House of Commons

# Treasury Committee

## Oral evidence: Bank of England Financial Stability Reports, HC 674

Wednesday 29 January 2025

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Watch the meeting

Members present: Dame Meg Hillier (Chair); Dame Harriett Baldwin; Rachel Blake; John Glen; John Grady; Dr Jeevun Sandher; Yuan Yang.

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### Witnesses

I: Andrew Bailey, Governor, Bank of England; Nathanaël Benjamin, Executive Director, Financial Stability Strategy and Risk, Bank of England; Dame Colette Bowe, External Member, Financial Policy Committee, Bank of England; Liz Oakes, External Member, Financial Policy Committee, Bank of England.

### Examination of witnesses

Witnesses: Andrew Bailey, Nathanaël Benjamin, Dame Colette Bowe and Liz Oakes.

Q1 **Chair:** Welcome to the Treasury Select Committee on Wednesday 29 January 2025. We are delighted to welcome the Governor of the Bank of England, Andrew Bailey, to talk about the Financial Policy Committee's work at the Bank. He is joined by Nathanaël Benjamin, who is the executive director for financial stability, strategy and risk; Liz Oakes, who is an external member of the Financial Policy Committee; and Dame Colette Bowe, who is also an external member of the Financial Policy Committee. A warm welcome to you all.

Governor, you and the Chancellor of the Exchequer have exchanged letters, as she wrote to you shortly after the election. I thought it would be helpful if you could summarise to us, before we go into the main session today, what you think you are going to be doing differently as a result of the letter that the Chancellor sent you. I know you have written back to her, but perhaps you could put it in simple, understandable language.

***Andrew Bailey:*** I will put it into context. Obviously, we are talking about the FPC here, but the PRC is allied to this. The primary objectives have not changed in terms of financial stability, but the Government have changed some of the language around the secondary objectives, particularly to emphasise growth and competitiveness. Let me be clear: we obviously welcome this.

Let me start by saying that it is important that we raise the growth rate in the economy. It is important for all sorts of reasons, including financial stability, so I am very supportive of the work of the Government, and, of course, the work of the previous Government. This is not a new thing, in a sense. I say that because we have had a low potential growth rate in this country, really, since the financial crisis, going back 15 or 16 years now. Addressing that is an important question. What I did emphasise in the letter was that, fundamentally, financial stability is a foundation for growth, so there is not a trade-off in a fundamental sense. Of course, we have seen the impact that a loss of financial stability can have in the financial crisis.

Going back to what I was just saying, there is a very interesting question as to what exactly is causing the low rate of potential growth, because it is not unique to the UK, by the way. The US is somewhat the outlier, if anything, rather than the UK, because it goes back to the financial crisis. There is an argument where you might say, "Well, you would say this, wouldn't you?", but in many ways it was the loss of financial stability during the financial crisis that had an impact on investment in the economy and has had an impact on growth.

Having said that, while I do hold very firmly to the view that there is not a trade-off and that we must maintain financial stability, I do agree that there are choices to be made about the particular choice of regulatory instruments and the particular choice of how regulation is operated to enable us to not only achieve the primary objective of financial stability, but also support the secondary objectives, including the growth and competitiveness objective. We are very supportive of this, so we see it in that context.

Q2 **Chair:** You are supportive of it, so what are you actually going to be doing that is different from before you received the letter? Is there anything that has radically changed?

***Andrew Bailey:*** Yes. We have addressed a series of questions around bank regulation and insurance regulation, and we will go on doing that. Some of those have been enabled by the UK's new position post Brexit. Some of them are to do with international standards. There is also the question of the way in which regulation actually operates in terms of the burdens it imposes.

Let me draw out two things that we are very keen on. Although they come more from the PRC world, they have an impact on financial stability. One is that we want to introduce a different regime for smaller

banks. The reason we can do this now—or will be able to do this in the future—is that the European Union approach is to apply the international standard for large banks to every bank. That is not the way it is done in the US, for instance.

Q3 **Chair:** So this will be for some of the fintech challenger banks that are smaller.

***Andrew Bailey:*** Yes. Sam Woods has called this the strong and simple approach to simplify regulation. We want to do that now. I have to say that in order to do that we do have to implement the new Basel rules, because we need you to do something in Parliament to unlock this.

Q4 **Chair:** Just for the ease of anyone tuning in who might not be a banker or a Bank of England follower, what would that mean for the consumer? What difference do you think that will make?

