



BANK OF ENGLAND

The PRA's Secondary Objective to Facilitate Competition

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UK arrangements for financial regulation

- **Financial Stability Committee (FSC) – 2011**
- **Prudential Regulation Authority (PRA) & Board – 2013**
 - 1,600 deposit takers, insurers or major investment firms.
 - 1,250 staff.
 - Home vs host supervision – limited powers over EEA branches.
- **Financial Conduct Authority (FCA) – 2013**
 - 56,000 firms.
 - Over 3,000 staff.
 - Prudential supervision for non-PRA firms and conduct for all; consumer protection and competition.
 - Payments System Regulator (PSR) as a subsidiary since 2015.



The FCA's objectives

- The FCA has a strategic objective to ensure that the relevant markets for financial services function well.
- Its formal operational objectives:
 - i. to secure an appropriate degree of protection for consumers;
 - ii. to protect and enhance the integrity of the UK financial system;
 - iii. and to **promote effective competition in the interests of consumers in relevant markets.**
- FCA has competition as a primary objective.
- As does the PSR. (**To promote effective competition in the markets for payment systems and services - between operators, PSPs and infrastructure providers.**)
- As does the Competition and Markets Authority (CMA).



Primary competition regulators

- Any of the CMA, FCA or PSR can enforce competition law, conduct market studies or make (relevant) market investigation references.
- 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, 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.
- The PRA does not have any such powers in relation to competition.



The PRA's objectives

- The PRA has three statutory objectives:
 - i. a general objective to promote the safety and soundness of PRA-authorized firms;
 - ii. specifically for insurers, to contribute to the securing of an appropriate degree of protection for those who are or may become policyholders; and
 - iii. a secondary objective to, so far as is reasonably possible, act in a way which facilitates effective competition in the markets for services provided by PRA-authorized persons in carrying on regulated activities.

What does this mean and how do these objectives fit together?



FSMA 2B: advancing the PRA's general objective

- “(1) In discharging its general functions the PRA must, so far as is reasonably possible, act in a way which advances its general objective.
- (2) The PRA's general objective is: promoting the safety and soundness of PRA-authorized persons.
- (3) That objective is to be advanced primarily by –
- (a) seeking to ensure that the business of PRA-authorized persons is carried on in a way which **avoids any adverse effect on the stability of the UK financial system**, and
 - (b) seeking to minimise the adverse effect that the failure of a PRA-authorized person could be expected to have on the stability of the UK financial system.
- (4) The adverse effects mentioned in subsection (3) may, in particular, result from the disruption of the continuity of financial services.”



Introduction of the Competition Objective

- Replaced

‘... must also have regard to ... the need to minimise any adverse effect on competition in the relevant markets that may result from the manner in which the PRA discharges those functions.’

- HMT 2013 amendment briefing:

‘As a secondary objective, the .. requirement .. is subordinate to its general objectivethe secondary objective requires the PRA to take **a more proactive approach** .. than implied by its existing duty to ‘have regard’ ..’



The PRA's strategy

“The PRA’s Strategy is to deliver a resilient financial sector by seeking: an appropriate quantity and quality of capital; effective risk management; robust business models; and sound governance, including clear accountability of firms’ management. This supports the PRA’s pursuit of its safety and soundness, policyholder protection, and (secondary) competition statutory objectives.

The PRA does not seek to operate a zero-failure regime. When failure does occur, this should be with limited disruption to the provision of core financial services and without spillovers to the wider financial sector.

This strategy will be achieved in close co-operation with other parts of the Bank, the FCA, and European and international counterparts.

In delivering this strategy, the PRA will be **judgement-based and forward-looking, proportionate** in its actions, and **efficient** in its allocation of resources.”

