HOUSE OF COMMONS

Treasury Committee

Oral evidence: Bank of England Financial Stability Reports, HC 140

Monday 11 July 2022

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Watch the meeting

Members present: Mel Stride (Chair); Rushanara Ali; Anthony Browne; Gareth Davies; Dame Angela Eagle; Emma Hardy; Kevin Hollinrake; Siobhain McDonagh; Alison Thewliss.

Questions 130-240

Witnesses

I: Andrew Bailey, Governor, Bank of England; Sarah Breeden, Executive Director for Financial Stability Strategy and Risk, Bank of England; Anil Kashyap, External Member, Financial Policy Committee; Carolyn A. Wilkins, External Member, Financial Policy Committee.

Examination of witnesses

Witnesses: Andrew Bailey, Sarah Breeden, Anil Kashyap and Carolyn A. Wilkins.

Q130 **Chair:** Good afternoon, and welcome to the Treasury Committee and to our hearing on the Bank of England July financial stability report. We are very pleased to be joined by four witnesses this afternoon. Will they briefly introduce themselves to the Committee, starting with you, Andrew, please?

Andrew Bailey: I am Andrew Bailey, Governor of the Bank of England.

Anil Kashyap: I am Anil Kashyap. I am an external member of the Financial Policy Committee.

Chair: I think, Anil, this will be your last appearance before this Committee in that capacity, because you stand down in September. I thank you for your service and your previous appearances.

Sarah Breeden: I am Sarah Breeden. I am the executive director at the Bank responsible for financial stability strategy and risk, and an internal member of the FPC.

Carolyn A. Wilkins: I am Carolyn Wilkins, external member of the FPC.

Q131 **Chair:** May I start with financial risk? Things are getting pretty tough out there, and the dark clouds are gathering. What is your assessment of where we are with the financial risk situation? Is it deteriorating? Are we able to withstand what is happening? What are your general thoughts?

Andrew Bailey: I will start. The picture is quite mixed. If we start with financial markets, there is no question but that during the course of this year we have seen an increase in the price of risky assets. By that, I mean that we have seen equity markets decline—but the main UK market not quite as much as others. That is to do with the mix of companies quoted on the UK market, which has a bigger energy component to it—and an increase in credit spreads. In previous hearings, we were probably saying that we thought that credit spreads were unusually tight, but they have moved.

On market trading conditions, I would say yes, they have got tighter, but markets are functioning. Compare that with the so-called "dash for cash" in March 2020. We are not in that territory; core markets are functioning. We saw, particularly in the early part of the period after the Russian invasion of Ukraine, as we highlighted in a section of the report, some quite difficult and tight issues in commodity markets. I am happy to talk about that if you wish.

On the other hand, our conclusion is that the banking system is resilient. We do not have concerns about the banking system. In that sense, it is a mixed picture, but I do want to get across that a key piece of the picture, relative to past times, is that we conclude that at the moment the banking system is resilient.

Chair: Does anybody else want to come in on this point about financial risk?

Sarah Breeden: Perhaps I might say something about the position of households and corporates. Obviously households and corporates are seeing that their finances are going to be stretched—indeed, already are. In the FSR, we have tried to size by how much their balance sheets might come under strain from here. The analysis that we have set out suggests that we do not see risks to financial stability from the household or the corporate sector. There will be pockets of strain, but not widespread issues with the debt affordability. That supports the Governor's comment that the banking system is resilient.

Q132 **Chair:** In your view, is it less resilient than it was some months ago, given the direction the economy has taken? If so, how can you quantify that in any meaningful way? What are your thoughts around that?

Anil Kashyap: I will take a try at that. I would say three things. First, the framework we are using to evaluate the stability of the system did not need to be adjusted for covid or what has happened since the war. We have a robust enough monitoring framework where we can map things into the standard channels. If you judge it that way, the resilience is pretty good. We had predicted back in December that capital ratios would drift down a little bit for the banks, for a bunch of accounting reasons and other small technical points, so I don't think there has been a material change in the capital situation. We came up with a new metric to judge the household vulnerability, the so-called cost of living adjusted accounting for how much interest expense people would have and their capacity to pay interest expense. That still looks like it is well off the highs, if you want to put numbers around the things Sarah just talked about.

The big difference—the thing that Andrew started with—is that some of the markets look much more dislocated, while the banking system is relatively sound. The variability has probably changed, but I think the levels still seem acceptable.

Chair: Does anybody else want to contribute on that point?

Carolyn A. Wilkins: The fact that the institutions in the UK are in this position is a function of the hard work that we have done following the great financial crisis. The fact that capital ratios are as strong as they are, and that liquidity and the quality of the assets is still very good, speaks to the importance of the hard work that was done, and of the work of the FPC.

Sarah Breeden: That goes to what we try to do on the Financial Policy Committee. We try to build resilience to possible shocks in the good times, so that when the shocks occur, we can come here, talk to you and say that the system will be resilient to them. We built resilience in banks and in the household sector as well, and I think we will be grateful for those actions, if there is stress.

Q133 **Chair:** Thank you for all those reassurances. Governor, may I change the subject and switch to the financial services and markets Bill? The press has carried some reservations that you have expressed about the power of the Treasury to reach in, and, overall, about the PRA in certain circumstances. Is that something that concerns you? Could you tell us a bit about that, please?

Andrew Bailey: You know better than I do that the Bill has not been introduced into Parliament yet. I believe that will happen next week—

Chair: Oh, right. September.

Andrew Bailey: I am not the authority on Parliamentary process, so I may well be corrected at any moment, but that is the last I heard. Obviously, there are other things going on.

Honestly, we have not seen the Bill in the form in which it will, presumably, come to Parliament, so I cannot comment on that. I do not know what will be in the Bill on this point, but when we see the Bill, if it is relevant, I will be very happy to come to the Committee and give my views on it.

Q134 **Chair:** There has been speculation about calling in decisions and so on. What sort of things would cause you concerns and make you think that the independence of the PRA as a regulator had been interfered with?

Andrew Bailey: I can certainly put it this way: I very strongly agreed with the excellent report, if you don't mind me saying so, that the Committee produced a few weeks ago. Admittedly, that was in the context of the competitiveness objective, but there is a point in common with the point that you are raising.

The independence of the regulators is important, because much of our international standing depends on this. Our international standing is part of the competitiveness, in the best sense of the word, of the UK as a financial centre. I recognise that there are always degrees, but that is a key point. The best example of this is the reports that the IMF do every four years.

Sarah Breeden: Every five years.

Andrew Bailey: That's right, every five years—the so-called FSAPs. Recent FSAPs on the UK have emphasised that because the UK is one of the world's largest financial centres, it is "a global public good"—that is, it is providing a service to the world. To do that, of course, you have to have high standards, so that is an important point.

The second point I would make on the international side is on what I call the post-Brexit settlement of regulation. As I have said many times in this Committee, I don't take a position on Brexit per se, and it pains me to hear people occasionally alleging otherwise. Our job has, for some years, been to implement what the people of this country have decided. Part of the post-Brexit settlement and organisation of financial services is that people in other countries have confidence, not that we will keep the same regulations that they have, but that standards will be maintained. That is a very important part of people being prepared to keep markets open. I emphasise those points and repeat that I would be happy to come to the Committee and give evidence on the Bill.

Q135 **Chair:** Under what circumstances might it be reasonable for the Treasury to reach in, stop decisions being made, review things, and potentially even overrule what you are doing?

Andrew Bailey: Again, we are not drawing up the Bill, as you will understand, but I think there is a genuine issue to do with objectives that are within the remit of the legislation, and then other things can turn up that are not covered by the remit. National security is a good example that I think came up at this Committee when I was at the FCA. For obvious reasons, we do not have a national security objective—we could not have one; we cannot execute national security—but it occasionally came up in the context of a Russian listing some years ago. There is a process for handling that, but at the time, it was asked whether that process was sufficiently robust for the purpose. Of course, that is a very specialist and quite narrow point, and I am deliberately making the distinction between the whole area in our objective and the issues outside it that can occasionally come up.

Q136 **Chair:** You mentioned our report. From memory, I think we said that we had a concern that there could be undue interference via the accumulation of such accountability measures. Is that something that you are slightly twitchy about? We do not need the detail, obviously.

Andrew Bailey: Obviously, you are the experts on this. My general view on the structure is that it is a sort of three-legged thing. Parliament and the Government make the legislation, and give us the objectives. Of course, the Chancellor writes remit letters to me—and to all of the committees, actually—setting out in higher frequency how to interpret the remit based on Government policy.

To give you an example, the Chancellor wrote to me recently in the light of the change in the Government's position on investing in fossil fuel industries; that is fair enough. We then execute that remit; you hold us to account for it. That, to me, is a very cleanly defined allocation of responsibilities.

Chair: Okay. I think we have got the point—that is useful.

Q137 **Alison Thewliss:** I would like to ask a bit more about the impact on household debt. Governor, what is the greater risk to household balance sheets at the moment: the outlook for the economy more generally. or interest rates rising more than households expect?

Andrew Bailey: Let me pick out some points, and develop points that Sarah made earlier. You may have seen that in the report there are a couple of good charts on page 21. The first plots income spent on essentials by household income decile. It makes the point—as I have done in previous hearings—that the lowest income decile spends far more on essentials than others. You can see that very clearly in the chart. That is relevant now, as we have discussed, because the inflation that we are experiencing is so concentrated on the essentials—food and energy products, in particular.

The second plot on that chart is the savings ratio. It makes the point again that the savings ratio goes up with the income decile. The right-hand chart, which is, again, by decile, shows the distribution of debt, both total mortgage debt and total consumer credit debt. It shows that the lowest decile has the lowest debt. In some ways, of course, that is not a great surprise, but although I do not have the numbers in my head, I would say that that distribution has probably got lower as time has gone by. In my days at the FCA, we spent a lot of time cracking down on payday lenders and high-cost credit operating in that area.

Two things make the impact of this situation better: the Government policy on fuel bills, which is targeted at that lower decile, and various steps taken by the FCA and the Bank of England—the FPC. In particular, the loan-to-income flow limit on mortgages is designed to cap the distribution of highly indebted households. That will help, but it will not take away from the fact that this inflation is still hitting low-income households. There is the immediate measure of the Government's support measures, and there is a backdrop of lower debt levels.

Sarah Breeden: I will add to that to advertise charts 1.3 and 1.4 in the FSR, which show how highly indebted households are exposed to these future economic stresses. The picture is different across mortgages and consumer credit. Because consumer credit is already at relatively high interest rates, the fact that interest rates go up does not have as much of an impact on the number of highly indebted households as on mortgages.

