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UK banks in international markets

Implications of UK-euro area divergence in regulation and supervisory practice

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Abstract

The United Kingdom has entered the post-Brexit period with a regulatory framework aligned with that of the European Union, and which is stronger in several areas. The changes in regulatory strategy and in the institutional framework that have been announced by the UK authorities are likely to intensify competition within the UK market and make regulation more flexible, while adherence to international standards is seen as an overriding aim. Regulation and supervision within the UK market will not fundamentally alter the already strong position of UK banks in international markets.

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LIST OF ABBREVIATIONS

BCP	Basel Core Principles for Effective Banking Supervision
BoE	Bank of England
BRRD	Bank recovery and resolution directive
CRD	Capital requirements Directive
CRR	Capital requirements Regulation
EBA	European Banking Authority
FCA	Financial Conduct Authority
FSA	Financial Services Act
FSAP	Financial Sector Assessment Program
G-SIB	Global systemically important bank
IRB	Internal-ratings based
MREL	Minimum requirement for own funds and eligible liabilities
NGFS	Network for Greening the Financial System
NGFS	Network for Greening the Financial System
PRA	Prudential Regulation Authority
RWA	Risk-weighted assets
SRB	Single Resolution Board
SREP	Supervisory Review and Evaluation Process
SRMR	Single Resolution Mechanism Regulation
TCA	Trade and Cooperation Agreement
TCFD	Taskforce on climate-related financial disclosures

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EXECUTIVE SUMMARY

The United Kingdom banking sector, comprising 122 regulated banks and 43 building societies, accounted for about one quarter of bank assets in the EU prior to Brexit. Since the UK's withdrawal from the single market, and following the associated loss of passporting rights, about £900 billion in bank assets (or 11 percent of total UK assets at end-2020) have moved to the EU. Further shifts of assets, staff and legal entities are expected to follow in the coming years [1]. Despite its diminished stature post-Brexit, the UK banking sector remains the largest globally in terms of cross-border claims, and the second-most important in terms of foreign claims consolidated in the home base. The liquidity, human capital and financial services ecosystem in the UK is set to sustain UK banks as a formidable competitor for internationally active euro-area banks.

The UK's now-independent regulation could in theory further bolster the position of the largest UK banks in international markets. However, concerns that the UK authorities will seek to tilt the level playing field in this way seem misplaced. When still in the EU, the UK interpreted many EU rules on banks' prudential treatment more stringently than was the case elsewhere in the EU. Such 'gold-plating' of common EU rules was justified by the UK's more complex and much larger banking sector, with financial sector assets at well over ten times UK GDP at end-2020. The UK practice of ringfencing banks' retail units, for instance, has not been replicated elsewhere in the EU. Three areas of supervision examined in this paper (credit risk management, climate risks, and bank recovery and resolution planning) similarly suggest a stringent approach, despite the multiple supervisory mandates defined in law or announced in policy.

Based on the new UK Financial Services Act of May 2021, the UK will complete its prudential regulation in close alignment with the EU (as has been the case for CRRII) and with the final provisions of the Basel framework. The international competitiveness of the UK financial sector will be taken into account in regulation, though only in the context of a continued close alignment with international regulatory standards.

Two key changes are currently under discussion in the UK and are likely to be adopted in the coming year. First, through a greater use of proportionality, banks which are small or not internationally active are set to be exempted from certain provisions related to Basel III. This change would be in line with the Basel framework and existing practice in many jurisdictions. It is likely to intensify competition within the UK banking market, and will, if anything, constrain the position of large UK banks in international markets. Second, greater regulatory powers are to be delegated to the Bank of England, which is likely to make UK regulation more responsive to international standards and structural changes in the industry, such as the ongoing adoption of digital technologies. Neither change suggests a departure from the past focus on the safety and soundness of UK financial institutions.

[1] Figures from New Financial (2021b).

1. INTRODUCTION

As a consequence of Brexit and the loss of passporting rights in the single market, UK banks have lost access to the major financial market on their doorstep, and EU clients have lost access to Europe's key financial centre[2]. The UK government could in principle define bank prudential regulation that diverges from the EU's capital requirements rules, and the Bank of England could further develop what is already a fairly holistic style of supervision, possibly seeking to boost the international competitiveness of the City of London as an intermediate goal. Divergence will in any case result as the ongoing programme of EU prudential regulation, especially in the implementation of further elements of the Basel framework, may differ from that in the UK in substance and timing. UK banks continue to command large shares in global banking markets outside Europe, in particular in emerging markets. In principle, there could be a concern that the UK's new regulatory independence could 'tilt the level playing field' to the benefit of UK institutions.

As this paper will show, these concerns are largely misplaced for two reasons.

First, there is no reason to believe that the UK would fall short of standards in the Basel agreement on bank prudential regulation. The original Basel accord on bank capital was introduced in 1988 with the primary objective of preventing risk-based capital regulation from biasing financial services exports towards jurisdictions with lighter regulation (Goodhart, 2011). This remains a binding standard that constrains national supervisors and is reflected in the new UK Financial Services Act. It remains a common floor for bank regulation, maintaining the international level playing field.

Second, shares in global banking markets will continue to be determined by a number of factors in the banks' home base other than regulation. Human capital and skills, the related ecosystem of professional services, deep local funding markets and the use of English law in most loan contracts have all underpinned the UK's position in international banking markets, and will continue to do so. 'Competitiveness' as a measure of relative unit labour costs may be helpful in assessing industrial sectors but is less useful in the context of the financial services trade.

