition issues too firmly to CBA risks delaying their consideration and creates a higher hurdle to developing options that facilitate competition. In cases such as the FPC LTI and Structural Reform where the policy being implemented was developed externally, the PRA will need to consider competition early on if it is to influence policy development. Even in the context of its own policies, options that facilitate competition may be more likely to be considered and selected if they are developed earlier in the policymaking process.

The Solvency II TDTP case study indicates that competition issues arising in relation to the insurance sector are receiving attention during policy development. That said, it seems appropriate that in its competition work to date, the PRA has focused on the banking sector, which is generally considered to suffer from more material competition issues. Nevertheless, and now that Solvency II has come into effect, there may be scope for the PRA to consider the merits of replicating for insurance some of its policy reviews of the effect of prudential regulation on competition in the banking sector. In this context it is relevant to note that HM Treasury's insurance growth action plan for the United Kingdom (HM Treasury (2013c)) indicated the PRA's (and the FCA's) commitment to ensuring that the authorisations process for new insurers is as streamlined as possible.

(iv) Proactive

Since the SCO came into effect, the PRA has initiated several reviews of existing policy initiatives. And, as evidenced by our case studies, a number of those reviews have allowed the PRA to identify scope to do more to facilitate effective competition. For example, the package of Authorisations reforms announced in 2013 were substantive and as such, subsequent commentary has tended to conclude that they addressed the most material prudential barriers to entry and expansion. Similarly, the revised approaches to credit and concentration risk in the Pillar 2A review had been discussed extensively with both with small firms' supervisors and with industry; as such the consultation process identified few further concerns.

Where prudential policy originates externally to the PRA, a proactive approach likely implies identification of competition issues arising during the policy formation phase, so that the PRA can take a proactive stance in seeking to influence the relevant policymakers. Negotiations to provide for Solvency II transitional measures concluded in advance of the SCO coming into effect, and so our evaluation did not seek to identify how proactive the PRA had been. It is relevant to note, however, that in communicating on implementation of the TDTPs, the PRA stressed the constraints it faced once the relevant legislation had been agreed. While such constraints are clearly real, noting them without also setting out that the PRA takes a proactive approach in international negotiations over policy, risks making the PRA seem more passive than it is.

Similarly, our work did not seek to unpick how far the PRA had proactively engaged with HM Treasury on competition issues arising in primary and secondary legislation for structural reform. Competition issues did not receive attention in relation to the FPC's LTI Recommendation until these were flushed out in the PRA's own consultation on implementation. IEO conversations with policy staff, as well as materials reviewed, indicated that drawing on lessons learned from this first FPC Recommendation requiring implementation by means of PRA rules, the PRA has engaged more proactively with FPC policymakers on competition issues arising in subsequent policy initiatives.

(v) Influential

There is evidence in the majority of the case studies that competition considerations shaped PRA decisions. Competition issues were central to the PRA's design of the Authorisations and Pillar 2A reforms, for example, as well as the final implementation of the FPC's LTI ratio limit. In some case studies, it was hard to single out the direct influence that competition considerations had because the policies advanced both the primary and secondary objectives together (for example, in the Solvency II TDTP case study). Competition had limited influence over decisions in the Rulebook review, though this was likely the result of the absence of material competition issues raised by the review, rather than competition issues not being given sufficient status.

Influence was more evident in policy initiatives where the SCO and competition issues were tackled from the outset of the policy implementation process. We additionally noted that where competition interests did influence policy outcomes, this was not always reflected in external communications. The tendency has been to record competition issues briefly and to state that a policy is consistent with the SCO without expanding on why or how.

5 Evaluation — linguistic analysis

This section summarises the linguistic analysis carried out by the IEO of papers considered by the PRA's policymaking committees. This complements the evaluation's other main workstreams: the framework review (Section 3) and the case study review (Section 4). The linguistic analysis looks at both the level of coverage (how frequently competition is discussed) and the type of coverage (the nature of the language used to discuss competition).

The techniques employed in the analysis are introduced below (Section 5.1), and the key results most relevant to our evaluation criteria are summarised thereafter (Section 5.2). More detail on methodology is provided in Annex 3.

5.1 Introduction to linguistic analysis

Linguistic analysis can be thought of as the quantitative analysis of text. The IEO team worked with the Bank's Advanced Analytics area[1] to undertake analysis of policy papers being submitted to the PRA's policymaking committees — SRPC and PRA Board — in order to establish the level and type of coverage that competition issues received. The set of documents under review covered the period from April 2013 (when the PRA formally came into being) to April 2015 (the start point of the IEO's evaluation); the SCO formally came into force in March 2014.

The work attempted to answer questions such as:

- How frequently are 'competition' and related terms being addressed in SRPC and PRA Board papers? This would give an indicator of the depth and frequency of coverage of the topic at different points in the PRA decision-making process.

- Have those frequencies of mentions changed over time? This could indicate, for example, whether the SCO has resulted in greater coverage of competition.

- Is competition being talked about at different frequencies when we look at papers across different 'dimensions', eg by sector (banking and insurance) or by source of policy initiative? This would indicate the consistency of coverage across different types of policies.

- What is the language used to discuss competition? This could provide insights into the way competition is being thought about within PRA analysis.

In carrying out linguistic analysis, we used three main techniques:

- **'Frequency analysis' (word counts)** — we used this technique to count occurrences of the word 'competition' and its derivatives across all SRPC and PRA Board papers. Frequency analysis provides a simple measure of the level of coverage of competition across policy papers and across different 'dimensions'.

- **Network analysis** — this technique allowed us to isolate paragraphs in which the word 'competition' (and its derivatives) occurred. We could then identify terms co-occurring in the same paragraph as 'competition' to assess the type of language used to discuss competition. Our network analysis focused on SRPC papers.

(1) The IEO would like to thank David Bradnum, Paul Robinson and Pedro Santos in the Advanced Analytics area of the Bank for their support in this workstream, as well as Henry Kwok and Michael McAuley for additional analytical support.

- **Topic modelling** — we used an algorithm to identify 'topics', again within SRPC papers. In this case, we did not impose the words of interest, but rather allowed the algorithm to identify 'clusters' of co-occurring words. Each cluster can be thought of as representing a topic which reoccurs across the papers.

We recognise that our work was, by construction, subject to a number of limitations, and so we are cautious about overinterpreting our results. For example:

- In the early days of the PRA's inception, one might naturally expect that discussion of matters relating to its Secondary Competition Objective were subsidiary to establishing its preferred framework, approach and operating model for the discharge of its primary objectives.

- It may be that the subject of competition was covered in SRPC and PRAB papers, but using alternative terms for its description — for example, being couched in terms of proportionality. On other occasions, competition may have been referred in the context of competitive market conditions affecting the prudential standards of firms, rather than the competition effects of prudential policy.

- More generally, our analysis necessarily required a series of subjective judgements to be made, for example in categorising policy papers, which again cautions against drawing overly strong conclusions.

Nevertheless, the analysis provided a useful overview of the coverage of competition within the PRA, and we found a number of results that were relevant to our evaluation criteria. An additional benefit is that our linguistic analysis may provide a series of quantitative benchmarks that could be drawn on to help track the PRA's progress on delivering on the SCO over time. This is consistent with the remit of the IEO project given by Court, which requested that we 'facilitate oversight,… using appropriate metrics and monitoring tools'.

5.2 Summary of findings

This section describes briefly the main results of our linguistic analysis that were relevant to our evaluation criteria. Some of our findings were relevant to more than one criterion. We have therefore grouped our criteria together where relevant, rather than consider sequentially as in our other workstreams.

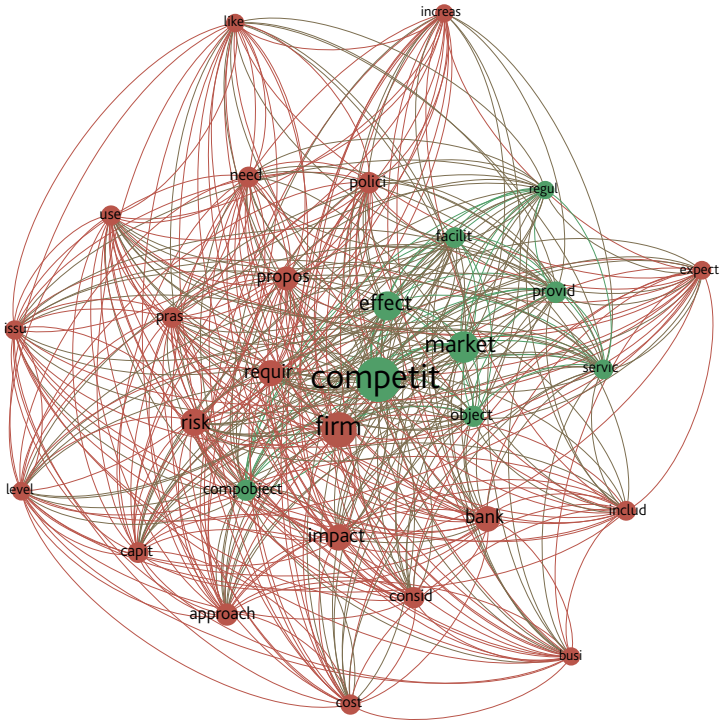
Clearly articulated

Linguistic analysis can provide a high-level view of whether competition is being clearly articulated within policy papers. Network analysis — which looked at the terms that occurred within the same paragraph as 'competition' — helps to shed light on the nature of the language used in the description of competition issues. Overall, the coverage of competition across all post-SCO SRPC papers seems to suggest a particular focus among policymakers on articulating the framework, reflecting the work that has been done in the early days of the competition objective on understanding the nature of the SCO and the way in which it relates to the PRA's policymaking approach. This is illustrated by **Chart 5.1**, which shows a strong co-occurrence between the word 'competition' and the terms contained in the SCO (facilitate, effective etc; marked in green in the chart). Other terms that co-occur with competition, including those more obviously associated with in-depth competition analysis, are denoted in red circles in the diagram.