The other thing that supports the impact of higher mortgage rates on highly indebted households is that many have fixed their mortgage rates. Back in 2013, only about 30% of mortgages were fixed; the figure is now 80%. It is only short-term fixed—two to five years—but there is a natural buffer there, which means the pass through of interest rates is on a slower burn. For that reason, and because of what Andrew said—the fact that we started with greater resilience and the Government's fiscal support—the position of highly indebted households at the end of 2022 is not very different from the position at the start of 2022.

Q138 **Alison Thewliss:** I have started to get some anecdotal evidence that people are starting to put their regular groceries on buy now, pay later or credit card debt. How widespread is that? How closely are you monitoring that? Do you expect that trend to grow, given the cost of living crisis?

Sarah Breeden: It is something that we have heard anecdotally. We are tracking it. So far, that seems to have been not at scale, but consistent with Andrew's discussion about the income distribution, it has not been seen more broadly. I would mention that, as you will remember from previous times we have talked to the Committee, households built up savings through covid. We have seen some of those savings reduced. That is another way of trying to manage through. We will continue to keep a close eye on this, to try to understand whether this is becoming a more widespread problem.

Andrew Bailey: Our regional agents have picked up some reports, particularly from consumer credit firms around the country, of some increase in customers wanting to rearrange payment schedules, which is another symptom and indicator that you would expect.

Sarah Breeden: In our discussions with some of the debt charities, that intelligence has come through—not huge amounts, but definitely a change on where it was.

Q139 **Alison Thewliss:** How closely are you monitoring the multiple debts that people may have? It might not just be a debt on one thing but multiple different debts. How well is that understood by the Bank?

Sarah Breeden: The data that we have on mortgages is good. The data that we have on consumer credit is good from certain areas. There are particular pockets that are harder to see and get good visibility on. That is something the FCA has been picking up—and is going to pick up—as part of regulating those bits of the consumer credit market.

Andrew Bailey: As you will know, the FCA is pursuing the question of the buy now, pay later sector.

Q140 **Alison Thewliss:** I am curious as to whether fuel debt is something that is being monitored. Do you have conversations with the energy companies to get a picture of where people are with that?

Andrew Bailey: We learn about that through the debt charities, because they tend to have quite good information about the mix of debts that people have. Back in my FCA time, when I spent time in the call centres with the people who spoke to consumers, they said that the mix of debt had shifted as we had clamped down on the payday lending sector to be more concentrated directly into utility-type company debt. People were not refinancing it, in that sense.

Anil Kashyap: The charts Sarah referred to give the flow version of what you were asking about, by saying, "Let's take all your income and try to parse out the parts that are committed." Fuel costs would be viewed as essentials. When they go up, that is built into the calculation precisely because we were worried, if this keeps going, about how much disposable income you are going to have left.

Q141 **Alison Thewliss:** When you gave evidence in January in your FPC role, you told us that we have come through quite a severe economic shock and not had a housing crisis or a mortgage lending crisis. How confident are you that we will get through this cost of living crisis without a housing crisis?

Andrew Bailey: I think that is where the mortgage measures that we have had in place for eight years are important, because they have sought to limit over-indebted households through mortgage lending. That is the combination of the loan-to-income flow limit and the affordability tools. We have just made a change on the affordability tools, simply for the reason that we thought they were duplicative. We have reduced it from three to two. We can observe through the shift in the mix of borrowing that that is having an effect, in terms of limiting the over-extension. That will really come into play now, because as interest rates go up—we can observe this in the data—it means that there is more headroom, wherever interest rates end up. It is important to be clear that, unfortunately, there will always be households who are affected at every level; I am deeply sorry for that. But it does mean that in aggregate there is more headroom.

Carolyn A. Wilkins: I think that these periods of real financial stress, whether they originate in the household or corporate sector, tend to go through the banking system at one point. The confidence that we have is, in part, looking at the data that the Governor was just speaking about, but also through the stress-testing exercises that we do. We try to model real tail events—things that are plausible but not close to the base case that the MPC comes up with. In those cases, we find that the banks are quite resilient. They have the capital liquidity to get through it. It is tough at an individual level, but for the system as a whole it seems manageable.

Andrew Bailey: Just to add to Carolyn's point, resilience is important for the stability of the system, but it is also important because it enables the banks to support customers better. A good example of that is the mortgage holiday arrangements that we put in place in the immediate covid period.

Q142 **Alison Thewliss:** Finally, to pick up on Sarah's point about the people who have savings accumulated and are on fixed-term mortgages, how long have people got, in your estimation, before those two things begin to run out, and what impact does that have?

Sarah Breeden: The modelling we have done takes into account what we know about when individual mortgagors' fixed rates come to an end. As I have said, 20% are floating and so will see that interest rate come through immediately. Of the 80% that are fixed, our data suggests that around a quarter of those will come off over the next 12 months or so. Of that 100% stock of mortgages, only 40% will see higher rates in the immediate period ahead. More of that will pass through next year, as other fixed rates come to an end. It is a broadly equal picture. Again, I just emphasise that our analysis suggests the share of highly indebted households will not go back up to anything like the pre-global financial crisis levels, so we have taken that into account in the analysis.

Andrew Bailey: It would take a big increase—above and beyond what the market interest rate curve thinks at the moment—for that to happen.

Q143 **Kevin Hollinrake:** Sarah, I think you referred to this earlier. In terms of corporate indebtedness, SMEs already have quite a lot of debt because of the covid crisis—£80 billion of debt and £47 billion in bounce back loans. They are now suffering the increased cost of doing business. How worried are you that SMEs and other businesses will be badly affected, and to what extent will that be? What impact might that have on the financial system itself?

Sarah Breeden: It is important to parse the corporate sector into its different bits. Let me talk about large corporates first. In fact, they have seen debt levels fall through the pandemic, so we are relatively reassured about the large corporate sector. SMEs, as you say, have seen their debt increase through the pandemic. A number of them were new borrowers who had not had debt before, but that debt was through the Government scheme, and that Government scheme is fixed-rate debt, not floating. It is at low rates—2.5%—and there are long repayment periods of six to 10 years, as well as the possibility of payment holidays.

All of that will mean that that debt will be somewhat insulated from here. However, the old debt—the non-Government guaranteed debt—is, in general, exposed to interest rates, it is a floating rate, and we will see that come through. We have seen a fall in the cash buffers of SMEs—much like the story we talked about with Alison about the household sector. However, again, what we saw through covid was cash buffers rise, so although cash buffers have fallen, they are not yet below pre-pandemic levels. All of that means there is likely to be some stress in the SME sector, but our judgment is that it has been shielded by the fact that much of the increase has been in Government-guaranteed debt. Importantly, the SMEs are not large borrowers from banks. They are less than a fifth of the banks' total. Again, to Andrew's point, while there may be some losses coming through, we do not think it will hit the resilience of the banks, which will enable the banks to continue to support their customers through it.

Q144 **Kevin Hollinrake:** Insolvencies are greater now than they were pre-pandemic, but you are saying they are not a worry for the financial system. Andrew, do you have any reflections on that?

Andrew Bailey: It is not a concern in terms of the resilience of the financial system, no. As Sarah was just saying, it is important that we have a financial system that, where appropriate, is in the position to support customers. The other thing that is interesting about the covid period—quite unusually in many ways, but I think it a good thing—was that there was quite a big increase in the number of start-ups during that period. That is actually quite unusual. Unfortunately, as we know with start-ups, there is a fall-out rate. The reason I say that is that the fall-out rate now is on the back of quite a big increase during the covid period, rather than the opposite.

Q145 **Kevin Hollinrake:** Sarah, you mentioned debt levels falling in a lot of the corporates, but certain sectors have been hit particularly hard—the airline sector, for example.

Sarah Breeden: Absolutely. It is a really great point. We are clear in the report that while in aggregate debt levels have fallen, the impact of this shock on different sectors will be uneven. We have done some modelling to look at which sectors are most exposed to energy price increases. We have looked at profit margins to see which are going to find it tough either to pass on price increases or, alternatively, end up financially stretched themselves. In consequence, the sectors that we call out in the report as perhaps particularly most exposed are transport, including airlines, and some areas of manufacturing.

The other sectors that we are keeping a close eye on are those that are going to be most exposed to the consequence of the household cost of living squeeze. Those that are in non-essential goods and services are likely to see their activity reduce, and that is the other area that we are concerned about. But you are quite right that the impact will be uneven across the corporate sector.

Q146 **Kevin Hollinrake:** What about impact across the regions? Have you looked in more detail at whether certain parts of the UK are more adversely affected?

Sarah Breeden: That has not come up as a factor in our analysis so far in terms of particular areas that are exposed.

Q147 **Kevin Hollinrake:** You mentioned manufacturing, and that is obviously more densely populated in certain parts of the country, isn't it?

Sarah Breeden: And in other parts of the country you have got restaurants and services. There is nothing in our analysis so far that suggests that there is a particular region that would be exposed.

Andrew Bailey: We get a lot of information from our agents, obviously, on that.

Sarah Breeden: So the sources of stress might be different, but it is stress more broadly.

Q148 **Kevin Hollinrake:** Sure. As you say, the increase in interest rates will cause some businesses a problem. I think you are predicting that, on interest coverage ratios, the number of businesses below 2.5 will increase from 36% to 46%. Again, you are not unduly worried about that.

Sarah Breeden: The point I would make is that it would take very large increases above and beyond the expectations in the market of where interest rates are going to go to take those levels back to their historical peak. So they will go up, but it would take another 200 to 500 basis points on Bank rate to get those numbers back to pre-crisis peaks. There is quite a lot of buffer there.

Q149 **Kevin Hollinrake:** Perhaps controversially, as part of the QE programme, you bought some corporate bonds. Generally, the price of corporate bonds has dropped a little bit because of various different factors. Have the ones that you bought dropped in value? Are you concerned about that?

Andrew Bailey: No. You are right that the market has moved. We have announced that we are going to sell the corporate bonds. They are, I should say, a pretty small part of the overall QE package. I expect we will be selling those over the next couple of years.

Q150 **Kevin Hollinrake:** And you expect not to lose money on them; you expect to be able to sell them for what you paid for them, or more.

Andrew Bailey: To be honest, we have not really started that process yet, so I am not going to put an estimate on where it will end up. We tend to look at overall QE cash flows; we do not particularly split it down by pieces of it. Of course, I should say that QE was never intended to be a profit centre.

Q151 **Kevin Hollinrake:** No. But would you sell them if you did take a loss on them?

Andrew Bailey: The P&L will not be a primary factor in our decision on selling.

Q152 **Kevin Hollinrake:** So, yes. Okay.

