The Prudential Regulation Authority's secondary competition objective

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- The Prudential Regulation Authority's (PRA's) secondary competition objective requires the PRA to act, where possible, in a way that facilitates effective competition when making policies to advance its primary objectives of safety and soundness, and policyholder protection.
- This article explains the rationale for the objective, how the PRA interprets it, and what this means for the PRA's regulation of banks and insurers.

Overview

On 1 March 2014 the PRA was given a secondary objective to act, so far as reasonably possible, in a way that facilitates effective competition in the markets for PRA-authorised firms carrying out regulated activities. This key addition to the PRA's remit applies when it is making policies in pursuit of its primary objectives: the safety and soundness of banks and insurers and insurance policyholder protection.

The secondary competition objective (SCO) has at its centre the notion of effective competition. This can be thought of as a market in which suppliers offer a choice of products or services on the most attractive, sustainable, terms to customers; where customers have the confidence to make informed decisions; and where firms enter, expand and exit from the market. Each of these characteristics provide important sources of competitive discipline. The PRA's responsibility for facilitating effective competition is complementary to, but distinct from, the role of the Competition and Markets Authority, the Financial Conduct Authority, and the Payment Systems Regulator. The SCO does not mean that the PRA regulates competition in financial services markets.

Acting to promote safety and soundness of banks and insurers and insurance policyholder protection by addressing market failures is likely to enhance effective competition. Therefore, the PRA's primary and secondary objectives are often complementary. However, the effectiveness of competition can be reduced if regulation has unintended consequences. So an important advantage of the SCO is that it provides a useful check on whether prudential interventions are being applied sensibly and proportionately by considering prudential regulation through a competition lens.

Since it came into effect, the PRA's SCO has helped inform the design of several important parts of the framework for prudential regulation. For example, the implementation of the new Pillar 2 capital regime for banks allows supervisors to exercise judgement when assessing credit concentration risk for small firms where the methodology could overstate risks. The SCO has also informed the implementation of a Financial Policy Committee Recommendation to the PRA on limiting the extent of high loan to income residential mortgages, which was designed to take into account the different business models of independent private banks and their ability to compete in the mortgage market. Looking ahead, the PRA will continue to ensure that the SCO informs the design of new policies.

In addition to new policies, the PRA also takes a proactive approach to its secondary objective by considering changes to existing policies to facilitate effective competition. Examples here include measures the PRA has taken to facilitate the entry of new banks. Finally, the SCO is also informing positions taken in international policymaking forums. For instance, the Bank of England's response to the European Commission's consultation on the possible impact of the Capital Requirement Regulation and Directive on bank financing of the economy emphasised that a more proportionate approach to bank regulation could support competition in the sector.

Click here for a short video that discusses some of the key topics from this article.

(1) The authors would like to thank Nicola Garbarino and Liam Kirwin for their help in producing this article.

Introduction

On 1 April 2013 two new regulators, the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA), came into existence, replacing the Financial Services Authority (FSA). The PRA is responsible for the prudential regulation of banks, building societies, and credit unions (referred to as 'banks' in this article), insurers and major investment firms. The FCA is responsible for ensuring that relevant markets function well, and for the conduct regulation of all financial services firms. It is also responsible for the prudential regulation of those financial services firms not supervised by the PRA.

Parliament initially gave the PRA two statutory objectives. First, a *general objective* to promote the safety and soundness of PRA-authorised firms. And second, an *insurance objective* to contribute to the securing of an appropriate degree of protection for those who are or may become policyholders. This article will refer to these two objectives as the PRA's 'primary objectives'.

On 1 March 2014 the PRA was subsequently given a secondary competition objective (SCO). This article explains the SCO. The first section discusses the rationale for the objective. By way of context, it also summarises the remit and powers of the competition regulators in relation to the financial services sector. The second section discusses how to interpret the SCO, explaining the concept of 'effective competition' and how the SCO fits with the PRA's primary objectives. The third section explains how the PRA advances the objective in practice, citing some examples of how it has informed decision-making to date. Paul Grout, PRA Senior Advisor on Competition and Professor of Political Economy at the University of Bristol, explains why the PRA has the SCO in a short **video**.[(1)(2)]

Rationale for the PRA's secondary competition objective

Setting the scene: the rationale for the PRA's primary objectives

The principle underlying the PRA's primary objectives is that a stable financial system, which is resilient in providing critical economic functions, is necessary for a healthy and successful economy.[(3)] Firms can adversely affect the stability of the financial system through the way in which they carry out their business and, in the extreme, by failing in a disorderly manner. It is not, however, the PRA's role to ensure that no firm fails.