(PRA Annual Report 2015)



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PRA Board

- Decision making body for:
 - Prudential rules, subject to public consultation.
 - Most important supervisory decisions for largest firms.
- Meets roughly twice a month.
- Comprises Governor (chair), 3 Deputy Governors, 1 other executive, the CEO of the FCA, plus 6 non-executive Directors appointed by HMT.
- CEO of PRA also sits on FCA Board and FPC.
- Prudential Regulation Committee replaces PRA Board this autumn.
- PRA's junior decision making committee meets twice a week.



The problem of multiple primary objectives: a view from the policy coordination literature

- **Can hit multiple objectives simultaneously if:**
 - Targets are independent and individually achievable.
 - **Targets should be coherent and match a single vision of how the economy will operate.**
 - Have at least as many independent instruments as independent targets (Tinbergen Counting Rule).
 - If different agencies, to avoid dynamically unstable paths ,
 - + need effective assignment of the instruments
 - + co-ordination between the agencies.
- Note: in a dynamic, stochastic system may never actually hit the objectives fully because of continuous shocks so ..
- ... aim for them in the medium term.



What is a secondary objective? Part I

- No academic literature?
- Concept applied to BoE starting with MPC in 1997, echoing Maastricht Treaty Article 105:

“ **Without prejudice to** the objective of price stability, the ESCB shall support the general economic policies of the Community..... The ESCB shall act in accordance with the principle of an open market economy **with free competition**, ...”

and then “subject to that ..” language in BoE Act 1998.

- ‘Secondary’ appears in 2010 HMT consultation paper on future of financial regulation. Underpins objectives of FCA, FPC and then PRA.



What is a secondary objective? Part II

- Interpretation as representing lexicographic preferences?
Inaccurate and not helpful.
- Observation:

a secondary objective is given to an agency when that agency is not given specific powers designed to achieve it ...

... but when exercising its powers to hit its primary objective, it can have significant spill-overs on that secondary objective.

- Intended to help avoid extreme outcomes eg ‘inflation nutters’
i.e. some requirement to be proportionate.
- Requires some dimension of discretion in advancing the primary objective e.g. time, or rules which are graded by balance sheet size.
- Helps promote co-ordination between agencies.



Alignment of prudential regulation with competition policy

Both are to do with managing important market imperfections. Spill overs can run both ways:

- ✓ Systemic risks are associated with larger firms – focusing in regulations on mitigating systemic risks should help promote competition.
- ✓ Uncompetitive markets can lead to insufficient attention being paid to risk, leaving firms vulnerable to cyclical or structural shocks.
- × Disproportionate over-regulation could inhibit competition.
- × Trying to impose perfect competition could lead firms to cut corners on expensive capital, liquidity and/or risk management and controls.

An appropriate degree of safety and soundness, and an appropriate degree of competition should, generally but not always, run together. Especially when consider both in the context of sustainable growth and financial stability.



Alignment ... Part II

- Assertion: no intrinsic reason why objectives not aligned. Aim to achieve effective competition between safe and sound firms
- Proportionality: not trying to achieve 'perfect competition' nor 'stability of the graveyard'.
- Language matters: we should not talk about trade-offs, nor conflicts, but near-term spill-overs – which is ok as long as each party takes a medium-term approach.
- Helps if co-ordination between agencies (mandated in statute anyway).
- If conflict eg don't reflect same vision of how economy should work, then Grade 1 policy problem – Government would need to internalise.



Precise meaning of the objective

‘When discharging its general functions in a way that advances its objectives...

- The PRA’s general functions include rule making and any general policies, principles or precedents; the competition objective is not directly relevant to firm-specific supervisory decisions unless precedent-setting.

The PRA cannot use its powers solely to advance its competition objective, it can only act if its primary objective is engaged.

EU law specifically precludes the PRA from considering the ‘economic needs of the market’ (i.e. competition) when deciding whether to approve a change of control. (The opposite of the US situation).



Precise meaning of the objective, part II

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

- Where the SCO is engaged, the PRA must seek to facilitate effective competition where it can.

But the PRA can't act in a manner inconsistent with its primary objectives.

And the SCO is limited to what is reasonably possible. There may be other binding constraints on the PRA (eg domestic or EU law).