Can I switch to crypto-assets? That is a bit of a change of direction. A couple of weeks ago, we had a really interesting session as part of an inquiry we are undertaking with a few people from the Treasury, the FCA and the Bank of England. I think it is fair to say that we are probably a bit cautious about crypto-assets—

Andrew Bailey: That’s because we’re all too old to own them.

Kevin Hollinrake: Is that what it is? Well, these were not particularly young people—

Chair: Speak for yourself!

Andrew Bailey: I count myself in that.

Q153 **Kevin Hollinrake:** We were quite surprised that all six people, including two people from the Bank of England, seemed to be really optimistic about the future of cryptocurrencies and crypto-assets. What do you think about that?

Andrew Bailey: I may be treading on the toes of my colleagues at this point. I think you have got to be a bit careful about it—I don't think it is helpful to talk about them as a sort of homogeneous lump, as it were. You have to split them down.

There are two broad categories. There is what we tend to call unbacked crypto, of the Bitcoin variety, and then there are so-called—I emphasise so-called at this point—stablecoins, some of which turn out to be less stable than their billing. I would just say that if you put the word "algorithmic" in front of something, that does not mean it is stable. One of those just collapsed in the US a few weeks ago.

The reason I split them up is not just because they are differently constructed but because they play a different role. I regard unbacked crypto as essentially—in inverted commas—a "store of value", in terms of money. I say in inverted commas, because I am well known for saying that I don't think they have any intrinsic value, because there is nothing behind them. But they may have extrinsic value, in the sense that people want to collect them. I think it is important that people understand them as such.

Stablecoins are quite different, because they are intending to be, and being promoted as, money as a means of payment. The FPC has spent quite a bit of time in the last two years on the subject, because we see this as a very important part of the stability landscape, and the FPC has developed some principles on what it wants to see for those stablecoins that become systemic, in terms of their importance. A key plank of that for me is that they have to have assurance of value. When people make payments, or use something to make payments, they want to be assured that the thing they are using to make the payments will hold value. That is important.

Now, that is important in terms of the structure and design of these things. I am afraid that many of the ones that we have today do not fulfil that category as we would expect them to. So, there is a lot of work going on, both here and also internationally in the Financial Stability Board, to say, "What is the right framework for those things—for digital payment assets?", because I think it is critical that they are viewed as being robust and that people have confidence in them.

With the unbacked stuff, I think it is more a matter that you have just got to understand what they are. If you want to own them, please understand what you are taking on, because they are very high risk.

Carolyn A. Wilkins: Can I add something?

Kevin Hollinrake: Yes, you made a speech on it quite recently.

Carolyn A. Wilkins: It is one of my favourite topics. I agree with everything that Andrew just said. I would just add two points. One is that even if the assets were fine, you still need to think about how the ecosystem is working and what kinds of risks are building up. They are really familiar. What we saw in the unravelling was leverage that needed to be unwound, and that accentuates price movements. We saw liquidity mismatch, so there are fire sales, and that causes more problems. When customers are worried about a stablecoin being able to hold the peg, they run. We have seen that before in the traditional system, so it is new in some ways but not so new in others.

The second point is that if there is a sense of excitement or optimism about this space, part of it could be about the technology itself and what it could potentially enable, in terms of efficiency gains and increased robustness of what are largely just plumbing parts of the financial system; it is not that exciting, in that sense, but it could be more efficient. We know that the financial system in the traditional space is very inefficient.

If I could just add a third point, I was in Scotland on a regional visit and I spoke with some fintech entrepreneurs; it is a really exciting space and they just cannot wait for regulation. They think that to get safe innovation and innovation that will stand the test of time, clear rules of the game are absolutely necessary.

Q154 **Kevin Hollinrake:** Sure. You are probably referring to distributed ledger technology in that case—

Carolyn A. Wilkins: Yes.

Q155 **Kevin Hollinrake:** But people are not buying that, are they? They are buying some notional value of Bitcoin, which is kind of in somebody's head, isn't it?

Carolyn A. Wilkins: That's right.

Q156 **Kevin Hollinrake:** The Treasury has already set out that it wants to become a world leader in cryptocurrencies or crypto-assets. In fact, it is minting its own non-fungible token; nobody on this Committee can see how that will—

Andrew Bailey: I am not sure I can help you on that!

Q157 **Kevin Hollinrake:** Do you not think we are sending the wrong signals to people that this stuff has more credibility than, perhaps—

Andrew Bailey: I think the key principle is that there is no trade-off between innovation and stability. You can have innovation, but you can't trade off stability for that.

Kevin Hollinrake: Okay. In terms of the stablecoins—Terra LUNA—they are, as you said, not very stable at all.

Andrew Bailey: Terra LUNA, yes. It's a bust.

Q158 **Kevin Hollinrake:** Yes, exactly. The Treasury has published a proposal on stablecoin regulation. Are you working with the Treasury on that?

Andrew Bailey: Yes, we are.

Q159 **Kevin Hollinrake:** What will be the timeline or outcome for that?

Andrew Bailey: I think it is going to appear in the Bill. That is the intention. It is a big Bill.

Q160 **Kevin Hollinrake:** In the Bill the Chair is referring to?

Andrew Bailey: Yes.

Q161 **Kevin Hollinrake:** Okay. Have you come to an agreed point with the Treasury on what that regulation will encompass?

Sarah Breeden: Perhaps I might pick that up, Kevin. The Bill creates a legislative framework for the regulation of systemically important stablecoins that are not banks. In parallel to that, our colleagues in the financial market infrastructure area of the Bank of England are going to have to set out exactly what that regulatory framework looks like. The nuts and bolts of whether a systemic stablecoin can meet the FPC's expectations are going to be determined by what that regulation looks like, what assets back the stablecoin and how operational risk and fraud are assured. That work is happening in parallel. The FPC will be closely involved in that to ensure that it sets expectations.

Q162 **Kevin Hollinrake:** You say it is being determined. Will it be determined by you or by the Treasury?

Sarah Breeden: The regulation will be determined by the Bank of England, much as we were talking about before. The statute will create the legislation for regulation to happen, and what that regulation looks like in practice will be for our colleagues in FMI.

Q163 **Kevin Hollinrake:** So you are confident you have the levers at your disposal to regulate this stuff?

Andrew Bailey: Oh yes. There is a lot of ongoing work on that front. In fact, I spent part of the morning on that subject. So, there is a lot of work going on there.

Q164 **Kevin Hollinrake:** What about any systemic risks? We have just seen Three Arrows Capital go under. It had borrowed $650 million from Voyager Digital and $90 million from somewhere else. Lots of hedge funds and the like have leveraged to buy this stuff on the basis that it is a one-way bet, when clearly it is not. Is that a worry?

Andrew Bailey: Someone else might want to come in. Our judgment at the moment is that it is not systemic at the moment. That is also the judgment of the global Financial Stability Board, which Sarah and I have been involved in. However, if, as you rightly say, it goes on developing the way it has, it will become systemic. That, again, makes the case for regulating—we are getting ahead there.

Sarah Breeden: We put out a document in March that set out how we thought systemic risk might arise in the crypto world—whether that is from its links to banks, to systemically important financial markets, to the payments infrastructure or to household and real economy balance sheets. What we said in that report, as Andrew just said, is that we do not think right now that those risks are of sufficient scale or are sufficiently connected with the rest of the financial system to be of a systemic nature. However, if they continue to grow at that pace and the interconnectedness with the system increased, we thought that it would become systemic. That is why we are working with Treasury and working globally to make sure that we are putting a regulatory environment in place.

Q165 **Kevin Hollinrake:** Are we confident that money our banks are lending on the face of it to other financial organisations, which you might think are safe loans, are actually not ending up with something very risky?

Anil Kashyap: I do not think there is enough direct exposure that, if you tried to do a stress test, it could matter at this point. In some sense, you can think of us as having lived through a real-time stress and seen that it did not really make the system come close to buckling. What it did reveal was a bunch of these assets that claimed they were inflation hedges and they were uncorrelated—it turned out they were not. That was not good for them but not devastating for the financial system.

Q166 **Kevin Hollinrake:** Finally, I will ask about a central bank digital currency, which you are looking to explore in more detail. If there was one, and I am a risk-averse investor, I might prefer to have my money with the Bank of England than with a commercial bank. Why would I not just put my money with you, rather than taking my money out of my bank and putting it with the others?

Andrew Bailey: We have not taken a decision; let me be clear on that. However, it is a really good question, which I would approach from a number of angles. This goes back to what Sarah was saying about having to set the standards for systemically important stablecoins. There is of course a point—and your question goes to this—where we say, "Well, the standard that we want to see for a globally systemic stablecoin is so near to the one we would want to have for a central bank digital currency, which is the better option?" I think that is the point you are making, really. We will have to have that discussion.

By the way, a number of—one or two people who considered issuing global stablecoins have said to me in the past, "Well, if you were to issue a central bank digital currency, we would not necessarily issue a stablecoin, because, actually, we would use your coin or currency and get the benefits that we want." That is often the big tech companies, which really want to get data. They do not really want to run a currency, but it is a means to get data, to then put it to work. We will get to that question.

Just to be clear, if we were to go ahead with this, it is not our intention to enter the retail banking business, and I think that most other central banks are in the same place. What that means is that we would set up, if you like, a sort of platform, off which people who want to issue our central bank digital currency could do so. I think the technical term is a "wallet", and people could hold our currency within that. Now, we would then want to ensure that, obviously, it was interchangeable between those issuers, and that the issuers themselves were stable. However, we have no desire to go into the retail business. That is not the right place.

The final thing I would say is that we have to be clear on what effect this central bank digital currency would have on the demand for central bank money, and what that would imply for the financial system. At the moment, of course, any of us who want to hold central bank money can only do so by holding bank notes. Notwithstanding the fact that, although the use of bank notes has come down, the stock in circulation has not, there is a limit, obviously, to the number of bank notes we all want to have—I assume there is, anyway—there is a sort of physical and security limit that would not exist for digital currency in the same way. Another question that we are looking at is, "Well, if we were to go down this road, would we therefore put a limit on each person's holdings of it, and how would we do that to make it robust?"

I will finish by saying that we must consider the implications of this central bank digital currency for the stability of the system, both in normal times and in stress times. If you made it easier for people to run to central bank money, which I think you would do if you did this, then what would be the implications? We must think those things through at this point.

Q167 **Kevin Hollinrake:** Sorry, I am running out of time, Chair. However, the intention is therefore that, as a retail investor or a normal saver, I could not partake in this; it would only be available to other intermediaries. Is that what you are saying?

Andrew Bailey: No. Your bank would be able to issue them—the principle is that you would get it through your bank. You are not going to get it directly from the Bank of England because we are not set up to do that; I do not think it is appropriate and it is not the right role for us anyway. It is still the same thing; it is still central bank money, but it depends on how you get it.

