Bank of England

The Rt Hon Jeremy Hunt
Chancellor of the Exchequer
HM Treasury
1 Horse Guards Road
SW1A 2HQ

Andrew Bailey
Governor

12 January 2024

Dear Jeremy,

As Chair of the Prudential Regulation Committee (PRC), I am updating my January 2023 response to your letter dated 8 December 2022 setting out your recommendations to the Committee. Such an update is required as a result of amendments made to section 30B of the Bank of England Act 1998 by the Financial Services and Markets Act 2023 (FSMA 2023).

Over the past year the international banking system experienced the failure of two large banks – Credit Suisse (CS) and Silicon Valley Bank (SVB) – both of which had material UK operations. SVB was successfully resolved and CS was purchased without the need for a bailout. Depositors, and other customers and counterparties, were able to continue to access vital services. Contagion to the global banking system was limited and we did not see any significant contagion into the UK financial system.

The UK regulatory regime achieved its core goal of maintaining financial stability despite these incidents. But there are important lessons to be learned from them. For example, capital underpins the stability of the whole system as it means investors and depositors can have confidence in firms, especially in bad times when that confidence is really needed. But capital only enhances confidence if it is properly measured. Our Basel 3.1 reforms focus on ensuring risk is properly, and consistently, measured across firms of all types. while being mindful of the impact on UK's international competitiveness and growth.

By maintaining confidence in our banks, the Basel 3.1 reforms are designed to promote stable and reliable financing to the UK real economy, thereby supporting UK growth. And by aligning with internationally-agreed minimum standards, our finalised proposals will advance competitiveness by promoting confidence in the UK as a global financial centre. As the IMF has noted, the United Kingdom's financial stability framework, its prudential policies, and the overall stability of the United Kingdom as a global financial centre are a global "public good". A clear and robust prudential framework is therefore an important contributor to maintaining the UK's status, reputation and competitiveness as an international financial centre.

Capital is one important part of the regulatory toolkit. But we cannot neglect the importance of liquidity. Deposit outflows at some regional US banks were large and rapid, with digital banking technology and social media playing a role in increasing the speed at which information was shared and deposits withdrawn. The PRA will contribute/is contributing to relevant international work to consider whether lessons can be learnt for the liquidity framework for banks, in the light of these events.

CS ultimately failed because investors lost confidence in its ability to sustainably make profits into the future. This reflected persistent low profits, a business model that was arguably ill suited to the post-crisis landscape, repeated and highly damaging misconduct cases and very costly risk management failures. The failure of CS highlights the importance of non-financial regulation and supervision, covering things like governance and controls, risk culture, and operational resilience. It also serves as a reminder that firms are most resilient when they can make profits and sustainably generate capital. As supervisors, analysing whether a firm's business model is viable and sustainable forms an important part of our supervisory approach.

Regulatory background

The PRA's primary objectives are to promote the safety and soundness of the firms it regulates, and to contribute to the securing of an appropriate degree of protection for insurance policyholders. The PRA also has two secondary objectives. One is to facilitate, subject to aligning with relevant international standards, the international competitiveness of the UK economy (including, in particular, the financial services sector through the contribution of PRA-authorised persons), and its growth in the medium to long term. The other is to facilitate effective competition by taking into consideration how proposed policies affect competition in relevant markets.

As you noted in your letter, financial stability is one of the essential pre-requisites for achieving the government's economic policy objective for strong, sustainable and balanced economic growth.

Having regard to the government's recommendations

Consistent with our statutory duties, the PRC will continue to have regard to the government's economic programme and the recommendations set out in the Annex to your letter when considering how to exercise the PRA's general functions.

Therefore, when the PRC considers how to advance the objectives of the PRA, has regard to the regulatory principles, and discharges its other relevant duties, it should continue – where relevant and practical – to have regard to supporting the government's ambition to encourage economic growth in the interests of consumers and businesses and to supporting the government's strategy to promote the international competitiveness of the UK.

Advancing our primary objectives

Ensuring that the UK banking and insurance sectors have adequate financial and non-financial resources for the risks they are running or planning to run supports a stable financial system that can act as a source of strength for the economy, ensuring that banks and insurers are able to continue to provide services to their customers in normal times and also during stress, precisely when they are most needed. This underpins the international competitiveness of the UK, confidence in the UK and the growth of the economy in the medium to long term.

The PRA has taken action this year to implement necessary prudential reforms in a range of areas that would serve to underpin confidence in the UK financial system. For example, we recently published the first of two near-final Policy Statements on the implementation of outstanding Basel III standards ('Basel 3.1') for PRA-authorised banks, building societies and firms.[1] These proposals maintain appropriately high standards that align with the international approach that the UK helped to shape, consistent with our status as a global financial centre. Another example is our consultation on life insurers' use of funded reinsurance transactions[2], which is a growing trend in the UK life insurance market which has the potential to pose risks to insurer safety and soundness and policyholder protection. A third example is our work to create a strong and simple regime for smaller banks and building societies. The aim is to create a regime where standards are not reduced, but firms can meet them in a more simple and proportionate, and therefore low cost way. Lowering costs for firms, without increasing riskiness, would make small firms more robust.

