HOUSE OF COMMONS

Treasury Committee

Oral evidence: Bank of England Financial Stability Report, HC 1115

Wednesday 6 January 2021

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Watch the meeting

Members present: Mel Stride (Chair); Rushanara Ali; Mr Steve Baker; Harriett Baldwin; Anthony Browne; Felicity Buchan; Dame Angela Eagle; Julie Marson; Siobhain McDonagh; Alison Thewliss.

Questions 1 - 61

Witnesses

I: Andrew Bailey, Governor, Bank of England; Sam Woods, Deputy Governor for Prudential Regulation and Chief Executive Officer, Prudential Regulation Authority; Anil Kashyap, External Member, Financial Policy Committee, Bank of England; and Donald Kohn, External Member, Financial Policy Committee, Bank of England.

Examination of Witnesses

Witnesses: Andrew Bailey, Sam Woods, Anil Kashyap and Donald Kohn.

Q1 **Chair:** Good afternoon and welcome to the Treasury Select Committee inquiry session into the Bank of England's financial stability report. We are very pleased today to have four representatives of the Bank join us as witnesses, and I am going to ask each of them to very briefly introduce themselves to the Committee.

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

Sam Woods: I am Sam Woods, Deputy Governor and head of the PRA.

Anil Kashyap: I am Anil Kashyap, external member of the FPC.

Donald Kohn: I am Don Kohn, external member of the FPC.

Q2 **Chair:** Welcome and thank you for attending today. Most of you have appeared before us at one time or another. If a question is not directed to you, and you really want to answer it and have something to add, please raise your hand and I will endeavour to bring you in at that point.

One point that I want to make up front in this session is that the London Capital and Finance report from Dame Elizabeth Gloster has been published now, but I want to make it clear that this session is not going to focus on that. However, Andrew Bailey has very kindly agreed to appear before our Committee on that matter on 8 February, and that will follow a session we are having with Dame Elizabeth Gloster, which will be held on 1 February. Just to reassure all those who have an interest in that matter—and I know there are many—the Committee will be looking very carefully and in some detail at the report. Indeed, we expect to have some sessions after Andrew's appearance on 8 February as well.

Having said that, let me start with the first question, which I would like to put to Andrew and then Sam, but please come in, others, if you wish to. We have now concluded our trade agreement with the European Union, which is reasonably strong in its coverage of goods but much weaker in its coverage of services, in particular financial services. We know there is now a push to come to a memorandum of understanding, in March of this year, on financial services.

Andrew, I wonder whether you could answer the following questions. First, what is it that we had before we came out of the transition period that we do not now have, which is a cause for concern in terms of financial services and the EU? Secondly, what are the implications if nothing really changes? We know that there will be changes but, if the status quo were to prevail, what would that mean, particularly around stability and the future of financial services? Thirdly, what do you hope would be in place in that memorandum of understanding, and where do you hope the endpoint of negotiations with the EU might be? There is quite a lot there, but, if you could unpack it, that would be a good start.

Andrew Bailey: That is a very important set of questions. Put very simply, what we had up until 31 December was that, during the transition period, in practice the UK remained a member of the single market. Therefore, we had access and we had passporting. That had been arranged as the transition period to last for a year, throughout the course of the calendar year last year. That is what we had before, so the big change was at the end of last year.

From the FPC perspective, it feels like we have been planning for this transition away since the referendum. It has involved a huge amount of work. The planning that the Bank of England, the FCA and the PRA have done, which we covered in nearly all the financial stability reports during that period, has been on the basis that there would not be any agreement on equivalence. That was not because we were predicting that; it was because we were taking a deliberately worst-case outcome, so that we felt we were covered in terms of the risks. We published quite extensively in FSRs a progress report and a traffic light demonstration of where we thought those risks were.

In the press conference we held when we launched the FSR, back in the beginning of December, I said that our assessment at that point was that we felt the financial stability risks—i.e the risks to the system—were substantially mitigated, although there are different views on the boundary of financial stability between the UK side and the EU. None the less, the real core of the system was substantially mitigated, but financial stability is not the same as market stability and it is not the same as dealing with all issues affecting customers and users of financial markets. I did make the point that the arrangements the UK has put in place for handling those things, particularly customers, allow for essentially more smoothing and therefore less disruption than we were somewhat concerned some parts of the European Union were doing.

In terms of what has happened, the good news is that markets have been very stable over the last week or two. It is fair to say that an important reason for that was that the markets were broadly expecting what they got: a trade deal. It was not one that went beyond what was being talked about before, but they were expecting a trade deal. If anything, our concern was that, had that trade deal not materialised, the markets were in quite a sanguine position, but in the end it ended up pretty much reinforcing their expectations. They were not expecting much on equivalence in financial services because of the telegraphing that had gone on before.

In terms of the implications for the future, you are already seeing that a certain amount of business is having to migrate to the European Union. There has been quite a lot of coverage of share trading. There has been quite a lot of coverage of the so-called derivatives position and the derivatives trading obligation, and those transitions have broadly happened, as far as we can see. Levels of activity may still be recovering after the holiday period. We were planning to ensure that happened without disruption, and so far so good, on that front.

People often calibrate it in terms of the number of jobs. It is hard to be exactly precise about this, but the numbers currently thought to have migrated are somewhere around 5,000, no more than 7,000. That is a day one thing, of course; it does not tell us what it might be eventually. It is substantially less than the sorts of numbers that were being talked about after the referendum, so there has been quite a bit of adjustment on that front.

The third question you asked was what we hope for. As you say, the trade agreement does not cover financial services in any depth. There is no financial services chapter to the trade agreement. By the way, that is normal in such trade agreements. There is some coverage of financial services by virtue of there being a chapter on services and investment, and there are two important things in there from the Bank of England's point of view that I would draw out. There is a so-called prudential carve-out in terms of trade in financial services, which is important because it allows us to take sensible prudential actions where we need to.

There is also a so-called central bank exemption, which is relevant to the application of state aid rules, because we do not want fuzziness in the boundary around what we do as a central bank. By the way, this is in monetary policy but also in things like lender of last resort. That exemption has been agreed; it covers both us and the European Central Bank.

What do we hope for? As you said, there is a commitment to produce and agree a memorandum of understanding by the spring. The Treasury will lead on it; it will have our full support to do that.

Q3 **Chair:** On that point, will the Bank be involved in the negotiations with the EU?

Andrew Bailey: We have not yet discussed that with the Treasury, so I do now know the answer to that question at the moment. Whichever way, the Treasury will have our full support, however it works in practice. There is some language in there that says it can be the basis for further review of equivalence. As we have discussed before, equivalence is a patchwork. Some bits of EU legislation have provision for equivalence and some do not. Its actual technical form differs from bit of legislation to bit of legislation. Obviously, it goes both ways; the UK gives the EU equivalence and the EU gives the UK equivalence, because we have on-shored the EU's legislation.

Towards the end of last year the Government granted equivalence to the EU in, I think, 17 decisions. Those are not all the areas in which the UK could give the EU equivalence. That was done unilaterally. The EU has given equivalence in only two areas, and they are both temporary. One is central clearing for 18 months and the other is securities settlement for six months. Going back to what I said earlier, had either of those not been given, it would have caused financial stability concerns. That was important, but they are only temporary; let me be clear on that.

I have said many times to this Committee that I am a strong supporter of open markets. It is important that we have open markets; I fail to see why people would want to close themselves off from open markets. The situation we find ourselves in is that the EU has said it wants more information from the UK about its future intentions on regulation. That is quite problematic, frankly, in terms of equivalence. What is the motivation here? I can think of three things, only one of which is sensible.

The first motivation would be that the EU thinks the rules should never change. That is obviously mad; I do not believe that is what it thinks, because it reviews and changes its own rules. Secondly, it thinks our rules should only change when its rules change. We have discussed this many times before, because that would be rule-taking, which we do not support. The third one, which is the sensible one, is that both of us will change our rules when it is sensible to do so. We are both transparent about it, but obviously we would be transparent at the time. We are transparent to everybody; that is nothing unique. That seems a sensible basis to me, and that is the basis for judging equivalence.

The major driver for us is that we abide by global standards. There are important global standards and they govern global markets. They come from the Basel Committee, from IOSCO in the securities world, from the International Association of Insurance Supervisors and from the Committee on Payments and Market Infrastructures. Those are the things that both we and the EU follow because we are all signed up to them. Those should be the basis for it, not some different process that involves some sort of regional overlay.

Chair: Thank you. That is very helpful.

Sam Woods: I will be very brief because Andrew made all the main points. I would just add two small ones. As Andrew said, we have been preparing for this outcome since the referendum, and very concretely since around April 2017. Most of it has happened already, so we are in good shape there. We are only on day six of the new world, and there are some things down in the undergrowth. There is a payment system called SEPA, which we think is going to be okay but we will not really know until direct debits flow in a big way, which happens later in the month. A few things like that, which are not going to be financial stability issues, could still cause a little trouble.

The second point is just a point of information for the Committee, because it might be useful to know. We have already signed, between the PRA and our equivalent organisations around Europe, both the national authorities and the so-called ESAs, around 30 MOUs. This would be an additional MOU—in practice it would be between the Treasury and the

Commission—which would be very helpful to have for the purpose that Andrew gave. There was already a lot of co-operative structure that has been bedded in, in a quiet way.