***Andrew Bailey:*** Well, I hope it would improve the competition in the banking industry, so it would improve the choices that consumers have. We have had quite a strong entry into the banking markets in the last decade. The number of new banks created has been higher than ever before. The question now is not so much that; it is actually ensuring that these institutions can grow into real challengers for the public.

**Chair:** Challengers for the big six, basically.

***Andrew Bailey:*** It is important that we do that. We do need an agreement on Basel going forward. We have delayed that because of the uncertainty from the US angle, because there is a competition issue there as well.

**Chair:** We will come to some of that later.

***Andrew Bailey:*** That is one example. We can do a lot on data reporting to simplify it. We would like to make quite a substantial investment there with the industry, both to simplify it in terms of the amount we collect and also to make it more efficient. We can do a lot on that front. There are a number of things that we can do there and that we will do.

On the insurance front there has been quite a lengthy process, which Mr Glen will be very familiar with, around the so-called Solvency II regime that came across from Europe. We have now broadly settled that, but it obviously has to be implemented and put into effect. We have had a lot of discussions with the industry. There is the potential for very substantial investment to come out of this. It is really out of life insurance; it is in that world. Again, that will support growth. The FPC's job is essentially the overarching view: "Are all these things consistent with financial stability?" The answer is that they are. We can do these things consistently.

**Chair:** We will get into detail on some issues.

Q5 **Rachel Blake:** You have set out that there are opportunities after Brexit

and with international standards. You have also said that the economic growth objective is not new. Obviously Brexit is a change, as are international circumstances and standards, but I would really like to understand why those changes that you are talking about around data reporting are new and why you are able to change them now rather than previously.

***Andrew Bailey:*** Lots of the data reporting actually follows from having more scope, post Brexit, to choose what we do. I always preface this by saying I take no position on Brexit, per se, so this is not me suddenly giving you a message on Brexit. I am not going to do that, but there is an opportunity, and the opportunity is that it gives us more choice. When you are in the EU, the EU is quite prescriptive over data reporting, for instance, so we do have more choice. Frankly, there is quite a lot of that reporting for which, when you talk to the people who supervise banks, they say, "Well, actually, we do not use it all". There is an opportunity to be nimbler, frankly, on that front.

Q6 **Rachel Blake:** So are you saying, then, that that opportunity with changes to EU regulations is the only thing that could possibly have changed from previous Governments' objectives around economic growth? You identified some categories of opportunities, and I am trying to get at what detailed opportunities there are that are not linked to Brexit.

***Andrew Bailey:*** Well, there is a whole set of other opportunities that come along as a consequence of technology changing and as a consequence of the financial technology changes there, which can make it more efficient. Like all organisations, we are also looking at how we can use artificial intelligence in terms of what we actually do. That is important as well.

We have made several other changes. You may be aware, but we have changed some of the way we regulate remuneration. Now, you may say, "Well, that is all very nice. Does that really contribute to growth and competitiveness?" The fact is that we were never strong supporters of these regulations, so in terms of reducing the burden of regulation we think those are sensible things to do as well.

Q7 **Rachel Blake:** Just to come back on your observation around additional competition in the banking sector, are there other benefits to consumers that you can identify?

***Andrew Bailey:*** Well, there are benefits in terms of the cost of financial services. Now, it is not easy to map those one for one—don't get me wrong—but we have to admit that regulation does come with a cost. There is no question about that, and the industry will tell you that quite forcefully, I am sure. Again, we have an obligation to ensure that the efficiency and cost of regulation is an objective, because it does get passed through to consumers, ultimately, so, in that sense, yes.

Q8 **Dr Sandher:** Thank you all for coming. Governor, I wanted to ask you

about some of your actions around the APF QT, and particularly its impact on financial stability. Could you outline how you at the Bank of England are approaching unwinding and selling off the assets you created underneath quantitative easing, and the implied effect on interest rates?

***Andrew Bailey:*** Last year I made a speech at the London School of Economics, the day before the election was declared—coincidentally, just to be clear—setting out our approach towards this. I set out that there are, in my view, two phases to this. The reason for that is that, if you look at our balance sheet, on one side of the balance sheet is a set of what we call reserves, which is the balances that banks hold with us. In a sense, that is the highest-quality stock of liquidity they can hold, because it is effectively cash. On the other side is assets, and those assets are essentially, at the moment, the stock of quantitative easing. It is gilts.