[1] **PS17/23 - Implementation of the Basel 3.1 standards near-final part 1 | Bank of England**
[2] **CP24/23 – Funded reinsurance | Bank of England**

Advancing our secondary competitiveness and growth objective

The Financial Services and Markets Act 2023 (FSMA 2023) gave the PRA a new secondary competitiveness and growth objective (SCGO). This new objective builds on the two recommendations in the government's last remit letter. The actions that the PRA has taken, and is planning to take, that advance the SCGO will also support the government's ambition to encourage economic growth in the interests of consumers and businesses and the government's strategy to promote the international competitiveness of the UK.

The PRA is seeking out opportunities to facilitate competitiveness and growth in ways that are consistent with its primary objectives. We set out how we plan to advance the SCGO in our recent consultation paper on the PRA's future approach to policy (Policy Approach CP).[3] The PRA's approach to the SCGO has been informed by the industry feedback received through different routes including during the international conference on the role of financial regulation in international competitiveness and economic growth held by the PRA on 19 September 2023. Our approach has also been informed by academic literature and internal research.

The PRA has been engaged in a wide range of initiatives that advance our new objective. We believe making rules that account more effectively for the UK's needs helps advance the SCGO. For example:

- in our Basel 3.1 consultation package we have proposed some adjustments to the international standards which better capture the risks and improve the UK's international competitiveness. This includes offering an adjusted risk-sensitive approach for exposures to unrated corporates under the standardised approach for credit risk.
- In the first of two near final policy statements on Basel 3.1 we made further adjustments to international standards where there was a competitiveness reason that did not undermine our primary objective, including for example aligning the modelled credit risk sovereign treatment in the trading book requirements with the treatment proposed by the US and EU.
- We also split the Basel 3.1 package to ensure full consideration of all comments received and ensured that firms have at least a year to implement the full package in line with their feedback.
- We proposed a significant number of reforms to our Solvency II prudential regime for insurers to simplify overly complex requirements and improve the flexibility for firms and the PRA to apply judgement in line with the UK's regulatory approach[4].

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[3] **CP27/23 – The Prudential Regulation Authority's approach to policy | Bank of England**
[4] **CP12/23 – Review of Solvency II: Adapting to the UK insurance market | Bank of England**

- In our first policy statement on Basel 3.1, we simplified the way the transitionals on credit valuations will work, taking on a suggestion that was made during consultation.
- We also finalised our policy on removing rules for the capital deduction of certain non-performing exposures held by banks[5].
- We made adjustments to rules on the structure of bankers' remuneration, including removing the bonus cap informed by our evaluation of the effectiveness of the previous policy.[6]
- Other relevant initiatives include our recent consultation paper, published jointly with the FCA, on proposals to establish rules and expectations for critical third parties (CTPs)[7] to manage potential risks to financial stability that may occur due to a failure in, or disruption to, the services provided by CTPs to authorised firms.

Responsible openness is another key element of a competitive financial sector and economy which we have worked to advance. For example:

- The PRA, together with the Bank, provides technical assistance to the Treasury on the financial services elements of the Free Trade Agreements (FTAs). the UK is pursuing. We have engaged closely with Treasury colleagues in support of the new FTAs negotiated with Australia and New Zealand, as well as on the UK's recent accession to the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP). We also continue to support Treasury on a range of live negotiations.
- We have also actively participated in negotiations with Switzerland to develop and establish new deference arrangements under a Mutual Recognition Agreement (MRA) for financial services. We have fed in views to Treasury on the scope of market access under consideration and the design of institutional arrangements such as regulatory safeguards. We will continue to work with Treasury on implementation of the MRA into 2024.
- The PRA has concluded the authorisation of 135 third country branches of EU banks and insurers that entered the Temporary Permissions Regime, providing confidence in the safety of these firms while maintaining the UK's status as an open jurisdiction to branches. The PRA continues to receive and approve regular applications from other foreign firms seeking to establish branches or subsidiaries in the UK.

[5] **PS14/23 – The non-performing exposures capital deduction | Bank of England**

[6] **PS9/23 – Remuneration: Ratio between fixed and variable components of total remuneration ('bonus cap') | Bank of England**

[7] **CP26/23 - Operational resilience: Critical third parties to the UK financial sector | Bank of England**

We think that the PRA can facilitate competitiveness and growth by supporting safe innovation. For example:

- the PRA and FCA published a joint feedback statement to a Discussion Paper on artificial intelligence and machine learning in financial services.[8] [9]
- We published a Dear CEO letter on innovations in the use by deposit-takers of deposits, e-money and regulated stablecoins,[10] as part of a wider package from UK authorities focussing on digital money and money-like instruments.
- We published a cross-authority roadmap on innovation in payments with the Bank of England and FCA.[11]
- We supported the Bank's Discussion Paper on a regulatory regime for systemic payment systems using stablecoins and related service providers.[12]
- We also supported the Treasury and Bank's work on establishing a Digital Securities Sandbox.[13]
- We have supported HMT's finalisation of its proposals for a UK regulatory regime for cryptoassets.[14]
- We continue to support ongoing international work on the regulation of digital assets, including via the BCBS, and the FSB.[15][16]
- Additionally, in 2024, we will pilot a roundtable with interested stakeholders to hear industry's views on how the PRA can facilitate safe innovation from firms.