Chair: Thank you very much. That has been a good overview, to start with.

Q4 **Felicity Buchan:** Good afternoon, everyone. Rather conveniently, you have answered a few of my questions, because I was going to talk about the actual impact we have seen in the first week on financial markets. You have already addressed many of those points, but let me dig a little deeper. Andrew, in the December FSR you highlighted three amber-risk areas: banking services, OTC derivatives and personal data. Would you mind elaborating on those three areas?

Andrew Bailey: Sam has for the most part covered the banking services one, in the sense that he mentioned this point about payments and the fact that, when you leave the European Union and you leave the transition agreement, the payment instructions require more information than they do if you are a member of the European Union. It is a question of banks ensuring and being prepared, so that their customer agreements and underlying payment documentation instructions have got all that information in them. Otherwise, there is a risk that payment instructions will be rejected. As Sam said, it will probably take a bit of this month to unfold because a lot of those direct debits tend to come later in the month after people get paid. There tends to be a clustering. If I have forgotten anything on banking, I am sure Sam will come in.

On OTC derivatives, this is the so-called derivatives trading obligation; it is actually an FCA responsibility. The issue there is that these trading obligations effectively limit the servicing of EU clients from London. It is like mirrors; because we have on-shored their legislation we have actually on-shored the derivates trading obligation. It works the other way round as well. Had it not been amended, there would be some clients who could not have dealt either in the UK or in the EU; think about an overlapping Venn diagram. They would have probably ended up using a US swap execution facility. The FCA amended the rules, so essentially we have said, if you are an EU client contracting in London, although this Venn diagram would force you out somewhere else, you can go on operating in the EU, which is sensible from an operating point of view.

On personal data, the trade agreement has in it, effectively, a temporary agreement, which if my memory serves me right is for four months at least and can be extended to six months. It allows the exchange of personal data to go on as it did before, pending what we hope will be a permanent agreement on the data front. We are not experts on personal data; I know a lot of other issues come into play and it is in the Information Commissioner's remit, but it is a good thing that that has happened. The fallback, which we flagged in a lot of FSRs, was that it is possible to insert language into contracts that we think takes care of that, but it was a less good fallback than getting an agreement. Sam, have I forgotten anything?

Sam Woods: On banking services, one issue I know the Committee has already been interested in is the offboarding of retail customers of UK banks in the EEA. There are about a million of those accounts with UK banks, and I know the Committee has noted that some of those customers are being offboarded—sorry, it is a blunt word—by UK banks. The reason for that in the main is that some jurisdictions—Holland being the most obvious one, and Italy somewhat—have taken a very strict interpretation that does not allow them to do passive servicing. A portion of those customers, not anything like all of them, are in the process of being offboarded by the UK banks, which is a bit unfortunate, but I am afraid that is just one of the frictions that arise from doing this.

Q5 **Felicity Buchan:** As a whole, what has been the feedback from banks and financial services providers over the last week? Are people relatively comfortable with how it has gone?

Andrew Bailey: Yes. It is early days, obviously. That is important to emphasise, but all the feedback we are getting is that it has gone as smoothly as people hoped it would. Although you see these quite big numbers for migration of share trading, for instance, that had been planned for quite a long time and planned very carefully. We have not detected any disruptions in that sense. What it is leading to is fragmentation of markets. That is no surprise; all these things are known.

Q6 **Felicity Buchan:** What are the risks with fragmentation of markets?

Andrew Bailey: There is the risk that people will get less good prices because you do not have the depth of liquidity of a single market. It is a liquidity issue. In big-picture financial stability terms, it is manageable. The test of that would be if we started to see some of the stresses that we saw back in March and the Covid crisis, because those were liquidity issues in financial markets. These are not core financial markets on the whole, so we are not talking about Government bond markets or foreign exchange markets, but none the less the main day-to-day impact is less good prices caused by illiquidity.

Q7 **Felicity Buchan:** Looking forward, are you optimistic about getting agreement on equivalence? Let me add another question to that. You mentioned that we had given equivalence on 17 areas unilaterally and in return we have had two, only on a temporary basis. Have we been too generous or did we have to give those equivalences in order for markets to function?

Andrew Bailey: The answer to your last point is yes. In fact, we have both given each other equivalence on those two things because we recognise those are core to financial stability. The best thing is to set those two things on one side, as there was an agreement, but as I said, in the EU's case, they are only temporary.

On the 17, if I can put it into perspective, we believe in open markets. You then get into what is almost a 19th century debate about unilateral free trade versus reciprocity. Mr Baker can come in and give us a lecture on Cobden in a moment; he is itching to. Do we say, "We believe in free trade and the right way to approach that is unilateral free trade," or do we say, "This is going to be an agreement; we will deal on this and come to a conclusion"? We have not unilaterally acted on all fronts by any means, but we believe in the things we have done.

You ask me where I think this will end up. I have to be honest with you; I am very realistic about this. I do not start by saying we have to get it. I do not start by saying it is the be-all and end-all. Going back to my point about rule-taking, if the price of this is too high, I am afraid we cannot just go for it whatever. By the way, as I have said for many years now, I do not take any position on Brexit. I know it is all over now, but I still say these things from that position.

Q8 **Felicity Buchan:** That is understood. Are there any areas where it is more important that we get equivalence, so we are less prepared to sacrifice them, if I can put it like that?

Andrew Bailey: We did a very interesting piece of work to essentially try to put a value on all of them. As I said, equivalence is a patchwork of measures; it is not a single thing. It is no great secret that the core piece of equivalence in financial markets is the MiFID II equivalence in what tends to be called investment banking services. That is the one that has the biggest all-round value attached to it.

Q9 **Felicity Buchan:** Do you think the end-of-March deadline is feasible?

Andrew Bailey: Yes. As Sam said, we have been working on these issues for a long time. We have many existing MOUs. I would emphasise a point that we have made many times. The relationships, particularly on the regulatory and day-to-day supervisory side, have remained very good. That has been a deliberate objective on both sides. We have strong relationships with our partners in the EU. We have very strong relationships, for instance, with the ECB and its supervisory side. Our joint objective is to keep it that way, because it benefits both of us in terms of our objectives. I say that because from that point of view we are starting from a solid base in that sense.

Q10 **Chair:** On this issue of what happens if we do not get a sensible agreement on equivalence, what do you think the EU is feeling? If nothing really moves substantially, what would its top concerns be? We are always focused on our concerns, but what would the EU's be?

Andrew Bailey: The stated objective of the EU is to build domestic financial markets. Can I put this into a longer context because I think it is important? Going back at least to 1999 when the euro and the euro area were created, there has been a long debate about location policy. In other words, how much of the financial and financial market infrastructure of the euro should be located in the euro area? I can tell you there was a very vigorous debate on it in 1999. There was then, as you may remember, a court case on clearing that ended up in the European Court of Justice.

One of the ways I look at this is that Brexit has been the prompt to reignite this issue. Meanwhile, there has been this whole question about a capital markets union of the euro area that the EU has been pursuing since the financial crisis, which is all about shifting the balance of financial intermediation somewhat away from the banking system to the financial markets, because the EU is a very heavily banked system. For many people involved in this, the objective is to have more of that within the EU and, to a great degree, the euro area.

Brexit presents another opportunity and, from their perspective, pressure to do so. I have to be honest; I cannot speak for them, but the question is whether they are going to do it. Is this the time when they do it? It has not happened to date in many areas.

Donald Kohn: I want to pick up on a couple of these themes on equivalence and Andrew's mention of free trade. Where the EU would benefit from granting the UK equivalence is giving its businesses and households more sources of liquidity, more places to go, cheaper finance, because they would be accessing this fantastic liquid market in London. It should not be about who is taking jobs from whom. It should be about which households and businesses get the best prices, how you get the best prices, how you have the most liquid markets. That is the argument for equivalence.

Q11 **Rushanara Ali:** My questions are follow-ups to the Chair's and the ones Felicity asked. Governor, in previous sessions you talked about there being no such thing as frictionless trade. Obviously we are all relieved to have got a deal, not least because of warnings that you and others provided of the dangers. Could you say more about the costs? We know the benefits of getting some stability, but what are the costs now that we have an actual trade agreement? The OBR said in its analysis that a typical free trade deal, long term, would cost us around 4% of GDP. Is that still the case? Is it lower, or is it likely to be higher?

Andrew Bailey: That is an important question. The trade agreement that has been agreed is the one we were expecting, and is pretty similar to the one we had factored into the monetary policy report in November. There may be a few tweaks in areas such as rules of origin, which might have a small positive sign on them, but in overall GDP terms it does not make a lot of difference. We will do the full analysis of that for the February monetary policy report. We are going to have a hearing on that, so I am happy to come back with a fuller answer to that when we have done the analysis.

You are right in saying that about frictionless trade. Very importantly, this agreement means that there are no tariffs, but there are non-tariff barriers. There are forms to fill and there is grit in the mechanism there.