Now, the question we face is this. If you look at history and go back to before the financial crisis, we had a very small stock of reserves. It was too small. You can operate monetary policy in normal times with a very small stock of reserves. Unfortunately, for financial stability purposes you need a larger stock of reserves, because those are the liquidity buffers that the banks maintain so that every day they have cash available. It also runs the payment system as well.

During the quantitative easing programme we increased that stock of reserves, and we increased it very deliberately above the level that you would need in normal times. That was deliberate because of the monetary policy objective. The first phase of the objective today, therefore, is to bring that stock of reserves down to what is the equilibrium level. Now, we do not know what that is, because we have gone from it being too low before the financial crisis to a deliberate excess during quantitative easing, so we have to find that middle ground.

The distance is very large. At the peak, we had getting on for £1 trillion of reserves. Pre financial crisis, we were operating sometimes with only about £30 billion of reserves. We have done quite a lot of work to ask, "Well, where is that equilibrium?" We will know it when we see it. We talk to the banks a lot about it. They give us numbers that are in the range of £400 billion to £500 billion, but we do not precisely know, and it can change over time. The first phase is, therefore, to get down to that level. We are well on the way. Based on the conversations we have had with the banks, we may get there later this year. We will see.

Q9 **Dr Sandher:** What do you see the impacts of this quantitative tightening on interest rates being? In June 2023, Dave Ramsden said there was an unexpected increase of around 10 basis points, but he does not say what the implied increase in interest rates is. Do you have an estimate, if you like, of what your quantitative tightening is doing to interest rates?

***Andrew Bailey:*** That remains about the best estimate we have, 10 to 15 basis points in terms of term effects. I have said this a number of times to this Committee in the past. I am not going to talk about monetary

policy this afternoon, but I will talk about the framework, if you do not mind. When we set the official interest rate, the bank rate, we set it taking everything into account in terms of financial conditions, including that 10 to 15 basis point impact. To be clear, it is not an add-on; it is taken into account when we set the rate.

At the moment we are doing very little in terms of gilt sales because we have a very large natural maturity of the portfolio this year. We maintained the overall run-off at £100 billion for this year, but £86 billion to £87 billion of that is just natural run-off. We are actually not selling much at the moment. We are doing very few auctions relative to the past.

Going to the second phase, when we get to the equilibrium level, as I said in the lecture at the London School of Economics, we will then have a decision to take as to what we do thereafter, because we are not then trying to reduce the level of reserves, because we will have hit the natural level. However, we will have interest rate risk on our balance sheet because we bought gilts and on the reserves we remunerate them at the prevailing bank rate. As I set out in the lecture, my objective would be, over time, that that interest rate risk should go back into the banking sector. It should not be on our balance sheet, and it should not, therefore, be on the balance sheet of the public sector. It should go back into the outside world. How quickly we do that is to be decided. That will be the decision for the second phase.

Q10 **Dr Sandher:** I think what I am trying to get to, Governor, is that your regime at the Bank of England has active sales of bonds, and in the United States they have not done so. At the very least, if you are winding it down quickly, it means a faster increase in interest rates. On the term premium side, my understanding from the lecture of Dave Ramsden—and I am happy to be corrected—is that the 10 to 15 basis points is about unexpected sales, not the run-off of sales, because, whatever quantitative easing was doing in the beginning, you would expect a symmetrical increase on the other side. I am not sure 10 to 15 basis points would add up to what we would expect the impact of QE to have been in creation.

***Andrew Bailey:*** That is our assessment of it.

Q11 **Dr Sandher:** My question is that the United States, Canada and the ECB are not doing active sales, but you are.

***Andrew Bailey:*** Can I explain the difference? Let us take the US as the example, as you said. The US public debt stock has a much shorter maturity than the UK public debt stock. When the Federal Reserve did its QE programme, it bought very short-maturity assets. It has been a deliberate policy of UK Governments for quite a long time to lengthen the maturity of the stock of gilts.

When the Bank of England started its quantitative easing programme back in the financial crisis, the decision was taken that we would buy a stock of gilts that essentially matched the profile of the stock of gilts in issue. That was deliberate, because we did not want to start affecting the relative price of gilts across the curve by us being more in one part of the market than another. That meant that we ended up with a much longer duration and maturity of gilts than the Federal Reserve.