Q168 **Gareth Davies:** Governor, I want to briefly ask about global debt vulnerabilities to the UK, if I may, and to just draw out some of the points that were made in your report. One of them was about the eurozone and the levels of net public debt. I think it described the UK as vulnerable to the debt that is piling up in the eurozone. You described it as a "material risk" to UK financial stability. What in particular are the spillovers into the UK financial sector from the eurozone?

Andrew Bailey: We do look at debt levels around the globe, in terms of risks to UK financial stability because, again, we have a highly international financial system here, a highly international banking system. We have highlighted corporate debt levels in the US, we have highlighted China and of course—you are right—public debt in the eurozone. In the case of the UK banks, it is not so much direct exposure; it is what would happen if there were a debt problem, and how that would spill over through macroeconomic channels. That is the thing that we keep a close watch on at the moment.

Q169 **Gareth Davies:** How does the UK compare with the eurozone at the moment in net public debt?

Andrew Bailey: The eurozone is not a single entity in that sense. It has quite a strong mix of countries with very different debt levels in it. UK debt levels would fit within that, but they are not at the extreme end by any means.

Q170 **Gareth Davies:** Anil, may I ask you about the US corporate debt market? The Report also flagged that as a potential risk to the UK. What is your view of likely defaults in the US corporate debt market?

Anil Kashyap: We have been talking about this for some time. It does seem that—even in a base case, if you look at what might happen to interest rates almost on a central path that the market has priced in—the corporates that will see their coverage ratios rise is going to be substantial. I think the number we had was moving from something like 30% of borrowers to about 44%—the all-time peak is 50%. That is under the central path, but suppose the Fed ends up doing a little more—so yes, that is a material risk to the US. Depending on which members of the committee you asked, we are worried about global slowdowns in growth coming from various places—we called out China, we are right next to the euro area, and a hard landing is very much a possibility in the US. If that does come to pass, the corporate sector will probably be close to the scene of the crime.

Q171 **Gareth Davies:** How exposed is the UK to that?

Anil Kashyap: Not directly. Again, it will not be the lending that we have done from banks here; it will just be that, if the US gets a cold, everyone else will have the sniffles. It is an indirect link. It is not baked in, by any means, but I don't think we are talking about a tail risk if you talk about the possibility that corporate debt becomes a drag on growth in the United States.

Sarah Breeden: I will add one thing on UK banks' exposure to highly levered US corporates: that has been part of our stress test, which we looked at in some depth. To Anil's point, it is less about the resilience of the UK banks to the direct exposure; it is the broader economic environment that might cause issues.

Q172 **Gareth Davies:** On that point, Sarah, you mentioned the Chinese property market in particular. When I read that, I thought it was specific. Will you just broaden on that and say, in the context of the UK, how worried should we be about the Chinese property market?

Sarah Breeden: China has been a country that we have called out as a specific area of concern for some time. Debt levels in China have risen very substantially, and obviously a number of UK banks have significant operations in Asia. What we were concerned about was whether the stress in the Chinese property market might lead to a broader fall-off in economic activity in China, which would then be a concern more broadly. Our judgment is that the kinds of stress that we are seeing in the Chinese property market right now are well within the sorts of stresses that we have applied to UK banks. We will continue to monitor it, but so far it has not led us to be more concerned.

Andrew Bailey: It is worth saying that it has always been a focus in our stress tests, because of the exposures. We have announced that we are starting our next test in September, so I am pretty sure it will feature in that as well.

Anil Kashyap: One of the things that we had in our December FSR, which was stunning, was how many of the properties that had been bought were owned as second and third properties. That is very scary. That is kind of peculiar to China.

Q173 **Gareth Davies:** Last question. If we zoom out from the Chinese property market, you list a number of potential shocks, everything from commodities to geopolitics—coronavirus, domestic price pressures and "others" also listed as potential shocks. How do you prioritise those? What are you most worried about in terms of shock to our financial system?

Sarah Breeden: It is our job to keep an eye on all of them in different ways, reflecting the different nature of the UK financial system exposure to them. We are concerned about European exposures, because of the obvious economic links; the US financial markets are core to financial stability globally; and China is significant as a source of growth for the world, and because two of our banks have significant operations in Asia.

Andrew Bailey: One of the things that our staff have spent quite a lot of time on—and always will, I suspect—is building analytical frameworks, which allow us to assess these things one against another, given that they are all different. It is an apples-and-oranges issue, but it is important from our point of view that we have a framework of reference—

Gareth Davies: That is what I am getting at. How would you rank them?

Andrew Bailey: Adding a range, one against another. Do you want to say anything?

Sarah Breeden: We looked to capture those in the stress test and to understand which of them would have the most significant impact on the resilience of UK assets—

Q174 **Gareth Davies:** And what is the answer?

Sarah Breeden: I think China is a significant contributor and, from financial markets, the US would be the most significant. It depends on whether you are interested in bank resilience or financial markets.

Andrew Bailey: It is interesting. To give you an example, there is a reasonably well-known framework called GDP at risk. The clue is in the name—it attempts to say, "How much GDP do each of these particular vulnerabilities put at risk?" We have worked on this for some years. That framework produced quite a high weighting for global debt, but then you have to lift the bonnet up and ask, "What is going on in here? Okay, interesting. Yes, noteworthy"—what is driving it? These things are not, or should not be used as, black boxes.

Gareth Davies: Okay, I will leave it there, but it is an interesting line of inquiry, to see what our exposure is.

Q175 **Dame Angela Eagle:** Governor, the report noted problems around commodity markets, including concentration of risk, interconnectedness and opacity. It did not mention sanctions. Are they another one?

Andrew Bailey: Let me slightly broaden that out. Sanctions are relevant in the sense that the events that really put the commodity markets under the spotlight were linked to the outbreak of the Russian invasion of Ukraine, and sanctions are part of the story of that. So, it is not directly about sanctions, but about the issues caused by the disruption to commodity markets following Russia's invasion of Ukraine.

Q176 **Dame Angela Eagle:** The commodity markets we are talking about there—are they things like grain, oil, fertiliser? What are we talking about?

Andrew Bailey: To give you the history, in the immediate post-invasion period—I am talking about March—it was more concentrated in energy markets. We also had the nickel market issue—

Q177 **Dame Angela Eagle:** Was that related to Russia?

Andrew Bailey: It is definitely related. The war is part of that story. There was a very big short position in that market; it is not related directly to the war, but involves a Chinese company. Part of the big movement in nickel prices, and prices in a number of other metals, was related to the invasion. Obviously the question becomes, "Who are the major suppliers of these metals around the world, and what part of it is coming from Russia or Ukraine?" Russia is a nickel supplier, that is true, so that was a shock to the market. Agriculture has been more of a focus in recent times, but not with the same level of stress.

Q178 **Dame Angela Eagle:** Although that would affect global food prices, and the social situation of a lot of people, who may be starving. That is not likely to cause security and predictability, is it?

Andrew Bailey: No, and one of the reasons why we were keen to look at the agricultural side of the commodity market was that, obviously, if there is financial stress in that part of the market, that will add to an already difficult situation, which we do not want.

Going back to March for a moment, and to energy, we saw very big and volatile movements in energy prices. Probably the biggest were in gas, but oil was also experiencing big price movements. In the markets that trade these commodities, and trade derivatives in them, that leads quite naturally to big margin calls on contracts. Those margin calls, where they are traded on exchanges, are initially largely to the banks that are members of the exchanges, but then they go down to the next level, which is often the big commodity trading firms. I have to be honest: that is quite an opaque part of the financial system.

Q179 **Dame Angela Eagle:** By that, do you mean that you don't know who owns those companies?

Andrew Bailey: No, we know who they are.

Anil Kashyap: They might have a situation where they have traded some stuff that is in an exchange, where we can see that it has cleared. They might have a hedge that is over the counter in a jurisdiction that we cannot see, and another hedge that we can see part of—

Sarah Breeden: And a physical commodity in a ship, moving.

Anil Kashyap: So trying to aggregate and get the full exposure is very difficult.

Andrew Bailey: And they are not UK-based companies, but obviously we have a big interest and there are markets in this country. My concern at that point was that there were big margin calls on these companies, which were obviously necessary because of the change in risk. To meet those margin calls, the companies often had to raise credit. If the credit was not forthcoming, that could have led to a fracture in the system that would have had very difficult financial consequences. It did not happen in the end, but it is into the near miss category, I suspect.

Q180 **Dame Angela Eagle:** You mean the metal—the nickel?

Andrew Bailey: And the energy.

Q181 **Dame Angela Eagle:** What do you think can be done to shore up the capacity of the system to survive those kinds of shocks in future?

Andrew Bailey: As you may have seen in the report, we have done a lot of work on this. By the way, the report includes a great chart on page 59; it looks extremely complicated, but it attempts to make a stylised representation of the system. It seeks to draw out "a complex range of interlinkages between commodity markets and the financial system". We are feeding this work into the global Financial Stability Board. The real work, in a sense, has to be done there, because these are international markets, not domestic ones. We think, and many of our international colleagues agree, that it is very important that we get to the bottom of this matter and understand where the weaknesses are in the system. We can then, of course, decide what we do about it.

Sarah Breeden: Might I add one other thing? One of the areas where we have been doing joint work is the gas market. We have been working with Ofgem, which obviously knows the energy suppliers and so has a better understanding of that bit of the market. We can put the physical commodities and financial commodities markets together. For some bits of the commodities market infrastructure, there is no Ofgem equivalent—the oil market, for example—but we are linking up with domestic regulators where we can.

Q182 **Dame Angela Eagle:** I am not sure that that gives me a lot of confidence, since Ofgem made a hash of dealing with the gas markets. There was the £4.6 billion cost of the failure to regulate the energy market properly; the failure of Bulb; and the decision to create false competition, through which we lost an awful lot of money, although the middlemen who set up the companies took an awful lot out of that. Is that really a good position?

Andrew Bailey: I do not think we can really comment on that, if you don't mind. That is not our remit.

Q183 **Dame Angela Eagle:** But it is regulatory failure in that market that led to this outcome. That happened because of a view about competition that did not turn out to be enormously accurate.

Andrew Bailey: That is not really for us to comment on. I can give you an example of a case where we worked closely with Ofgem—the case of a company supplying gas from Russia to Europe. There was quite a critical UK dependency there. We offered our experience of resolving banks, and to help come up with the framework by which this was eventually sorted out, because we have a lot of experience, unfortunately, of dealing with problems in the banking system. We can help there, but we are not involved in what I would call UK energy supply issues.