Finally, we think that the PRA can facilitate competitiveness and growth by improving our regulatory processes and engagement with firms. For example:

- we have moved to more frequent and detailed publication of performance metrics on authorisation activity to provide more transparency on how we meet our statutory service level for processing authorisation applications.
- We have launched the Banking Data Review[17] and the insights from the review will help us to streamline in the coming years to the data collected from banks.

[8] DP 5/22 Artificial intelligence and machine learning |Bank of England
[9] FS 2/23 Artificial intelligence and machine learning |Bank of England
[10] Letter from David Bailey, Nathanaël Benjamin and Vicky Saporta on 'Innovations in the use by deposit-takers of deposits, e-money and regulated stablecoins' | Bank of England
[11] cross-authority roadmap on innovation in payments |Bank of England
[12] DP regulatory regime for systemic payment systems using stablecoins and related service providers
[13] Consultation on the first Financial Market Infrastructure Sandbox: The Digital Securities Sandbox | HM Treasury
[14] Future financial services regulatory regime for cryptoassets| HM Treasury
[15] Consultation on Cryptoasset standard amendments | Basel Committee on Banking Supervision
[16] International Regulation of Crypto-asset Activities: A proposed framework – questions for consultation |BIS
[17] Banking Data Review | Bank of England

- We are using the ongoing repeal and replacement of retained EU financial services legislation, as an opportunity to bring our policies together on one user-friendly website, streamline our materials, and adopt a coherent approach to the structure and language we use.
- As part of our reforms to the Solvency II framework, we are making a number of changes to streamline parts of the regime,[18] including an overall reduction in reporting requirements, and simplifications to the rules for internal model approvals.

The PRA will report yearly on how we have advanced this new objective, including both qualitative descriptions and quantitative metrics. The quantitative metrics that we will publish, which have been agreed with Treasury were set out in the Policy Approach CP.[19]

Advancing our secondary competition objective

Effective competition can improve the supply of financial services to the real economy, particularly in under-served sectors of the economy, and encourage innovation and efficiency among firms. The PRA has continued to advance its secondary competition objective, notably by:

- Publishing the first of two near-final Policy Statements on the Basel 3.1 package. In addition to maintaining appropriately high standards, these policies will promote a more level playing field between firms using internal model approaches and firms using standardised approaches, and will increase the consistency in risk weighted assets approaches across firms;[20]
- publishing the first policy statement of the 'strong and simple' framework for non-systemic banks and building societies to simplify the prudential regime for smaller firms, with eligible firms being able to opt into the Small Domestic Deposit Takers regime from 1 January 2024. We have also made our remuneration requirements for smaller banks more proportionate;[21][22]
- outlining the PRA proposals for non-systemic banks and building societies in the UK to prepare, as part of their business-as-usual activities, for an orderly 'solvent exit';[23]

[18] **CP12/23 - Review of Solvency II: Adapting to the UK insurance market | Bank of England**
[19] **CP27/23 – The Prudential Regulation Authority's approach to policy | Bank of England**
[20] **Timings of Basel 3.1 implementation in the UK | Bank of England**
[21] **PS15/23 – The Strong and Simple Framework: Scope Criteria, Liquidity and Disclosure Requirements | Bank of England**
[22] **PS16/23 – Remuneration: Enhancing proportionality for small firms | Bank of England**
[23] **CP10/23 – Solvent exit planning for non-systemic banks and building societies | Bank of England**

- developing policy proposals and implementation of regulatory reforms to the existing supervisory regime for Insurance Special Purpose Vehicles which will implement greater flexibility in the insurance market;
- as part of reforms to the Solvency II framework, encouraging entry to the insurance UK market by:[24]
    - raising the thresholds for small firms to be subject to Solvency II, to enable them grow larger under relatively simpler prudential rules and compete more effectively with larger firms;
    - removing capital requirements for branches of international insurers operating in the UK, which will facilitate greater entry into the UK market;
    - introducing a new ‘mobilisation’ regime for new insurers to facilitate entry into insurance markets.

Further information on the PRA’s approach to competition is set out in the Annual Competition Report which forms part of the PRA’s annual report.[25]

Yours sincerely,

[24] **CP12/23 - Review of Solvency II: Adapting to the UK insurance market | Bank of England**
[25] **Prudential Regulation Authority Annual Report 2022 | Bank of England**