As set out in a previous *Bulletin* article,[(4)] the rationale for these objectives stems from the risk of poor outcomes — termed 'market failures' — in the provision of critical economic functions by banks and insurers to customers. These include:

- **the possibility of a large bank becoming subject to a 'run'** — whereby a large number of customers attempt to withdraw their deposits at the same time — even if the bank is solvent, leading to unnecessary costs;
- **harm to the financial system caused by a loss of confidence** following the failure of one or more firms, or by a wave of insolvencies among counterparties to financial contracts triggered by the insolvency of other firms; and
- **excessive risk-taking by banks and insurers caused by uncertain values of assets and liabilities**, for instance, due to differences in incentives between the managers and owners of these firms and the difficulty for policyholders and shareholders to monitor risk-taking properly.

The benefits of competition and the potential for ineffective regulation to harm effective competition

Generally speaking, strong and fair competition in markets generates greater choice, lower prices, and better-quality goods and services for consumers. For businesses, a competitive environment encourages innovation and efficiency, both of which can help to drive productivity and growth in the economy as a whole.

Prudential regulation designed to address market failures can affect the way that banks and insurers compete for customers' business. In most instances prudential regulation aimed at addressing market failures will enhance effective competition. However, due to its often complex nature, there exist challenges in the design of prudential regulation which in some cases can create unintended consequences and undermine effective competition in financial services markets. For instance, regulation might create barriers to entry for new firms whose small size and significance mean that they might pose only a limited risk to the disruption of critical economic services (for example, new retail banks).

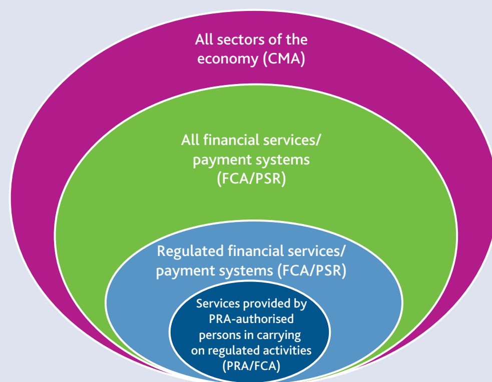
The relationship between prudential interventions aimed at addressing market failures and effective competition applies also in the opposite direction. Ineffective regulatory oversight that fails to adequately tackle market failures might spur ineffective competition which, ultimately, does not deliver good outcomes for customers. For instance, in the run-up to the recent financial crisis, the expectation of

(1) https://youtu.be/pB6r84Ggziw.
(2) The previous page includes a correction to the printed version of the *Bulletin*, which cited 'aspects of the Solvency II regime' — as well as the Pillar 2 capital regime — as allowing supervisors to exercise judgement when assessing credit concentration risk for small firms.
(3) The PRA defines critical economic functions that firms provide to be: payment, settlement and clearing; retail banking; corporate banking; intra-financial system borrowing and lending; investment banking; custody services; life insurance; and general insurance. See Bank of England (2014a).
(4) See Bailey, Breeden and Stevens (2012).

Competition responsibilities in the regulation of UK financial services(1)

This box explains the relationship between the competition responsibilities of the concurrent competition regulators — the CMA, the FCA, the PSR — and their interaction with the PRA in relation to financial services. It distinguishes between their objectives and powers, and the markets to which their remits apply. The coverage of the different authorities is summarised in **Figure A**.

Figure A The scope of different UK bodies' competition responsibilities



Competition and Markets Authority (CMA)

The CMA assumed its role as the United Kingdom's primary competition and consumer agency in April 2014. In doing so, the CMA brought together most of the powers and responsibilities of the now-abolished Competition Commission and the Office of Fair Trading. The CMA has a UK economy-wide competition remit including financial markets (the magenta ellipse in **Figure A**), overseeing the promotion of competition with the aim of making markets work well for consumers, businesses and the economy.