Q184 **Dame Angela Eagle:** We have an odd thing going on: somebody who is Chancellor is running around TV studios announcing huge tax cuts across the board, outside a Budget—cuts of £50 billion at the last count. When it comes to financial stability, we have always talked about how stable our political system is, but it seems to have gone a bit mad recently. Does that potentially impact on financial stability?

Andrew Bailey: First of all, it would be entirely inappropriate for us to be involved in the choice of the next leader of the Conservative party; that is for others.

Dame Angela Eagle: I did not ask you to give an opinion on that.

Andrew Bailey: I think that the question was trying to head in that direction. Obviously, it really would not be appropriate for me to say anything about that.

Q185 **Dame Angela Eagle:** But normally financial policy and fiscal policy, which you have to take account of, is done in Budgets—not in Tory leadership elections by an existing Chancellor. I care less about what the other 15 or 20 candidates, or however many there are, think about this, but I care about somebody who is actually the Chancellor running around doing it. That can move markets, can't it? That can cause problems.

Andrew Bailey: I do not like offering views on the constitution. I do not think that things that should be done in Budgets can ultimately be done outside Budgets. Obviously, all of you have all sorts of views on these matters. I do not really think that I can go beyond that.

Chair: Very good. Can I come to Emma, please?

Q186 **Emma Hardy:** Afternoon, everyone. On the eight main banks—Barclays, HSBC, Lloyds, Nationwide Building Society, NatWest, Santander, Standard Chartered and Virgin Money UK, what would happen if one of them failed? Could the Bank of England resolve it without costing the taxpayer, and without disruption to the financial markets or the economy?

Andrew Bailey: Recently, as I am sure that you have seen, because it refers directly to this, we published our first resolvability assessment framework. That is important, because for a long time we have made the commitment to the Committee that we would end "too big to fail". The bottom line is that we think we have; we do not believe that the failure of these institutions, from now on, would require public money. That is, to me, the critical plank of the policy on "too big to fail". That was a very detailed and important piece of work. That is the key message.

For each institution we picked out things that they need to improve, because the devil is in the detail on this stuff—not because we think that it would prevent resolution but because it could be done much more easily. Having done resolutions myself—Sarah has done lots of them—I know that you have to keep working on it.

The second really important thing—there is nothing radical about my saying this—is that we cannot say to you that we have ended "too big to fail" for all time because the world moves on and things change. Ending resolution today, we are going to rerun this exercise in 2024 and do it again. The world will have moved on, things will have changed and we have to keep them up to date. I envisage that we will just have to go on doing this for good. We have to be able to say to you—and to ourselves, indeed—that they are resolvable as of today.

Q187 **Emma Hardy:** As you mentioned, there is obviously a bit of a mixed bag—some have more work to do than others in your report. Did you find similar problems across the board?

Andrew Bailey: There are common elements. To pick out some of the things that we referred to—they have these things in varying degrees: the ability to access the necessary data to support the so-called valuation process for a bail-in; and the way in which they can mobilise collateral to maintain funding in resolution. I had direct experience of that during the financial crisis, when we were having to do loans at very short notice. It is great when they come in and say, "Here's evidence of the collateral"; it is not so great when they say, "Hmm, well—that's interesting. We're not sure we have a system to deliver that."

Contract continuity—again, with a bail-in, you don't want anything in there that falls over at that point because they have written a contract that is triggered by it. It is the same with operational continuity and access to financial market infrastructure. These are the things we are going to be taking forward and getting them to make more progress on.

Q188 **Emma Hardy:** You mentioned that you are going to reassess in a couple of years' time. What are you going to do to basically keep an eye on them in the meantime, to make sure that they are addressing some of these issues?

Andrew Bailey: They will be hearing rather more from the Bank of England's resolution division than they would want to. Again, we have issued letters to each of them, which we have published. We expect progress.

Q189 **Emma Hardy:** So you are going to be regularly keeping up to date with them?

Andrew Bailey: Yes.

Q190 **Emma Hardy:** How are they co-operating? What can you do if they do not? Is there a difference—do some co-operate more than others?

Andrew Bailey: They have been very co-operative; there has been no problem about co-operation. There are the things that I listed off—some of them have better systems than others in terms of their underlying IT and some have more work to do than others. If they did not co-operate, we would use our powers as a supervisor.

Q191 **Emma Hardy:** How does what you are doing here in the UK compare to what other countries are doing to resolve the same issues?

Andrew Bailey: Anil may want to come in on this. The US has done something a bit similar. I think the US always has to wrestle with the multi-agency problem. We are probably in a bit of a better position because we have resolution and regulation in the same institution, and we can work together. What do you think, Anil?

Anil Kashyap: There has been this global agreement towards this MREL that has got everybody with some debt that can be bailed in. That is a similarity everywhere, but then the particulars of the way bankruptcy laws work and the question of who triggers some of these things can differ. The FDIC would go and do the clean-up, but there is also the primary supervisor side. That complicates it, but the general idea that there ought to be something standing between the taxpayer and—more than just the common equity—is pretty big.

The stress tests are absolutely essential. If anybody were to almost fail the stress test, they would immediately have to turn off their dividends. If you look back to 2008-09, US banks paid out something like $125 billion after Bear Stearns. The spigot was still on; there was no way to stop them. That would never happen now. You would like to think that you would catch this stuff sooner and have more scope, but until we see one of these—in the US, I am not sure; I am much more confident about the framework here, because it is all basically in the same building, but no finger pointing.

Carolyn A. Wilkins: I was going to say, for Canada, that I see a lot of similarities in the overall approach, but also in the lessons. Canada's framework is a bit different, because the central bank does not do resolution of banks—that is done by another authority—but this idea that each institution has to improve its plan continually, that this is a dynamic plan, is really important. Actual resolution requires co-ordination and co-operation across a number of agencies, so not only do you have to plan, but you have to practise—to go through tabletop exercises and other things, realising how you need to improve. The work that has already been done has taken the UK in a really positive direction, and I am happy to see that, but it is never going to be viewed as mission accomplished.

Q192 **Emma Hardy:** No. As highlighted, a lot of the firms are international; they are not based solely here in the UK. How does your resolvability assessment framework deal with profitability concerns that could happen overseas, but impact here domestically?

Andrew Bailey: That is a very good question. We work closely. We identify, for each bank, the key authorities that would need to be involved in any resolution—we run what we call resolution colleges. It is critical of course that everyone understands what is going to happen, how it happens and who takes the decisions, because you cannot get to the night of a resolution and sit down saying, "I've not met you before." That is a critical part of it—that everyone understands their roles.

Q193 **Emma Hardy:** By everyone, do you mean international organisations?

Andrew Bailey: That is predominantly our fellow regulators and central banks around the world. For each bank, depending on the pattern of their operations, we would have a different configuration in terms of the college.

Sarah Breeden: Perhaps I might add to that. In previous roles, I have been the executive director responsible for UK banks, and the executive director responsible for international banks, so I have been a part of these resolution colleges with home and host hats on. As Andrew said, there are different individuals around the table for discussions, reflecting the different footprints of each of the groups, but the key is that the information on resolution planning is shared in good times, with tabletop exercises in good times, in order that if ever such a stress arose, we would not be doing it for the first time.

Q194 **Emma Hardy:** Okay. You looked at the eight major firms, but are you looking at resolvability for smaller firms as well?

Andrew Bailey: Yes, we did. We have a resolution toolkit, which the resolution legislation has enabled. The smaller you get, the simpler the resolution becomes, fortunately. We have been confident for quite a while that we can deal with the smaller institutions. There is a trigger—Sarah mentioned it earlier—in terms of size, beyond which they have to hold MREL, which is the additional tier or slice of debt that can be converted up into capital. When you go below that tier of banks, into the small banks, you are much more confident that you can resolve them using existing, fairly standard legal processes, because they are simpler institutions.

Q195 **Emma Hardy:** My final question is about the worst-case scenario. What happens if more than one bank fails at the same time?

Andrew Bailey: I have always taken the view that with bail-in, where you are bailing private creditors in and converting this slice of debt into loss-absorbing capital, the bank is not failing. This is the key thing, in the sense that you have to get in and sort the bank out before there is any disruption. While it would be a lot of work—there would be lawyers everywhere—you could do it. It's a little bit like the recapitalisation that we had to do in October 2008 for the major banks, which the Government did and we worked very closely with them. You are not trying to deal with an individual failure and with all the consequences of it. You are saying, "Okay, if you get into that situation, we are bailing in your MREL slice." You could do that. Provided you go back to the points I made earlier and you have got what I call operational issues under control, you ought to be able to do that.

Q196 **Emma Hardy:** So you are quite confident.

Andrew Bailey: Well, we've been there. We have had the experience. This is a different world to the one we had in the global financial crisis, as Anil was saying.

Emma Hardy: Thank you.

Q197 **Siobhain McDonagh:** You have kind of acknowledged that the Bank of England is aware that there is a Conservative party leadership election.

Andrew Bailey: I read about it, obviously.

Q198 **Siobhain McDonagh:** Great. You might also have noticed that they have pledged £235 billion in tax cuts, or roughly one and a half times the annual NHS budget. What would be the inflationary impact of £235 billion in tax cuts?

Andrew Bailey: I am afraid I cannot do that question in my head. We condition our view of monetary policy on announced Government policies, so we will do that, but I am afraid we are not going to run through individual candidates' ideas.

Q199 **Siobhain McDonagh:** I am not asking you to do that.

Andrew Bailey: I don't know is the honest answer.

Q200 **Siobhain McDonagh:** Okay. Obviously, this money has to come from somewhere. Either we are going to cut the NHS for 18 months or perhaps we would borrow the money. What would be the impact of an additional £235 billion in Government borrowing?

Andrew Bailey: I think that is a question for the Debt Management Office ultimately. Again, I am sorry, but I cannot do off-the-back-of-the-envelope fiscal impact calculations for monetary policy. Once we have a Government that has a programme and a Budget, we can do that.

Q201 **Siobhain McDonagh:** What do you think would be the impact on the cost of living crisis of £235 billion extra—

Andrew Bailey: I'm sorry, I can't—

Q202 **Siobhain McDonagh:** Do you think it would be a good thing for the cost of living crisis?

Andrew Bailey: I am not going to answer that question. I am not going to get involved in the choice of the next leader of the Conservative party.

Q203 **Siobhain McDonagh:** I thought you might be able to offer a few professional words or guidance—

Andrew Bailey: I think it is entirely necessary that I do not do that. I am an observer of it and nothing more than that.

Chair: You have learned from your previous appearances.

Q204 **Siobhain McDonagh:** It was fair to have a go—*[Laughter.]*

Andrew Bailey: I didn't choose a career as a politician.