This paper examines recent UK bank regulation and supervision reforms and announcements about the future direction in these policy areas, and shows that concerns about deregulation and relaxed standards in supervision are not justified. The UK's access to the EU single financial market, or the lack thereof, is now well understood. This paper will therefore focus on the position of UK banks in international markets, where UK banks compete head-to-head with euro-area banks. Even though the UK has announced a more flexible and differentiated prudential regulation, it is unlikely that changes in international market shares, loosely termed competitiveness, would result from this policy.

This paper focuses on micro-prudential regulation and supervision and proceeds as follows: section 2 provides a snapshot of the size and world market shares of the UK banking sector. This underlines that a 'tilting playing field' due to regulatory divergence could in theory be a concern for large euro-area banks active in global financial markets. Section 3 demonstrates that UK bank regulation has not only been closely aligned with that of the EU, but in many areas has in fact gone beyond what was required. For instance, capital requirements are applied at both entity and group level, and retail banking units have been ringfenced for financial-stability purposes. Policymakers have stated the main future directions of regulatory divergence, mainly relating to a greater use of proportionality, and greater powers for the Prudential Regulation Authority (PRA). within the Bank of England. Neither is likely to

[2] For UK financial institutions, the loss of passporting rights alone could result in additional trade costs of up to 22 percent of total financial services exports (HM Treasury, 2018).

drive significant regulatory divergence. Section 4 then sets out how the supervisory mandate of the PRA differs from that of the European Central Bank. Competition is, by law, a secondary mandate and several other objectives have been stated in policy. The UK's different approach to supervision is then compared to that in the euro area in the three areas: the use of bank-internal models for credit risk, how the risks from climate change are reflected in the supervisors' dialogue with banks, and the respective approaches to bank crisis management and resolution. All three areas suggest a consistently conservative approach that is unlikely to be loosened to benefit the international business of UK banks. The concluding section points to a dynamic within the financial services industry that may in fact favour the jurisdiction with *higher* regulatory standards, underlining the need for continued dialogue between the UK and euro area authorities.

2. THE UK BANKING SECTOR AT THE END OF THE TRANSITION PERIOD

The UK hosts one of the world's largest and most complex financial sectors. Total financial sector assets are about ten times of GDP, with half of these assets in the domestic banking sector (IMF, 2016). This degree of financial development is the most advanced of any industrial economy bar Hong Kong, and is exceeded only by some offshore financial centres. It entails significant financial stability risk (IMF, 2018a) but also efficiency as a financial marketplace, arising from economies of scale and agglomeration effects within London as a global financial centre. The City of London has long benefited from a well-qualified workforce, supporting professional services, and English law as the basis of most contracts (see also section 3.1). Financial sector productivity remains well above other major financial centres, though productivity growth has levelled off somewhat since the earlier periods of deregulation and the global financial crisis (OECD, 2020).

Even though the Bank of England as supervisor is tasked with pursuing competition in the banking sector as a secondary objective, the UK sector remains moderately concentrated compared to euro-area countries (Table 1). The five largest banks control just under half of system assets. This measure of market concentration fell in the aftermath of deregulation in the early 2000s as other measures of competition also improved, though since the global financial crisis has in fact risen as competition became *less* intense[3]. Within the UK market, the Bank of England has a policy to support the entry and growth of so-called challenger banks. Nearly a quarter of bank revenues face potential competition from Fintechs, and such firms are set to benefit from a number of supportive regulatory measures[4]. For now, the three UK headquartered banks that are deemed of global systemic importance (G-SIBs), and which account for the bulk of the UK's international banking (HSBC, Standard Chartered and Barclays), face limited competition.

Given ongoing structural transformation and compliance costs, some large UK banks have gone through a period of low profitability. The average return on equity in the four years to 2018 was lower than for a number of euro-area markets, including Spain, France and the Benelux countries, and also varied widely across the UK sector. This in turn is expected to constrain future investment in updated IT systems and other innovation[5].

[3] Bank of England and Prudential Regulation Authority (2020).

[4] See the Kalifa Review of UK Fintech.

[5] Bank of England (2019).

Notwithstanding the loss of access to the EU single market, the UK will remain a significant competitor to euro-area banks in global markets. UK financial sector exports stood at roughly £60 billion in 2019, accounting for almost one fifth of total UK service-sector exports and resulting in the largest net financial services trade balance of any country[6]. A 2021 index of global financial centres shows that a measure of international financial services activity in the UK stood at nearly five times the level of the most active euro-area countries (France and Germany). Even though the UK has lost some international market share to Asian financial centres, it remains the world's second most important financial centre after the US (New Financial, 2021a). Table 2 shows the commanding UK position in terms of cross-border claims, though this derives primarily from claims on other financial institutions. Table 3 shows consolidated data, which include claims by UK-owned foreign affiliates that may be funded within their host countries. By this measure the UK is second behind Japan, and at a similar level to the United States. UK banks are therefore highly focused on international business. Less than half of total loans by UK banks are to domestic residents, whereas one fifth is extended to emerging-market borrowers (2018 figures from IMF, 2020).

[6] Data on UK financial service trade: https://www.ons.gov.uk/economy/nationalaccounts/balanceofpayments/datasets/3tradeinservicesthepinkbook2016.

Table 1: Measures of concentration and profitability in the UK and three euro-area countries

	Share of five largest banks in system assets (%)				Return on equity (%)			
	UK	France	Germany	Spain	UK	France	Germany	Spain
2011	55	93	40	52	4.0	5.6	6.7	-3.2
2016	48	88	36	69	2.5	7.0	4.3	3.2

Source. World Bank supervisory survey (2019).

Table 2: Bank cross-border positions, by location of reporting bank and sector of counterparty, end-2020 ($ bn.).