Issues of articulation can also be explored using our topic modelling work, which used an algorithm to identify 'topics' within SRPC papers. Overall, the results of our topic modelling work appear consistent with that of our network analysis — in the early stages of the life of the SCO, there appears to have been a particular focus on discussing the nature of the objective and the framework.

In this topic modelling work, we were able to pre-define the number of topics so as to identify either a small number of broad topics or a larger number of more specific topics. We ran the analysis for three different topic models, at 20, 50 and 100 topics. Key topics such as bank capital and stress testing were evident even within a relatively small number of topics (ie a 20-topic model). But less frequently covered topics only became evident when the number of topics was increased.

Chart 5.1 Network diagram for paragraphs in SRPC papers that contain the word 'competition' — covering the period after the SCO came into effect



Notes:

(a) Terms are shortened or 'stemmed' — for example the stem-term 'competit' captures the word 'competition' and all its derivatives.
(b) Terms colour-coded as follows: words contained in competition objective in green circles; words used in analysis of competition and other terms in red circles.
(c) The diagram shows the terms used most frequently in SRPC paper paragraphs that contain the word 'competition'. The size of the circles shows the number of terms with which that word co-occurs. The weight of the lines linking pairs of words illustrates the frequency of co-occurrence of these words; and proximity reflects stronger co-occurrence with the set of nearby words. Terms with low co-occurrence have been removed.
(d) The illustration is not sensitive to the *proximity* of words within paragraphs in the source documents — it simply reflects *co-occurrence* in the same paragraph.
(e) The sample size was 738 paragraphs containing the word 'competition', with an average of 74 words per paragraph. The results shown in the figure are for papers considered after the introduction of the SCO (March 2014 to April 2015).

It was necessary to run the analysis for a relatively large number of topics — around 50 — before a topic emerged that obviously included some coverage of competition. For comparison, a topic tied to the safety and soundness objective appeared in a model with around 20 topics, although that is perhaps not surprising given the primacy of the safety and soundness objective and that our work spans the early days of the PRA. At a larger number of topics — around 100 — a distinct topic relating to competition analysis (as opposed to articulation of the competition framework and objective) became clear. There is no readily defined number of topics at which point any theme should manifest itself, but up to 100 topics is a relatively large number of topics to stretch to in this regard.

Table 5.A shows the top 15 terms within the main competition-related topics, for a model specified to contain 50 topics (left-hand column) and a model specified to contain 100 topics (right-hand column). Terms from the main competition-related topic in the 50-topic model largely relate to general discussion of the PRA's objectives, with mention of safety, soundness, objectives etc. By contrast, terms from the main competition-related topic in the 100-topic model more obviously relate to in-depth competition analysis, with mention of supply, demand, markets and so on.

Proportionate and consistent (considered together)

Frequency analysis can provide an indication of whether competition is receiving consistent coverage across policy papers, and can also in principle shed light on the question of the proportionality of the PRA's approach to the SCO. As our frequency analysis readily lent itself to the construction of time series, it also provided us with a crude measure of the attention paid to competition issues over time, both before and after the SCO was introduced.

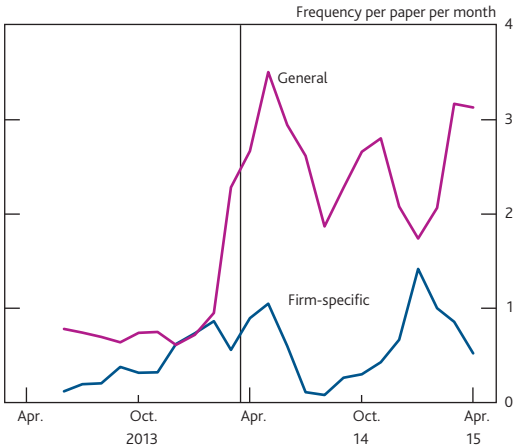
Table 5.A Top terms within main competition-related topic, within 50-topic model and 100-topic model

Top terms in competition-related topic for 50-topic model	Top terms in competition-related topic for 100-topic model
Object	Market
Effect	Price
Ensur	**Competit**
Sound	Effect
Gener	Consequ
Safety	Particip
Appropri	May
Advance	Facilit
Possibl	Lead
Reason	Behaviour
Seek	Demand
Competit	Affect
Advers	Advantage
Must	Suppli
Carri	Potenti

Notes: The topic models are derived from the set of SRPC policy papers spanning March 2013 to April 2015. This spans a period before and after the SCO, in order to maximise the volume of documents under analysis: topic modelling works best with a large set of inputs. Analysis took place at the level of individual paragraphs.

In terms of proportionality, for example, we can see that competition receives significantly greater coverage in general policy papers provided to SRPC than in firm-specific papers (see **Chart 5.2**). This difference in coverage between general papers and firm-specific papers naturally follows from the formulation of the SCO — the SCO is only normally engaged in general policymaking rather than in firm-specific assessment and decisions. This could be seen as indicating an appropriately proportionate approach, in that attention paid to competition issues appears to be greater when the SCO is engaged. **Chart 5.2** also shows the apparent step-up in consideration of competition issues in general papers following the introduction of the SCO; see also 'Influential' below.

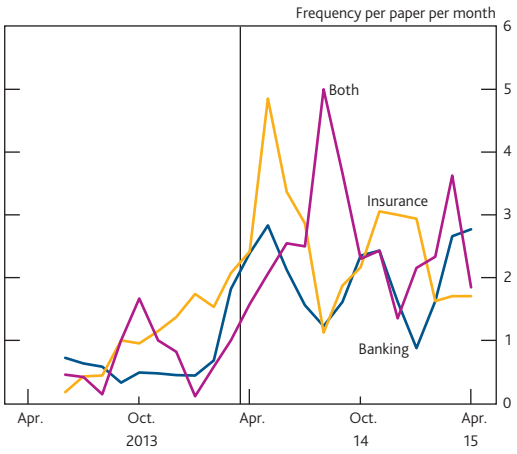
Chart 5.2 Frequency of 'competition' in SRPC papers, split by firm-specific and general papers(a)



(a) Three-month moving averages; this smoothes through monthly volatility in frequencies, providing a clearer illustration of underlying trends. The vertical line through March 2014 shows the point at which the SCO came into force. Excludes the periodic updates received by SRPC specifically on the subject of the SCO.

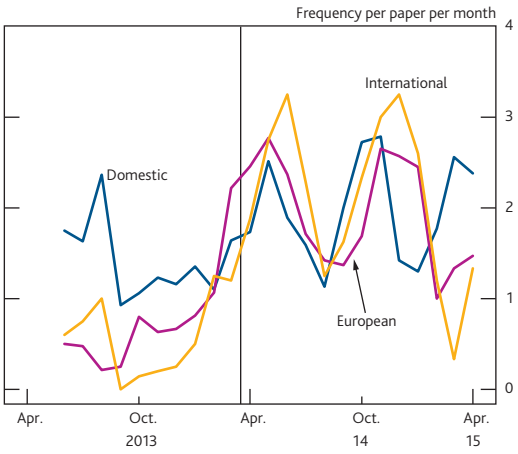
Under our consistency criterion, we considered whether competition issues were receiving consistent attention irrespective of the source of policy (domestically generated, or international) or the sector to which the policy related (eg banking or insurance). **Charts 5.3** and **5.4** appear to corroborate the finding of our other workstreams, that the PRA's current approach seems to support the consistent treatment of competition issues across different types of policy. There is little discernible difference in the frequency of 'competition' mentions in papers relating to different sources of policy, or to different sectors.

Chart 5.3 Frequency of 'competition' in SRPC papers, by sector(s) to which policy relates[a]



(a) See footnote to **Chart 5.2**.

Chart 5.4 Frequency of 'competition' in SRPC papers, by source of policy[a]

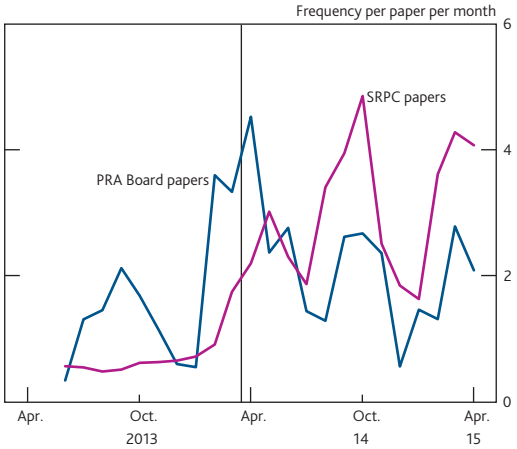


(a) See footnote to **Chart 5.2**. 'International' policies are those initiatives originating from non-UK and non-EU sources, such as Basel initiatives.

Proactive and influential (considered together)

Frequency analysis and topic modelling can give an indication of the extent to which PRA processes have ensured that its approach to the SCO has been appropriately proactive and influential. Frequency analysis showed that there has been a sustained pickup in coverage of competition within SRPC papers, and particularly within general policy papers, since the SCO was introduced (see **Chart 5.2** and **Chart 5.5**), suggesting that the introduction of the SCO has been associated with an increased amount of airtime devoted to competition issues. This sustained pickup was less clear with respect to PRA Board papers, however.

Chart 5.5 Frequency of 'competition' in PRA Board and SRPC papers (including six-month updates on SCO)[a]



(a) Three-month moving averages. The vertical line through March 2014 shows the point at which the SCO came into force.

As described in Section 3, both SRPC and the PRAB receive periodic updates on progress made on embedding the SCO. Usage of the competition terms spikes around once every six months when SRPC and PRA Board receive these updates (**Charts 5.6** and **5.7**). The three six-monthly papers to the PRA Board account for just over 20% of all references to competition, for example — this is unsurprising given the tight competition focus of these updates. The spikes indicate that the regular slot plays an important role in ensuring that the SCO and competition issues receive attention, a theme emerging from our framework review. But it does also suggest that competition is not receiving as much attention at other times.