There is a lot of reporting about this, and we have been talking a lot to people over the course of this week. It is too early to assess that at the moment. If I can give you one illustration, one of the things we monitor carefully, as we were before Christmas, because of Covid, is port traffic. Looking at HGV traffic around Dover and Eurotunnel, for instance, there is a seasonal pattern to it. Based on the movement data of lorries over the past three or four years, we would not expect it to come back to a more normal level in any year until about a week from now. That is consistent with people saying there is not much around that.

Q12 **Rushanara Ali:** Going back to the 4%, would you say that it is likely to remain around 4%?

Andrew Bailey: The OBR is right. Most models give you something like that. We put in our numbers that in the third year, the tail end of our monetary policy forecast, the modelling would give you just over 2% on GDP. These effects are very long run, by the way, because they are the way in which the real side of the economy adjusts. When you let the model play out—the OBR's and indeed ours—something around 3% to 4% for this sort of deal is probably right. That is what the model tells you, but what actually happens depends, first of all, on how much disruption we see in the next month or two, and then on how quickly the economy adjusts to the new trading arrangements.

Q13 **Rushanara Ali:** I am going to move on to a question around investment. This morning, Professor Catherine Barnard gave evidence in another Committee. She described the deal as very unstable, according to press reports, given the shaky foundations of the agreement, which can be terminated for numerous reasons. We have already talked about some of that. Are you concerned that these shaky foundations could influence companies—we are pretty early on—in their decisions to invest in the UK, in the short to medium term and the longer term?

Andrew Bailey: It is a big agreement, particularly on trade in goods. There is no cause at the moment to reach a judgment one way or the other or to question its foundations. The question that is rightly raised is how easily it can be walked away from and taken away. We had this with financial services as well. One would hope that there is a spirit of goodwill and common sense that that is a very stupid thing to do.

We go forward with saying that, certainly on the trade in goods side, this is a comprehensive free trade agreement. You are right that this is key, because we have had a very low rate of investment in the economy now for about the last decade. You can put this down to a number of things. You can put it down to coming out of the financial crisis and some longer-term global trends, but uncertainty around the referendum and how Brexit was going to play out—and there is lots of literature on this—reduces investment. If people can put off a decision until the future when they know more and are more certain, they will do that. It is important for the economy, and critically coming out of Covid, that we see a reduction in uncertainty and therefore stronger conditions for investment, and the trade agreement supports that.

Q14 **Rushanara Ali:** The point being made here is that it is unstable. It is unstable compared with what we had before, not least in relation to financial services. Unless this MOU is agreed and both parties can see the benefits of having stability in relation to financial services, we are going to have an unstable set of circumstances for investment, are we not?

Andrew Bailey: I have to be honest with you; I have not seen what Catherine Barnard said this morning, so I cannot really comment on how she described that uncertainty.

Q15 **Rushanara Ali:** How about just giving your own perspective, then?

Andrew Bailey: If you take financial services, we can get certainty by not having equivalence and we can get certainty by having equivalence. As I said before, it will be much better for both sides if we have open markets and therefore certainty that way. If we do not, the markets and firms will evolve, particularly in financial services, because we are a global financial centre. They will evolve to do other things.

Q16 **Rushanara Ali:** The evolution of that will cost us, will it not? To your point earlier about rule-takers, it is a question about whether the language of being a rule-taker in the negotiations around an MOU is appropriate any more, because they now increasingly hold the cards. Our Government focused much of their energy on getting an agreement on fishing, and some would argue they should have spent as much time and energy on getting a deal and stability around financial services. We are where we are, but are we actually going to end up being a rule-taker on financial services? Is it wishful thinking to think that we are not going to be, given that they now hold the cards?

Andrew Bailey: I have said quite a number of times in this Committee, but I am happy to say it again, that I would strongly recommend that we do not become a rule-taker. That is a very bad place to end up in and, if the price of that is no equivalence, I am afraid that will follow. That is the wrong outcome for both the European Union and the UK but, as you have heard me say many times, I am strongly opposed to rule-taking.

Sam Woods: We are not on that rule-taker path at all, and the MOU is not going to take us to that place. The aim of the MOU will be to help strengthen the exchange of ideas and dialogue between the two sides, but there is an absolute recognition, as Andrew said, that both sides need to evolve their rules. They will do so in their own way. As to instability, the problems around instability are much worse in equivalence than they are in an FTA. That is one of the reasons why, when looking at the trade-off, if you had to be a rule-taker to get equivalence, you would be crazy to do that deal.

Andrew Bailey: Can I give you an example, because it may help to illustrate this? There will be examples that the EU will come up with, but the EU has very recently adopted a rule that allows the value of a bank's own capitalised software to count within its capital. That is against the Basel accord, and we are just not going to implement that rule, because it is unsound, I am afraid. Come the day when you need the free capital, and I emphasise the word "free", I do not know how you think you get the value out of your software at that point. We are not going to do that. I am sure they will come up with something we have done that they will say does not make any sense. I cannot think what it is, obviously, because we have not done anything that does not make sense, but we are just not going to be in a situation where we take rules like that.

Q17 **Rushanara Ali:** What we can all agree on is that we are going to be in a period of constant negotiation, and this trade agreement is not the end of the matter. Mr Kohn, do you have any reflections on any of those points, as well as on the US experience and what all this means for a trade agreement with the US?

Donald Kohn: My reflections very much match Andrew's reflections on the discussion you just had about rule-taking. The Financial Policy Committee has been very clear and has repeated many times since the referendum that we need to be able to make the rules and recommendations that protect financial stability in the UK. We need to have the freedom to do that to hit the objectives that you, as Parliament, have set for us. Being a rule-taker will not meet those criteria. We need to be able to make the rules to fulfil our duties that you have given us.

Free trade agreements with the US are hard to negotiate. They are a tough slog. Agricultural interests are important. I have been eating chlorine-washed chicken all my life; I think it is okay, but that is for UK citizens to decide. There are a lot of interests in there. It is important, to be a bit serious here, that the US engages with the UK and the UK engages with other countries to increase the flow of goods and services between us, to benefit the people who reside in our countries. The negotiations will be tough, but both sides can benefit from a free trade agreement.

Anil Kashyap: I want to reemphasise something Andrew said at the very beginning. A lot of the direction of travel for all the financial regulation will come from global bodies. It is not like the EU can hold the UK hostage. It has to comply with the same things through the Financial Stability Board and the list of all the other regulators. Big picture, that is what is going to drive things. The FPC can be a leader in thinking about a lot of these regulatory issues, and we intend to carry on doing that. That is a very important baseline to keep in mind.

Q18 **Anthony Browne:** My questions are going to be about the UK's future regulatory framework, with particular reference to the Treasury's financial services future regulatory framework review. We have our own regulatory regime. What we have done so far is transpose most EU financial services regulations into UK law. We now have control over that. The Treasury says that there are significant disadvantages to maintaining this on-shored regime over the longer term. This is a question for the Governor, first. Do you see disadvantages in maintaining the current on-shored regime, and what are they?

Andrew Bailey: There is a very big question that we face. In the context of equivalence, the on-shored regime is a patchwork of pieces of legislation originating in the EU. There are at least 50, developed over a long time. More particularly, it is also a patchwork in terms of the levels at which it was created in the EU and whether it was done at the top political level; there is level 1, level 2 and level 3, basically. If you describe it in abstract, it can sound quite simple and logical, but people who are close to it and have been involved in it say that it is a real ball of wool, when you put it together and start unpicking it.

We have on-shored it because it was the only thing we could do. The only thing we could do in the time available was to take the whole thing and bring it over. There is a very big question as to whether we then say, "We can probably organise it more rationally now we have the chance to do so." I do not want to underestimate the scale of that, for both of us. For us as regulators, the Treasury and you as Parliament, it is a very big undertaking, so we have to go into this with our eyes open.

Q19 **Anthony Browne:** One thing that the Treasury suggests in its consultation paper is that it has the right to be consulted by the regulators, including the Bank of England, before you publicly consult on any policy changes. That consultation goes on in an informal way at the moment, and in my many years of dealing with the Bank of England I have never known it to contradict the Treasury in any way. Would having that formalised, legislated right by the Treasury to be consulted by you before you make any policy changes really constrain your independence as a regulator?

Andrew Bailey: I do not think so. Let me say two things on that. First, in terms of rule-making powers, going back to the point I made about how the EU system works and level 1, level 2 and level 3, you may not like me saying this, but this proposal transfers quite a lot of power to us, relative to the EU system. That is sensible. You are going to say, "He would say that, wouldn't he?" The EU system takes the Parliament too much down into the detail, whereas it should be setting the objective and strategy.

With the give and take on that, there are two things. Given the different approach that we are taking, first, I have no difficulty in terms of consultation with the Treasury but, secondly, the really important point is that we must be accountable to Parliament on this. This rule-making power is a big shift relative to how the EU does it, so we must get it right in terms of accountability. I do not have a problem with the consultation point, because in terms of the shift it is quite sensible.

Q20 **Anthony Browne:** That is one thing we are going to be discussing as a Committee in future meetings. One question mark that keeps coming up is over competitiveness. Various people have said there should be more duty on international competitiveness. You do not have that objective at the moment. Is there any argument for you to have that objective, or is the risk of a light-touch regime or a replay of the global financial crisis too great?

