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News release

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Looking both ways – Speech by Sam Woods

Sam Woods, the Deputy Governor for Prudential Regulation and CEO of the PRA, says that we are living through "a vital moment" in the supervision of banks, building societies and insurers. Reflecting on the role of supervisors for more than a century, he says that today's generation are alert to whether each of these firms – and the individuals running them – meet the intention, as well as the letter of, regulation.

At Mansion House in October, Sam said "the revolution is over. Long live the revolution!". The overall framework of regulation in the UK had "reached the end of the revolutionary period in which major reforms to prudential standards were required in response to the 2008 financial crisis". In pursuit of a safe and sound system, the task was to "secure the progress that has been made as memories of the last crisis fade", including through supervision, which is the "bread and butter of our role".

As Sam says today, supervision – the dynamic pursuit of our statutory objectives through oversight of the activities of individual firms – is essential not least because "history tells us that the commercial incentives of firms will create pressures to find ways to minimise the impact of regulations". He acknowledges that "financial institutions will always be able to innovate faster than we are able to modify the prudential rulebook", warning that some innovation is "pure regulatory arbitrage" – that is, action taken by firms to reduce specific regulatory requirements without any commensurate reduction in their risk. Sam calls out the following:

- **Off-balance sheet leverage**. Some special purpose vehicles, derivatives, agency structures or collateral swaps carry material credit risk which escapes the detailed aspects of the capital framework.

- **Treatment of liquid assets**. Firms can account for the value in their liquid assets buffer on a "hold to maturity" basis. This raises the risk that – especially if gilt yields should rise – market price movements in liquid assets buffers could lead to unrealised losses.

- **Liquidity horizon**. Some banks are seeking out funding that matures just beyond the time horizon used to calculate regulatory liquidity requirements.

- **For insurers, the Solvency II contract boundary**. Firms cannot recognise future premiums on unit-linked savings policies that do not include any insurance cover or financial guarantee of benefits. Some have sought to amend existing contracts to extend the contract boundary and recognise more future profit.

In each of these areas the PRA has identified behavior that "might meet the letter of the regulation", but is "designed to circumvent the spirit". Consistent with the PRA's statutory duty, firms should expect questions and should be prepared to defend them "according to our principles of prudence, effective risk management and adequacy of financial resources at all times". Ultimately this remains the responsibility of senior managers and Boards of Directors, and we will hold them to account.

PRA supervisors also pay close attention to emerging trends and potential future risks – such as a potential "return to the punchbowl". Sam observes that net interest margins at building societies are coming under increasing pressure. This is mainly a function of increased lending competition and is exacerbated when pitted against the mutual pricing strategy many have adopted to protect members in an era of low rates. Across the wider market, the PRA is observing – not from all firms, but definitely from a few – a shift in credit risk appetite as lenders compete with each other to find ways of widening the pool of available borrowers, increasing the size of loans available to them, or reducing the credit premium charged for inherently more risky loans. Supervisors will continue to keep a close eye on the effects of issues such as these on the viability of business models and future strategy for building societies.

Looking back, Sam considers the troubles of the Albert Life Assurance Company in 1869, of Barings Bank in 1890 and of Grays Building Society in 1978 – among many other chapters of supervisory history. Sam is confident that the PRA has distilled the best (often basic) elements of supervisory practice from its mixed heritage.

Today's supervisors are forward-looking, judgment-based, focused on the key risks to our objectives (which are not changed by Brexit), and apply a healthy dose of common sense. While supervisors of the future will surely identify ways to improve on various elements, Sam thinks that, in pursuit of a safe and sound system, the core of the PRA's approach will endure. So firms should continue to expect alert supervisors who have their "eyes peeled", their "ears to the ground" – and who "can smell when something is off".

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Notes to Editors
Link to speech