Chart 5.6 Frequency of 'competition' in PRA Board papers, including and excluding periodic updates on SCO

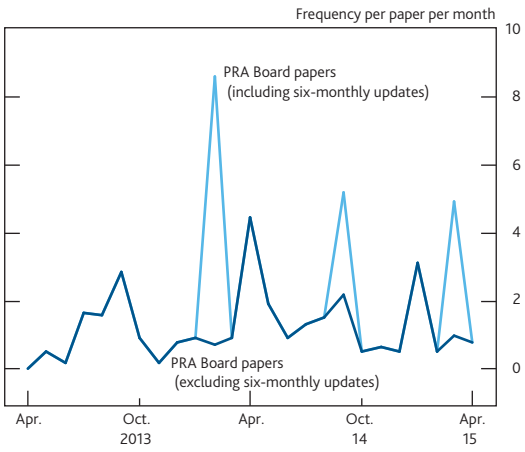
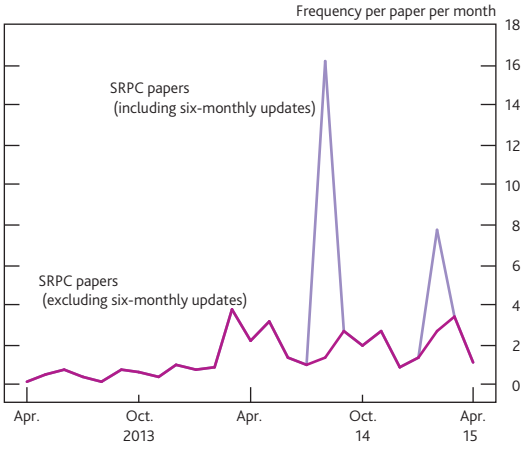


Chart 5.7 Frequency of 'competition' in SRPC papers, including and excluding periodic updates on SCO



Notes: In contrast to the previous time-series charts, these charts show monthly figures rather than three-month moving averages. This is in order to illustrate the one-month effect of the six-monthly update papers.

6 Conclusions and recommendations

6.1 Conclusions and common themes

For each of the three workstreams described in Sections 3 to 5, we examined the PRA's emerging approach and processes with reference to our evaluation criteria: clearly articulated; proportionate; consistent; proactive; and influential. This section seeks to identify common themes emerging from our work, while Section 6.2 sets out our recommendations.

It should be noted that the PRA paused some of its planned competition initiatives pending the outcome of this evaluation, and this is relevant to some of our findings (for example, some planned initiatives on articulation were paused, reflecting a desire not to front-run the findings of this work). We are also mindful that, as one would expect given the SCO is a new objective, the PRA's framework for, and approach to, its competition objective is continuing to evolve; we note below where this is relevant to our evaluation.

Clearly articulated

Taking into account that the SCO had only been recently introduced at the time of the IEO evaluation, we found numerous positives in the articulation of the PRA's framework and approach. These included the relatively high degree of understanding across the policy area of some key aspects of the SCO, for example that it applies when the PRA is making policy to advance its primary objectives and creates an obligation on the PRA to consider options that facilitate effective competition where possible. Progress has additionally been made in disseminating this understanding externally, for example in the 2015 *Quarterly Bulletin* article (Dickinson *et al* (2015)).

Nevertheless, we found uncertainty remained among policy staff about aspects of the SCO, and that there was therefore scope both to disseminate and to develop the PRA's articulation of its intended approach more fully.

For some of those uncertainties, the challenge appeared to be largely one of internal dissemination among policy staff of the emerging consensus of senior PRA management and in-house competition specialists. For example, the question of how to interpret the concept of 'effective competition' had been considered at some depth at both PRA Board and among the in-house competition specialists, but there was scope to improve awareness and understanding of this concept across the policy areas. There was similar scope to improve internal dissemination of what the SCO requires the PRA to do from a legal perspective, as well as of the PRA's preferred approach to considerations of competition where the framework affords discretion.

For some other aspects of the SCO, we observed that the PRA's thinking about its interpretation and its intended approach was at an early stage of development — for example, on the nature of the interaction between the SCO and the institution's primary objectives. That thinking on these aspects of the SCO is still at an early stage is not wholly surprising given the short life of the objective to date. A complicating factor is that, as explained in Section 1.1, there are uncertainties about how prudential regulation affects competition and how, in turn, competition interacts with safety and soundness and insurance policyholder protection. Given the PRA's need to understand these relationships more clearly, further research — as is currently planned by policy staff — seems to be an important investment in embedding the SCO.

More generally, we observed during both our framework review and our case studies some residual misgivings about the SCO in parts of the organisation, and specifically a residual tendency to envisage 'conflict' between the PRA's primary objectives and the SCO. For example, structured conversations with some policy staff, and reviews of documentation in both our framework workstream and our case studies, indicated a degree of ongoing doubt about the potential compatibility of the SCO with the PRA's primary objectives. Some of those misgivings appear to have persisted despite the PRA's relatively positive practical experience of the SCO to date; as illustrated by

our case study analysis, much of the post-crisis reform agenda has focused on addressing market and regulatory failures, and so has tended to advance the PRA's primary and secondary objectives simultaneously.

Two final aspects of our observations on clear articulation relate to the scope for accelerating 'learning by doing' and the PRA's approach to external liaison with other regulators in the competition landscape.

On learning by doing, we noted that similar issues of policy design cropped up in different case studies — for example, a recurring theme appeared to be how policies that apply to a wide range of firms should be adapted for 'niche' firms with specialised business models. These issues were considered from first principles each time, however, suggesting that there may be scope to consolidate what is currently known about competition issues that commonly arise.

In terms of external liaison, we observed that, as the PRA's familiarity with the SCO increases, there may be scope to invest further in explaining to external stakeholders how the PRA interprets and intends to approach competition issues. Part of this relates to the PRA's view of how its own responsibilities fit into the wider landscape for competition in financial services, where there may be scope for the PRA to say more on respective responsibilities and an agreed approach to co-ordination.

Proportionate

Ensuring that the efforts devoted by policymakers to competition issues are proportionate to the likely risks to the SCO is an important element of ensuring that the PRA uses its resources efficiently and effectively.

In this regard, our framework review pointed to numerous positives, including that internal guidance encourages policy leads to consider competition issues as early as the 'initiation' phase of policy design. Planned horizon-scanning of future and existing policy initiatives by in-house competition experts should act as an important cross-check on the work undertaken by staff in the policy design area. Taking these features together, and coupled with the requirements on the PRA to consult widely on its policy proposals, the existing framework is likely to be reasonably effective in supporting identification of material competition issues. That is supported by findings from our case study review, where, for most of the initiatives we looked at, competition received a relatively high level of attention from policymakers.

Our work did, however, identify a number of ways in which the existing framework could be strengthened to support more effective prioritisation by the PRA of its efforts. For example, it may not be optimal to key the effort devoted to competition assessment off the overall rating assigned by the PRA to individual policies.(1) There may be instances where the scale of the competition issues raised by a policy are higher (or lower) than the overall impact implied by the policy rating (as illustrated, for example, by our case study on the PRA Rulebook review).

There also appears to be scope to build on the planned process of horizon scanning by the in-house competition specialists to ensure that it is as effective as possible.

Consistent

Our 'consistency' criterion tested whether competition issues received consistent consideration for different types of policy (for example, policies relating to insurance rather than banking) and across different stages of the policymaking process (for example, initiation phase, policy development phase and at the PRA's policy committees).

In the main, we found that the PRA's approach to the SCO encouraged consistency of policymaking across different policy types. The same framework and processes support prudential policymaking irrespective of its origin (PRA-initiated or external) or the sector to which it relates. The benefits of this approach could be seen in our case study analysis, where competition considerations were approached reasonably consistently for different types of policy. For example, competition issues arising in our case study on the insurance sector (on transitional

(1) As set out in Box 3 in Section 3, each PRA policy is assigned a rating — relating to the policy's likely overall impact on PRA firms, the system or the PRA's objectives — that subsequently informs resource prioritisation and the decision-making process.

measures to support Solvency II implementation) received a material amount of attention. Our linguistic analysis also suggested that competition had received relatively consistent attention across banking and insurance.

Looking more broadly, substantive initiatives designed in whole, or part, with competition issues in mind, seem to have occurred more frequently in banking than in insurance — with an example being the review of the authorisations process and policy, which extended to banks only. That approach seems reasonable in the early life of the SCO, not least given that the scale of competition issues in the banking sector is known to be relatively material. Nevertheless, there is scope for the PRA to give future consideration to whether any of the work carried out in relation to competition in banking has a read across to the insurance sector (including now that Solvency II has gone live). In this context, it is relevant to note that HM Treasury's insurance growth action plan for the United Kingdom indicated the PRA's commitment to ensuring that the authorisation process for prospective insurers is as streamlined as possible (HM Treasury (2013c)).

As set out in our framework review, guidance to policy staff encourages consideration of the potential competition effects of policy initiatives from early in the policy life cycle. However, our case study analysis suggested that this guidance was not always followed in practice, meaning that the degree of attention paid to competition at different stages of the policy life cycle varied from case to case. For example, competition issues received a consistently high degree of attention throughout the Pillar 2A reforms, in part due to the early and sustained involvement of small firms' supervisors. In some of our other case studies, however, competition issues were mainly considered at the later stages of the policy cycle, with the risk that this raised the hurdle for generating alternative options that facilitated competition.

At present, PRA guidance to policy leads positions the competition assessment as part of a wider cost benefit analysis (CBA). This carries the risk that policy staff see their responsibility as being primarily about coming up with estimates of the competition effects of policy options which have already been developed, rather than considering competition issues throughout.

Proactive

When formulating the SCO, a key intention of government was to require the PRA to take a more proactive approach to competition issues arising in relation to prudential regulation wherever possible. In many instances, the PRA is required to implement policy formulated by others — for example by domestic parties (eg HM Government, or other parts of the Bank such as the Financial Policy Committee (FPC)) or by international parties (eg the European Commission). The approach taken by these various external formulators of policy will be determined by their own policy priorities and statutory frameworks. But, in numerous cases, there may still be scope for the PRA to demonstrate appropriately proactive intent.