The Federal Reserve is in a position where it has to take the reverse decision. Its stock will just naturally run off very quickly and the decision it has had to take as it started on this is, "How much do you let run off, or how much do you throttle it back by continuing to buy short stuff to stop too fast a run-off?" We have had the opposite issue, which is that the stock is very long. The stock will be with us in substance for decades, so it puts us in a different position, to your question about sales, than many of the other central banks, although not all. The Swedes, for instance, are selling as we are, but it puts us in a different position to many others.

Q12 **Dr Sandher:** I want to come on to what the impacts on the fiscal side are in terms of what it is doing. You are actively selling bonds. If the base rate falls, the loss the Treasury would have to indemnify would also fall through time. Is that correct?

***Andrew Bailey:*** That is correct, yes.

Q13 **Dr Sandher:** So by doing so at the moment—i.e. by doing active QT now—you are directly increasing government borrowing, whereas if you let them run off just a little bit longer there is a fiscal saving. I appreciate the indemnity is one thing, but I am saying there is an impact here.

***Andrew Bailey:*** Can I just be very clear that there is a balance here? The longer we leave them, you've then got the cost of carry. Remember, as I said earlier, that we have this interest rate risk. We are remunerating reserves at bank rate. That is how we essentially anchor the short end of the curve for monetary policy reasons. On the whole the gilts have lower coupons on them, because of when they were bought during the very low interest rate era.

I always correct this point that, "Well, if only you held on to these gilts you would not have the same cost". Actually, in an efficient market, it would balance out. You would have the cost of carry, the interest rate differential, versus the cost of selling. Those two things have to be seen together to actually calculate the effects.

Q14 **Dr Sandher:** I accept there is a cost of carry. The market would not be fully efficient and we would need to price it in. I am saying, more broadly, if I was to sell the bonds at the end of this year as opposed to the beginning, there is a possible fiscal implication. That tends to reduce on the fiscal side of things.

What I am particularly concerned about—I will carry on or let others get

on to this—is that there are investments we have to make to protect our financial stability. I am thinking about climate change. I suppose my worry at the moment with the APF and quantitative tightening is whether you are considering the ways in which your actions around this are reducing investments, by the private sector as well as the public sector, and reducing those risks in the long term.

***Andrew Bailey:*** There are two points on this. First of all, let me just make the point that, of course, if you spread out the profile of the run-off, you will have the same cost in an efficient market. You will spread it over time. There are different judgments on whether that is a good thing or a bad thing. I just want to make the point that you do not change the actual overall cost over time.

To come to the second point, you really need to get the people in who are experts in Government accounting, which I am certainly not, if you do not mind me pleading on that one. How this affects Government cash flow and how it affects the fiscal rules is important, because, obviously, that is determined by the nature of the fiscal rules. You may remember that the Government made a change to the fiscal rules in the Budget in terms of how the stock of debt is calculated, including the debt that we hold.

If you do not mind me saying so, you would want people who are much more expert than I am in terms of how those cash flows and the fiscal rules work to understand the impact of those actions on the overall fiscal position and on the constraints it has, because it is not simple. I often read articles saying, "It is very simple; the cash flow is this". No, it is not, because it depends on how it works within the fiscal rule.

**Dr Sandher:** That is very kind. Thank you, Governor.

***Andrew Bailey:*** It is kind of you to say that.

Q15 **Yuan Yang:** This is a question mostly for the Governor, but possibly for Mr Benjamin as well. The Governor just mentioned this phase two getting to equilibrium, possibly in the next few years, or maybe you want to specify the timeline, Governor. At that point, the banks that are currently getting a much better deal right now, because the Bank of England and the Treasury is taking on all of the interest rate risk, will be asked to suddenly have a bunch of risk that they might not want offloaded on to them. I was wondering what you think this means for the banking sector and its response to that side of the bargain, as it were. Are the banks willing? Will there be a fight? How do you see that working out?

***Andrew Bailey:*** I do not envisage a fight on this front at all, actually. It is quite natural. First of all, they have to choose the level of reserves that they think is appropriate. Now, it is not a completely free choice, because we have policies, obviously, on liquidity in the banking system. We have tried this in the past, and it ended badly, to have it running at too low a level.

Then, of course, it is for the banks to decide how they hedge the interest rate risk on the reserves, which they will do. They will have a set of deposits with us, on which they are remunerated at bank rate. They will have to decide what assets they wish to hold. Sorry, their asset is actually the deposit with us. I got that the wrong way round. They will have to decide what rate they pay on the liabilities, but also how they hedge those positions, because they all have what I call structural hedges in place, which hedge interest rate risk on their deposit book and on their assets over a period of years. I think they agree with this. It is not a subject that really comes up much in conversation. The natural place for that to be managed is in the banking system.