Chair: Sorry, Siobhain, did you—

Siobhain McDonagh: That's it, Chair.

Chair: It was short but memorable.

Siobhain McDonagh: Best way to be.

Chair: We will go to Anthony.

Q205 **Anthony Browne:** I will cut to the chase. Would you like to come out in favour of any candidates? *[Laughter.]*

Andrew Bailey: I am sure you are all enjoying yourselves.

Q206 **Anthony Browne:** I have two sets of questions. The first is about the UK countercyclical capital buffer.

Andrew Bailey: Ah, now we are down to serious business.

Anthony Browne: It is what my constituents write to me about every day. I have a couple of questions about the problem of central frameworks for financial regulation and the small banks, which you are currently consulting on. On the countercyclical capital buffer—

Andrew Bailey: It is hard to say, actually.

Q207 **Anthony Browne:** On the CCyB—the countercyclical capital buffer—we have gone through a cycle. You cut it at the beginning of the pandemic and you have now announced it is rising to 1% by December this year and then to 2% next year. What has been the impact of that? Is there evidence that it has actually worked in terms of promoting financial stability and economic growth?

Andrew Bailey: I am sure colleagues will want to come in on this. The answer of course is that we have been through a very large shock, and we have had a very resilient banking system. The reason for that is not only because it has got more capital, but we have got a structure that allows that capital to be put to use, and that is important. I think the last two and a half years have demonstrated the benefits of this.

In terms of the decision that we took in this round to get back to 2%, our view is this. We do an assessment of what we call the risk environment. Back towards the end of 2019, when we first intended to move to 2%, we concluded that a "standard risk environment" was, in the current setting, consistent with a 2% CCyB. That does not mean that 2% is always the number, but a standard risk environment is consistent in the current setting with 2% CCyB. To go back to the original question at the start of the hearing, we have seen an increase in risks, but we still think the environment is consistent with a standard setting. We think it is important to build resilience at this point in time, but as we said in the language, we are prepared to move it either way, depending on how things pan out.

The situation at the moment is that we are not at a point where banks are realising large losses. We have seen an increase in impairment charges for the first time—was it the first quarter?

Sarah Breeden: Yes.

Andrew Bailey: So about £1 billion in impairment charges. Those are the modelled impairments that the banks produce. That was a sign of a turnaround, because over the previous four or five quarters, I think, they had been going the other way.

Sarah Breeden: That's right.

Andrew Bailey: But we still think we are in a standard setting. The only thing I would add—this was not relevant to the decision, but it is worth noting—is that the banks have the capital, so in many ways we were taking a decision to lock in capital that was there.

Sarah Breeden: If I might add something about our experience of having released the buffer during the crisis—

Q208 **Anthony Browne:** That was my question. It is quite a new thing—has it worked?

Andrew Bailey: Yes.

Sarah Breeden: That's right. What we saw through that period is that the banks were willing to support their customers. We had very significant draws on revolving credit facilities—tens of billions. We talked earlier about the payment holidays that they gave to households.

As a general rule, through the period of the covid stress, we saw banks supporting their customers. There were particular areas where they might not—where firms were outside risk appetite—and the Government came in to support their lending. What we saw through that was that the release of the countercyclical capital buffer gave them confidence that there was sufficient distance from the point at which things would happen to them, in terms of having to put restrictions on their business to enable them to use their capital to support their customers.

There is an international exercise happening at the moment, Anthony, through the BCBS, which is looking to compare activity across different countries. We will get a better read on this answer when that exercise is complete, because other countries did not have a CCyB to release in the same way, so we will be able to more fully answer your question at that point.

We did release the CCyB, banks were able to support their customers through it, and there are other aspects of capital stack where we have seen banks be a bit nervous about using their buffers—the Basel buffers. They are less willing to put those to work, in our experience.

Q209 **Anthony Browne:** To come back to the question you yourself answered, Governor, you are putting it up to 2%, and you said that you think that risk is normalised now, but there is obviously widespread concern about economic performance in the coming year. We could be going into recession again—you yourself have commented on that in the past. Isn't there a risk that raising the countercyclical capital buffer now will reduce the ability of banks to lend? Isn't it procyclical, rather than countercyclical?

Andrew Bailey: That's why I emphasised that we stand ready to move it either way if conditions change in that direction. Of course, as we have demonstrated before, we don't wait until it is actually in place; we can take the decision to vary it at any point in time.

Q210 **Anthony Browne:** So what would prompt you to row back from the 2%?

Andrew Bailey: I would go back to the risk framework. I made a point earlier that the risk framework is currently standard, but if we saw a change to that assessment of the risk framework, we would change our view.

Sarah Breeden: The way I think about it, the countercyclical capital buffer is released so that banks are able to absorb losses and continue to lend. If we are seeing very large losses coming through and unwarranted restrictions on lending, we are unlikely to be in a standard risk environment. We are more likely to be in one where it is appropriate to release.

Andrew Bailey: We also have to think about this in a framework where we now have—as you will remember, Anthony—expected loan loss provision through our IFRS 9. We have to think about that in a coherent framework.

Q211 **Anthony Browne:** One of your deputies, Sam Woods, gave a speech in April this year in which he recommended changes to the countercyclical capital buffer, inventing the term "global Bufferati", which I thought was quite amusing. He suggested simplifying it, but as far as I can understand, his recommendation is to effectively merge all the different capital regimes into a bigger one. It seemed to me a bit like universal credit merging all the different benefits together. Are you in favour of reform of the countercyclical capital buffer, and what would you like to see?

Andrew Bailey: First of all, any reform to this would have to be agreed internationally. Sam made an important point: we currently have a very complex capital structure. It has grown in a highly complex way. Sarah made the point that we have had experience, and some buffers are more usable than others. The essence of Sam's proposal is to merge these buffers into a single buffer.

Then you would have to have a graduated response from our side in terms of rateability, but the key element of that is that the stress test would become more important, because it is the stress test that we use to calibrate the buffer. Sam floated the idea that maybe you could have a lower minimum capital level if you had a larger buffer with more transparency around it, which is a really interesting idea. You would then be putting more emphasis on the stress test, which is also an interesting idea and has potential.

To Sarah's point, if we made this thing simpler and more transparent, would the banks and the markets—because obviously the banks look to the markets, who value the banks—feel that it is easier to use the flexibility in the system than to use a complex system of the nature of the one we have today?

Sarah Breeden: Perhaps I might add two thoughts. I think Sam put the speech out to prompt debate. It is great that we are having the debate here, but it is, as Andrew already said, really important to do this internationally. Secondly, we found similar issues with the use of liquidity buffers as well: banks had liquidity ratios well above 100% but were reluctant to use their buffers. We put out a discussion paper on this topic, in large part because—to Andrew's point—it is not just about us and the banks' views. We need to know what the market thinks of these issues as well, because how the market perceives the safety and soundness of individual institutions will matter a lot to how they use the buffers or not.

Q212 **Anthony Browne:** I am just wondering what the objective is here. As you say, the regime is complicated, which it obviously is, but are there particular problems that you are trying to address?

Andrew Bailey: I think the issue is: do the words and the music match? We created this buffer structure. We have often used the language, "Buffers are there to be used." The question is whether they are as usable as our headline suggests they are.

Q213 **Anthony Browne:** If banks are resistant to using it, because they are not able to pay out dividends, there is no point in having it.

May I move from complexity to simplicity, and on to the "strong and simple" framework that you are consulting on at the moment? I think you yourself are probably not working on it.

Andrew Bailey: It is Sam again, actually.

Q214 **Anthony Browne:** Your current consultation is on the definition of a simpler regime. At a high level, what are you hoping to achieve here? What will the impact be for end consumers?

Andrew Bailey: The background to this is as follows. The Basel regime has always—from day one, back in the 1980s—applied to so-called internationally active banks. For the big banks, you get Basel, as implemented domestically. Some regimes have, as the EU has done, applied Basel across the whole shooting match, so everybody gets Basel. Others have not done that.

Anthony Browne: America.

Andrew Bailey: Yes. They have got domestic regimes for small, non-internationally active banks. But the EU did not do that.

Brexit obviously gives us the opportunity to re-think that and ask, "Do we wish to devise our own"—as Sam put it—"strong and simple domestic regime for small banks?" That makes it simpler and, frankly, less costly for small banks to manage it, and also gives us the chance to simplify the regime, which has benefits for us. That is the germ of the idea that Sam has put out: we could do that now. I am speaking for myself now, and I think that there are considerable attractions in doing that.

On your very good question about the advantages of doing that, it could well help competition, for instance, because it would be a simpler regime for new entrants to adhere to.

Q215 **Anthony Browne:** Do you think that it would simply be a reduction in the administrative burden for small banks—these are complicated rules for them—or is that small banks can be required to be excessively capitalised at the moment, and are required to have more capital than is necessary for their financial stability?

Andrew Bailey: Certainly, for small banks, some elements of the regime are excessively complex. Basel does have variants, but it is somewhat a one-size-fits-all approach—certainly if you are on the standardised approach.

Q216 **Anthony Browne:** Do you think that some smaller banks will as a result be required to have lower capital than at the moment under the current regime?

Andrew Bailey: Not necessarily. One of the big lessons from the financial crisis was that—if you go a long way back in time, we used to have higher capital requirements for small banks than for big banks. That was on the basis that small banks could suffer idiosyncratic problems, which they can because they are less diverse, so they needed greater buffers to meet that—bearing in mind somewhat that there was no resolution regime.

The problem with the financial crisis was that it was the big banks that failed, and the fact that the big banks had lower capital than the small banks was not only no help but a positive disservice. The whole balance has swung the other way, if you like. The whole aim at the moment is that the small banks do not have that, so they do not have the same buffers that we have been talking about.

Because we have not yet really fleshed out the strong and simple regime, I am not going to say, "It would mean this in terms of aggregate capital relative to where they are today." I would be much more confident at the moment of saying that it was a simpler regime and therefore a less costly regime for them.

Q217 **Anthony Browne:** You are not, I believe, a "no failure" regulator. Would you be prepared to see small banks fail?

Andrew Bailey: Well, yes. The philosophy of the PRA from day one was that we are not a no failure regulator. I could go on about this subject at length. It is sometimes challenging, if I am honest with you, because of the way in which failure is viewed. There have been hardly any bank failures in the modern, post-crisis times.

If we go down the "strong and simple" route, that should be a matter of debate. That is, frankly, a much bigger issue to do with where society wants to pitch its tolerance for that sort of thing happening.

Q218 **Anthony Browne:** You might get complaints from politicians if a small bank fails.

Andrew Bailey: Yes, actually.