Competition powers: the CMA is responsible for:

- investigating mergers between firms which could restrict competition;
- investigating where there may be breaches of UK or EU prohibitions of anti-competitive agreements and abuses of dominant positions;
- conducting market studies and investigations in markets where there may be competition and consumer problems (see for instance its current market inquiry into retail banking)(2) that do not generally involve any firm(s) (or individual(s)) breaching UK or EU competition law;
- bringing criminal proceedings against individuals who commit cartel offences;
- enforcing consumer protection legislation to tackle practices and market conditions that make it difficult for consumers to exercise choice;
- co-operating with sector regulators, such as the FCA and PSR, and encouraging them to use their competition powers; and
- considering regulatory references and appeals.

Financial Conduct Authority (FCA)

The FCA's competition mandate is twofold, involving a competition objective and a duty. The FCA is required to act in a way that is compatible with its strategic objective of ensuring that relevant markets for financial services function well, as well as advancing its operational objectives, one of which is to promote effective competition in the interest of consumers in **regulated financial services** (the pale blue ellipse in **Figure A**). This includes 'regulated activities', which refers to PRA and FCA-regulated activities. The FCA also has a competition duty to promote effective competition when addressing its other operational objectives, in relation to consumer protection and market integrity. This means that it must look to achieve its desired outcomes using solutions that promote competition regardless of which objective it is pursuing, so far as compatible with acting in a way which advances the consumer protection or integrity objective. The FCA can use its Financial Services and Markets Act powers to pursue its competition mandate, including conducting market studies.

Competition powers: in April 2015 the FCA received powers in relation to the enforcement of UK competition law. It has powers like those of the CMA to enforce against breaches of the prohibitions on anti-competitive behaviour. It also has additional powers to carry out market studies and powers to make market investigation references to the CMA, in relation to the **provision of all financial services** (the green ellipse in **Figure A**), of which 'regulated financial services' are a subset. In other words, its concurrent competition powers extend to a wider set of markets than its competition objective.

Payment Systems Regulator (PSR)

The PSR, which is a subsidiary of the FCA, is an independent regulator of payment systems. It was established in April 2014 and became fully operational in April 2015.

(1) Where the effect of anti-competitive behaviour extends beyond the United Kingdom to other Member States, EU competition law is applicable. The European Commission, through the Directorate General for Competition, is responsible for EU-wide enforcement of competition law. The CMA and FCA have powers to enforce EU competition law in the United Kingdom.
(2) The CMA is investigating the SME banking and personal current account markets: for more detail, see https://www.gov.uk/cma-cases/review-of-banking-for-small-and-medium-sized-businesses-smes-in-the-uk.

The PSR has an objective to **promote** effective competition in **markets for payment services**.[1]

Competition powers: like the FCA, it has powers to enforce UK competition law. The PSR's competition powers relate to participation in payment systems.

PRA

The Financial Services and Markets Act 2000 as amended placed a duty on the PRA to 'have regard' to a number of regulatory principles, in addition to its safety and soundness, and policyholder protection objectives. These regulatory principles included 'the need to minimise any adverse effect on competition in the relevant markets that may result from the manner in which the PRA discharges [its] functions'. In essence, this regulatory principle sought to ensure that competition considerations were at least a factor the PRA should consider when taking actions to meet its primary objectives. Subsequent to the adoption of the Financial Services Act 2012, a Parliamentary Commission on Banking Standards (PCBS) was established in 2012 to conduct an inquiry into professional standards and culture in the UK banking sector and to make recommendations for legislative and other actions. One of its recommendations argued for greater weight to be placed on competition considerations by the PRA, with the addition of a secondary competition objective. In 2013, the Government agreed with the PCBS's recommendation and introduced the SCO.

Competition objective: the PRA's secondary objective to **facilitate** effective competition relates to markets for services provided by PRA-authorised persons in carrying out **regulated activities** (the blue ellipse in the diagram). These are markets in which PRA-authorised firms, including branches located in the United Kingdom, supply regulated services. They may be local, national, or international in nature. For instance, the reinsurance market tends to be considered international in scope, with UK-based reinsurers supplying customers in other countries and *vice versa*, while life insurance tends to be considered a national market. Similarly, the market for the provision of corporate and investment banking services to large corporations tend to be global in nature, whereas the geographical scope of retail banking activities is typically aligned with national boundaries.

Competition powers: the PRA is not responsible for enforcing competition law, and therefore does not have associated competition powers.

Interaction between the PRA and the CMA, FCA and PSR

The PRA consults with the FCA and PSR where its **policymaking** is expected to be of material interest to one or both of them, and *vice versa*. This could include the competition implications of new policy.