Q16 **Chair:** Mr Benjamin is nodding. Is there anything you wanted to add? He is just agreeing with the Governor.

***Nathanaël Benjamin:*** The only thing I would add is that gradually, as we return to this new normal, we will see an increase in the use of our lending facilities and our repo facilities, such as the short-term and the long-term repo. That is a feature of the new world that we will be returning to, so that is a very healthy feature of that evolution towards that new normal.

***Andrew Bailey:*** As of yesterday, we currently have about £57 billion of lending out in the repo market. It is mostly short term, but there is a bit of longer term as well. We are providing liquidity into the market, but at the policy rate, so we take no interest rate risk on that lending. That is the key difference.

**John Grady:** I wonder whether we should give the Governor a rest.

***Andrew Bailey:*** That is a good idea.

Q17 **John Grady:** Dame Colette or Ms Oakes might be willing to help me with some questions on geopolitical tensions. Paragraph 2.2 of the report, under "Geopolitical and global fragmentation risks", says, "Heightened geopolitical tensions pose a significant risk to financial stability". Has this become more or less predictable since November 2024, noting changes in France and other large countries?

***Liz Oakes:*** The geopolitical situation is complex. It has become much more complex in the last few years. It is very difficult in the early days of a new Administration in the United States to predict precisely how this is going to play out, but we can all see that tensions—whether it is in China and Taiwan, or in the ongoing Russia-Ukraine situation—continue to put pressure on supply chains and the cost of energy more broadly. There are a whole range of different channels by which that transmits into the financial sector.

Whether it is going to get any better or any worse is almost anyone's guess. The challenge that we face is trying to work with financial institutions and advise people, or at least identify some of these risks and enable people to take measures or at least look at the situation and

consider to what extent are they exposed, to what extent their environment and ecosystem is exposed, and whether they are aware of the complexity of the environment they are operating in.

Q18 **John Grady:** Out of interest, how does the Bank go about assessing this? It has become a lot more unpredictable and there is probably a fairly short supply of true experts in this field. How does the Bank assess this risk?

***Liz Oakes:*** I am an independent member of the committee, so I am relying on a lot of diverse feedback from multiple sources within the Bank structure. The international division, for example, reports back on things that are happening that it sees through its chain of conversations and inputs. From where I am standing there are also a range of different segments of the Bank that are looking at particular impacts at different moments in time.

Fundamentally, while it is geopolitical, it also has a different angle or lens to it, whether it is about the energy sector or different horizontals within the market. We then look at it through a lens of whether it is impacting the insurance markets or the financial markets, and where those channels of transmission are starting to materialise.

***Dame Colette Bowe:*** Liz has talked about the political threats and so on. There is another side to this. As you know, we operate within a quite complex series of global institutions. Right at this moment, what we cannot see and do not know is whether those institutions are going to continue to be robust in the light of all these various geopolitical, etc, tensions that Liz has mentioned. That is another thread in this, and it is quite an important one.

Q19 **John Grady:** That is a very important thread, Dame Colette, and my colleague, Mr Glen, will pick up on some of those themes in a moment. With this ever more complicated background, how does the Bank keep under review whether it is assessing these risks in the right way or whether there are better ways of assessing these risks?

***Dame Colette Bowe:*** As Liz has said, we have a range of sources of advice within the Bank that we take. As we are external members of the committee, of course, we all have our own sources of intel, if I can put it like that, which is one of the things we bring to the committee. This might seem a bit obscure, but our job is to look at what is going on in the tail of the distribution of probabilities. That is the job of the whole committee.

As external members, we feel that it is particularly our role to say, "Hang on a minute, have you thought about that thing over there or that other thing over there?" Frankly, at a moment of great complexity such as this, there are not quick, simple answers that say, "Well, this is how it is going to pan out". Our job is to make sure that we have got our heads around the range of possibilities.

Q20 **John Grady:** My final question is completely unrelated to international matters. The FPC has an outstanding recommendation that the Pensions Regulator should have the remit to take into account financial stability considerations on a continuing basis. Has this been acted on?