We found evidence of a proactive approach in both our framework and case study review, such as in the PRA's stated intent to be an active and persuasive participant in international negotiations. The PRA's October 2015 submission to the European Commission consultation on the impact of the new capital regime is one example of an appropriately proactive approach in the international sphere.

While this intent to take a proactive stance internationally has been set out in external and internal communications, there is scope for some minor adjustments to guidance to internal policy leads to ensure that it does not inadvertently suggest that the SCO does not apply when the PRA is implementing EU legislation. The SCO is engaged whenever the PRA makes new rules and policy, and as illustrated by our case studies (specifically, our Solvency II case study), there are instances where the PRA has a degree of scope for discretion even when implementing maximum-harmonising EU Directives. More broadly, there is scope for the PRA to reinforce in guidance to policy staff that it intends for them to take an equally proactive approach where policy originates from domestic sources. This would help to underpin what seems to happen to some extent in practice already, which is for PRA policymakers to flag any material competition issues that might arise in relation to prudential policy being developed domestically.

Since the SCO came into effect, the PRA has stated publicly that it will carry out 'periodic reviews of existing rules to identify areas where changes would facilitate greater competition without compromising the safety and soundness and policyholder protection objectives' (see, for example, Bank of England (2014a)). This is also

indicative of a proactive intent towards the SCO, and a number of our case studies related to policy initiatives of this sort — perhaps most materially, the substantive package of Authorisation reforms announced in 2013. While the SCO does not explicitly require such *ex-post* reviews of existing PRA policy, conducting targeted reviews of this nature seems a potentially important way in which the PRA can continue to demonstrate its proactivity in relation to the SCO.

Influential

If the PRA's approach to the SCO is to prove effective, then competition considerations need to be gaining airtime not only in policy discussions, but also in policy design. In relation to most of the policies included in our case study review, we found positive evidence that competition considerations were helping to shape PRA decisions. For example, competition issues were central to the PRA's design of the Authorisations and Pillar 2A reforms, as well as the final implementation of the FPC's LTI Recommendation.

We also found evidence — both in our framework review and in our linguistic analysis — that the six-monthly discussions of the SCO (which occur at both PRA Board and at the supporting Supervision, Risk and Policy Committee (SRPC)) play an important role in helping to ensure that competition considerations gain traction, and that the SCO becomes more fully embedded in the PRA's overall approach. There is scope, however, to enhance the effectiveness of these discussions, for example by using them to provide the PRA Board with the findings of a suitably enhanced horizon-scanning exercise, as well as with more systematic updates on progress on developing the PRA's approach to the SCO. This would additionally aid the PRA Board and the Bank's Court to exert effective oversight.

An important aspect of ensuring that competition issues gain an appropriate degree of traction in prudential policymaking is to create the conditions for challenge internally and externally. Increasingly the PRA's senior advisor for competition and its competition experts are playing this role, both through their involvement in policy design and impact assessment as well as by feeding in views when policies are brought to SRPC and PRA Board. Additionally, it is relatively common practice to involve supervisors in policy development, and those who supervise small and expanding firms are often well-placed to flag potential competition issues. Guidance encourages the setting out of competition issues in external consultations also, which in turn helps to expose proposals to external scrutiny. Nevertheless, and as a further check that competition considerations are getting sufficient traction, there may be scope to further stress to policy staff the importance of inviting internal and external challenge.

In our case study review, we noted that there were opportunities to demonstrate more consistent compliance with the SCO in both internal and external documentation. The tendency appeared to be to record competition issues briefly, and to state that a policy is consistent with the SCO without expanding on why or how. Recording more consistently the relevance of competition considerations to individual policy initiatives, and what the PRA's intended approach to these was likely to be, would help to demonstrate to external stakeholders the PRA's commitment to discharging its responsibilities under the SCO. Perhaps more substantively, more consistent documentation of the PRA's assessment of competition issues would facilitate a greater degree of internal and external challenge, and thus help to ensure that competition considerations are appropriately influential in prudential policy design.

6.2 Recommendations

The findings outlined above indicate that there is scope to build on early investment by the PRA in its framework for the SCO, and the policymaking experience to date, to ensure a sufficiently positive and proactive approach which complements delivery on the PRA's primary objectives.

The recommendations set out below are grouped under three headings that align with the IEO's broader remit: inputs into, infrastructure supporting and outputs of the Bank's policy areas. **Table 6.A** below summarises our recommendations.

Table 6.A Summary of recommendations

Inputs into policy decisions	1 **Identification and prioritisation of competition issues**	• Refine processes to ensure competition issues are consistently identified early in policymaking, including by: – developing 'trigger' questions to help identify where detailed competition analysis is merited; and – strengthening existing horizon-scanning exercises. • Ensure research focuses on the questions the PRA needs to answer, including on the relationship between the PRA's primary and secondary objectives. • Keep the adequacy of existing specialist competition resources under review.
Infrastructure supporting policy decisions	2 **Clear articulation of the PRA's approach to the SCO**	• Ensure sufficient clarity among policy staff on the statutory requirements of the SCO, and the PRA's intended approach to delivering those. • Improve internal dissemination of recent thinking on the SCO, including potential synergies with the PRA's primary objectives, and interpretation of 'effective' competition. • Accelerate 'learning by doing' by consolidating what is known about competition issues that commonly arise in prudential policymaking.
	3 **Embedding the SCO into policymaking**	• Update internal guidance to stress the SCO is relevant throughout policymaking, not just in cost benefit analysis, and that where reasonable it implies developing policy options that facilitate competition. • Use internal guidance to reinforce the intended proactive approach to the SCO when influencing the development of prudential policy in domestic and international fora.
	4 **Governance**	• Enhance the effectiveness of the six-monthly updates to PRA Board, including through more systematic reporting on policy initiatives. • Demonstrate consistent compliance with the SCO across internal and external policy materials.
	5 **External co-ordination with competition regulators**	• Build understanding of the PRA's remit, and invest further in co-ordination with relevant competition regulators.
Outputs of policy decisions	6 **External communications**	• Use forthcoming communication vehicles (eg new Annual Report on competition) to set out more fully the PRA's recent experience and evolving thinking towards the SCO. • Find opportunities to communicate the PRA's approach to the SCO to a suitably wide set of stakeholders.

Inputs into policy decisions

1 Identification and prioritisation of competition issues

The earlier in the policymaking process that competition issues can be identified, the more likely it is that these can be addressed effectively, either by the PRA directly or through its input into external policymaking. As such, we recommend further investment in those aspects of the PRA's existing framework designed to support the early identification of competition issues — for example via introducing the use of 'trigger questions' and enhanced horizon-scanning exercises.

Drawing on industry best practice, and specifically the Competition and Market Authority's guidelines for competition impact assessment (Annex 1), a set of simple trigger questions could be devised to help policy leads identify at an early stage whether a prudential policy is likely to have material implications for competition. This could replace the current approach of using the overall rating assigned to a policy when determining how much effort to invest in competition analysis. Policy staff may additionally find it easier, in the early stages of policymaking, to make use of what would be a relatively simple tool as compared with the more extensive competition assessment currently suggested by internal guidance.

In addition, the planned horizon-scanning exercises by the PRA's competition experts could be enhanced and become the key determinant of the level of attention that competition issues arising in relation to any individual policy should receive. These enhanced exercises could scan for risks to the SCO against agreed criteria, and have a broader scope that extends to externally-generated as well as PRA-initiated policy. It would also be beneficial if

these enhanced exercises were to benefit from input from a wider range of stakeholders than is currently the case. Seeking the views of those engaged in wider policymaking (both across the Bank and internationally) as well as small firm supervisors, and discussing the results of the exercise at the PRA's policy committees, would help to flush out all relevant initiatives.

A more formal approach to identification and prioritisation would also help ensure that any reviews of existing prudential policy focus on areas where there are suspected, or known, to be material competition issues. This will help ensure efficiency and effectiveness in the PRA's approach to the SCO. Furthermore, the exercise could help to identify where initiatives carried out in relation to the banking sector — such as the review of authorisation requirements — might usefully be replicated in relation to insurance.

A complicating factor affecting a number of aspects of the PRA's current approach to the SCO — including the identification and prioritisation of competition issues — is uncertainty about the interaction of prudential regulation with competition, and of competition with the PRA's primary objectives. Given this, further targeted research has the potential to be an important investment. The relatively long list of uncertainties in this space, coupled with finite expert resources, creates a need to prioritise such that the focus remains on researching those questions that the PRA needs to answer most urgently; it is suggested that research under way and planned is regularly reviewed to ensure it remains sufficiently tightly focused. In this context, exploring how prudential regulation affects 'effective' competition and how effective competition interacts with safety and soundness seems more of a priority than contributing to the more general and (so far) inconclusive debate on the compatibility of financial stability and competition.

On resourcing of competition analysis more broadly, the model adopted by the PRA — whereby policy leads are responsible for ensuring that their policies are as consistent as possible with the PRA's objectives, but can draw on a team of specialist competition experts as needed — seems appropriate. To the extent that there is scope for the PRA to focus and accelerate its efforts in relation to competition, this seems to stem from the relative newness of the objective as well as the residual concerns about its compatibility with safety and soundness, rather than resourcing issues. Indeed our recommendations are designed to support, and should be largely consistent with, the more effective deployment of existing resources. That said, it will clearly be important for the PRA to keep under review whether existing, particularly technical, resources are sufficient to deliver its approach to the SCO and to consider bolstering them if there are signs of stretch.

Infrastructure supporting policy decisions

2 Clear articulation of the PRA's approach to the SCO

One of the themes emerging from our work has been signs of some residual misgivings about the compatibility of the SCO with the PRA's primary objectives. That is despite what has been a reasonably positive practical experience of the SCO to date. Articulating more fully the PRA's intended approach in the light of this experience, and disseminating that intended approach more widely both in internal and external communications, should help to ensure that an appropriately positive and proactive approach to the SCO becomes fully embedded among all policy staff.