The PRA also interacts with the CMA, FCA and PSR on competition matters in relation to their **market studies and market investigations**; where, for example, the PRA may be requested to supply information about the prudential regulatory regime.

(1) The competition objective also extends to the markets for services provided by payment systems, in the interests of those who use, or are likely to use, services provided by payment systems.

government-funded support for institutions that were perceived to be 'too big to fail' meant that investors expected to incur only limited losses in the event of these firms failing. This created artificially low funding costs for these firms, placing them at a competitive advantage relative to smaller rivals. This, in turn, enabled these firms to increase lending and risk-taking (for example, corporate finance for mergers and acquisitions, or sub-prime lending).[1]

Similarly, there are examples where ineffective regulatory oversight in the insurance industry has had adverse effects for competition. French, Minot and Vital (2015) discuss the case of HIH Insurance Group, the Australian general insurance company which monopolised the market for mandatory builders' warranty insurance by underpricing risk to such an extent that competitors exited the market and new entrants were deterred from entering, which caused a disruption in the provision of this service when the firm in question failed.

A secondary competition objective for the PRA and how it fits with the competition objectives of other regulators

On 1 March 2014 the PRA was given a secondary competition objective (SCO). The objective states that, when discharging its general functions in a way that advances its primary 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 out regulated activities. No specific powers or toolkit have been given to the PRA in relation to promoting competition — these lie appropriately with the primary concurrent competition regulators active in the financial services sector, namely the FCA, the Payment Systems Regulator (PSR), and the Competition and Markets Authority (CMA).

(1) In addition, this caused moral hazard, contributing to excessive risk-taking since these firms did not bear the full economic cost of their actions. See Noss and Sowerbutts (2012).

Although it has an SCO, the PRA is not a 'competition regulator'. The SCO applies when the PRA is exercising its general functions (such as making rules or setting general policies) to advance its primary objectives. The PRA's objective to facilitate effective competition is distinct from, but complementary to, the concurrent powers of the competition regulators relating to the financial services sector, the FCA, the PSR and the CMA. As explained in the box on pages 336–37, these bodies are responsible for promoting competition and have a wide-ranging toolkit and specific powers to achieve their objectives.

Interpreting the PRA's secondary competition objective

To understand how the PRA meets its competition objective in the context of the design of prudential regulations it is useful to consider: the secondary nature of the objective; the PRA's duty to facilitate effective competition as far as is reasonably possible; what is understood by 'effective competition'; and how the objective fits together with the PRA's primary objectives. This section considers these in turn.

The secondary nature of the objective

When the PRA is considering options for new regulation it will assess the scope to facilitate effective competition, choosing prudential regulation options that do so as far as is reasonably practicable. The SCO does not require the PRA to act in a manner that is incompatible with its primary objectives. In many cases the PRA's primary and secondary objectives will be fully aligned: for example, reducing 'too big to fail' distortions appear to have made both the financial system safer and competition more effective. Nevertheless, cases might exist where, within the range of prudential regulation 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. The existence of the SCO means that the PRA should consider — but is not necessarily required to adopt — those options which would deliver greater benefits to competition for a given objective of safety and soundness or policyholder protection.

The PRA should facilitate effective competition as far as is reasonably possible

The PRA's duty under the SCO extends 'as far as is reasonably possible' recognising that the PRA must comply with some laws where it may not have a choice of regulation options and, therefore, a choice of considering a range of outcomes for competition. For instance, there could be legal restrictions on the implementation of regulation changes, such as where the PRA is bound by domestic legislation or European law.[1] Indeed, a large proportion of prudential regulation applied by the PRA is derived from 'maximum harmonising' European law, where countries do not have discretion as to how they implement the rules.

Facilitating 'effective competition'

The legislation setting the PRA's SCO does not define 'effective competition'.[2]

Effective competition is not the same as what economists term 'perfect competition'. In a world of perfect competition, individual suppliers can increase supply but have no effect on price, and can freely enter and exit the market. Products and services in the same market are assumed to have the same specifications and quality. Buyers are perfectly-informed and can switch supplier without cost if prices rise above the market price. Market prices reflect the costs of supplying the product and the cost of any side-effects that fall on others in society.

In such a market there is no need for regulation as there are no market failures to be addressed.[3] These conditions, however, tend not to exist in markets for financial services.