***Andrew Bailey:*** We cannot act on it, I am afraid. This is a recommendation to others. The situation goes back to the previous Government. When we originally made the recommendation, the previous Government said that they agreed with it, but it requires that to be put into the objectives of the Pensions Regulator, which is not something we can do. It has not been acted on, so that is why it is an outstanding recommendation, in that sense.

Q21 **John Grady:** Would you be able to shed any light on why this has not been acted on?

***Andrew Bailey:*** I cannot speculate as to why this is the case. By the way, I would also say that we have had a lot of co-operation. We have worked very closely with the Pensions Regulator, particularly in addressing these issues that came out of the liability-driven investment issue of just over a couple of years ago.

To give you an example, the buffers that these funds maintain have been increased. We also work very closely with the overseas regulators, as many of these funds are in Luxembourg and Ireland. There is no shortage of co-operation on that front. What I would say, however, is that we felt that it was important to embed the objective. As I say, there was agreement, but it has not happened.

Q22 **Rachel Blake:** Reflecting on Dame Colette's remarks about focusing on the different ends of the probability curve, I want to come on to public sector borrowing and how you have assessed the risk of public sector borrowing on financial stability.

***Dame Colette Bowe:*** I am just thinking about how to respond to that without getting into the areas that the Governor said at the beginning that we were not going to talk about. I am sorry if that sounds really disrespectful to this Committee.

**Chair:** No, not at all. We understand you are in purdah.

***Dame Colette Bowe:*** I am sure you all understand the box we are in because of the timing of this hearing. I am really sorry to have to say that, Ms Blake, but there is not a lot we can say without getting into that rather difficult area. Governor, you are going to disagree with me now. That is good.

***Andrew Bailey:*** I will offer a primer and you can take over.

***Dame Colette Bowe:*** We do not have groupthink, you see. This is good.

***Andrew Bailey:*** This is a point not unique to the UK by any means, and we have said this in the financial stability report. When you look at

sovereign indebtedness, what we have seen in many countries is an increase in public debt. There are a number of very substantial structural headwinds in the current world, and I would pick three of them out.

One is that the UK, like all other industrialised countries, has got an ageing population. That has an impact on a whole raft of public policy issues, and it does have an impact on aspects of public debt. That is No. 1.

The second one is that I do not think it is at all controversial to say that, sadly, the post-Cold War dividend in terms of defence spending is not there as it was, for reasons we all know.

Thirdly—again, not wishing to embrace any controversy from changes in other countries, and recognising that should not be a full burden on the public sector—there is obviously the cost of climate change that goes with it.

I say that because all of those three things are very big structural headwinds that we face. I am not going to comment on the politics of this, but those are important points that have to be managed. Frankly, if we had any one of those three at any one time then we would have a substantial issue on our hands, and we actually have at least three of them at the moment. I am hoping this does not fall into your trap. When you think about public indebtedness, we have to think, therefore, about how we structure it going forwards, thinking about the impact of these structural factors.

I would also say that some of the long-run projections of public indebtedness rather simplistically assume that it is just going to get the ruler out and extend it. Very big decisions are going to have to be taken about it, because if you take that ruler-like approach then you will get huge levels of public indebtedness a long way out into the future. That seems to me to be making very big assumptions about what public policies are going to be.

Yes, I would put it like that. I do not think that gets us into monetary policy. We are very careful about not wishing to comment on fiscal policy, but recognising these headwinds is important. It is not controversial, in that sense.

Q23 **Rachel Blake:** To follow up on that, am I right in understanding that you do not think that public sector borrowing is just heading in one straight line direction, and therefore your assessment of the impact on financial stability is more subtle and more iterative?

***Andrew Bailey:*** Yes. First of all, as the Bank of England we always operate on the basis that we take stated government policies. Given that the Chancellor has been very clear on our position on fiscal policy, that is the basis on which we operate. As I said, there are structural headwinds that fiscal policymakers in all countries are having to deal with.

The second point I would make is a financial stability one. Nat may want to come in on this, because it is one of the reasons we did the system-wide exploratory scenario. We have seen very big changes in the way financial markets are trading and position taking in government debt. There is much more hedge fund activity in government debt. Much bigger positions are being taken. Because of the size of these positions and the potential that, if there is a very big shock, they may get suddenly unwound and the world suddenly changes, we did what I think is a world-leading exercise to ask, "At what point does financial stability become compromised by these changes in activity in government debt markets?"