	All sectors	Bank sector	Non-bank sector		
			Total	Of which: Non-bank financial	Of which: Non-financial
All reporting countries	35,713	17,016	16,861	7,848	8,486
United Kingdom	5,421	2,832	2,537	1,569	968
France	4,501	1,723	1,613	939	674
Germany	2,351	1,340	1,011	291	720
China	1,372	708	664		
Hong Kong SAR	1,712	978	734		
Japan	4,320	1,070	3,250	1,349	1,902
Singapore	853	343	364		
Switzerland	903	489	412	216	196
United States	3,393	1,739	1,654	1,269	385

Source: Bruegel, based on BIS Locational banking statistics, Table A2.1.

Table 3: Consolidated banking statistics, by nationality of reporting bank, end-2020, (US$ bn.)

	Total claims		Total assets
	Foreign claims	Domestic claims	
All nationalities	33,736	72,539	100,135
United Kingdom	4,009	3,166	8,355
France	3,429	5,716	9,745
Germany	2,210	6,213	9,254
Japan	5,031	18,935	
Singapore	611	450	1,133
Switzerland	1,644	1,779	3,512
United States	3,953	13,224	18,062

Source: Bruegel, based on BIS consolidated banking statistics, Table B1.

3. UK REGULATION: EU ALIGNMENT AND FUTURE DIVERGENCE

Large UK banks began the post-Brexit period within a regulatory regime that was fully aligned to that of the EU. Already in 2018, the UK passed the EU Withdrawal Act, which essentially made sure there would be legal continuity, even in the case of an exit without a withdrawal agreement. This process applied not just to EU legislation that was already in force, but also to provisions that would apply in future, following a transitional phase-in period (only inoperable provisions were exempted). The Capital Requirements Directive (CRD V, EU 2019/878, covering a number of refinements in pillar 2 supervision and making micro- and macroprudential supervision more consistent) was transposed into UK regulation in December 2020, just before the EU-wide deadline and at the end of the UK's transition period. To date this process of so-called onshoring of EU financial law into the UK's legal system has been comprehensive and faithful, and the UK remains compliant with the Basel accord[7].

The UK has also often adopted a relatively conservative interpretation of the EU's prudential rules, a practice often referred to as 'gold-plating'. For instance, the UK applies the capital requirements at an entity level (applying to each bank in a group), as well as at consolidated level, as do several euro-area countries. Along with higher pillar 2 capital requirements, and higher counter-cyclical capital buffers, this has contributed to a generally high capital adequacy of UK banks compared to EU peers[8]. Also, large UK banks were required to set up intermediary holding companies in the US, and independently-capitalised subsidiaries within the EU, resulting in higher capital coverage for groups a whole (New Financial, 2020). A further illustration of the traditionally high UK prudential requirements is the ringfencing of retail and small business banking from wholesale banking, which has been in effect since 2019. Based on the report of the so-called Vickers Commission, a 2013 law required large banks to create separate entities for retail deposit-taking and payment services (currently seven banking groups have set up 15 such ringfenced bodies). Ringfencing is expected to reduce systemic risk, improve resolvability and reduce risk to the taxpayer by segregating retail deposits from riskier activities. It may also spur further increases in the capital base (IMF, 2016)[9]. The equivalent proposal made by the Liikanen Commission in the EU was dropped and then superseded by the resolution regime.

The UK's Financial Services Act (FSA) became law in April 2021 and represents the first major piece of financial services legislation adopted by the UK outside the EU[10]. The FSA already empowers the Bank of England to adopt rules that translate the outstanding elements of the Basel agreement on prudential capital. In the case of the Capital Requirements Regulation II (which covers, among others, banks' leverage ratios and intermediate holding companies), UK and EU rules are therefore now closely aligned (with one exception biasing the UK towards a stronger regime)[11].

The more contentious final elements of the Basel framework ('Basel 3.1') are still under consideration in the UK, as in the EU and other major jurisdictions. These provisions on bank capital would impose limitations on bank internal models used in calculating risk-weighted assets. The so-called output floors are set to limit the variability in banks' risk-weighted assets that cannot be justified by underlying risks

[7] BCBS (2020): Implementation of Basel standards and RCAP on consistency. In the EU, there was a determination of material non-compliance on risk-based capital in 2014 based on EU legislation at the time, though standards applied by the ECB in the supervision of significant institutions makes this a non-issue for the largest banks.

[8] The EBA Risk Dashboard for end-2019 shows both tier-one and total capital ratios above the EU average.

[9] A review of ringfencing is planned during 2021, based on the upcoming report of an independent panel.

[10] For a summary of the key changes see Sherman & Sterling: https://www.shearman.com/Perspectives/2021/05/The-Future-of-Financial-Regulation-in-the-UK.

[11] Under the UK definition, banks' software assets are not included in regulatory capital.

of assets, though would be introduced over an extended phase-in period, taking full effect only in 2027. At the time of writing, there remains considerable debate about the EU's final legislative package, with some countries calling for a differentiated approach that would shield some banks from the full impact (Enria, 2021). In addition to such 'pillar I' requirements, both UK and euro-area supervisors are in any case reviewing banks' internal models in the bank-specific discussions (see section 4.2).

The present UK pipeline of regulatory and supervisory initiatives (summarised in Table 4) seems to closely shadow that of the EU. For now, all other regulatory changes require a statutory process (see section 3.1 for the potentially greater extent of delegation and BoE powers in future). Apart from its current mandates, the BoE will need to take into consideration four intermediate objectives: the impact of measures on lending to the UK economy; the relative standing of the UK financial system; implications for equivalence decisions; and meeting international standards[12]. These are novel aspects in UK financial services law, though these considerations will be subordinated to the existing primary statutory objective of safety and soundness, and the secondary objective of competition.