Policymakers therefore need to recognise the challenges posed by the existence of market failures. In doing so, they can seek to achieve a world of 'effective competition', which can be broadly understood as one in which market and regulation failures are either not significant or else have been addressed. The regulation framework, designed to overcome market failures, enables suppliers and customers to interact, with suppliers meeting customers' needs and customers' demand stimulating rivalry between suppliers for customers' business. This framework for rivalry enables the benefits of competition to materialise — lower prices, better quality, and greater innovation — across markets in financial services, ranging from offering mortgages to dealing in investments, without striving to create the conditions for perfect competition, which could be an unrealistically difficult, or unnecessary, standard to achieve.

As such, the PRA view is that a market which consists of rival products or services would tend to demonstrate effective competition if the interaction between suppliers and customers, and the conditions for entry, expansion and exit, display the following characteristics:[4]

(1) For example, the Capital Requirements Directive and Regulation which, among other requirements, sets the level of capital requirements.
(2) It is worth noting that the objective refers to 'competition' rather than 'competitiveness'. Under the Financial Services and Markets Act 2000, the FSA, which was the predecessor to the PRA and FCA, was required to have regard to 'competition' and 'competitiveness'. Competitiveness is usually taken to mean a firm's, or a group of firms', or a nation's ability to compete internationally on cost or quality grounds. Ability to compete is a part of competition, but competition is shaped by other factors, including the range of firms competing in the market; barriers to entry, expansion, or exit; and incentives to compete. So while the two concepts are related, they are clearly distinct.
(3) Another departure from the assumptions of perfect competition is that financial services vary widely in the extent to which they are standardised. Products range from commodity futures contracts traded on exchanges, with specification of quantity, quality and delivery dates, to highly bespoke services, such as insurance against damage to a pop star's voice.
(4) Our definition of effective competition is consistent but distinct from the definition of effective financial markets described under the Fair and Effective Markets Review, where the lack of transparency is seen as the major constraint to the development of fair competition among financial market participants: see paragraphs 20–21 of Bank of England (2015).

Table A Examples of how the prudential regulation framework supports effective competition

Aspect of effective competition	Examples of how supported by regulation framework
Suppliers compete to offer a choice of products or services on the most attractive terms to customers — such as lower prices or better quality	The existence of banks perceived to be 'too big to fail' was a key factor in the financial crisis. Not only did such banks impose losses on taxpayers when they failed (rather than just those directly involved in the bank), their 'too big to fail' status encouraged them to take greater risks in good times, increasing the likelihood that they would eventually fail. Stronger capital requirements for firms reduce excessive risk-taking by realigning the incentives of systemically important banks with those of wider society, making competition more effective. Similarly, consumers may find it difficult to judge the comparative financial soundness of insurers and whether insurers will need to take excessive risks to meet policyholders' claims.[(a)] There have been prominent examples of certain life insurers competing by offering savings products with high guarantees that subsequently many such insurers were unable to meet. In several cases, these episodes followed deregulation which was arguably too extensive.[(b)] The prudential framework established more recently under Solvency II creates a minimum set of standards around safety and soundness and policyholder protection which means insurers should compete more effectively on the basis of the products they offer and how well these meet consumer demand.
Customers have the confidence to make informed choices	Other aspects of the prudential regulation regime enable customers to exercise choice. Deposit guarantee schemes provide reassurance to depositors that they can safely leave their money, at least up to certain thresholds, with banks, whether these banks are incumbents or new entrants. This is important not only to avert 'bank runs', but also to empower consumers (depositors) to shop around with confidence. Consumers can look more to those attributes of the retail banking service which they can verify such as cost and service. Insurance guarantee schemes, by protecting policyholders from the effects of insurance company failure, play a similar role, enabling greater consumer choice in insurance markets.
Effective entry, expansion and exit	As discussed above, 'too big to fail' banks not only had increased incentives to take risk, but they were also able to maintain their share of the market. This is because the 'too big to fail' status of some banks effectively reduced their funding costs, undermining the ability of smaller but efficient, well-run banks to gain market share, potentially forcing some to exit the market and others not to try to enter at all. A robust resolution regime helps to remove the funding distortions caused by the 'too big to fail' perception, helping new firms to enter markets and to expand. A resolution regime also aims to ensure that firms exit markets in an orderly manner if they do fail.[(c)] The prudential regulation framework and deposit/insurance guarantee schemes also help build consumer trust in the safety and soundness of new entrants. This mitigates the barrier to entry arising from consumers' tendency to favour established brands over unfamiliar ones.[(d)]

(a) See Debbage and Dickinson (2013).
(b) See Das, Davies and Podpiera (2003).
(c) See Bank of England (2014b).
(d) Brand-building (or 'persuasive') advertising can be a source of what economists term a 'sunk' cost which might operate as a barrier to entry and, in particular, expansion and this could help to preserve an oligopolistic structure. See, for instance, Geroski (1995).