***Nathanaël Benjamin:*** One of the ways in which pressures on sovereign debt can feed into financial stability is through causing volatility in financial markets that are core to the economy. As the Governor said, that volatility can then be amplified by existing vulnerabilities in market-based finance in large leverage positions, for example. Those amplification effects are what we wanted to test in calm times to understand how the ecosystem would behave and respond to those shocks, and had the potential to amplify them. That is why we ran this exercise, to test those particular effects.

It was very insightful and very instructive, both for us and for the market participants, because we found things that we did not know before. We also found that some markets were more resilient than they were before. The gilt market has improved and has strengthened its resilience, but we also found that the gilt repo markets may run into some capacity constraints, for example, and the sterling corporate bond markets may hit some forms of illiquidity. It is very important that all the participants in that exercise factor the learnings into their internal risk management, so that should those shocks happen they are prepared to manage them and to deal with them.

The only thing I would add is that one of the pioneering features of this exercise was the flow test aspect of it. We did not assume the behaviours of players in those core markets; we actually asked them. We checked the extent to which the assumptions of certain market players were consistent with the reaction functions of their counterparties. We reconciled, "Actually, you assume something that will not happen". We told them. Those are the types of things that helped them improve their own preparations and risk management for those shocks if they do happen.

Q24 **Rachel Blake:** I wanted to come back to Liz Oakes or Dame Colette around the relationship between growth and financial stability. We heard from the Governor about different categories of where there might be changes and opportunities to pursue growth in a balance and alongside financial stability. Are there any more changes that you anticipate from the remit?

***Liz Oakes:*** Even before the remit, actually, because I have just joined the committee in the last six months.

**Chair:** That was just before the election.

***Liz Oakes:*** Literally just as the election happened. One of the things I have observed as an external member is the ability to ask those questions around consultation with market participants, how the consultation is conducted, what we ask them and whether we ask them the right questions. Are we actually asking what the cost of the regulations or the cost of the change is? We also ask around the complexity of the change, because sometimes, when we introduce changes that within the Bank are perhaps perceived to be quite straightforward, they might not be quite as straightforward within a financial institution and its ecosystem. That has certainly been one area where it is valuable to continue probing all the time as to how we are thinking. Are we thinking as market participants would think around the changes that we are proposing to make?

The other side of it is what the Governor referred to earlier around strong and simple. I am very much an advocate of reducing complexity where possible. To encourage new or existing market participants to expand competition in a particular product set or a particular area of the market, they have to understand how complex it is to participate and what is involved in getting into that particular area of the market. As an outside observer that is actually quite difficult if you have to navigate what rules are involved and whether it is the PRA, the FCA or the raft of different regulatory authorities we have, and that is just in the financial markets.

My background has been in payment systems. When you look at things such as open banking, open data and open finance, quite often there is a convergence between other regulated sectors of the broader industry and market. It is actually very difficult to navigate what rules are required in the telecom sector at the same time as the financial sector, and what the crossover is.

That level of complexity and compliance overlay that exists now in order to participate in the market is complex if you are based in the UK. It is really complicated if you are also then looking at new entrants or foreign direct investment from other participants who would seek to come to the UK and compete or to expand into the UK. Those are the areas where it is valuable to continue to probe and to ask those questions.

They are not easy things to change, I am sure you will appreciate. I certainly see that the work that has been going on, which Sam Woods referred to when he came to speak recently at Parliament, was around simplifying some of those data requirements and data reporting. The Governor referred to data reporting earlier. Data reporting is probably the tip of the iceberg.

Q25 **Rachel Blake:** You talked about the telecoms overlay and the relationship between those regulations and how other sectors might experience the same challenge of overlay. Are there any other sectors that might face that challenge?

***Liz Oakes:*** Yes, certainly with things such as open data and the regulation of people's personal data. It is also the fact you have multiple regulators. For me, open banking was a very clear example where you actually had the data regulator responsible for one aspect of people allowing open access to their personal information, transactions that they conducted or their banking information, while at the same time you have a financial regulator that is obviously responsible for regulating what happens with financial data.

It is quite often very challenging for a financial regulator—for example, the FCA—to look at the business model of an entity. Perhaps they have created an app for you to improve your fitness, your diet or something, and it happens to take the data from the last food that you purchased, and the receipt data is examined, etc. The crossover there between financial regulation and people's personal or medical information is unique and quite complex. For the FCA to try to navigate and figure out how it works is quite a task.