[12] Financial Services Act, Section 144C.

Table 4 Selected regulatory initiatives scheduled to take effect before end-2022

Climate stress tests (biennial exploratory scenario)	**ongoing, results to be published by May 2022**
Trading activity wind down	**end-2021**
Resolvability Assessment Framework	**largest firms by January 2022** **mdi-sized firms by January 2023**
Operational continuity in resolution	**mid-2021**
MREL review	**by end-2021**
Solvency stress test	**by Q4 2021**
Implementation of remaining Basel III standards	**2023 implementation deadline as set by BCBS**
CRR II implementation	**final rules to be adopted in Q3 2021, to be effective from 2022**
Review of IRB approach to credit risk	**by 2022**

Source: Bruegel, based on Bank of England and FCA Regulatory Initiatives grid (available on the FCA website.) The reforms listed here are indicatively rated by the regulators as having a high impact on firms.

The four additional objectives listed in the UK FSA appear to give the Bank of England a certain amount of discretion within well-defined constraints. Yet, none of the statements made by UK officials to date suggest that deregulation and a loosening of standards for large banks is planned. On the contrary, announcements on the future regulatory strategy regularly point out that strong and effective regulatory standards underpin the UK's financial system competing in international markets (Bank of England, 2021).

In any case, the UK-EU Trade and Cooperation Agreement (TCA) could act as an additional constraint. No market-access commitments were made and the TCA contains only a few fairly broad provisions on financial services trade (a memorandum of understanding covering the sector is limited to administrative issues; see Lanoo, 2021). As is common in trade agreements, a prudential carve-out confirms that the UK has wide-ranging regulatory and supervisory independence, and this will allow each side to take measures necessary for investor protection and the integrity of the financial system (Art. 184 TCA).

At the same time, the UK and the EU have confirmed a commitment to internationally agreed regulatory standards[13]. The UK has lent much support to international coordination in regulatory reform since the global financial crisis and chairs two of the four international standard-setting bodies

[13] Art. 186 TCA states: *"The Parties shall make their best endeavours to ensure that internationally agreed standards in the financial services sector for regulation and supervision, for the fight against money laundering and terrorist financing and for the fight against tax evasion and avoidance, are implemented and applied in their territory."*

(on payments and markets and on insurance). Regulatory easing that could be interpreted as non-compliance with the Basel framework of bank regulation is unlikely, not least as could be deemed a violation of the TCA.

Only the future regulatory framework that is yet to be proposed by the UK Treasury would likely offer greater clarity on the extent of rulemaking discretion and how trade-offs between the various objectives will be navigated[14]. The UK Treasury and Bank of England have announced two major aspects of this future framework.

3.1. The UK's Future Regulatory Framework Review

Changes in the UK's own institutional structure have long been flagged as a major benefit of financial services regulation outside the EU. According to several announcements, a new design should meet three key objectives: first, by being more adaptable and agile, financial regulation could more quickly reflect new international standards, or respond to emerging risks in regulation; second, a politically-expedient loosening of standards, which may give a boost to economic activity, should remain difficult as short-term and long-term incentives of the regulator should remain aligned; third, the regulatory authority should have legitimacy as it only acts within its political mandate (Saporta, 2020).

While these features of prudential regulation seem universally sensible, jurisdictions have navigated the inevitable trade-offs in different ways. Typically, only two of the three objectives can be realised at the same time. For instance, prudential regulation that is rooted in primary legislation meets the criteria of legitimacy and time-consistency, but is unlikely to be flexible. By contrast, delegation to government officials would meet the criteria of flexibility and legitimacy but would open the door to political interference in prudential outcomes. Greater delegation to a regulatory body would lack such legitimacy.

The design of the UK regulatory framework is still undergoing extensive consultation (HM Treasury, 2020), though it appears likely the UK will choose a model that involves a large degree of delegation of rulemaking to the Bank of England. PRA rules, rather than primary legislation, could eventually define the bulk of the prudential framework. Yet, this discretion would be constrained by the existing mandate of financial stability and competition, and the PRA would need to account for its decisions regularly to the UK Parliament. BoE research suggests that greater independence of a prudential regulator is generally associated with improved financial stability outcomes (Fraccaroli *et al*, 2020).

Some UK observers have also argued that common law, which is based on judicial precedent, is more suitable for the operation of a major financial centre than is the civil law tradition of EU legislation. According to this view, common law has explained the success of major international financial centres, such as New York, and was therefore adopted in a number of emerging-market financial centres, including Dubai, Abu Dhabi and the Astana International Financial Centre. Elevating case law would entail a much more comprehensive redacting of EU financial law from the UK rulebook (Reynolds, 2021).

In any case, greater regulatory independence through delegated powers is set to make UK regulation relatively flexible. This may emerge as the key difference with the long-standing EU model of regulation

[14] The consultation by the UK Treasury on the Future Regulatory Framework closed in November 2020.

defined in primary legislation[15]. EU level 1 regulation resulting from the inter-institutional legislative process accounts for the bulk of EU rules. Even though the Acts of the European Banking Authority (EBA) and delegated acts of the European Commission are important in implementation, they are limited to technical issues, given the need for legitimacy and ensuring consistent implementation across all EU countries

3.2. Proportionality: 'strong and simple' UK regulation

A second key aim of the UK's post-Brexit regulatory strategy is simplification of the regime for smaller banks. Originally, the Basel regime was designed only for internationally active banks. Only for such banks was the objective of a level playing field and preventing competitive distortions between banks seen as relevant, as reduced prudential standards could result in cross-border spillovers (Financial Stability Institute, 2018). However, because the Basel prudential regime initially covered only bank capital, most jurisdictions applied the framework to *all* banks. Only with the more complex Basel III regime, also covering leverage and liquidity, among other things, has there been greater use of the so-called proportionality rules through simplified regimes. The Basel framework allows for prudential rules to be tailored to bank size, risk profiles and complexity. In a survey of six major Basel Committee on Banking Supervision jurisdictions, Castro Carvalho *et al* (2017) found that full Basel standards are generally applied only to mid-sized to large banks with balance sheets beyond a certain size. Smaller banks are often subject to a modified Basel standard, or to entirely different and simpler prudential rules.