(a) **Suppliers compete to offer a choice of products or services on the most attractive terms to customers — such as lower prices or better quality.** At the same time, suppliers appropriately price in the risks associated with their businesses such that they have confidence in their ability to meet their service obligations.

(b) **Customers have the confidence to make informed choices.** These choices are based on those quality attributes that are easy to observe. Products and services can be obtained, and customers receive the products and services they expect, at a price that allows suppliers to earn a return on their investment commensurate with the level of risk taken. Suppliers do not place unreasonable or unnecessary restrictions on products and services that would prevent customers from exercising choice.

(c) **Effective entry, expansion and exit.** It is possible for suppliers, including those offering new products and services, to enter the market and to expand; and suppliers offering products or services on unattractive terms, or which are unable to meet their obligations, to exit the market in an orderly fashion.

The relationship between the PRA's primary objectives and effective competition

Effective competition and regulation in pursuit of financial stability or policyholder protection are normally fully consistent. Regulation designed to improve financial stability (by addressing market failures) can facilitate effective competition. For example, regulation can ensure that firms' and investors' decision-making appropriately reflects the social cost of risk-taking, reducing incentives to compete in a way that harms others in the financial system such as taking unsustainable levels of risk only to expose others to losses through failure and loss of confidence. A robust minimum prudential regulation standard can also provide customers with greater confidence in the financial soundness of new banks and insurers, enabling entrants to gain a foothold in the market and to expand.

Similarly, regulation that creates minimum standards of protection for policyholders means customers can have greater confidence that insurers will continue to be required to meet their claims or payments of benefits, although these may only materialise many years into the future. This enables insurers to compete based on the quality and costs of their products, responding to customer demand, taking prudential standards as a given.

Some examples of how the prudential regulation framework supports effective competition are considered in **Table A**. The examples refer to the three main features of effective competition set out above and are not confined to regulation addressing financial stability concerns. The box on page 340 reviews some of the arguments put forward in the academic literature on the relationship between competition and financial stability.

But not all forms of regulation that promote financial stability or policyholder protection will necessarily facilitate effective competition. For example, due to its often complex nature, regulation may have unintended consequences that could have a negative impact on effective competition. An advantage of looking at prudential regulation through a competition lens, therefore, is that it provides an additional check on whether prudential interventions are being applied sensibly and proportionately.

The relationship between competition and stability in the banking sector

There is no general consensus on the relationship between competition and financial stability in the banking sector (there is only a very limited literature available on this issue for the insurance sector). It is helpful to distinguish between two separate, but related, issues. The first issue, discussed in the main text, concerns how and whether changes in regulation to achieve the appropriate level of safety and soundness in the banking sector help facilitate or hinder effective competition.

The second, discussed below, relates to how changes in competition, with prudential regulation held constant or indeed absent, impact on the stability of the banking sector.

Is competition positive or negative for financial stability?

On the one hand...
There are a number of hypotheses that argue for competition improving financial stability. The mechanisms by which competition improves stability include: entry, expansion and exit of firms; and reducing risk-taking.

Competition promoting stability through entry, expansion and exit: increased price rivalry among banks can benefit both deposit holders — banks compete for deposits by raising deposit rates — and borrowers — banks lower interest rates on loans. Banks that are more efficient can thrive under this sort of competition by offering the best deposit and loan rates, taking business from less efficient, or less well-managed rivals over time. Efficiency can be in the form of better monitoring of customers and management of loans. These banks are able to attract the least risky customers and investors are willing to fund their activities given they make fewer overall losses.(1) The stability of the banking sector is improved over time as more efficient banks either take over inefficient banks and/or inefficient banks leave the market.(2)

Competition reducing the level of risk-taking by borrowers: higher-risk projects tend to generate higher returns. For an entrepreneur borrowing from a bank to invest in a project, higher loan rates could make lower-risk projects unviable. However, where competition reduces loan rates, more of these low-risk projects become viable. A wider spectrum of lower-risk projects can expect positive returns on investment (net of interest payments) reducing the overall level of risk in banks' lending portfolios, and increasing financial stability.(3) Separately, expected lower loan rates (due to expected competitive rivalry among lenders) could motivate entrepreneurs to apply more effort to making a project a success, since they would keep more of the profits than if loan rates were higher, helping banks avoid losses.(4)

On the other hand...
There are also a number of hypotheses that focus on the potential trade-off between financial stability and competition. These mechanisms include: increasing risk-taking and reducing banks' ability to absorb losses.