Andrew Bailey: I am not in favour of that regime. We have a structure where the FPC and the PRC—the Prudential Regulation Committee—have objectives given to them in legislation. We meet those objectives, but, subject to those objectives, I receive a letter from the Chancellor on a regular basis for each committee, and for the Monetary Policy Committee, which says, essentially in the language of the legislation, "Subject to those top-level objectives, these are the other policy objectives the Government have." The position of London as a financial centre does enter into those letters. That system works effectively, so you will probably be unsurprised to know I would prefer to stick where we are on that one.

Q21 **Anthony Browne:** I want to ask about possible specific policy changes. You mentioned the capitalisation of bank software, which is outside Basel rules, and that you would not want to adopt that in the UK. Are there other areas of policy where you think you might want to change things? I have two particular questions: one is Solvency II and one is CRD IV.

Andrew Bailey: Sam leads on both of those two.

Anthony Browne: I am very happy to ask him. Sam, the British insurance industry has been complaining endlessly about Solvency II and its ability to compete internationally as a result of that. A lot of technology industries in particular that require venture capital have said that it diminishes the ability of insurance companies to take a small position in higher-growth industries. Do you think there is scope for reform of Solvency II now that we have control over it?

Sam Woods: I absolutely think there is. There is a narrower point and a broader point. The narrower point is that there are some things in Solvency II that do not work terribly well. The most obvious is something called the risk margin, which we talked about at this Committee three years ago. Both we and industry agree that the current design is not good and needs to be fixed. Whether we completely agree, when we go through it, on what the right solution to that problem is, we will see. Broadly, we agree that it is not working as currently described.

The broader point is that Solvency II is the perfect example of what Andrew was talking about. You have a really staggering volume of detail, including some quite complex actuarial correlation tables and things of that kind, in the equivalent of primary legislation. That is really not a sensible way to promote policyholder protection or safety and soundness of insurance companies. It is a sensible way to make 27 countries do exactly the same thing. Now we are out, subject to full and, I presume, enhanced parliamentary accountability, we need to move back to the approach adopted in most other jurisdictions that the very detailed stuff is done by the regulators.

Q22 **Anthony Browne:** Do you have particular plans to reform Solvency II?

Sam Woods: Currently it is jointly held by us and the Treasury, because a whole lot of this stuff is in primary legislation.

Q23 **Anthony Browne:** Under the framework, a lot of it would be devolved to you as the regulator. You would then have the ability to change the rules.

Sam Woods: Yes, but here is where it gets complicated. In parallel with the financial regulatory framework review we were talking about a moment ago, the Treasury is also running a Solvency II review. It is in the call for evidence stage. Our preference would be exactly what you just said. If we could adopt the structural financial regulatory framework proposals for implementing the Solvency II review, we could do it massively more smoothly and quickly. I hope we will be able to do that.

Can I add one other point that is relevant for the Committee to be aware of, on the competitiveness question? The Committee should be aware, if it is not already, that in the Financial Services Bill 2020, for the implementation of what we call Basel 3.1, the Treasury has not proposed a competitiveness objective for the PRA, for all the reasons Andrew gave. But it has included a 'have regard' on competitiveness. That makes sense. If we are going to take on a bigger role, some of which used to be done by the Treasury and the European Commission, we have to have more regard, somewhere, to things they would have had to do had they kept those rules to themselves.

Q24 **Anthony Browne:** On capital requirements directive four, something that the Governor and I used to discuss regularly, when I was the chief executive of the British Bankers Association, is the impact on challenger banks that cannot use advanced capital models, and the amount of capital they have to put aside for prime mortgages in particular, which they say makes them uncompetitive. The Basel rules are meant to be for international banks, not banks that only operate within the jurisdiction of one country, yet the EU regulations applied it to all banks, wherever they operate. Are you open to reform of the capital regulations to improve the competitiveness of challenger banks in mortgage markets?

Sam Woods: There are two things we are doing in particular. First, we lobbied hard in Basel to get the risk weight reduced for banks that do not have a model for low-LTV mortgages. We got agreement to that from 35% to 20%, which is a big cut and brings it quite a lot closer to the models, although not all the way. That will come in, funnily enough, under the piece of legislation we were just talking about as part of Basel 3.1.

We are also coming at it the other way. We have decided that enough is enough in terms of the reducing risk weights for residential mortgages in the UK. We have a proposal out there to put a floor under that for firms that run models. That is a sensible thing to do, and it is a good example of a place where you can advance safety and soundness, and competition at the same time.

Anthony Browne: Levelling up, as it were.

Sam Woods: Levelling up in financial regulation land, exactly.

Q25 **Siobhain McDonagh:** I wanted to ask some questions about mortgages. Governor, why is the Financial Policy Committee considering the calibration of the mortgage rules, and how have the 2014 rules affected the proportion of mortgages that go to first-time buyers?

Andrew Bailey: Those are important questions. We review the 2014 mortgage rules frequently. In fact, we have done them roughly once every two years. We review these rules more frequently than any other rules we have. To my mind, the reason for that is that, while all our rules obviously affect people and society, these rules have very direct effects on things that matter very much to people. It is important that we keep these rules under careful and close review, and adjust them if we think there is a case for doing so.

What is the case that we are looking at now? I want to put this very carefully, because it is an open question. Two things have really changed over the years on the interest rate side. This is the affordability rule, really. First, there has been a general decline in the expectation of increases in future interest rates. As we have discussed in MPC hearings, in the monetary policy world this is often associated with a decline in the equilibrium interest rate globally, so the R-star phenomenon. I was looking the other day at options pricing. Back in 2014, if you asked, "What is the probability that in five years the overnight sterling interest rate will be 100 basis points higher?", the probability was 70%. Just to give you the numbers, if you went to 200 basis points it was 50%, and if you went to 300 basis points it was 30%. Today, those three numbers are clustered somewhere in the 0% to 2% range, a big change, consistent with the story about low interest rates persisting for longer.

The second thing, which is directly relevant to the affordability test, is that what I might call the relationship between the relative interest rates has changed somewhat. In particular, there has been an increase in the spread between the quoted mortgage rate—the rate you get when you go in and get a quote, although you do not go in these days—and the so-called reversion rate, which is often known as the standard variable rate. That is relevant to the affordability test, because the affordability test is a margin over the reversion rate. If you add that spread on to the fixed margin over the reversion rate, you have essentially toughened the test beyond what we originally intended it to be. That is one side of it.

However, this is an open review. The other things we look at may go the other way: "What are the risks to incomes? How do we think about unemployment going forward?" We will bring all those things in. The fact that we have seen those rates move around, for me and I think for colleagues, is a good enough reason to review it.

You asked about first-time buyers. It is a very interesting question, because the evidence does not show there has been a decline in first-time buyers in this country. I would not agree with any suggestion that these rules are preventing first-time buyers, but it is important in terms of the calibration of the tests, because the calibration of the tests is relevant to first-time buyers and, indeed, any other buyers, for that matter, in terms of affordability. Other colleagues may want to come in on this, because it is something we talk about a lot.

Anil Kashyap: It was important that the 2014 rules always included a knockout that said 15% of the flow of mortgages could be made to people outside the loan-to-income guidance. There have always been safeguards to let first-time buyers get on the housing ladder, and we have seen a bunching of people at four times loan-to-income staying below the guidance of four and a half, which is kind of what the policy was designed to do. The banks have capacity to make exceptions for people where they need to make exceptions, and it seems like this has been an example where the policy has worked as intended. We have the stability benefits but we have not been knocking people out of the housing market.

Q26 **Siobhain McDonagh:** Anil, I defer to your expertise in this area, but as a layperson and a politician I do not feel the same way. I see proportions of owner occupation plummeting, particularly among young people, and I am concerned that your 15% limit on four and a half times somebody's earnings is squeezing out first-time buyers. Is it first-time buyers who are most risky? Do they get their houses repossessed? The constituents I see would love to be able to pay these sorts of mortgage repayments, but are private renters and are paying 60%, 65% and sometimes even 70% of their incomes in rent to landlords. I feel we have a really big issue. I am not sure how much the responsibility for that lies on the Bank of England; you might have opinions about that. Does the Bank of England have a moral duty to ensure that people can get into owner occupation?

Anil Kashyap: I will let Don start. He was here in 2014 when the Committee first made this rule, so he has watched the whole thing.

Donald Kohn: What is holding back first-time homebuyers is the price of houses, especially in the London and south-east area, and coming up with the down payment to make those purchases. I do not think it is our requirements; it is the loan-to-value issues that have come to the fore, not so much the income or affordability issues. That is really about Government policies or other policies that will encourage the increase in the supply of homes to keep those prices more in check relative to demand.

We need to be careful not to create financial instability issues in the process of trying to promote first-time homebuyers. Coming from the

United States, having lived through 2007, 2008 and 2009, that housing bubble and subsequent collapse was created in part because we were encouraging people to get on the housing ladder who really could not afford to be there and were not resilient when prices fell and the economy softened. We were doing those people no favour in doing that, and there was a lot of collateral damage.

Q27 **Siobhain McDonagh:** Was that not a direct response to self-certification mortgages? No checking was going on of anybody's real income.

Donald Kohn: There was a lot of misrepresentation going on, but it was also part of a broader Government policy to encourage low-income people on to the housing ladder, and then unscrupulous lenders taking advantage of that and pushing people into mortgages they really could not afford.