The EU initially rejected comprehensive carve-outs from the Basel rules for smaller banks, and the Capital Requirements Directive sought to adopt uniform treatment across the single market. Rules are largely applied in the same way to *all* banks, irrespective of their size, complexity or international engagement. Business models and complexity differ widely across jurisdictions, and national prudential regimes for groups of smaller banks would undermine integration within the banking union. The Basel rules allow a certain differentiation, for instance by applying the standardised approach to capital requirements for smaller banks, or in future by imposing a floor on the permissible risk weights calculated by internal models. Moreover, proportionality is built into supervisory practice, by subjecting significant institutions to ECB supervision, and tailoring the annual Supervisory Review and Evaluation Process (SREP) to the risk profiles of institutions (ECB, 2019).

Having the freedom to depart from CRD standards, the UK is now likely to make greater use of proportionality[16]. This change would be designed to reduce for smaller banks the regulatory complexity that arises from the costs for banks of understanding, interpreting and operationalising Basel III rules. In the view of the Bank of England, continued full application of such rules could reduce earnings of small firms, raise their risk appetite, and possibly even lead to reduced resilience. The long-running inability to raise the intensity of competition in the UK banking sector is also attributed to the inability of smaller banks to grow and an excessive regulatory burden that has deterred new entrants, and hence reduced competition. Reducing firms' operating costs and ensuring these costs are

[15] This regulatory power at the highest level in fact is at odds with the 2001 Lamfalussy Report, which informed much of the subsequent financial architecture, and which advocated a focus on principles in the legislative process and greater discretion for supervisory agencies (p.22).

[16] Bank of England (2020). Following the release of a discussion paper (Bank of England, 2021) the BoE may launch a consultation on proportionality during 2022.

proportionate to firm size and complexity would help reduce barriers to entry and expansion of challenger banks in the sector.

Bank of England research finds that, in fact, the benefits of resilience achieved through prudential regulation seem to arise mainly from larger firms (de-Ramon *et al*, 2018). The regulator will weigh the benefits of addressing this complexity problem against the risks from creating new barriers to growth, as small firms may be deterred from growing larger once they hit a threshold beyond which the full regime applies. This could be achieved, for instance, through the use of graduated criteria. Prudential requirements might increase in a number of stages with firms' size and complexity. In this way, the PRA's primary objective of banking sector stability would still be consistent with a more dynamic and diverse banking sector, in which firms regularly exit and enter.

In essence, the UK is likely to adopt prudential regulation that is differentiated according to the size and complexity of the supervised institutions. The more active application of proportionality principles and the reduced complexity for smaller firms in the UK will likely result in greater competition and market entry by challenger banks, underpinning operational efficiency (Vives, 2016), though constrained by a more limited presence of, and potential entry by, EU firms.

4. SUPERVISORY MANDATES AND PRACTICE

A further source of diverging banking sector competitive dynamics, even in the context of regulation that so far remains fully aligned, could arise once approaches to supervision by the Bank of England and the ECB differ more sharply.

A 2016 IMF assessment of supervisory practice suggested the UK was well advanced in reflecting the lessons of the 2008 financial crisis (IMF, 2016). Overall, the Fund found few shortfalls relative to the 29 Basel Core Principles for Effective Banking Supervision (BCP)[17]. This review already took stock of the early experience with important post-crisis reforms in UK supervision. In 2012, UK supervision was transferred back into the Bank of England, and the PRA subsequently lost its status as a subsidiary when it was fully merged into the central bank. The UK therefore continues to follow the so-called 'twin-peaks' model of financial supervision with separate authorities for conduct issues (located within the Financial Conduct Authority or FCA), and prudential supervision within the Bank of England. A further important innovation in 2016 was a new Senior Managers Regime, which the IMF acknowledged would bolster public confidence in the banking system and repairing damage done by number of cases of misconduct.

4.1. The mandates of the Bank of England and the ECB

One source of divergence between the UK and euro area results from the different mandates given to the two supervisors. As for most supervisors, the safety and soundness of supervised banks is mandated in primary UK legislation (the Financial Services and Markets Act). Clarity in responsibilities, objectives and powers appears to be in line with standards set in the Basel core principle for effective banking supervision[18].

[17] Unlike the Basel Agreement, the BCP apply to the entire banking sector irrespective of local regulation, and will again be examined in the 2021 FSAP.

[18] IMF (2016) and https://www.bis.org/basel_framework/standard/BCP.htm?type=all.

It is quite common to find that additional objectives for supervisors are defined in primary legislation or in related policy statements (

Table 5 summarises the main advanced jurisdictions covered by the Basel Committee). By law, and only as a secondary objective, the PRA has, since 2014, been tasked with ensuring effective competition as far as reasonably possible. The PRA states that its primary and secondary objectives are normally aligned, though that it may choose the latter over the former in certain situations (Bank of England/PRA, 2018). In addition, the Bank of England has accepted further responsibilities, including combating financial crime, fostering financial inclusion and literacy, and developing the Fintech sector, though these do not seem to influence its core supervisory tasks.