Precise meaning of the objective, part III

...facilitates effective competition...

- Use of 'facilitates' indicates that the PRA can help to create the conditions for effective competition and is not outcome focused; 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 prudentially good outcomes. So focus is different to that usually used in competition policy.

More on this to follow ...



Precise meaning of the objective, part IV

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

- The markets where the SCO applies are broad. In principle applies to markets beyond the UK, if PRA-regulated firms are involved.

However, analysis of competition effects must be proportionate and does not need to consider all markets in every case.



What is 'effective competition'?

- Market failures mean that perfect competition not realistic in practice.
- Some definitions focus on the market power, or entry and exit.
- Immediately suggests conflict o/a problems of allowing large banks to exit.
- Markham (1950): defined workable/effective competition as competition where 'there is no clearly indicated change that can be effected through public policy measures that would result in greater social gains than losses'.
- Pollution example: don't want free entry to the market for firms that compete by being prudentially unsound.



What is 'effective competition'? Part II

Quarterly Bulletin 2015 Q4, describes 3 aspects of effective competition:

- i. Suppliers compete to offer a choice of products or services on the most attractive terms to customers, such as lower prices or better quality, and prices appropriately reflect risk.
- ii. Customers have the confidence to make informed choices – eg deposit guarantee schemes enable choice in banking.
- iii. Effective entry, expansion and orderly exit.

NB Effective competition not the same as (international) competitiveness!



The UK banking industry

- Five UK big retail banks: Barclays, HSBC, LBG, RBS, Santander and one big building society: Nationwide.
- Clear returns to scale? 7th largest retail deposit taker, Co-op, is much smaller than 6th.
- CMA: largest 4 banks have 71% of personal current accounts and 83% of business accounts.

What do we do to them?

- These 6 are our 'category 1' deposit takers = Board level decisions.
- These 6 plus Co-op currently are in line for ring-fencing by 2019.
- These 6 plus StanChart are subject to co-ordinated stress testing.
- Extra capital requirements on GSIBs: HSBC (+2.5%), Barclays (+2%), RBS (+1%), StanChart (+1%)
- And DSIBs: these 8 plus 8 others.



How the PRA considers competition issues

- Small unit of competition experts in policy department.
- Academic senior advisor – Prof Paul Grout from Bristol University.
- Regular consideration as policy is first formed.
- Routine consideration as policy is decided.
- Summary via 6 monthly reports to the Board.
- Must publish Annual Report on how SCO has been advanced. First due shortly.
- Engagement with FCA and CMA.
- By being ‘proportionate’ in its strategy and SCO carried through to international policy negotiations.



Example policies

- The Bank's Independent Evaluation Office (March 2016) used 6 case studies:
 - FPC recommendations on limiting the flow of high loan-to-income ratios
 - Use of *de minimis* thresholds to ensure impact was proportionate.
 - Updates to Pillar 2A capital requirements (supervisory discretion component).
 - Greater consistency = level playing field.
 - Solvency II for insurers – allow long transitional arrangements.
 - Avoid sudden changes for firms with long-dated books.
 - Competition review of new PRA rulebook.
 - Structural reform (“ring-fencing”).
 - Applies to largest banks. Reduces implicit TBTF subsidy.
 - Authorisations of new banks.
 - Rules for new entrants permissive not prohibitive.
 - New Bank Start-up Unit.



Conclusions

- PRA not a primary competition regulator.
- But Secondary Objective ensures that spillovers to competition are addressed – proactively – whenever primary objective is advanced.
- More synergies have emerged than conflicts to date.
- No direct powers, but can be proportionate.
- According to IEO report, PRA doing well but opportunities exist to:
 - i. better identify and prioritise competition issues,
 - ii. improve internal articulation of SCO,
 - iii. embed the SCO further into policymaking,
 - iv. enhance its governance via the Board,
 - v. improve external coordination with other regulators,
 - vi. improve external communications.