To ensure that staff across the PRA's prudential policy area have sufficient understanding of the statutory requirements that the SCO creates, as well as of the PRA's preferred approach where the framework affords discretion, internal reference materials and guidance should be updated (we note that some initiatives in this area were paused pending the outcome of the IEO evaluation). Indeed one or more 'go-to' documents could usefully draw on the greater clarity gained through the structured discussions conducted during the course of our evaluation, spelling out in more detail the nature of the statutory obligation.

Specifically, it would be helpful to set out more clearly the implications of being a secondary objective, particularly where the framework affords scope for discretion. For example, it is both valid and important for the PRA to consider a range of prudential policy options, including those that appear to have differing impacts on its primary and secondary objectives. Within the range of options available to the PRA, there may be some which would deliver greater benefits to competition and others which would deliver greater benefits to safety and soundness or policyholder protection (or may do so on different time horizons or in a different way on a

firm-specific and system-wide basis). The SCO means that the PRA should consider (but is not necessarily required to adopt) those options which deliver greater benefits to competition.

Given the uncertainties encountered as to whether the PRA's primary and secondary objectives are really compatible, there is also need to ensure that policy staff understand that the PRA is expected to facilitate 'effective' competition (rather than the less desirable aspects of competition that occurred during the pre-crisis period in the context of inadequate regulation and insufficient private market discipline). Disseminating more widely among internal staff emerging thinking on what 'effective' competition looks like from a prudential perspective would be a useful step in this regard. Furthermore, outlining how the PRA has, during the first two years of operating the SCO, identified ways to formulate prudential policy such that it advances both its primary and secondary objectives would also help to reinforce the message that there is potential for synergy. The efficiency and effectiveness of policymaking may additionally be aided by setting out what is known, so far, about competition issues that have commonly arisen during prudential policy design. These include the challenge of mitigating the effects of 'broad scope' policies that may have a disproportionate impact on firms with specialised or 'niche' business models.

It will be important for the PRA to repeat training for policy staff to familiarise them with the latest thinking on what the SCO requires and how the PRA intends to approach it. At the same time, wider engagement with staff would help to test both the analysis underpinning, and the usability of, materials and guidance under development during the IEO evaluation, with a view to refining it so it can be made as robust and user-friendly as possible.

3 Embedding the SCO into policymaking

To help embed a more proactive approach to considering the competition effects of prudential regulation, policymaking processes and guidance should be updated to clarify that as a statutory objective, competition issues are relevant throughout the policy 'life cycle' from policy initiation through to implementation. Furthermore, the SCO implies that in developing policy to advance the PRA's primary objectives, policy staff should actively seek to identify prudential policy options that facilitate competition, rather than focusing, as they had done under the 'have regard' requirement, on mitigating any materially adverse effects arising from policy interventions.

The PRA faces genuine challenges and constraints in facilitating effective competition, given that a sizable share of prudential policy is externally developed, including by third parties that have no explicit competition objective. Nevertheless, internal policymaking processes and guidance could be updated to flag more explicitly the PRA's stated intent to take a proactive approach to influencing policy developed by others (both domestically and internationally), where the aim would be to promote consistency with the SCO as well as with the PRA's primary objectives. It is, however, important to note that the approach of these 'external' policymakers to considering and addressing any issues flagged by the PRA would be determined by their own policy priorities and/or statutory objectives.

4 Governance

The six-monthly updates to PRA Board on the PRA's approach to the SCO play an important role in governance, but there is scope to improve their effectiveness. For example, these updates could cover the findings of enhanced horizon-scanning exercises, report more systematically on the key steps being taken to embed the SCO into policymaking, and update regularly the PRA Board on the status of policies where material competition issues had been identified. More systematic reporting on these issues could additionally support Court in carrying out its oversight role effectively, including by providing management information.

Additionally, the PRA could usefully review whether its current policymaking processes support a sufficiently robust and consistent degree of internal challenge on competition issues. This would include ensuring that the PRA's senior advisor on competition and/or the PRA's in-house experts are able to input to and provide challenge at the PRA's policymaking committees as they see fit.

Both to support internal and external challenge, as well as to demonstrate consistent compliance with the requirements of the SCO, it seems important to encourage fuller documentation of competition issues.

Specifically, written briefing to the PRA's policy committees (the PRA Board and SRPC) should consistently demonstrate compliance with the SCO by documenting (i) any competition issues arising and (ii) the extent to which the PRA was able to address these issues (setting out any relevant constraints on action).

5 External co-ordination with the competition regulators

Although the PRA's competition remit and tools differ from those of the United Kingdom's primary competition regulators, there are interdependencies in relation to policymaking. There may be value in building on existing working-level interactions to deliver a more structured approach to co-ordination on policy issues of mutual interest. The PRA would need to consider, and discuss with the Competition and Markets Authority, the Financial Conduct Authority and the new Payment Systems Regulator, whether this is best achieved through regular senior-level engagement bilaterally or whether there is merit in the three competition regulators (the CMA, the FCA and the PSR) plus the PRA meeting periodically. Ultimately, there may be scope to update existing MOUs to confirm how co-ordination will take place. The recent changes in the competition landscape, specifically the new Payment Systems Regulator, mean that this may be an opportune time for the PRA to invest in agreeing and communicating its intended approach.

Outputs of policy decisions

6 External communications

In the early phases of the SCO, the PRA's external communications on its approach, as well as on the competition issues arising in relation to individual policies, tended to be brief. More recently, and as familiarity with the new framework has grown, the PRA has found several opportunities to articulate in more detail how it interprets and will approach the SCO. There is more that could be done in this space, however, and the first Annual Report on the PRA's SCO, as agreed with HM Treasury and announced in the 2015 Productivity Statement (HM Treasury (2015)), offers opportunity to articulate more fully the PRA's overarching approach as well as the experience of operating the SCO to date. There would additionally be value in considering how the PRA might communicate its emerging thinking and approach on the SCO to an appropriately wide set of stakeholders, potentially by the use of a range of communication vehicles.

Annex 1 CMA guidelines for competition assessment

In evaluating the steps taken to embed the SCO into policymaking, we took into account 'best practice' guidelines for policymaking in general, as well as for competition assessments in particular. This annex summarises the guidelines for competition impact assessment published by the Competition and Markets Authority (CMA) in 2015.

The CMA's guidelines aim to help in policy design by providing detail on how to conduct an in-depth assessment of a proposed policy's likely impact on competition.

The CMA guidelines suggest that after setting out the purpose of their proposed policy measure, including why such an intervention is merited, policymakers should carry out initial screening using a 'competition checklist' to identify whether a policy has potential to result in a restriction of competition.

It is suggested that if one or more of the four following questions is answered in the affirmative, a more in-depth competition assessment of the likely impact would be merited:

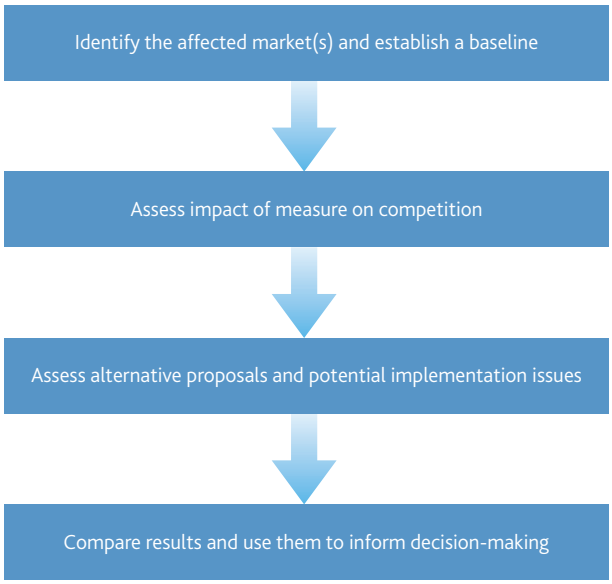
(1) Will the measure directly or indirectly limit the number or range of suppliers?
(2) Will the measure limit the ability of suppliers to compete?
(3) Will the measure limit suppliers' incentives to compete vigorously?
(4) Will the measure limit the choices and information available to consumers?

The guidelines explain what is intended by each of the questions, setting out the underlying factors that could be considered, as well as providing examples across a range of sectors.

Where it is identified that an in-depth assessment is merited, the guidelines describe four steps (as per **Figure A.1.1**) which involve:

- identifying the products and geographical areas directly impacted as well as wider or related markets that may be indirectly affected;
- establishing a baseline option against which to assess the impact of the proposal (eg considering competition under a *status quo*/do nothing option);
- assessing the alternative proposals by revisiting for the questions (and sub-questions) in the competition checklist in more detail; and
- drawing on this analysis to inform decision-making, noting that where proposals may adversely affect competition, credible alternatives should be considered.

Figure A.1.1 Suggested components of an in-depth competition assessment



Source: Adapted from the CMA's September 2015 'Competition impact assessment: guidelines for policymakers', available at www.gov.uk/government/publications/competition-impact-assessment-guidelines-for-policymakers.

Annex 2 Background information on case studies

This annex sets out more detail on the six policy initiatives considered in our 'case study' workstream, the findings of which are summarised in Section 4. The six initiatives under consideration were: the FPC Recommendation on loan to income ratios; the PRA review of Pillar 2A capital requirements; Solvency II transitional deductions from technical provisions; the review of the PRA Rulebook; ring-fencing (structural reform); and the review of authorisations and barriers to entry in the banking sector.

FPC Recommendation on loan to income (LTI) ratio

Background. On 26 June 2014 the FPC issued a Recommendation to the PRA and the FCA requiring that they ensure that mortgages lenders 'limit the proportion of mortgages at loan to income multiples of 4.5 and above to no more than 15% of their new mortgages' (Bank of England (2014b)). With a view to proportionality, the FPC decided to set a *de minimis* threshold such that the Recommendation applied only to lenders extending residential mortgage lending in excess of £100 million per annum.(1) This Recommendation was to be implemented as soon as was practicable and was made three months after the PRA's SCO came into effect.