In comparison to other jurisdictions the ECB's supervisory mandate is exceptional in being narrowly focused on financial stability and the safety and soundness of the supervised institutions[19]. No other secondary mandates are defined in the original regulation establishing common banking supervision, even though, as we show below, the ECB has of course stated its own objectives and has issued guidance to banks in several other areas, including climate-related risks and cross-border financial integration within the euro area.

Table 5: Supervisory mandates and responsibilities in key jurisdictions

	Safety and soundness	Financial stability	Crisis management	AML/CFT	Resolution	Consumer protection	Financial inclusion	Financial literacy	Fintech and innova	Financial sector development	Efficiency	Competition	Climate change	Financial centre
UK	•	•	•	x	•		x	x	x		x	•	x	
ECB	•	•												
China	•	x	•	•	x	•	x	x		x			x	•
Hong Kong	•	•	•	•	•	•	x		x	x			x	•
Japan	•	•	•	•	•	•	x	x	x	x	x		x	x
Singapore	•	•	x	•	•	x	x	x	x	•	x	x	x	•
Switzerland	•	•	•	•	•	•								
United States	•	•	•	•		•	•	x	x				x	

Source: Bruegel, based on Kirakul *et al* (2021); • = statutory, x = non-statutory objective.

Based on its secondary mandate regarding competition, the PRA has reduced costs of compliance for smaller firms and taken a more proactive stance in encouraging market entrants. It attempts to minimise barriers to the growth of smaller firms by applying regulatory thresholds only gradually. This complements the work of other UK agencies, for instance on consumer switching in retail banking markets. In principle, greater competition in banking need not come at the cost of fragility (Vives, 2016). The PRA indeed seems to have successfully navigated this trade-off and Bank of England research shows that competition has in fact increased the stability of high-risk firms (de Ramon *et al*, 2018). Given the PRA's focus on competition, it is in principle more likely that challenger banks emerge, and retail banking clients switch between alternative providers compared to the singular focus on stability in the context of ECB-led supervision. Despite the more limited contestability due to the UK's reduced banking services trade with the EU, competition within the domestic banking market should prevent the largest UK firms from establishing dominant positions that bolster their international business. In practice, the relatively high concentration among the top five UK banks has barely changed since the last financial crisis (Bank of England/PRA, 2020).

[19] Council Regulation (EU) No 1024/2013 of 15 October 2013, Recital 30 and Art. 4.

As discussed below, three areas of supervision show that the Bank of England's approach to supervision has in fact been relatively strong, and that the additional mandates stated in law and announced in policy do not compromise bank safety and soundness.

4.2. Review of credit risk and internal models

The use of bank internal models for the calculation of regulatory capital has been controversial since the inception of the Basel II framework. Even though the use of such models is subject to supervisory approval, banks with similar portfolios show vastly diverging risk-weighted assets (RWA, Al-Darwish *et al*, 2011; Admati, 2016). As these models are primarily designed and applied by the largest banks, the use and possible abuse of such models matters greatly for an international level playing field.

The 2016 IMF FSAP flagged some shortcomings in the UK in this area which were rooted in the EU's own non-compliance with Basel standards at the time. Nevertheless, already in 2016, the UK seemed to adopt a more conservative approach (IMF, 2016). Since then, the PRA has enhanced its coverage of internal models, seeking to review at least 60 percent of firms' modelled credit risk risk-weighted assets. It is also starting a comprehensive cross-firm review of all internal-ratings based (IRB) models to ensure firms meet the new regulatory standards by default. There is an expectation that firms will reduce unwarranted variability in IRB model-driven RWAs. A review of mortgage exposures is to be completed by 2021 and of other asset classes by 2022 (IMF, 2020).

Similar work has been under way at the ECB since 2016. An EBA benchmarking study found wide differences in the valuation of a hypothetical portfolio based on banks' internal models (Breuer, 2017). The variety of national banking business models, and of past national supervisory practices, has made the ECB exercise more protracted than parallel work in the Bank of England. The ECB's final report on internal models, released only five years after the start of the review process, concluded the largest project in the ECB's history and confirmed significant shortcomings[20]. For the 65 large banks that were examined, the ECB issued a total of 5,800 recommendations, about 30 percent of which were serious, that required remediation by the banks. 253 supervisory decisions were issued and should result in a 12 percent increase in the RWA (€275 billion).

4.3. Reflecting climate change in supervision

Climate risks are the latest area requiring a new approach to micro-prudential supervision. The coordination between the ECB and UK authorities has been close, and the two supervisors have adopted broadly similar approaches, albeit with the UK challenging banks earlier.

Most supervisors now accept that financial risks related to climate change should be the target of prudential policy. Even though climate-related risks are difficult to model and their materialisation potentially distant, the physical and transition effects of climate change could have material implications for credit risk (ECB, 2021b). The survey of the 27 jurisdictions in the Basel Committee shows that 13 other jurisdictions, though not the ECB, included climate change in the formal mandate for their supervisors (Kirakul *et al*, 2021).

The Bank of England has led international efforts among central banks in integrating climate change into prudential and monetary policy. As in the case of the ECB, the relevance of climate change for supervisory work has been accepted in numerous statements of policy. In March 2021, the UK Treasury

[20] ECB (2021): Targeted Review of internal models, project report, https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.trim_project_report~aa49bb624c.en.pdf.

explicitly included climate change in the Bank of England's mandate. Alongside changes to monetary policy, a letter by the UK Chancellor to the Bank defined a new remit for the Financial Policy Committee which oversees micro- and macro-prudential policy:

> *"The shift to a world where we are at net zero will mean systemic changes across all parts of our economy. This includes delivering a financial system which supports and enables the transition to an environmentally sustainable net zero economy by expanding the supply of green finance, and that is resilient to the physical and transition risks that climate change presents.... the Committee should continue to act with a view to building the resilience of the UK financial system to the risks from climate change and support the government's ambition of a greener industry, using innovation and finance to protect our environment and tackle climate change"*[21].