Q28 **Siobhain McDonagh:** That suggests it is a regulation issue, doesn't it?

Andrew Bailey: Just to be clear, since 2014 the actual share of mortgages above the four and a half times has never been near 15%. It is an insurance guardrail and has always functioned as such. It is not the case that there are people who would like to get those mortgages and are constrained from doing so by that limit.

Can I pick up on what Don was just saying on the UK equivalent of this? Going back to my past, I have been painfully aware of the mortgage prisoner issue, which we have discussed here in this Committee; Ms Ali has raised it with me a number of times. If you go back to the root of that issue, it was people overextending on mortgages. I say that not to criticise them one bit; they have had to live with very difficult circumstances.

Q29 **Mr Baker:** I refer to my interest in Glint Pay. You will not be surprised that, when I looked at the report, my attention was drawn to stablecoins. I wonder if you can say something about the current and potential relevance of stablecoins to the payment system and to financial stability.

Anil Kashyap: That is a great question, and it is one of the most highly debated issues in all central banks. Every central bank in the world is thinking about central bank digital currencies. I know you know this, but for the record it is important to distinguish between stablecoins, which would have fixed values and might be suitable for being used in payments, and things like Bitcoin, which are more of a casino-type investment that you can see fluctuating greatly.

There are two very, very different things. There is the fintech idea that you should be able to put your money somewhere and maybe hedge against fiat moneys, which has one set of issues, and then there is the relevance for trying to squeeze costs out of the payment system and create something like that. We are committed to publishing a discussion paper in March that will lay out a bunch of the issues. I am sure we will be back here after we have done the analysis to tell you where we come down on the spectrum of exactly where we want to go, and whether the Bank of England will endorse something that would be its own currency.

The principle we have laid out is that anything that is serving the same purpose has to be regulated to the same standard. It does not matter how it is labelled: if it is going to function as money, it has to have all the protections of money. We are going to guarantee that that is there, but beyond that we have not prejudged exactly what the landscape should look like. It is important to have innovation. We do not want to stifle innovation, but we also do not want to put our thumb on the scale to prejudge one outcome versus another. I am sure Sam, Don and the Governor can elaborate.

Mr Baker: Do; I do not want to have too short a conversation now. I am now looking forward immensely to the March report.

Donald Kohn: Let me elaborate on one point Anil made. For private stablecoin used in payments, the committee has said that financial stability will depend on people being as confident in their ability to exchange that means of payment for goods and services for other means of payment as they are in bank deposits, which are another private form of payment. The regulation of the stablecoin should ensure the same kind of confidence that, once you have a stablecoin, you can convert it into a bank deposit or a bank note, the cash that people have for bank deposits.

The concern is this. If you created stablecoins, and people thought they were good for payments and convertible into fiat money at a fixed rate, and then they were not, it would cause a huge amount of damage, certainly to the people holding the stablecoins, but it could more broadly undermine confidence in the payments system, which is the core of the financial system. There may be a number of ways of achieving that equivalence of regulation of certainty, depending on what is backing the stablecoin. You do not have to regulate stablecoins as banks if they are not holding bank-like assets. If they are holding much safer assets, there may be another way of doing it, but the goal should be that same assurance that you have when you are holding a bank deposit.

Q30 **Mr Baker:** When you talk about stablecoins perhaps being backed by safer assets, might they be backed by central bank reserves, for example?

Donald Kohn: That is certainly possible. That is one model that people have talked about, issuing stablecoins and holding a deposit directly or indirectly at the Bank of England. That is one model, which presumably would require much, much lighter regulation, if any, than one where the stablecoins were backed by other kinds of assets.

Q31 **Mr Baker:** This raises innumerable fascinating issues. It seems to me to be surfacing so many questions that we have taken for granted, perhaps for a couple of hundred years since the Bank Charter Act, such as the nature of redemption: redemption in what? What does it mean to redeem? For the record, you are nodding, and I am grateful.

In particular, when we talk about a stablecoin potentially being backed by central bank reserves, is the question then on the table that we could end up entirely nationalising the monetary system? If stablecoins are being used widely in the payment system, are backed by central bank reserves and are possibly issued by the central bank, does a world emerge where people say, "I am going to cut out the private banks altogether and keep my money in stablecoins at the Bank of England"?

Sam Woods: There is a dynamic version of that question, which is directly a financial stability question. If you had a reserve-backed digital currency or, in one extreme form, an actual central bank digital currency, what might happen when you go into a stress? It might be quite rational for people to herd out of bank accounts and into the CBDC. That is the kind of stuff we need to think through.

Q32 **Mr Baker:** Another question that comes up with this is privacy, because one of the things people do not realise with blockchain is that it is a ledger that tracks movements of assets from one person to another. I can see a world where civil libertarians like me get quite concerned that the state's central bank has this enormous ledger that can track where everybody has spent all their money. I do not know who to come to; Anil and Donald, you are both nodding.

Anil Kashyap: That is a great point. There is also a broader point, which is just keeping in mind that private banks provide services beyond just their liabilities. It is not just that banks exist to make payments; that is one thing they do, but they also provide lending services and do all kinds of other things. It is not inevitable that we will see the demise of private banking. You have just pointed out another advantage that the private banking system might have relative to this thing.

It is like an exam question for the FPC to go and think through all these issues. It is one of the most active areas internationally. Our March paper will hopefully put us in a leadership position vis-à-vis lots of other countries in laying out our principles, and what we think and have done. The committee will be spending a lot of time on this in the next couple of months.

Mr Baker: That is very interesting.

Andrew Bailey: You have put your finger on many of the big issues that we want to cover in this paper, so that is excellent.

Mr Baker: I will give myself a gold star.

Andrew Bailey: Actually, I think I will hire you to write it.

There are two things that I want to observe. First, as you know, one thing that has been doing the rounds in the last year or so is this proposal that was called Libra and is now called Diem, which has been associated with Facebook. That has caused quite a few reactions, but one of the issues in that is where the business model is in this thing. Is it actually in the privacy of information in terms of access to information which would not be central banks, of course. This would be private sector access to information. How do you make money off this thing? Is it actually via the access to information? You raise a very important question there about the whole question of information privacy.

You mentioned the Bank Charter Act, so I have to say this. The interesting thing in this country, and we did flag this in the FSR, is that oddly enough we have a bit of an old model for this, which is the arrangements for the issue of bank notes in Scotland and Northern Ireland. Going back to two pieces of legislation just a year before the Bank Charter Act, they are backed by Bank of England central bank money. Although that is obviously the paper world, there is a model that we have in this country, which most countries do not have, that has some of the characteristics of the central bank reserves point you were making.

Q33 **Mr Baker:** I want to touch on dividend policy. Sam, how useful was it to have the policy to prevent the payment of dividends by banks in securing financial stability?

Sam Woods: It was a necessary thing to do. We were in an extraordinary situation back in March for two reasons. First, we knew at that point that we were about to experience a huge drop in the economy. It was not clear quite how big it was going to be, and it was extremely unclear how that was going to impact the banks. That was a really extraordinary position, but unfortunately that position arose—and this is the second point—precisely at the moment that banks were very late in their annual dividend cycle. They were poised to pay out, and had declared that they would, over £7 billion of capital. We looked at that, looked at our objectives and thought, "It is clear from a safety, soundness and financial stability perspective that it has to be safety first. We have to make sure the banks are going to be strong through this in order to support the economy." That was the motivation for it. It has moved on since then, but I will pause there.

Q34 **Mr Baker:** Has the ECB not been stricter than you? You have clearly said safety first, but why were you not a bit stricter, like the ECB?

Sam Woods: We and the ECB did pretty much exactly the same thing back in March. We have now both moved on the policy a bit, and it is true that their formulation, while quite similar to ours—we co-ordinated very closely, in the way that we were talking about earlier in the session—is a little tighter, but it is marginal. To give you a sense of it, our formulation, which is the higher of 20 basis points of capital or a quarter of two-year earnings, compares with theirs being slightly lower than that, but I do not think the formulation we have adopted will lead to more than somewhere between 20 and 30 basis points of capital leaving the system. With everything that we know now, and with the banks' current capital levels, in that type of capital, of 15.8%, I do not think that will present a danger.

Q35 **Mr Baker:** Can you contextualise what that means for cost of capital, just for those watching this session? You said 15 to 20 basis points on cost of capital.

Sam Woods: Sorry, not on the cost of capital. It is 15 to 20 basis points of the capital resources. If you have 15.8% of common equity tier 1 in the banks, maybe 20 to 30 basis points of that could be paid out under the formulation we have now adopted, but we have put that decision back with bank boards.

On the cost of capital question, the best way to look at that is through price to book. That had got back to about 0.8, which is obviously still not very high, in January. It has been low for a long time. It then dropped to 0.4. It is now hovering somewhere beneath 0.6. The role that the dividend issue has played in that has perhaps been slightly exaggerated. People are looking at what is happening to economies and interest rates around the world, and feeding that in. If you look at the big movement in bank stocks today the only plausible explanation is changing interest rate assumptions due to what is happening in the US.

Q36 **Mr Baker:** I hope you will not mind my saying, but as always you have demonstrated your total command of the subject, as we would all expect, of course. What would be the retail message for members of the public to take away about what is going on with bank dividends? Account holders and shareholders will all have different interests. It is a matter of acute interest to many.