Process. The FPC formally agreed its policy on the LTI limit at its 25 June 2014 meeting and communicated its Recommendation publicly on 26 June 2014. In light of the FPC's view that the policy would ideally take effect from the day of the announcement it had sought the PRA's views in advance. The PRA determined that it would implement the Recommendation by means of rules and issued a consultation paper (CP) on the same day that the FPC Recommendation was published in order to facilitate prompt implementation (PRA (2014b)). The PRA then issued its final rules in October 2014 (PRA (2014c)).

Competition issues. In explaining the likely impact of the LTI policy, the FPC noted that the limit was not expected to have a material impact on aggregate mortgage lending if house prices and mortgage approvals grew in line with its central projection, but could act to constrain mortgage lending at LTIs above 4.5 if the underlying strength in the housing market turned out to be greater than expected. Recognising that the policy could otherwise affect individual lenders, and with a view to ensuring proportionality, the FPC also agreed to set a *de minimis* threshold such that the policy only applied to lenders extending more than £100 million of residential mortgages per annum. The record of the FPC meetings noted that as such, the policy would capture nearly 99% of gross lending, but exempt around 75 institutions which were currently active in the mortgage market.

The PRA noted in its CP that the FPC's LTI policy was not expected to have a material effect on competition. It was explained that under the central projection, a very small minority of firms with concentrations in high LTI mortgage lending might be affected, such that they had to adjust their business strategies, but there was 'sufficient lending capacity overall to avoid breaching the limit' and as such 'the current extent of competition for very high LTI lending is not expected to change as a result of the rule'. Even in the upside scenario, where a limited impact on aggregate supply was expected, the CP set out that the scale of the change was not expected to impact on levels of competition in the market. The PRA's CP noted that the *de minimis* threshold recommended by the FPC had the effect that 'small firms and small challenger banks in particular would not be subject to the burden of additional regulatory limits, provided their lending does not exceed the threshold'.

It is relevant to note that the Bank sought to ensure that the LTI limit was as effective as possible and to that end sought to implement a broad scope policy with few exclusions. As such, the PRA's CP explained that 'the measure applies equally across all lenders'. The measure was also applied at the regulated entity level.

(1) See 'Record of the Financial Policy Committee meetings 17 and 25 June 2014'; www.bankofengland.co.uk/publications/Documents/records/fpc/pdf/2014/record1407.pdf.

Responses to the PRA's consultation identified that some niche, typically small, lenders that carried out high LTI lending would be disproportionality affected by the proposed rules. These respondents believed that the implementation of the LTI flow limit would be constraining and would immediately impact on their business model. In addition, other respondents raised concerns that the proposals to apply the LTI limit at the regulated entity level may disproportionately impact groups which contain more than one regulated entity that conducts mortgage lending.

Outcomes. The PRA implemented the Recommendation in October 2014 through its rules, making two additions to the original Recommendation to address the potential effect on competition identified in responses to its consultation. These were to include an additional volume based *de minimis* threshold for lenders extending fewer than 300 residential mortgages each year; and to allow for the application of the FPC's 15% limit at group rather than regulated entity level (so allowing a lender that is part of a group to allocate all or part of its high LTI allowance to any other regulated entity within that group). The PRA published its final rules and approach in its policy statement (PS) on 1 October 2014, the same day on which the FPC limit was effective (PRA (2014c)). The PRA noted in its PS that by mitigating the risk that the policy could have a disproportionate impact on narrow segments of the market it was contributing to its secondary objective on competition.

PRA review of Pillar 2 capital requirements

Background. The PRA's review of its Pillar 2 capital framework sought to create a more risk-sensitive and consistent approach to setting Pillar 2A capital. It was also an opportunity to align the framework with the PRA's statutory objectives and supervisory approach. The review was prompted by the introduction of CRD IV[(1)] and the publication by the European Banking Authority (EBA) of guidelines for the Supervisory Review and Evaluation Process (SREP). The period preceding the review had seen various reports published that had highlighted that the capital framework, including some aspects of Pillar 2, could have implications for competition. These included ICB (2011), Bank/FSA (2013) and PRA/FCA (2014).

The aim of Pillar 2 capital is to ensure that firms have adequate capital to support the relevant risks in their business, and to encourage firms to develop and use better risk management techniques in monitoring and managing their risks. A firm's Pillar 2 capital consists of two parts, a Pillar 2A requirement to cover risks to the firm which are either not captured or not fully captured under Pillar 1; and a Pillar 2B requirement, called a capital buffer, to cover risks to which the firm may become exposed over a forward-looking planning horizon, for example due to a change in the economic environment. Therefore, in ensuring the correct pricing of risk, Pillar 2 capital acts to further the safety and soundness of firms.

Process. The PRA reviewed its approach to assessing capital adequacy under Pillar 2 during 2014 and a CP was published in January 2015 in which reforms for credit, concentration, pension and operational risks were proposed (PRA (2015a)). The PRA's final policy statement was published in July 2015 setting out the revised methodologies that would be effective from January 2016 (PRA (2015b)).

Competition issues. ICB (2011) highlights that prudential capital requirements could act as a barrier to entry for new and/or small banks. In relation to concentration risk, it was noted that 'smaller banks are likely to be less geographically and/or sectorally diversified than larger banks, and thus are more likely to be required to hold additional capital against concentration risk'. For credit risk, 'the risk weights on their assets might be higher due to using a standardised rather than advanced approach to risk-weighting…[this] is particularly prominent in prime mortgage lending'.

The PRA's proposed new methodology for setting firms' Pillar 2A capital requirements for credit risk was based on a comparison of firms' Standardised Approach (SA) risk weights at a portfolio level to an Internal Ratings-Based (IRB) risk-weight benchmark calculated for portfolios of mortgages, credit cards, corporates, sovereigns and institutions. The PRA's judgement as to whether a firm should hold additional capital for credit risk was based on an 'unders and overs' approach which allowed portfolios with excess capital relative to IRB benchmarks to offset the capital of those credit risk portfolios whose Standardised Approach risk weights were lower than IRB

(1) The Capital Requirements Regulation (575/2013) (CRR) and Capital Requirements Directive (2013/36/EU) (CRD), jointly 'Capital Requirements Directive IV'.

benchmarks. The PRA proposed to use the benchmarking exercise on an exceptions-only basis as analysis indicated that the revisions would impact relatively few firms.

Recognising that smaller firms might find it more difficult to diversify than larger firms, the PRA also proposed to make allowance for supervisors to exercise judgement when setting Individual Capital Guidance (ICG). For geographic concentration risk, all credit portfolios other than residential mortgage portfolios on the standardised approach were considered, benefiting smaller firms whose business models were reliant on mortgages.

In describing the new methodologies (PRA (2015a)), the PRA explained that: '[the] proposals have the potential to change competitive conditions in which firms operate. Generally, the PRA anticipates a redistribution of capital requirements, with higher total Pillar 2A requirements for systemically important firms and lower total Pillar 2A requirements for smaller firms and new entrants'. Individually, the PRA believed that any redistribution would be small, and that 'these proposals will make relative market conditions more attractive for new entrants and smaller firms than under the current framework'. In addition to detailing the competition effects of the policy, the PRA sought feedback on the proposals specifically inviting 'smaller firms, niche players and challenger banks to consider how the proposals could affect their business models'; this was supported by proactive engagement with the industry that facilitated both clearer explanation and feedback. In creating a more consistent approach, the PRA acknowledged the benefits of reducing differences in supervisory assessments of similar risks given that inconsistent outcomes that unintentionally impose higher costs on, or confer benefits to, some firms could cause competitive distortion in the markets.

Outcomes. The PS and Statement of Policy were published in July 2015 with a small number of changes to the methodologies for credit and concentration risk that were outlined in the consultation (PRA (2015b)).

Solvency II transitional deductions from technical provisions (TDTP)

Background. Solvency II is a new regime for the prudential regulation of European insurance companies that applied from 1 January 2016. It contains a number of transitional measures that are helping firms adjust to the new framework by limiting disruption and addressing any unintended consequences. Provision was made for these transitional measures in a 2013 update to the Directive called Omnibus II which came into force during 2014.

While the previous UK regime had required that UK insurance companies meet requirements based on principles similar to those of Solvency II, there were some differences. One is that Solvency II requires that future claim costs, or insurance liabilities, are held at their market or transfer value. To meet this requirement, technical provisions (reserves set aside to cover expected future claim costs) now consist of 'best estimate' liabilities plus the risk margin, which is a new component that has the effect of making the insurance liabilities market-consistent. Previous UK requirements did not include a risk margin, which can be significant in size, particularly for long-term capital-intensive business such as annuities. As Solvency II ultimately requires some firms to hold a greater quantity of technical provisions one of the transitional measures, the transitional deductions from technical provisions (TDTP), acts to phase in the risk margin.(1)

Article 308d(2) in Omnibus II set out that the TDTP should be calculated by comparing the value of the previous regime's technical provisions and Solvency II technical provisions as at Day 1 of the new regime (ie 1 January 2016). The difference between the two requirements is then deducted from technical provisions for 2016, the first year. Over the next 16 years, the amount of the deduction reduces linearly each year until it reaches zero.

Process. The PRA consulted on its proposed approach to implementing TDTPs on 23 January 2015 (PRA (2015c)). The final rules and supervisory statement were published in a PS in March 2015 (PRA (2015d)) and came into effect on 1 January 2016.

(1) In addition to the TDTPs which are the focus of this case study, other measures included in the package were the 'matching adjustment', the 'volatility adjustment' and an agreed method for the 'extrapolation of the risk-free rate'.

Competition issues. The TDTPs were needed because, in their absence, some firms that had written business in the past and managed in a way compliant with the previous regime would have faced a shortfall in financial resources compared to higher Solvency II requirements. These firms would have had to either: raise short-term capital potentially disrupting the market, take other management actions,(1) or cross-subsidise their existing business with new business, which would have restricted their ability to compete for new business on equal terms with new and recent entrants.