This mandate elevates the climate change-related work done within the BoE and PRA, though in reality largely confirms the approach taken for several years previously. Already in 2019, the PRA communicated to banks its expectations about management of climate-related risks. These were further sharpened in a subsequent communication, which set a deadline for implementation of end-2021[22]. Climate-related disclosure is as yet not regulated, based on the BoE's 'comply or explain' approach, but in November 2020 the UK government announced that disclosures of climate risks will become mandatory for the entire economy by 2025, and for banks from late 2021. This is an ambitious timeline compared to other G20 economies. In June 2021, the BoE also launched a bank-specific stress test for seven large UK banks and building societies, and also for a number of insurers. This exercise is highly prescriptive on the use of climate scenarios, as defined by the Network for Greening the Financial System (NGFS).

The work by ECB bank supervisors seems closely aligned to that of the Bank of England, even though implementation is about one or two years behind (Table 6). To date, the ECB's focus has been on banks' exposures to climate risks (ECB, 2021a). A guide to banks on climate-related risks was issued in 2019, though a first review, in November 2020, of banks' management of climate risks revealed many gaps[23]. These will be taken up in bank-by-bank discussions during the regular supervisory cycle. From 2022, such risks may translate into additional capital requirements under the SREP process. The ECB has run a stress test of climate exposures based on aggregate figures this year, and this will be re-done based on banks' 'bottom-up' submissions in 2022.

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[21] Remit and recommendations for the Financial Policy Committee, Letter from the Chancellor to the Governor, March 2021.

[22] Enhancing banks' and insurers' approaches to managing the financial risks from climate change, Supervisory Statement 3/19 and Policy Statement 11/19.

[23] ECB report on institutions' climate-related and environmental risk disclosures, November 2020.

Table 6: Milestones in bank-related climate change initiatives in the UK and euro area

	UK PRA	Euro area
Climate risk management	Supervisory Statement in 2019, a further communication in 2020, set a deadline at end-2021	Supervisory: ECB Guide for banks issued in November 2020
Disclosure	Specific principles mandated by the Task Force for Climate Related Disclosures (TCFD) become mandatory for banks end-2021.	Regulatory: CRR disclosure requirement, and EBA Guidelines elaborating materiality Supervisory: ECB Guide November 2020
Stress test	Initiated in 2019, implementation by 7 large banks in 2021, to be published in 2022	Macro-based: 2021 Bottom-up: 2022
Use of scenarios	Stress test implements NGFS scenarios	Stress test implements NGFS scenarios
Use of taxonomy	Screening criteria to be finalised by end-2022	Taxonomy regulation in force since 2020. Technical criteria for climate related activities published in April 2021.

Source: Bruegel.

In sum, the climate change-related work by the supervisors of large banks in the UK and the euro area seems very similar, even though financial institutions in the two jurisdictions will now operate under different regulatory frameworks, in terms of taxonomies of sustainable activities, financial sector disclosure and standards for green financial instruments such as green bonds. As yet, the Bank of England rejects the idea that regulatory capital requirements should be differentiated between green and brown exposures, a proposal which remains under consideration by the European Commission. Also, strengthened climate risk management in financial institutions is not synonymous with the alignment of the financial system with climate outcomes, such as a path towards 'net zero' in lending and investment portfolios, which has been advocated by some observers in the UK[24]. The above-cited mandate letter to the Bank of England alludes to the government's objective in this regard, though does not define such an objective for the financial sector.

4.4. Crisis management and bank resolution

Recovery and resolution planning is an important extension of bank supervision. By making sure an institution is prepared to withstand a crisis, and can be safely wound down should it fail, supervisors and resolution authorities impose a crucial discipline on bank management. As bank resolution regimes have been implemented in both advanced and emerging markets since the global financial crisis, investors and owners can no longer rely on taxpayer-funded bailouts. At the international level, there is evidence that moral hazard within banks seems to have been contained and that the funding cost advantages of the largest banks (which were previously deemed 'too-big-to-fail') have diminished. Risk spreads on debt also suggest that investors now deem resolution of a failing institution a credible threat (FSB, 2021). The resolution regime is therefore a key determinant of funding conditions for systemic institutions, as investors no longer factor in state support in a resolution scenario. Within the

[24] Climate Change Committee (2020), "The road to net-zero finance".

EU, the partial coverage of the resolution framework and incoherent national rules for bank liquidation have justified the review of the framework for crisis management and deposit insurance.

There are no reasons to believe the UK crisis management framework will be weakened outside the EU. In the area of recovery planning, the PRA's updated supervisory guidance of December 2020 is closely aligned to the Bank Recovery and Resolution Directive (BRRD) and implementing legislation previously defined by the EBA, and indeed references these documents extensively[25]. Similar to the proportionality principle in prudential regulation, and consistent with the BRRD, there are simplified obligations for smaller institutions whose crisis or failure would have no significant impact on financial markets. The UK resolution regime also resembles closely that which applies to the largest banks in the euro area, as established in the BRRD and the parallel regulation applying for the single resolution mechanism. BRRD II (requiring modified MREL targets) was transposed into UK legislation in December 2020 and remains unchanged following the transition period.

Two factors may even make the UK regime *more* effective compared to that in the euro area. First, both prudential supervision and the resolution function are within the BoE, though are separate as required by law. This should result in reasonably swift and effective coordination between the BoE's supervision and resolution units following the determination that an institution has indeed reached the point of resolution (though unlike in the euro area, there have been no recent resolution actions that have tested the functioning of the process). By contrast, bank resolution in the euro area involves the ECB, the European Commission, and the national resolution authority alongside the Single Resolution Board (SRB). The SRB lacks full operational independence and decision-making is complex and potentially lengthy (Véron, 2019; IMF, 2018b).