Competition reducing banks' ability to absorb unexpected losses: increased price rivalry may compress banks' margins and reduce their ability to generate profits. This, in turn, reduces banks' ability to accumulate additional capital in order to absorb any losses that might occur, which could worsen financial stability.(5)

Competition increasing risk-taking by banks: lower profit margins from greater competition can push lenders to seek creditors with higher, but less certain, returns — that is, they take on higher-risk lending.(6) Shareholders are prepared to take the risk because they reap the benefits if things go well but their losses are limited if things go badly (their limited liability means the most they can lose is the value of their equity). This is commonly referred to as a loss of 'charter/franchise value' of the bank.

Competition reducing screening of borrowers: increased price rivalry can also reduce lenders' incentives to screen and monitor borrowers' creditworthiness properly. Banks invest in collecting information about borrowers but where competition is strong, banks cut costs wherever possible, which could include the costs of gathering information. This could lead to banks taking greater risk than anticipated and suffering higher losses.(7) However, as argued before, under these circumstances there can be strong offsetting incentives to *improve* the screening and monitoring of borrowers, in order to outperform rivals which have underinvested in these essential activities.

(1) See Perotti and Suarez (2002).
(2) See Degryse and Ongena (2008).
(3) See Boyd and De Nicolo (2005).
(4) See Padilla and Pagano (1997).
(5) See Marcus (1984).
(6) See, for example, Dewatripont and Tirole (1994).
(7) See, for example, Chan, Greenbaum and Thakor (1986). Similarly, in competing for borrowers by offering lower loan rates, banks might be exposed to the 'winner's curse' problem, where the winning bank might have overestimated the borrower's creditworthiness: see Broecker (1990).

How does the PRA apply the secondary competition objective?

The competition objective informs decisions about new regulation or supervision policies (so-called 'general functions'). Work to date to embed the objective across regulation and supervision activity within the PRA's scope has included updating internal decision-making procedures; developing training and guidance for staff; and recruiting specialist competition resources, including the appointment of a Senior Advisor on competition.

The PRA carries out competition analysis using established methodologies, adapted to its own objectives, to ensure the secondary objective informs the design of new policy. Applying its definition of effective competition, the PRA considers which policy options, among those that promote its primary objectives and are credible, also facilitate effective competition. The PRA considers whether its policies could have unintended consequences for effective competition. Where this is possible, it identifies how a policy option could change the behaviour of suppliers and customers, or market structure, such as barriers to entry, in the markets affected by the policy. For instance, the PRA sets capital and liquidity requirements. The PRA assesses whether on balance these changes are positive or negative for the effectiveness of competition and, where possible, chooses the action that facilitates effective competition while not undermining its primary objectives.

Important examples of competition analysis informing the PRA's decision-making to date include:

- **The PRA's consultation on the 'Pillar 2' capital framework for banks.** The Pillar 2 framework deals with shortcomings in the measures of risk-weighted assets.[1] A fundamental principle underpinning this review was to make Pillar 2 capital methodologies more risk-sensitive, including via higher total capital requirements for systemically important firms and lower total requirements for smaller firms and new entrants. Moreover, under the new regime, supervisors may exercise judgement when assessing credit concentration risk — whether on a sectoral or a geographical basis — for small firms where they identify that the credit concentration risk methodology could overstate risks, or could incentivise risk-taking behaviour.

- **The FPC's Recommendation in June 2014 that the PRA (and the FCA) take steps to ensure that mortgage lenders constrain the proportion of new lending above a certain loan to income threshold.**[2] This action was designed to limit the size of any future economic downturn by limiting the excess build-up of household debt with a high loan to income ratio ahead of any downturn. From the perspective of effective competition, the final PRA rules to implement the FPC's Recommendations were designed to take into account the different business model of independent private banks (that is, those not part of a larger group) and their ability to compete in the mortgage market. For these banks, the minimum amount of lending required in order for a firm to fall within scope of the rules was set at a higher level than for other types of firm, and stand-alone private banks were exempt from the measures altogether.