As a maximum-harmonising Directive, Solvency II limited the scope for the United Kingdom to decide how the transitional measures were implemented. However, in advance of HM Treasury transposing the Directive, there were a number of implementation aspects that were considered. These included:

- *How to ensure that the transitional deduction did not take a firm's Financial Resources Requirements (FRR) below its current level?* Omnibus II recognised that, in creating a smooth transition to the new regime, supervisory authorities may wish to limit the size of the deduction in circumstances where it could reduce a firm's financial resources below that calculated under the previous regime. The PRA achieved this by proposing in its CP (PRA (2015c)) that firms compare the FRR required under Solvency II with the financial resources requirements that applied to the firm under the pre-Solvency II overall financial adequacy rule, including under both Pillar 1 and Pillar 2.

- *Whether the scope of transitional relief should only extend to existing or also new business?* The transitionals had been designed to allow insurers time to meet the new requirements in relation to their existing business (business written before 1 January 2016) and not new business (business written after 1 January 2016); however, this distinction was not explicit in the Directive text. The PRA reflected the intended scope of the TDTP, explaining in the CP (PRA (2015c)) that the transitional measures were targeted at the existing business of incumbent firms. This was aimed at facilitating effective competition between incumbents and new entrants.

Outcomes. The PRA confirmed in the PS (PRA (2015d)) and final supervisory statement (SS) that the TDTP would be implemented using the Pillar 2 technical provisions amount as the starting point. While the main cost to policyholder protection during the transitional period was from lower financial resources than would be required had there been an immediate introduction of the full Solvency II regime, the PRA considered that the cost would not be material due to the Directive's 'cap' on the amount of transitional benefit a firm may derive. The PRA concluded in its PS that the ability to limit the amount of the transitional deduction was 'likely to be necessary to ensure that the deduction will not reduce the current level of policyholder protection'. Moreover, by ensuring that firms were held to a common standard for policyholder protection, the PRA expected to facilitate effective competition and therefore advance its SCO.

Competition review of rules in PRA Rulebook project

Background. The FCA and PRA inherited the FSA Handbook in April 2013, at the point that the new regulatory framework took effect. At that stage the FSA Handbook was provisionally split into FCA and PRA Handbooks. Therefore the aim of the PRA's Rulebook project was, as set out in the PRA's Supervisory Approach document, 'to substantially amend and streamline the current PRA Handbook, and the associated materials carried over from the FSA, creating a new PRA Rulebook and body of supporting supervisory statements' (PRA (2014a)).

Reviews of existing rules engage the SCO and the PRA chose to leverage the opportunity to undertake a relatively thorough assessment of whether its rules might have distortive competition effects.

Process. The Rulebook initiative extended across a broad and relatively diverse set of PRA rules (both existing and new). These ranged from the FSA's high-level Principles for Business, which the PRA was replacing with Fundamental Rules to better support its objectives, to the transfer across of rules which were a direct copy-out of EU law. In light of this breadth and diversity the project was split into four parts with the PRA consulting on, and

(1) Management actions can include asset allocation decisions, running off lines of business or exiting the industry.

then issuing PSs and final rules for each part in turn beginning in early 2014.(1) The PRA published its PS on the fourth and final part of the Rulebook in December 2015.

The PRA's competition experts asked policy leads to complete a questionnaire to identify any competition issues arising in relation to rules being dealt with in each part of the project in turn. Rules which were a direct copy-out of EU or domestic law with no additions or exercise of discretion by the PRA were excluded from the competition review.(2)

Competition issues. One issue was raised in relation to Fundamental Rule 3 (FR3) which requires that 'a firm must act in prudent manner' where there was some discussion of whether this could limit appropriately competitive behaviour. Ultimately, and as set out in the CP for part 1 of the Rulebook project, the PRA concluded that acting prudently was consistent with 'sensible competitive conduct' and that this was positive for wider stability and consistent with its new competition objective. The exercise did not identify any other changes to rules which raised competition issues.(3)

In the CP for part 1 the PRA established a forward-looking approach with respect to the SCO: '[in] preparation for this secondary objective, the PRA has assessed whether the proposals in this CP facilitate effective competition'. With the exception of the comment in relation to FR3 the CP recorded that '[m]ost of the proposals relate to existing rule and guidance provisions which are being carried over to the Rulebook so no new competition barriers are being set…' and that '[t]he PRA has not identified any obstacles to competition where new rules are proposed'. The June 2014 PS for part 1 concluded that '[t]he proposed rules are neutral with respect to competition in the relevant markets'.

The subsequent stages of the Rulebook project were more administrative in nature in that they did not 'represent a policy change; they are, in substance, replacing the equivalent rules currently in the Handbook'. As such, no further competition issues were identified and the CPs for parts 2, 3 and 4 stated the PRA's opinion that these changes 'do not give rise to any adverse effects on competition'. Additionally, the CP for part 2 of the project stated that '[t]hose provisions that implement European Directives have not been assessed from a competition perspective'.

Outcomes. No further competition issues were raised through the consultations and the PSs confirmed that the rules were transferred as per the outcomes of the consultations.

Ring-fencing (structural reform)

Background. In its response to the financial crisis, the Independent Commission on Banking (ICB) produced its final report (also known as the 'Vickers Report') in September 2011 on how the banking system could be reformed to improve financial stability and competition. It proposed the 'ring-fencing' of vital banking services from risks elsewhere in the financial system to protect retail banking from risks unrelated to the provision of that service. The intention was that this would help to ensure that banking groups could be resolved in an orderly manner, thereby avoiding taxpayer liability and ensuring the continuous provision of necessary retail banking services.

Structural reform (SR) is a policy initiative which the Government anticipates will have the effect of 'levelling the playing field by removing distortions in the market that favour large, incumbent banks' (HM Treasury (2013b)). The Banking Reform Act 2013 set out the statutory framework for SR and also introduced the PRA's SCO; the focus of this case study was on how competition issues were considered by the PRA as it drew up rules to implement SR.

The Banking Reform Act received Royal Assent in December 2013. The Act defines 'core activities' as the regulated activity of accepting deposits and requires that banking groups which undertake core activities place

(1) For the four consultation papers, see PRA (2014d), PRA (2014e), PRA (2015e) and PRA (2015f).
(2) This was the same approach taken by the FCA in its handbook review as described on page 47 of its 2014/15 *Annual Report*. See FCA (2015b).
(3) The FCA's review did not identify any significant competition issues in the areas of the Handbook that it has discretion to change, but found that some areas needed further assessment. It noted that the FCA will 'continue to examine the impact of the regulatory regime on competition through our market studies'. See FCA (2015b).

these activities into ring-fenced bodies (RFBs). The Act also prohibits RFBs from undertaking 'excluded' activities and specifies that this includes dealing in investments as principal. It also amended the PRA's general safety and soundness objective to incorporate ring-fencing and the new definitions, requiring the PRA to discharge its general functions for the purpose of continuity of provision of these core activities.

The detail of the policy was implemented by HM Treasury through secondary legislation which was consulted on in July 2013 and finalised in July 2014. The legislation specifies that ring-fencing should apply to UK deposit-takers with core (ie retail and SME) deposits in excess of £25 billion so creating a *de minimis* threshold below which the requirements do not apply. The secondary legislation also prohibits RFBs from having exposures to 'relevant financial institutions' which are, broadly, financial firms that are not RFBs.

Process. Once secondary legislation had been agreed the PRA was able to make its own rules for detailed implementation. The significance and complexity of the changes were considered such that the PRA decided to run and govern the PRA rulemaking as a project. Firms within the scope of ring-fencing reforms will need to comply with the requirements by 2019.

The PRA's first CP was published in October 2014 shortly after the introduction of the SCO (PRA (2014f)). It set out the PRA's proposed ring-fencing rules in three areas that made up the principal aspects of the ring-fencing reforms: the legal structure of banking groups; governance; and the continuity of services and facilities. A corresponding PS was issued in May 2015 (PRA (2015g)). A second CP was published a year later covering intragroup arrangements, prudential requirements and the use of financial market infrastructures (PRA (2015h)). A third consultation will cover reporting and disclosure requirements for the RFBs.

Competition issues. The PRA recognised, in its first CP, the ICB's intent that ring-fencing should have positive effects for both financial stability and competition, and described the likely competition benefits associated with the specific rules and policy being consulted upon. This included that requiring a 'sibling' structure between RFBs and non ring-fenced bodies (NRFBs) could help to reduce cross-subsidies, and therefore funding advantages enjoyed by the latter, which could in turn reduce barriers to entry. The PRA also recognised that proposals to improve the operational continuity of RFBs could, by making them more resolvable, help reduce implicit subsidies. It also recognised that the governance proposals, in ensuring that RFBs were able to take decisions independently of other group members, might also help reduce cross-subsidies further.

The PRA acknowledged the difficulty in determining the precise extent to which SR reduced distortions associated with implicit guarantees compared to the effects of other reforms designed to address the 'too big to fail' problem.(1) The PRA (2015h) noted that 'there are areas where the resolution regime and operational continuity considerations will require banks to alter their existing legal structure and operational arrangements regardless of the requirements under structural reform' and also that 'the proposed policies also facilitate the restructuring of a group in recovery or following a resolution event, further reducing the potential costs of a banking crisis'.

The consequences of RFBs and NRFBs facing higher costs (funding and other) as a result of ring-fencing was considered in relation to the impacts on retail and corporate customers of RFBs passing on to them the costs of complying with SR. The conclusion from the analysis, as explained in PRA (2015h), was that their ability to pass on higher costs will depend on factors that affect the intensity of competition in the relevant markets, such as the ease of switching for customers and barriers to entry and expansion. In areas where competition is less intense it might result in customers of RFBs paying higher prices.