Andrew Bailey: The very clear message is that it is not our intention that, as regulators, we should take over setting dividends. As Sam said, we did it in a very, very particular and special circumstance. We regard what we announced before Christmas as taking us back to the point where boards agree dividends and shareholders vote on them. We have guardrails. Normally the guardrails come from stress tests; we did not have a stress test last year because of Covid but we will have one this year. We are heading back to where we normally are.

Mr Baker: Thank you very much indeed for a really interesting and important set of evidence. I am really looking forward with genuine enthusiasm, as you will expect, to your work on stablecoins.

Q37 **Julie Marson:** I would like to talk about the future potential for the economy. I will begin with the Governor, but if anyone else would like to come in, please, I would be really interested in your views. We are now in a slightly novel position in the cycle of this pandemic, where we have tough restrictions but we have vaccinations, which offer us a pathway out of those. As the vaccines are rolled out, even while the restrictions are in place, how likely is it that people's behaviour might change and demand might start rising? What would it potentially look like, and how will the Bank be monitoring behaviour and potential rising demand?

Andrew Bailey: That is more of an MPC question, so I will have a go. By the way, we are about to embark on the next MPC forecast, published in early February. We already have a date fixed with you for the evidence session on that, so we will be looking forward to that. On behaviour, let me have a go. There is quite a bit of literature, and we may have discussed this at the last MPC hearing. Government policies are one thing, but another thing that innately drives behaviour is people's individual actions, fears and concerns.

Interestingly, if you go back over the course of last year, we saw a very, very big reaction last spring, in terms of the impact of the measures and people's reaction to them. The evidence we are gathering—and we get this a lot at the moment from the high-frequency, real-time indicators—indicates that, in the second lockdown, the one in November to early December, the impact on economic activity was not as large. There was an impact but it was not as large.

That may be a number of things going on. First, it was somewhat shaped by the structure of the lockdown arrangements. People operating businesses learned from the first lockdown and adapted. Secondly, consumer behaviour adapted. People found ways of buying things, and one of those has been a big increase in online purchasing. The evidence we are seeing for the fourth quarter at the moment—please do not suggest I am painting a very rosy story about the fourth quarter; I am not—is that, given what happened with the lockdown and what happened post the finalisation of the forecast, the downside in the fourth quarter relative to where we were probably was not that great.

Let me caveat that by immediately saying that none of that tells us what is going to happen as a result of what you are voting on today. It is honestly too early to tell. We cannot judge that at the moment. We do not have any evidence to go on for that one. It is interesting, as you say; people adapt in terms of their economic behaviour. I do not find that at all surprising. So far, that has had something of a positive sign relative to expectations, but not a big one; let me be very careful about what I say here. But people find ways to adapt their behaviour.

Donald Kohn: This is mostly an MPC issue, not an FPC issue. From our perspective, what is important is that, when the economy rebounds, the banks are there and have the ability, as they do, to support the resumed flow of credit and help businesses through to the other side, so they can support activity when it comes back. It will come back, but there will be changes in people's behaviour and structural changes in the economy that both businesses and Government will have to work through.

Q38 **Julie Marson:** You might have seen parallels being drawn between now and the last pandemic, the post-1918 world and the roaring twenties that we might be about to enjoy. What do you make of that kind of speculation, and what do you think it means for policy?

Andrew Bailey: I would be very careful about drawing very literal comparisons with the 1920s in that sense, because we have a very different policy framework. It is important to remember that one of the things that went on post-first world war was quite a strong tightening of both fiscal and monetary policy, causing a very big recession immediately after the first world war, which coincided with the period of the Spanish flu. I am not saying there was any causal relationship, by the way, but there was a very substantial tightening. If you look at the economic policy reaction to the period of the Spanish flu relative to what we have seen in the last 12 months, it was very different in that sense.

What happens thereafter? There are many different things relative to the 1920s, so I am frankly a bit cautious about people who slightly overdraw the comparison with the roaring twenties. It might be something to cling on to in a superficial way. I have to say it did not end well; let me put it that way.

Julie Marson: That is another question about policy.

Anil Kashyap: A different way to put the point Andrew and Don made is that the financial system is in such a better position now than it was in 2007. It is a great thing that we are not having to come up here and talk to you about our concerns that some bank is going to tip over and the system is not in the way that we think it can be to support the economy. The most important thing for the FPC is that all the work of the last 10 years has paid off, and that the banks can support the economy and not amplify all these shocks. That is the thing that we are going to keep our eye on in the FPC.

Q39 **Harriett Baldwin:** Picking up from Julie's questions, I wanted to move on to the countercyclical buffer and where we are in the economic cycle. You have sent very strong signals that the countercyclical buffer is not going to change for the foreseeable future; it is at zero. Have you had strong intentions from the banking system that it will lend once the Government schemes fade away?

Sam Woods: It also points to an interesting lesson that we may have learned from this crisis so far. So far, the banking system has done its job in terms of doing the lending. A lot of that has come through the Government-guaranteed schemes, but there was also a very important phase at the beginning of the crisis where corporates were drawing down lending facilities from banks in huge volumes, something like £75 billion in those four weeks when this crisis was erupting. The pattern since then has been more one in which corporates, as they got steady and were able to raise money in other ways, have been repaying the banking system and SMEs have been taking out loans, mostly those guaranteed by the Government. To illustrate that for you, in October, from memory what happened was corporates paid back £6.7 billion and SMEs took out £1.7 billion, so it was a net repayment of £5 billion.

That is what is happening at the moment. There was a big drawdown from corporates to begin with. Now we are into a SME phase, largely Government-backed but administered by the banks. We are confident that the banks have the ability and willingness to lend beyond that, but the reason we have cut the CCyB is to provide the extra lending room for them to do that.

The last point I would make, and this is where there is a question mark, is about the way our system is designed. You have big buffers of capital and then you have minimum requirements. The idea is that banks should be able to draw down those buffers and use them to do the type of lending you refer to. Luckily at the moment we are some way above even those buffers, but we are not so confident that, if banks get down to those buffers, they will then choose to go into them. It is not right in front of us, but that is a bit of a problem in the framework.

Q40 **Harriett Baldwin:** The reduction in the buffer is meant to have freed up £190 billion-worth of lending. How much of that has been used?

Sam Woods: It is £23 billion in capital, and we can then turn that into a lending number. At the moment, hardly any of it has been used, for the reason I just gave, which is that big corporates are repaying and most of the small business lending is being done through the Government schemes. Of course—this is probably where your question is going—those Government schemes will come to an end at the end of January. How much demand there will be beyond that point from small companies to borrow more, given the conditions we are in, is genuinely uncertain.

Q41 **Harriett Baldwin:** But the banks have enough money to provide that if there is the demand. That is the assessment of the FPC at the moment.

Sam Woods: Absolutely, yes.

Q42 **Harriett Baldwin:** This is just a technically ignorant question, but can the countercyclical buffer go below zero?

Sam Woods: No is the simple answer. You are not the first person to ask it.

Q43 **Harriett Baldwin:** On the subject of negative, we know that you have written out to the banking system in terms of negative interest rates from the MPC point of view. From the FPC point of view, are you comfortable that, if interest rates had to go negative, the banking system could cope with that from a financial stability point of view?

Andrew Bailey: I would like to bring my colleagues in, because I am also a member of the MPC. It is very important that the FPC, as it has been, and the PRC are very much involved in this question. As we have said in the MPC hearings, when you go into this sort of territory, including where we are at the moment to some degree, but even more so when rates go negative, the interaction between the transmission mechanism of monetary policy—the interest rate—the structure of the financial system and, therefore, the impact on the financial system and on banks' margins becomes even more important and critical to the efficiency and effectiveness of the transmission of monetary policy than in the days, if we can remember them, when we used to operate in more normal territory and moving the official interest rate around did not have much impact in that respect.

That is why it is important. It has been very important that both the FPC and the PRC are involved in the consideration, not in any decision—we have not got to this point yet—of whether we would use that negative interest rate tool, but in the structure of the approach and making sure, as I have said a number of times, that it is not just a tool in the box but is one that we can use and that the FPC and the PRC are engaged with. My colleagues may want to come in at this point.

Sam Woods: I can just add an operational point. The other thing we have been looking into quite carefully is a Y2K-type issue. Do bank systems have the ability to go negative? We have had 160 pretty detailed responses to that, which we are currently working our way through. The plan is to publish something on that as part of the monetary policy report in February, so you will get a chance to see that then. The answer from firms is broadly that the answer varies considerably, and it is rather less straightforward to do it for retail customers than it is for wholesale or corporate.

Q44 **Harriett Baldwin:** Can I move on to the subject of productive finance and the work you are doing on making sure, absent the current cyclical challenges, that there is enough productive finance in the UK for companies? Can you give us an update on the FPC's role in that work and whether you think you have enough tools at your disposal to make improvements in this area, or whether you need new tools from the Treasury? What conversations are you having with the Treasury about whether it should continue with the bank guarantee schemes past the current scheduled dates?