In each case the PRA was able to advance its primary objectives while also facilitating effective competition.

The Bank undertakes research to help it improve its analysis of competition issues relating to prudential regulation, which in turn benefits its development of new regulations. Work is under way, for instance, to better understand the relationship between safety and soundness and effective competition, as part of the One Bank Research Agenda.[3]

The PRA takes a proactive approach by considering how it might facilitate effective competition by making changes to its existing regulation framework, without undermining safety and soundness and policyholder protection. For example, in 2014 it conducted a review of the changes it made in 2013 to facilitate entry and expansion in banking markets. Noting positive developments,[4] it decided not to make further changes at that stage.[5]

Finally, the PRA is taking a proactive approach to considering facilitating effective competition in its approach to international negotiations. It identifies international negotiations on sets of rules (including existing ones under review) where the outcome is likely to have a material effect on competition in the United Kingdom, and takes into account the scope to facilitate effective competition without compromising the PRA's primary objectives. One recent example is the Bank's response to the European Commission's consultation on the possible impact of the Capital Requirements Directive and Regulation on bank financing of the economy, where the PRA has argued that a more proportionate approach to bank regulation could support competition in the sector.

Clearly, there is a need to be flexible in such negotiations, particularly when interacting with other regulators that have different objectives. But by forming a strategy at an early

(1) For more information on the Pillar 2 framework, see www.bankofengland.co.uk/pra/Documents/pillar2framework.pdf.
(2) See *Financial Stability Report*, June 2014, available at www.bankofengland.co.uk/publications/Documents/fsr/2014/fsrfull1406.pdf.
(3) See Theme 2 of the agenda, available at www.bankofengland.co.uk/publications/Pages/news/2015/032.aspx.
(4) Since the changes made by the PRA and FCA to the Authorisation process in 2013, thirteen new banks have been authorised, with around 20 more applications for authorisation in the pipeline.
(5) See Bank of England and Financial Conduct Authority (2014).

stage it gives the PRA a better chance of influencing the rules before they are made and before the PRA must implement them. In practice, some of the PRA's most important international work to promote safety and soundness — removing 'too big to fail' distortions or the appropriate calibration of capital requirements — is also its most important work for facilitating effective competition.

Conclusion

A stable financial system, which is resilient in providing critical economic functions, is necessary for a healthy and successful UK economy. Prosperity can be reduced when there are material market failures, creating risks to the safety and soundness of the financial system and to policyholder protection. These failures provide the rationale for prudential regulation. While prudential regulation improves prosperity and is likely to enhance effective competition, there can be instances where regulation has unintended consequences. The PRA's secondary competition objective places an onus on it to facilitate effective competition, whenever possible, to guard against the risks of such unintended consequences.

The PRA's secondary competition objective does not, however, imply it should act as a competition regulator. Its role is complementary to, but distinct from, those of competition regulators. Nevertheless, the focus on effective competition in the PRA's secondary objective makes clear that prudential regulation and competition that improves prosperity are normally aligned.

Prudential regulation requirements must be implemented in a proportionate way, in order not to stifle competition, for example, from new and small firms. Nevertheless, trust in robust but proportionate minimum prudential regulation standards empowers competitive rivalry based on superior efficiency, service quality and innovation. Effective competition not only benefits customers, but also improves over time the resilience of the financial system.

The practical implication of the secondary competition objective is that when the PRA considers new and existing policies, it analyses the effect of different policy options for mitigating risks to safety and soundness and/or policyholder protection, and considers to what extent these options would facilitate effective competition. It will consider options to facilitate effective competition where this would not undermine the objectives of safety and soundness and policyholder protection.

Since it came into effect, the secondary objective has informed the PRA's approach. Examples highlighted in this article include the capital framework for banks and insurers, as well as the implementation of an FPC Recommendation in respect of limiting the growth of high loan to income mortgage lending.

The PRA has taken a proactive approach by considering the effect of the existing regulation on the effectiveness of competition, seeking to remove or alter regulation that is unnecessary for safety and soundness and/or policyholder protection. Competition considerations can also inform our approach to international negotiations on both new rules being designed or existing ones under review.

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