Second, there is also close integration between the resolution process and fiscal policy executed by the UK Treasury, which is crucial given the potentially sizable sum involved in recapitalisation and liquidity provision. Under the Financial Stability Board's core principles of effective resolution, public-sector backstop funding should be available that is large enough relative to the entities that might become subject to resolution, can be delivered rapidly, and would be available for long enough following the resolution. In line with this principle, the BoE has established a Resolution Liquidity Framework to provide funding and to allow a bank in resolution to make the transition to market-based funding. This liquidity is provided through the BoE, though the central bank may in turn obtain a guarantee ('indemnity') from the UK Treasury. As in the US, no upper limit for this funding is set and losses subsequently incurred would be recovered from the industry. This ability to fund a bank in resolution, which may temporarily lose access to market funding, is a key factor in implementing a resolution plan. Market participants need to assume the chosen resolution is credible and will result in a newly viable institution (Lehmann, 2018). A similar backstop for the Single Resolution Fund was established at the European Stability Mechanism in 2020, though this remains capped, and subject to potentially lengthy approval procedures.

Apart from these important institutional differences, the implementation of the UK resolution regime also seems to be more advanced than in the euro area. Already in 2019, the Bank of England adopted a framework for assessing the resolvability of banks (a comparable SRB policy only came into effect one year later; SRB, 2019). Banks are obliged to draft their own resolvability assessments and will need to publish parts of these assessments by mid-2022. Ahead of the COVID-19 pandemic, the Bank of England made a commitment to the UK parliament that major institutions will become resolvable by 2022, two years earlier than envisaged for the euro area at the time of BRRD II adoption.

[25] PRA Supervisory Statement on Recovery Planning SS9/17, December 2020.

5. CONCLUSIONS

The UK financial sector began life outside the EU single market with substantial transfers of banking sector assets into the EU, and the loss of some firms and human capital. The industry will continue to adapt to the loss of passporting rights, and the limited prospects of access to the EU single market based on equivalence provisions. Nevertheless, the largest UK banks, including the three UK-based G-SIBs, will remain formidable competitors for euro-area banks, in particular in emerging markets.

As of mid-2021, UK regulation has remained closely aligned with the EU, and the regulatory and supervisory system has been described as *"first rate"* (IMF, 2020). All EU financial rules have been 'on-shored' into UK law in a process lasting right up to the end of the transition period in late 2020. Crucially, key elements of the prudential regulatory framework, namely CRR II and the remaining elements of Basel III rules, are set to be adopted in close alignment with the EU or based on the principles set out by the Basel Committee. This is indeed in line with the UK's history of high regulatory standards, with some features, such as the ringfencing of retail units, underlining a conservative approach to bank soundness. Similarly, some aspects of supervision, such as the scrutiny of credit risk models or the reflection of climate risks in stress tests and regulatory capital requirements, also underline a stringent approach, which in several instances was followed by euro-area supervisors with a delay.

The UK government and Bank of England have repeatedly underlined the importance of continued strong regulation and there is no reason to assume that a process of deregulation will set in. Two major innovations will likely be implemented before end-2022. First, smaller institutions that do not compete in international markets are set to be exempted from some Basel rules, which is in line with practice in many other jurisdictions, and indeed with the requirements of the Basel Agreement. Second, the institutional setup and competences will be reshaped, as set out in the UK's 'Future Regulatory Framework' concept. This is likely to result in delegation of considerable regulatory powers to the Bank of England, subject to accountability to the UK Parliament.

The new Financial Services Act of May 2021 already refers to the international competitiveness of the financial sector as a secondary objective in rule-making. This is common also in other financial centres, including Australia, Hong Kong and Japan. In any case, the BoE remains tasked with the primary objective of financial stability, and the alignment with international standards is an additional consideration it will need to take into account. Stimulating competition in the domestic banking market remains a statutory objective and will prevent large internationally active UK banks from reaping rents in the home market from dominant positions.

A period of financial liberalisation provided the original motivation for rules establishing a level playing field and common standards in regulatory capital (Basel Committee, 1999). While Brexit is obviously a reversal in this process of integration, large UK and euro-area banks still compete in the same international markets. A high-quality supervisory regime will attract institutions which expect to benefit in terms of their reputation and funding costs. This may reduce the overall quality of the institutions that remain in the other jurisdiction (Morrison and White, 2005). Both the UK and euro-area supervisors should therefore have an interest in alignment with the Basel framework, in supervision of comparable high quality, and in ongoing bilateral dialogue.

In a debate about the regulation and supervision of UK and euro-area banks, the following questions could be considered:

- What is the experience with dialogue between the ECB and the Bank of England, within the supervisory colleges, but also in coordinating on broader prudential policy issues, including during the COVID-19 crisis?
- What does the Bank of England's experience suggest for the scrutiny of bank internal models by the ECB?
- What does the experience with the broad and multi-faceted mandate of the Bank of England suggest in the context of the ongoing ECB policy review? Should climate change become a more explicit objective and be included in the mandate for banking supervision?

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The United Kingdom has entered the post-Brexit period with a regulatory framework aligned with that of the European Union, and which is stronger in several areas. The changes in regulatory strategy and in the institutional framework that have been announced by the UK authorities are likely to intensify competition within the UK market and make regulation more flexible, while adherence to international standards is seen as an overriding aim. Regulation and supervision within the UK market will not fundamentally alter the already strong position of UK banks in international markets.

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