Andrew Bailey: The productive finance issue is very important because, as I said earlier, we have had low investment rates in this country for quite a while. As we come out of the Covid crisis, as we have been discussing, we will come out with a corporate sector that has more debt and is more leveraged. We also have the challenge of financing climate change, for instance. All these things call for a higher investment rate.

Moreover, there is a critical issue, much talked about, of the sustainable rate of growth coming out of this and how we deal with the legacy of public debt. The economics of that say it will be more straightforward to deal with that legacy if the sustainable growth rate exceeds the interest rate on the debt; the debt trap is the other way round. There are many reasons why we need to be focused on this question of investment, and therefore on the productive finance question. The FPC and the Bank are very focused on it. We are working very closely with the Treasury and the FCA on it, as we said in the report, because it goes across all of our responsibilities. For me it is a very high priority.

Q45 **Harriett Baldwin:** I am glad to hear that, but is it urgent? When are we going to see the results of this work?

Andrew Bailey: At the moment, we are working with the industry, particularly with the asset management industry. I am very clear that sleeves have to be rolled up; let us get down to the real issues here. What are the barriers to deploying pension savings and the higher saving rate we have seen during the Covid crisis to support productive investment?

There are a number of things coming forward in areas to do with pensions, the structure of pensions and pension regulation, and we are very closely engaged with the industry on that. Sam and I regularly talk to the asset managers, and we have said, "We are not going to rest until we get to a point where we have structures that work to support long-term investment." I am very happy to keep you closely in touch with what we are doing on that front.

Q46 **Harriett Baldwin:** Are we likely to see something on that soon?

Andrew Bailey: I hope so.

Q47 **Harriett Baldwin:** Can you just touch on the extension of the Government guarantee or whether you would like to see that end sooner or later than currently scheduled?

Andrew Bailey: Those two questions are a bit different. On the question of whether we are going to see progress on productive finance, I hope so, but I am not going to put a precise date on it because we have sleeves rolled up, unearthing issues and wanting to find solutions to them. We will tell you what the issues are and what the solutions are.

On the guarantee schemes, that is fiscal policy. It is important that I do not opine on fiscal policy. As my colleagues have said, they have been very important over the last year. They have played a vital role in supporting businesses. It is entirely sensible that the Chancellor took the decision he did on their term, but I am not going to get into the business of saying what should happen next.

Donald Kohn: One important place where the Financial Policy Committee intersects with the productive finance agenda is in open-ended funds. We have bond funds, and even property funds, that promise instant liquidity and are holding illiquid assets. To establish a fund that will invest in really illiquid assets that can support productive finance, we have to reform these other funds, which the former Governor said are living a lie. They are promising more liquidity than they have. If we can get those in better balance, that will help with pricing and financial stability, and will help establish a route for opening other funds that do not promise instant liquidity and can invest in these longer-term assets that will support productive finance. We are working with the FCA on that and we are expected to have something by mid-year.

Andrew Bailey: We are also working extensively on this internationally, in the Financial Stability Board. It is an international question because many of these funds are not just UK funds.

Harriett Baldwin: It feels like a very, very important issue at the current stage of the economic cycle. We look forward to an update by mid-year.

Q48 **Alison Thewliss:** I have questions on the impact of bad debt. The FPC's record notes that some headwinds to banks' capital positions were anticipated over coming quarters, principally from risk-weighted asset inflation and the reduction in transitional relief on the existing stock of provisions as unemployment and insolvencies increased and some assets moved into default. How bad do the members of the FPC expect those headwinds to be?

Sam Woods: This is the easiest way to think about it. Large banks in the UK have about £260 billion of equity capital. That is what they have to absorb losses. They have taken losses of about £20 billion during the last year, but those are forward looking, and therefore, for the moment, we have transitioned a lot of those in such a way that they will not hit their capital position until they come through, so until a loan goes bad. They have made some estimates and said, "We think this amount may go bad in time and therefore we will take that hit." Partly what we are referring to is that, if they have got that number right, that £20 billion will migrate through into an actual loss, and then that will hit capital. You can think of that £20 billion compared with that £260 billion; that is not at all a worrying number in that context.

As banks' risk models adapt to the new environment, risk weights will go up, which will put on downward pressure. On our current central expectations, even if I try to extend them a bit for the latest lockdown, I am not worried about that from a financial stability and a safety and soundness point of view. We have also stress tested banks against a much, much worse outcome, which we think they can also accommodate.

Q49 **Alison Thewliss:** Do you feel that perhaps there is an extent to which the pain to the banks as a result of the crisis has been insulated due to the Government support schemes and the Government backing?

Sam Woods: That is true. That is not a bad thing; it is sensible for the Government to support the economy through this. It is mainly true in two ways. One is that, as we were discussing a few moments ago, the Government themselves have taken the strain of quite a lot of the lending that has had to occur. That has been done through the banks, but the capital treatment is very favourable.

The other, and this is the more important one, is that, by softening and cushioning the blow, the actions the Government have taken will reduce the number of mortgage defaults and insolvencies that we have through time. They will also spread them out through time. In the banking system, it is really a short, sudden hit that is the most difficult to absorb.

Q50 **Alison Thewliss:** Do you feel that cushioning is enough that it is not building up a problem for the future?

Sam Woods: There is a question that is coming, which is much more a conduct question. Andrew may want to come in on this, given his prior experience, or he may not, actually. It is likely that some significant portion of particularly the bounce back loans will default. We are all expecting that. A very important thing—and this Committee has been heavily engaged on this in the post-financial crisis setting—will be how, between the Government and the banks, it is agreed to handle that situation when it arises. There are many scars on people's backs from what happened last time round.

Andrew Bailey: I cannot emphasise that enough. As you know from hearings of this Committee in the past, this crisis experience is lined with utter pain at times. It is critically important that, as Sam says, there are very clear rules of engagement, that all sides understand and then proceed transparently. Otherwise, I am afraid the record is not good.

Q51 **Alison Thewliss:** I was going to ask about that as well. What confidence do you have that we are not going to end up in a similar situation where banks take action that is a bit more dramatic than would be helpful?

Andrew Bailey: The confidence I have is the fact that the pain of the past has not been forgotten, and everybody understands that self-interest determines that we should avoid that, but it has to be done. As Sam said, this is lending on a very big scale, absolutely sensibly and necessarily. It makes a lot of sense that the period to work these loans out has now been extended. That is an extremely sensible thing to do, but the clear thing is that there are very transparent rules of engagement for doing so.

Q52 **Alison Thewliss:** Many businesses will have seen a complete loss of income and will have taken loans, and we are now going into this further period of lockdown. What proportion of bounce back loans are unlikely to be repaid at all at this stage? Are you able to put any estimate on that at this point?

Sam Woods: I am happy to, but I would like to do so cautiously. I am sure you will have seen the report from the PAC on this topic. It estimated a range of £15 billion to £26 billion out of about £43 billion, so the top end of that is a 60% range. When we look at it, we tend to think of there being a fraud element. There will be a fraud element to this. That fraud element will be higher than for normal lending, but it will still be a very small fraction of the losses. The banks themselves are expecting quite considerable credit losses. To benchmark that for you, they say that about a third of this lending is lending that they would not have done, left to their own devices. If you push them for a range, they tend to talk about 30%, 40% and 50%. The top end of the PAC range is probably high, but lower within that is quite plausible.

Andrew Bailey: It is important to interpret that. It is not saying a third of it should not have been done, because part of the reason for doing these schemes was to change the risk appetite due to the nature of the

Covid crisis. There is an important distinction between what the banks say they would do in normal circumstances and what was right to do in these circumstances, and that is why the guarantees make sense.

Q53 **Alison Thewliss:** Are you confident that banks can absorb that?

Sam Woods: Most of it will come through to the taxpayer because of the guarantee. Where the banks will take losses is if they have not properly done the checks that they were meant to do. We will see whether that is the case; some of the fraud cases might be of that kind, but it goes back to your earlier question. The thing that will be really painful, most importantly for SMEs, but it will also hit the banks, is if the handling of that situation is done badly and we get into conduct issues we had in the past, which was extremely painful for everyone, including financially.

Andrew Bailey: As an important parallel to this, this involvement from the Government has enabled the banks to extend quite extensive payment holidays in the mortgage and unsecured lending area, at their own risk. There is more than one part to this, and we needed all those things to happen to bridge through this crisis. It is important to look at the role that the banks have played across the board.

Anil Kashyap: To emphasise what Sam and the Governor said, we wanted to pay people to stay home so that they did not get sick. If the Government end up footing the bill for some of it, that is what social insurance is all about. Given that there will be losses, socialising them makes sense to me. The alternative would have been much, much worse. It was nobody's fault that businesses could not operate, and forcing them into bankruptcy or something like that seems like exactly the wrong thing to do.

Q54 **Alison Thewliss:** The Commission has been noting that there might be a need for bad banks in the euro area. You might generally have confidence about UK banks, but how much of a risk to the UK is there from that kind of action?

Sam Woods: It is very low. They will only do that if they think it will improve the health of their banking system. Small, individual bank versions of that have been happening quite a lot already, so I am not really concerned about that development if it comes to pass. It has been very difficult to get that agreed in the past, because within Europe there is a concern that it shifts burdens from one country to another.