Q219 **Anthony Browne:** The current consultation you have out is about the definition of "simpler-regime firm". You suggest a "maximum…of £15 billion of total assets" for simpler banks that -do not do significant trading and so on. Why have you chosen £15 billion? The level for MREL is £25 billion. Why do you not simply align them, say that a simple bank is a simple bank, and then have quite a generous upper limit?

Andrew Bailey: We can look at that. Obviously, there are various thresholds in that world—there is a ring-fencing threshold as well. We are very much at the consulting stage at the moment.

Q220 **Anthony Browne:** So are you open to views on that?

Andrew Bailey: Yes, we are genuinely open to debate on it.

Anthony Browne: We will be doing an inquiry on the matter.

Q221 **Rushanara Ali:** I have a range of different questions. First, I appreciate that you do not want to get drawn into Conservative party leadership issues, but I have a really important question—Anthony, behave. *[Laughter.]* Tom Tugendhat effectively blamed the Bank over quantitative easing. There has been quite a bit of criticism. He has said, "We haven't been controlling our own money supply adequately. I'm afraid the quantitative easing…has been…inflating a sugar high of growth…And that's triggered the inflation." There was also the earlier exchange with the Chair regarding certain views about the Bank of England's independence, and so on.

So, I am concerned that there is this sort of culture building up now in these debates about what the Bank does. Of course, I am not suggesting that you should not be criticised—far from it; I am often a critic. However, the question is this: does all of this have a corrosive effect on the independence of the Bank, and should you be sticking a metaphorical two fingers—

Chair: One finger.

Rushanara Ali: Not literally, like the Education Minister—at those who are trying to delegitimise the independence of the Bank, which is a serious issue in my view?

Andrew Bailey: It is a very serious issue. All I will say again is that I will not join in the debate around who should be leader of the Conservative party. That is not for me, but it is—

Rushanara Ali: That wasn't my question.

Andrew Bailey: But this is, of course, a very serious issue and I hope that people understand the importance of central bank independence, and the fact that, as I have said a number of times before, this is the point in time, given the stress that we are experiencing, that the independence and the Bank has to do their job, and we are doing our job.

As a general matter, because it's obviously a point that gets made, I'm afraid that I don't subscribe to the view that QE is responsible. If that was the case, I think we would have a much stronger domestic demand in this country than we have. However, I will not join in that debate.

I will simply say that people need to understand the importance of central bank independence as a cornerstone of economic policy, and it's not just in this country; it is, of course, now in many countries around the world.

Q222 **Rushanara Ali:** Are you concerned that in this contest the central bank could become a political football in the pursuit of individual conditions by leadership candidates who want to be Prime Minister, and is that acceptable?

Andrew Bailey: Look, I am afraid I am not going to join in the debate. All I can say is that there is an election going on; people must express their views and no doubt the electorate will determine what they want to achieve.

Q223 **Rushanara Ali:** Some might argue that you are not forceful enough in defending the independence of the Bank. Some might argue that you are being too soft on people who think the Bank is fair game and its independence is fair game. And we have seen attacks on our institutions by the Prime—former Prime—well, I don't know what to call him now; the outgoing Prime Minister. And isn't it the case that this latest round of some candidates making remarks about the Bank, QE or the Bank's independence could involve the Bank losing legitimacy, and that this could be an attack on yet another of our institutions? And shouldn't you be standing up to people who do that? Perhaps some of your predecessors might have been more robust in doing that—

Andrew Bailey: We have our views on that, but I will not join in the debate over the election of the leader of the Conservative party. I will just say this: I think that Parliament is an important bulwark, in terms of institutions in this country—public institutions, that is. And I very much value the role—

Rushanara Ali: Parliament has been—

Andrew Bailey: Can I just say that I very much value the role that this Committee plays? We are accountable to you; you are an important part of the overall structure of the institution.

Q224 **Rushanara Ali:** I think I am inviting you to speak out for the independence of the Bank even more robustly, and without fear or favour, against those politicians who try to compromise your independence.

I will move on to another question. Sir Jon Cunliffe said in a recent interview that the Bank was prepared to do whatever is necessary to bring inflation down to the 2% target, but obviously you have quite limited room for manoeuvre, given the cost of living crisis and the other pressures that have been well rehearsed.

We have had five increases in interest rates since December. Picking up on earlier points about interest rates, how rapidly should we expect them to go up, and what will they go up to? How many houses should we expect to be repossessed? You mentioned mortgage holidays; before anyone says that this is straying into policy, I suppose I am looking to the financial crisis and some of the actions that were taken to prevent mass repossessions. Your main tool is going to be interest rate rises as part of the "whatever is necessary" mantra to bring inflation down to target. It would be helpful to understand what period we are looking at, where we expect interests to get to and what mitigation will be taken.

Earlier, Ms Breeden talked about how 40% of people on fixed rates are going to be affected. In order to mitigate against people ending up at risk of losing their homes, what can our constituents expect on that front?

Andrew Bailey: The most important thing—John Cunliffe was exactly right in what he said—is that we bring inflation down to target. If we do not do that, things will be worse.

Q225 **Rushanara Ali:** That is very welcome, but, in that spirit, what is the timeframe for bringing it on target, and what should we expect in terms of raises in interest rates?

Andrew Bailey: We are literally about to start work on the August inflation report forecast next week—we have not started work on that. The May report had a profile that brings inflation back down to target over the course of just over two years. It actually has a very steep downward slope in the course of next year. I always go into forecasts with an open mind—that is critical—but I think the basic fundamentals of that profile remain in place today. I think we have seen a certain amount of news since May, and we will have to crunch that through the whole thing. We have some very important data to be released, which we haven't yet had but will have by the time we complete the August report and take our policy decision.

As I said a couple of weeks ago, the important thing about the June meeting was not just that we did our fifth interest rate rise, but that we also changed the language we used around looking forwards. I have been very clear that means there are a range of things that are on the table when we get to the meeting at the end of this month. That is the right way to view it. It is my view that we should not, in advance, commit to what we are going to do, because we have a lot of work to do on a forecast and then as a committee we have to sit down and put that evidence together and see what we come out with. That is what we will do.

Q226 **Rushanara Ali:** But you will appreciate how the people watching this are going to feel. I am sure that people around this room feel that way. People will need to make some plans around how to manage their finances. We have already got skyrocketing food and fuel prices. If you then look at the 40% of people who are going to come out of fixed rates and pay a lot more when their mortgage increases, waiting for the analysis to happen without any sense of where we are likely to end up is not satisfactory. What can we do to ensure they are prepared? What can we learn from the financial crisis—if there are any lessons because I appreciate it is a different context—to prevent repossessions? How many repossessions are we looking at?

Andrew Bailey: Let me take that in two parts—I will come back to repossessions. I will repeat something that I have said before in hearings: the situation in the UK is that there is a very big external shock hitting us. It is a real-income shock caused by increases in the price of things we import, particularly energy but food to a degree as well. Every time we take an interest rate position, we have to reassess just how big the impact of that shock is going to be in terms of domestic demand and bringing down inflation, in and of itself. As I have said before, we have a trade-off situation now in terms of the impact. That is quite different to the US, by the way.

Q227 **Rushanara Ali:** But, Chancellor—apologies, I have not done this before. Governor, we are looking for answers. There is a lot of it already, and the country is looking to you for pointers in the direction of travel on some of this. What is the timeframe for bringing down inflation back to target? Is it a year? Is it two years? We need some clarity.

Andrew Bailey: Let me go back to what I said earlier about the profile we have had, which I think still remains the case. Other things being equal, we expect, sadly, that there will be a further increase in inflation—I will come back to that—but, during the course of next year, our best judgment is that there will be quite a steep downward slope on inflation and that it will come back to target somewhere just beyond the two-year point.

Now, what is going to make other things not equal? The risks, as we said in the May report, are on the upside. I would point to two things: one is domestic and the other is international. The international thing is Russia and Ukraine—you can see this in the May inflation numbers—and, increasingly, the pressure is coming from one source. To give you an example—I was looking at this before I came over—since the May monetary policy report, most commodity prices have actually declined because there is now a much more pessimistic outlook for the world economy. With one exception: gas in Europe, for which this winter's price is substantially up. So we will have to balance those things in terms of—

Rushanara Ali: I appreciate that, but it is very helpful to have some idea about—

Andrew Bailey: I think we will still have the same profile. The second thing is, obviously, domestic price setting and the domestic labour market. That is the big other thing.

Q228 **Rushanara Ali:** Yes. It is very helpful to have this up to two years, barring the external point about Ukraine.

On mortgages, if, as we can expect, rates will continue to increase, what is your view on the numbers that we are looking at in repossessions?

Andrew Bailey: To go back to what I think Sarah was saying earlier, when we look across the whole population—here I want to make it quite clear again that I fully understand that there will be people who will be in a much more difficult place than the average of the population—the market believes that we will go up to around 3% in terms of the Bank rate. Now, let's be very clear: I am not endorsing that.

Rushanara Ali: Sorry, I did not catch that.

Andrew Bailey: The financial markets believe that our official interest rate will go up to somewhere around 3%. I want to be very clear: I am not endorsing that; I am just using it as a benchmark. As Sarah said earlier, if you look at the measures of historical stress in terms of debt affordability in this country, you can put on about 2% or so on—it depends on what you assume on fixed rates.

Rushanara Ali: I have got quite a lot of questions, so I would be grateful if we could rattle through this.

Andrew Bailey: The point is that, on the country as a whole, there is headroom in that respect, but I do not want to take away from the fact that, of course, there will be people in very different positions. One of the reasons—going back to points I made earlier—that we want the banking system to maintain its resilience is so that it is in a better position to help those people.

Q229 **Rushanara Ali:** That is reassuring; thank you.

Moving on to climate change, in June 2022 the Bank published the findings of the climate biennial exploratory scenario. What more should banks and insurers do to understand and manage exposure to climate risks? How will the Bank try to ensure that financial institutions manage climate risk appropriately? I rather like the summary to the "It's the risk management, stupid!" speech this morning where, Mr Kashyap, you made a point that is an important rebuttal to those questioning the Bank's engagement in the agenda and the new, additional remit. What else should be done in this territory to ensure that financial institutions manage climate risk appropriately?

Sarah Breeden: Maybe I will start, and then Anil can come in. There are two big takeaways that we have from the climate BES exercise. The first is that banks and insurers need to do much more to improve their risk management of climate-related risk. They did not have the data that they needed and they had not developed the methodologies. They were looking to third parties to help them. We put out a whole load of good practice and, through our supervision of these firms, we are going to drive through the improvements that are needed. We will also share them more broadly, because not just the largest banks and insurers but every financial institution needs to do a better job of managing these risks. We can look to reduce them only if we have seen where they are.