Another issue addressed was the impact of the reforms on mid-market corporates and the risk that difficulties in accessing investment/corporate banking products that cannot be provided by RFBs might create competitive distortions. This risk arises because a mid-market corporate is likely to rely on a very small number of banking relationships to meet its needs for investment banking services. Such a business has more limited choice of suppliers and less negotiating power than larger corporates. The analysis, as set out in PRA (2015h), concluded that any competitive distortion should be small.

(1) As an example, rating agencies have mainly attributed cuts in ratings, specifically the elements of which represent likely government support, to resolution rather than ring-fencing reforms.

PRA (2015h) also explained the requirement on the PRA to set a systemic risk buffer (SRB) rate for an RFB and that the FPC is responsible for determining the criteria and methodology by which the SRB rate will be set.

Outcomes. The PRA made some minor changes to the proposed overall approach to implementing ring-fencing which were described in the PS published in May 2015, none of which appear to have adversely impacted the competition issues identified and addressed in the corresponding CP. One of the changes made was to broaden the definition of a 'dedicated intragroup services entity' to allow for the provision of services to third parties. The decision was taken on the basis that it would facilitate the ability of smaller banks to access services and facilities provided by larger banks' services entities, thereby supporting competition in banking markets.

Authorisations — barriers to entry

Background. A March 2013 Bank/FSA review ('Barriers Review') set out a package of substantive reforms to authorisation processes and capital and liquidity requirements for new banks.(1) The Barriers Review was undertaken following reports by the Office of Fair Trading (OFT) (2010) and ICB (2011) that included consideration of whether authorisation processes and regulatory requirements might act as competitive barriers. In response to the ICB Report, HM Treasury asked the Bank and FSA, in the run-up to legal cutover to the PRA and FCA, to 'review the prudential and conduct requirements for new entrants to the banking sector to ensure they are proportionate and do not pose excessive barriers to entry or expansion'.

Process. The Bank/FSA Barriers Review was published in March 2013 just before the PRA came into existence. It was implemented at a point at which the PRA was under a statutory obligation to have regard to the need to minimise any adverse effects on competition. This was replaced by the SCO around a year later.

The Bank has carried out subsequent updates of progress in implementation. For example:

- 'One year on' (July 2014) — a joint PRA and FCA (2014) review which assessed progress in implementing new processes, clarified some aspects and summarised recent authorisation activity.
- 'Two years on' (March 2015) — a speech by Martin Stewart (2015) summarising the PRA's approach to new banks and the impact of new entrants on the market.

The focus of the OFT and ICB reports and the Bank/FSA Barriers Review was on banks specifically, but the PRA and FCA later committed to ensuring that authorisation processes are 'as streamlined as possible' in relation to insurers (see HM Treasury (2013c)).

Competition issues. This policy initiative involved a review of existing regulatory processes and prudential standards, motivated in large part by competition considerations (around barriers to entry and expansion in the banking sector). Such barriers were perceived to be one of a number of factors which had contributed to a lack of effective competition.

In carrying out the Barriers Review, the Bank/FSA (2013) took into account the PRA's 'philosophy of regulation', underpinned by its safety and soundness objective and reflected in its supervisory approach, which recognised that 'bank failure should be accepted as a normal market process as long as there are clear mechanisms in place to resolve banks smoothly without threatening financial stability'.

The proposed changes, which would be implemented by the PRA, were assessed to be consistent with its statutory obligation to have regard to the need to minimise any adverse effects on competition. The reforms were subsequently assessed also to be consistent with the SCO (PRA and FCA (2014)).

Outcomes. The Barriers Review resulted in a number of changes to authorisation processes and prudential requirements for new entrant banks, including:

(1) See Bank of England and Financial Services Authority (2013). The review covered both PRA and FCA authorisation processes, and reviewed prudential and conduct requirements, but our focus is on the PRA's processes and requirements.

- Changes to authorisations processes, most significantly a new option for bank licence applicants to submit a shorter application and, if approved, enter a 'mobilisation' phase while the full application is completed — this is intended to reduce uncertainty during the application process.(1)

- Changes to capital and liquidity requirements:(2)

  – no automatic Pillar 2A scalars applied just because the bank is new;

  – a more flexible approach to Pillar 2B, whereby the capital planning buffer will usually be set as the bank's wind-down costs and therefore be significantly reduced as compared with the standard methodology;

  – new banks allowed more time than existing firms to meet their combined buffer requirement when they use it;

  – minimum capital requirement lowered from €5 million to £1 million for small specialist banks;

  – PRA to continue to work to reduce distortions created by requirement for entrants to use the standardised approach to credit risk (rather than the internal risk-based (IRB) approach); and

  – with respect to individual liquidity guidance, no automatic premium applied just because the bank is new.

The PRA has implemented the reforms progressively over time.

(1) Reforms to authorisations processes also included a new 'challenge' session in the pre-application stage (intended in particular to identify areas of the applicant's plans that need further work) and streamlined information requirements.
(2) Bank and FSA (2013).

Annex 3 Supporting material for linguistic analysis

Linguistic analysis techniques

As explained in Section 5, linguistic analysis can be thought of as the quantitative analysis of text. The IEO evaluation team worked with the Bank's Advanced Analytics team to undertake analysis of internal prudential policy papers, in order to establish the degree and type of coverage received by competition within these papers. Our work focused on policy papers presented to PRA's Supervision, Risk and Policy Committee (SRPC) and the PRA Board, the PRA's two key committees for the making of prudential policy.

In carrying out linguistic analysis, we used three main techniques, described below.

- **'Frequency analysis' (word counts)** — this strand counted occurrences of the word 'competition' and its derivatives. Derivatives of the word 'competition' include 'competitor', 'competitiveness' and so on; while these words have subtly different meanings from 'competition', combining the terms made the analysis more tractable. We also looked at occurrence of a range of words related to the analysis of competition — eg entry, supply, demand — but these terms occurred infrequently and sporadically, so we chose to focus more narrowly on 'competition' itself.

  We used frequency analysis to give a simple assessment of coverage of competition across policy papers over time, and across different 'dimensions', eg the sector to which papers related. When assessing coverage of competition across dimensions, we excluded from our analysis the six-monthly updates on competition, in order to observe coverage of competition in the PRA's normal course of work.

- **Network analysis** — this work isolated paragraphs in which the word 'competition' (and its derivatives) occurred. It then pulled out the terms that co-occurred in the same paragraph as 'competition' to give an assessment of the language used in its description.(1) Network analysis focused on SRPC papers. SRPC papers were provided to us in Word format, whereas PRA Board papers were in mixed formats including PDF. We found that PDF files were technically much harder to break down into individual paragraphs, so at the paragraph level we only analysed SRPC papers, given their availability in Word format.

- **Topic modelling** — this strand used an automated algorithm to identify 'topics' within SRPC papers.(2)(3) Unlike the other two strands, this approach did not pre-impose the set of words of interest, and instead allowed the algorithm to identify 'clusters' of co-occurring words. The analysis was based on the full corpus of SRPC papers, including the regular six-monthly updates on competition.(4) These topics constitute the subjects covered across the entire set of SRPC papers — this is a very broad range of subjects, given the PRA's wide remit.

Processing steps involved in linguistic analysis

Several steps were taken in order to prepare the documents for analysis, as is customary in undertaking linguistic analysis. These steps included: converting all words to lower case; removing extremely common words that add little to the content of the text; removing numbers and punctuation; and removing suffixes (eg to convert 'competition' and 'competitors' to a single stem-word 'competit'). In addition, SRPC papers were broken down to the paragraph level in order to carry out analysis at this more granular unit level. This paragraph-level analysis was relevant to network analysis and topic modelling, but frequency analysis was carried out at document level.

(1) For more on network analysis, see Heymann and Le Grand (2013).
(2) For more on topic modelling, see Bholat *et al* (2015) and Griffiths and Steyvers (2004).
(3) The algorithm employed was the Latent Dirichlet Allocation; see Blei, Ng and Jordan (2003).
(4) We created the model using paragraphs as the 'unit of analysis'; the paragraph level is preferable to the paper level as individual paragraphs are more likely to be based around a single theme, so the model is better able to identify distinct topics.

These 'transformed' documents were then represented by a term-document matrix (TDM), with rows corresponding to unique stemmed terms (eg 'competit') and columns corresponding to each different document. Each cell within the TDM equals the count of the particular term within the document. A TDM was also created at the paragraph level, with columns corresponding to each document paragraph, and cells equal the count of the term within the paragraph. These TDMs were the starting point to each subsequent form of text analysis (frequency analysis, network analysis and topic modelling).

In relation to topic modelling, a final step in pre-processing was to drop words that are not useful for identifying content. A simple counting approach may be inappropriate because it can overstate the importance of a small number of very frequent words. Conversely, words that appear in just a few documents may indicate real differences in content. To address these concerns, we used the 'term frequency-inverse document frequency' (tf.idf) weighting scheme. This gives lesser weight to words that appear more frequently and greater weight to those words that appear less frequently yet still carry valuable information. Following this weighting scheme, visual inspection determines the cut-off point for low-scoring words.

In advance of undertaking the frequency analysis, each SRPC paper was classified according to a set of characteristics. This process was carried out through a manual review of the topic and content of each SRPC paper. The classification would enable multi-dimensional analysis across different 'dimensions' — these characteristics were as follows:

- Policy type — whether the paper covered general policy or firm-specific issues (the SCO normally only applies to general policy);
- Sector — whether related to the banking or insurance sector or both;
- Policy source — whether the origin of the policy was domestic (eg from FPC, PRA or Government), European (eg an EC directive or regulation) or international (eg Basel agreements); and
- Materiality rating — the internal policy rating, indicating the significance of the policy initiative.

The set of documents under analysis varied between the different analytical techniques. **Table A.3.A** summarises the set of documents used in each case.

Table A.3.A Set of documents used in each analytical technique

Analysis strand	Set of documents
Frequency analysis for all policy papers	PRA Board and SRPC papers
Frequency analysis across different policy 'dimensions'	SRPC papers
Network analysis	SRPC papers
Topic modelling	SRPC papers

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