Andrew Bailey: To go back to the dividend issue for a moment, Sam answered the question, "Why is there a bit of a difference between us and the euro area on this dividend question?" One underlying reason is that they are somewhat less confident across some of their sector about the underlying revealed loss position at the moment, which lies behind this point about the bad bank.

Q55 **Dame Angela Eagle:** I want to ask about the unregulated shadow banking area, particularly the extent to which the understandably stricter regulatory framework on regulated banks that followed the 2008 financial crisis might just be transferring the risk into the shadow banking area, which is unregulated. How well sighted is the FPC on potential problems with the shadow banking area, which has increasingly come to finance US treasuries and other places where one traditionally dashes for cash?

Andrew Bailey: That is a fascinating question, which has quite a big scope to it. If we focus on the dash for cash issue, you are right that one of the issues that last March brought home was the increasing share of intermediation activity taking place outside the banking system. This is a very big issue internationally and in the Financial Stability Board, of which we are a leading member. It literally goes across markets. There is a whole set of work going on there. The interim report on the dash for cash was published by the Financial Stability Board under the auspices of the G20. It looked at a number of angles. There was an angle that Don referred to earlier about non-bank funds and the risks they take in terms of liquidity positions.

There is a second set of work, which you have rightly just referred to, which is the presence of non-banks acting as market-makers, and frankly whether they are fair weather friends that disappear just when the market-making capacity is needed, and because there is an illusion of liquidity in markets the crisis then becomes worse. In some minds there is an issue as to whether the effect of the post-financial crisis regulatory changes—particularly in the liquidity regulations and somewhat in the leverage regulation in the US, probably—has reduced the capacity of banks to make markets. That is quite a controversial area; there are very different views on that one, but all these issues are in the mix.

There is a further issue that has been raised, importantly, as to whether, if there was greater focus on clearing in some markets, such as the US treasury market, that would alleviate some of the pressures. Anil or Don, you may want to come in on this issue because you are much more expert on the US treasury market.

Q56 **Dame Angela Eagle:** Before you do, the motivation of shadow banks is very different from ordinary, regulated banks in that they tend to make their money with short-term arbitrage decisions and repo contracts. Is that causing more volatility? Is that causing there to be stress when an ordinary, regulated bank would provide liquidity?

Andrew Bailey: That is a very good question.

Dame Angela Eagle: To what extent is the Bank actually sighted on what is going on in the shadow banking area?

Andrew Bailey: We do not really use the term "shadow banking" any more because it is such a big umbrella that it has many parts.

Dame Angela Eagle: The non-regulated area, then.

Andrew Bailey: Some of them are regulated; they are just not always prudentially regulated. If we stick to the area you are talking about, which is a very important one, wholesale market-making, the backdrop to this is that one of the thrusts of the post-financial crisis reform was to move some areas of financial intermediation out of the banking system and into the non-bank system because they were not suited to being in the banking system, illiquid assets being a case in point.

There is a long debate about whether market-making is naturally the home of banks and to what extent it is the home of non-banks, but you are right that there has globally been a shift from the banking system to the non-bank system. There has been a growth of what you might call non-bank intermediaries, fast trading activity, and that extends to some of the core markets, of which the US treasury market is probably the best example. The risk we therefore have to look at is whether that market has characteristics that mean it is not stable enough. Because it is relied upon as a core market for collateral, for instance, to have this sudden burst of illiquidity when people withdraw their market-making capacity is a risk to stability.

Anil Kashyap: To amplify what Andrew was saying about the treasury market, partly because of Covid, if you look at the amount of treasury issuance that is going to follow for the next five to 10 years, it is going to swamp the capacity of the dealer banks to intermediate. It is almost inevitable that we are going to have to reform the way the treasury market functions, just because the balance sheet capacity of the dealer banks is not going to be there. Whether it goes through central clearing and exactly how much that will solve is a very active area of inquiry and study. It is something the Bank is looking at, as are the international regulators and the US.

Secondly, there is one thing that is very hard to fight. If you do not know the creditworthiness of somebody you are transacting with, one way to handle that problem is to lend to them for a very short term. I may not trust you enough to give you the money for three months, but I will give it to you overnight. Part of the way the thing you were calling the shadow banking system functions is that it is using maturity as a substitute for capital and discipline. That is one thing that we are chasing down and trying to keep track of, but it is fundamental that you see that that is the way the system would start out, and then it is up to us to try to find cases where that is happening where it is dangerous. That is why Don mentioned all these open-end funds where we just think there is a fundamental mismatch.

Q57 **Dame Angela Eagle:** Is it not a risk to financial stability if lending times do get short like that?

Anil Kashyap: Yes.

Dame Angela Eagle: Immediate volatility can be very dangerous to the financial system. To what extent are you aware of the level of risk that is building up in these areas so that you could rapidly respond if there was a problem, especially if lending times are very short?

Andrew Bailey: We follow it very closely, but it is an international issue. It can happen in sterling markets, and it did in March, but obviously the dollar markets are the biggest. There is another dimension to this; this is the other big issue internationally and domestically. In March, when we faced this situation, because it was in the non-bank world, the central banks, including us, had to intervene with massive doses of QE. We needed that QE for monetary policy reasons as well, so we were not at odds here, but the fact that we had to go in so heavily, so quickly, at the end of my first week as Governor was not just for monetary policy reasons; it was because we had to use the only tool we had to get to market liquidity.

There are very big questions, and one of my colleagues, Andrew Hauser, is now leading the work internationally with the New York Fed on this to say, "There is one set of issues around what the market structure impact of this is, and there is a second set of issues, which is what the right central bank tools are to deal with this if you have to."

Q58 **Dame Angela Eagle:** That was going to be my next question. Given that this was so dramatic and so sudden, it is likely that, given the level of state deficit there is now around the world, there may be volatility. The Fed's rescue was necessary but it is also a moral hazard, because it has let off a load of people who made a lot of money taking risks, which were then taken off them. How is it solved?

Andrew Bailey: That is what we are working on. You are right; we do not like it, but we had to do it. By the way, if the Fed or the ECB were here, they would say the same thing. We had to do it.

Q59 **Dame Angela Eagle:** By the way, I am not saying you should not, but it does create that situation.

Andrew Bailey: There are aspects of it that we just do not like. The question is what combination of measures on the market structure and stability side, plus central bank tools that we may not have at the moment, we should adopt, because we do not like what we saw; I will be honest with you.

Q60 **Dame Angela Eagle:** We will keep a close eye on that.

Andrew Bailey: Do.

Donald Kohn: The dash for cash, this huge demand for liquidity—very, very short-term assets, bank deposits, central bank deposits—in mid-March when the uncertainty just got sky high and everybody needed cash, revealed weaknesses that we had been tracking for a while. For example, the open-ended funds had been a subject, and we were looking at it with the FCA. We had talked about liquidity pressures from hedge funds, although we had not seen quite how severe they might be in this. Some of these things were on our radar, but some of them were not.

The international effort right now, with the Bank of England playing an important role, is to size what happened and why, and then to approach it from both building the resilience of the pieces of the system that were revealed as weak, and looking at whether central bank intervention should be made more regular and predictable, what would be available there and how to deal with the moral hazard of that. We are coming at this from multiple angles. Just to emphasise, we saw some of the weaknesses but not all of them.

Dame Angela Eagle: This is an issue we need to come back to.

Anil Kashyap: Usually I would not tell you to read central bankers' speeches unless you have sleeping problems, but if you are interested Andrew Hauser has given two very good speeches, Jon Cunliffe has given two speeches and I gave a speech. A lot of our thinking is already laid out if you want to go into the fine details.

Dame Angela Eagle: Thank you. That is five speeches.

Q61 **Chair:** That brings us to the end of this session. Thank you all very much indeed, particularly Don. Don is stepping down from the FPC in March, so this will be your last appearance before this Committee. Despite your comments about having consumed copious quantities of chlorine-washed chicken, you look in fine shape, and I am sure you will have a long, successful and healthy retirement from the FPC. We thank you. Andrew, you wanted to say a few quick words.

Andrew Bailey: I just wanted to thank Don. Don is an original member of the FPC—the two of us are—but last year marked the 50th anniversary of Don starting to work in the Federal Reserve system. He did 40 years in the Federal Reserve system and had an incredibly distinguished career, becoming a governor and vice-chairman. We were then lucky enough to have the next 10 years of his involvement in the central banking world, and we have been incredibly lucky. He is one of the wisest people in world central banking, I can tell you from long experience.

He is probably one of the few people to have had a long career appearing before congressional committees and then this Committee, so if you ever get a moment ask him about the difference. It is fascinating. I just wanted to put my thanks to Don on the record, because he has made a huge contribution to us and the FPC, but also a huge contribution to central banking.

Donald Kohn: Thank you, Andrew, and thank you, Mel. It has been a great honour and privilege to be part of this process and to have a relationship with the TSC. This morning I was actually reflecting; my first testimony before the TSC was about 20 years ago in January 2001, and I have been impressed with the knowledge and focus that you guys have brought to this. As Andrew says, if you want a comparison sometime it will be fun to talk about, but perhaps not now in public.

Chair: Another time. Don, thank you very much for your kind remarks.

Once again, as Andrew says, thank you so much for all that you have contributed, not just before this Committee but at the Bank of England and to our country.