Q230 **Rushanara Ali:** While you are on that, I want to bring in climate catastrophe. Sam Woods said that the Bank has not tested for a sudden and unanticipated hardening of climate change policy, which would be triggered by some sort of event—presumably an environmental catastrophe. Why has the Bank not put in place such a test, and will it do so in future? Is it linked to data and evidence?

Sarah Breeden: Exactly. What we were trying to do in this very first stress test was to focus on where we thought the biggest risks would be. For banks, it was credit risk. For the insurers, it is investment risk and the physical risks on the policies they have written. What we have seen, even through that exercise, is that there is a lot more to do. We need to continue to push through those improvements and fill in the gaps, exactly as you said, Rushanara.

Q231 **Rushanara Ali:** Are they being complacent? I have heard this sort of answer—not from you, but from the banking sector—for some time, even before the current Government joined, about there being a lot that needs to be done. Meanwhile, the climate emergency becomes ever more of an emergency.

Sarah Breeden: I will say two quick things, then Anil may want to add to them. Do not underestimate how hard this is. It is an unprecedented challenge.

Q232 **Rushanara Ali:** Sure, but can I push you on that? The pandemic was an emergency of a scale that we did not foresee, and we were able to act very quickly. Some would argue that when something is right in front of you, you can act faster. There seems to be a real lack of urgency here. Shouldn't you be doing more to push those who are giving that answer, rather than making excuses?

Sarah Breeden: What the financial firms need is data from their real-economy customers. It is businesses and households that are emitting the carbon that creates the risk, so it needs to be done in partnership with their customers. That is where there is an important role for Parliament in legislating for sustainability disclosures.

Anil Kashyap: I gave that speech this morning and there were a number of bankers and insurance companies in the room, including people who had led the efforts at a few of these organisations. I was struck by three things. Firstly, none of them pushed back on the basic premise of my speech, which recounted a lot of the things Sarah said about things that they needed to do better.

Second, they recognised that they have a bunch of work to do. People kept talking and saying, "This is version 1.0, and we know it is going to be iterative. We are in this for the long game." One concern I thought could arise is that they viewed this as just a hurdle to get over and now that it is behind them, that is it—it's over. That is not it at all. There are people in these organisations who are going to be pushing this agenda. There is actually a fair bit of co-operation among them. They are going to do some of this without us even pushing, which is very good. They have these industry forums where they are co-operating. They are down in the weeds, saying, "What did you assume about this?" and, "How are we going to do this?" That is very good to see. I think we catalysed some effort here. You may think that they need to go faster. What Sarah said about the data is a real problem.

Q233 **Rushanara Ali:** Okay, but it is quite frustrating, to be honest, because this is the argument that has been made for a long time. Can I turn you to the president of the ECB, Christine Lagarde, who has twice said that the ECB should consider green-targeted lending schemes to help channel lower interest rates for green activities and reduce exposure to volatile energy sectors, which are a primary source of monetary instability. The Bank of Japan, the Bank of Korea and the Bank of China have already implemented such programmes and the Network for Greening the Financial System has already outlined how such green-targeted refinancing lines could work. Should the Bank be considering how it can green its own targeted refinancing lines—through, for example, the green banks term funding scheme?

Andrew Bailey: The first central bank in the world to apply a green tilt to its corporate bond portfolio was the Bank of England.

Q234 **Rushanara Ali:** Yes, but I suppose the question is, what do you make of these sorts of suggestions? What is your view?

Andrew Bailey: I will put this carefully. I am very pleased—we talk to other central banks a lot, but to be honest with you, we were the first one to do it.

Q235 **Rushanara Ali:** Yes, but that is not the question. Obviously it is welcome and your predecessor was very enthusiastic about this agenda, but we cannot rest on our laurels. We have a climate emergency. In a way, the Ebola crisis and the pandemic have been a good example of things happening over there, in other places, and then they come and catch up with wealthier countries such as ours—during the pandemic, for instance. We can see some of the signs of the climate emergency in certain countries in the south where there is drought, flooding and so on, and whole economies are already finding themselves in trouble. There is a lack of urgency here, so although we have done well and are leading the way—there is no question about that—I want to know what is next. What do you think of this particular suggestion?

Andrew Bailey: Sarah leads our work on this, and we are heavily involved and engaged internationally. Perhaps I would say that we are leaders internationally—you are a leader internationally, Sarah. We are very committed to this and I rebut the people who say that this is some sort of dilettante thing that we do.

Rushanara Ali: Sorry, can you say that again?

Andrew Bailey: I said we are leaders in this. Sarah is a world leader on this; there is no question about that. I rebut the people who say that this is some sort of dilettante activity that is not core to us, for the reason you give: it is affecting our core responsibility as of today. That is why we are engaged with it and why we are prepared to put a lot of effort in internationally as well.

Q236 **Rushanara Ali:** What do you make of this point about how the Bank can green its own targeted refinancing lines?

Anil Kashyap: Can I give you an example from our speech? I pointed out that one of the things the insurers said in the CBES is that they have the same objective to try to meet their climate objectives. They want to have that in the assets they are holding and they want those things to be sustainable. They pointed out that in lots of companies in whom they would have to invest, there is no such thing as an ESG score. An ESG score is an incomplete thing; it is not just climate, but when you take the ratings that exist, they are heterogenous across things, so to say that we want a greener portfolio is easier said than done. Finally, one of the things we found in the CBES is that they all say they want to do that and then you look up and say, "Is there enough green stuff to buy?", and the answer might be no. You might need to support the brown sector transitioning to be more green in the interim. There are speed limits on how fast you can go on all of this.

Q237 **Rushanara Ali:** It would be useful to know how much, if anything, the Bank is offering in terms of cheap funding to banks to lend for dirty activities, at least, so that we can understand the transitions.

Anil Kashyap: We are not doing that.

Andrew Bailey: We are not currently funding banks, so we have nothing to tilt, as it were. Can I come back to what we are doing? A very important thing we are doing this year is the International Sustainability Standards Board, which is leading the way internationally to come up with a disclosure framework within the accountancy world. This is critical because unless we have consistency in the disclosure standards—this goes to Anil's point—you cannot compare things properly. We have put a lot of emphasis behind that and I chair the global Financial Stability Board supervisory and regulatory co-operation committee. We are heavily committed to making this work and it is going well at the moment. It is going very well. Sarah is also heavily involved in all this work. We are putting effort into this.

Q238 **Rushanara Ali:** Thank you. I have one last question on a different matter. The financial stability report notes that there has been a decline in the demand for risky assets. What are the implications of that for financial stability and investment? Would it hamper investment in innovation?

Andrew Bailey: I view this in two ways. First, it is unsurprising in a way that, as I was describing right at the beginning, as the risk position in financial markets changes you get a different supply and demand balance with risky assets. What worries us particularly is this thing we call the non-bank financial institutions issue. In other words, when there is a stress, we have a part of the non-bank world that, pro-cyclically, is trying to put its assets into the market. That was a big part of the story in the dash for cash, and it caused clear dislocation and disorder in financial markets. We think—again, it is a very important global issue on the Financial Stability Board—that we need stronger international standards to say that there must be stronger regulation in the non-bank world to prevent that happening in the way that it did. The idea that central banks will always come in and just buy this stuff is not going to—we cannot go on in that world. That is an important part of this point about procyclical demand for risky assets.

Carolyn A. Wilkins: Could I just add something? I think in and of itself, a decline in wanting to invest in risky assets is not necessarily a bad thing at this stage, given where we saw risk premium. There is a great chart in the financial stability report that shows just how compressed they were. Now, in a lot of places, they are back to where we might feel more comfortable, because they are around historical averages. When you take risk, and the pricing is there that is right, it is better.

The Governor raised the issue that, as assets move around, especially in the non-bank financial intermediation, it can cause stresses. Certainly, what we want to see is that adjustment being done in an orderly way so that financial institutions and markets can still fund good investment projects. However, at the end of the day, the investment will also be dictated by the returns on those investments that businesses expect to get. In an uncertain environment, with respect to the macroeconomic outlook, that will be an important factor in any of those decisions, as are the supply constraints—they are saying that if they want to buy a new machine, it could take a year to get it. Those are other factors that are also pretty important for the investment decision.

Chair: Kevin, did you want to come in on this?

Q239 **Kevin Hollinrake:** Obviously, you remember very well what happened post-2008, in terms of banks withdrawing support from businesses, particularly those in the commercial property field, with no notice. Often, the baby went out with the bathwater, in terms of good businesses with less-good businesses.

How are we going to stop that happening as banks move their policies on, in terms of climate change? Anil mentioned speed limits—you can do this only so fast—but you could see something happening, where banks have something, whether through ESG priorities or through regulations.

Andrew Bailey: If you do not mind my saying so, this is not—we have a role, but the Government have a role as well. As I think Anil or Sarah was saying earlier, this is a long transition, so you are right, Kevin, that we have to have not just policies but an environment in which financial institutions feel confident to fund institutions through a long transition. I fully understand that no Government can bind their successor, but financial institutions will look for confidence in the overall public policy framework and that there is continuity with a clear goal in mind.

I think you are right to raise this issue, because it concerns me as well. I welcomed the fact that the Chancellor wrote to me in the remit letter about the Government's adapted policy on investment in fossil fuels, because it seemed consistent with a transition that has to run over a period. We have to be clear that financial institutions will say, "Okay, I get that. Can you give me the confidence that, for a transition that goes on over 20 years or whatever, that will be the policy?" That is an important question.

Q240 **Kevin Hollinrake:** We did hear in some evidence on the oil and gas sector that one of the reasons the North sea has not been developed is that banks would not fund it, even though gas is perfectly legal and will be with us for decades.

Sarah Breeden: If I may, that was one of the big points that came out of the climate BES exercise. To my mind, there were two: first, "It's the risk management, stupid!", and secondly, that we need to use the time of the transition to transition and make the currently dirty green; not rush to pull the plug out, with all the macroeconomic and societal consequences that come with that. Building an infrastructure that supports that is key.

Parliament has a great role in disclosure, transition plans and providing the climate policy signals that Andrew outlined.

Kevin Hollinrake: Thanks very much.

Chair: That brings us to the end. I thank you all very much for appearing before us. Anil, we wish you luck in your life after the FPC. Is there any life after the FPC, we wonder? It has been a very interesting discussion and good to receive your general reassurance about financial stability, given the more difficult times that we are moving into. There was an interesting discussion on the financial services and markets Bill, which the Committee will look at closely, particularly in regard to the independence issues that have surfaced today. I thank you for your input on that. When we next meet, there will be no Conservative party leadership contest, and I think we will all be pleased about that. That concludes the session.