Q26 **Rachel Blake:** Does the responsibility for doing that lie with the FCA on the basis of the change in the remit letters, or does it lie elsewhere?

***Liz Oakes:*** Historically, as a result of EU legislation it resided with the FCA. There is an element of it that resides with the data regulator, but the business model analysis is typically with the FCA.

Q27 **Chair:** Are these crossover areas one of the challenges for growth?

***Liz Oakes:*** I think so. It is the complexity. It is not that we have deliberately set out to make it complex; it is just the nature of when you open up the floodgates and you say, "Okay, we are going to do open data". It is fantastic. You see all this innovation with wonderful new companies coming in and saying, "Look, if I have that data I can actually do something really new and quite groundbreaking with it", but we have not figured out exactly who should be responsible.

Q28 **John Glen:** Can I just add one short supplementary on that specific issue? On the open data, open banking thing, is it not the case, though, that there is a massive imbalance of power in the industry? Incumbent banks are very reluctant to open up, while lots of new players are very keen to gain access to that. Surely that is the heart of it and we have to grip that.

***Liz Oakes:*** I see both sides of the argument, probably because historically we did not expect banks to do anything with the data. In fact, we gave them a fiduciary responsibility to protect the data. Personally, I do not want my bank sharing what I do every day, and I am pretty sure that the vast majority of the population probably does not either. But then you ask people, "Okay, but would you like this app that tells you about your fitness and what you are eating, and in order to get to that you need to do X, Y and Z?" Sometimes we are on that path of discovery and figuring out, "Okay, how far can we go with this?"

There are some boundaries that are very, very clear, for example with medical information. If you went to a pharmacist and purchased medication, you would not want your bank to sell that data to an insurance company that would then determine that you had a terminal illness, for example. There are a lot of things where we are thinking through the logic of the customer experience and the data experience. What does that actually mean, and where are the risks and liabilities? It is almost being done as a test and learn process as we evolve this environment, so there is an element of, "How fast can you go?" It is not an area where you can go fast and break things, because once some of this data is out in the wild you cannot contain it again.

**Chair:** There are huge opportunities and huge threats.

Q29 **Yuan Yang:** Slightly jumping back to the discussion that Mr Benjamin had on stress tests and on gilt market volatility, I just saw that yesterday you had opened your new lending facility for non-bank financial institutions, insurance companies, pension funds and the like in times of severe gilt market dysfunction. I was wondering how much of a first this is for the Bank to start having a lending facility to non-bank financial institutions and what risks you saw for making that first step? Secondly, it would be great to just get a bit of the background on where the idea for this had come from and the origins of the need for the new facility.

***Nathanaël Benjamin:*** This is indeed a first and it is a great new tool that we have in our toolkit. It is the first time that we have equipped ourselves in this way. We are now open for applications for this new tool. It means this would be a way for us to have the ability to lend directly to pension funds, insurers and LDI funds if we decided that there was a severe dysfunction in the gilt market that justified us taking liquidity directly to that corner of the financial sector in order to avoid asset sales, for example.

This is a great additional tool to have in our toolbox. It is for situations when we think there are dysfunctions that are so severe that only we can restore functioning of those markets. It is great to have that tool in our toolbox. It is for us to decide when to activate it and how it would be used, should that be required, but it is a great addition.

***Andrew Bailey:*** Can I make a couple of points on that? This is very important. It is a great question. The first one is this: historically—and this is almost a canon law of central banking—we only provide liquidity to the banking system, and we expect the banking system to distribute that liquidity to wherever it is needed and for it to happen. This goes back to Walter Bagehot in the 19th century.

Now, you may say, "Why have you made this change?" This is quite fundamental. Somebody wrote an article saying, "Walter Bagehot would be turning in his grave". I actually do not think he would, because he would realise we had a problem to deal with, which he criticised the Bank of England for not doing in the 19th century.

The point I want to make is this: going back to the exercise we have done and what we have observed, the growth of non-bank activity and the growth of this position-taking activity is now so much that we cannot rely on an assumption that the liquidity would always get to where it is needed via the banking system. That is really the crucial point that sits under this for why we have made the change. That is the first point.

The second point goes back to the liability-driven investment episode, but it is relevant to the questions you are asking about growth. Colette mentioned the question about the tail of the distribution of bad things. Regulation is designed to cover quite a large part of the tail of the distribution of bad events, but if you set out and said to me, "Why don't you cover the whole tail?" I would say, "Well, we do not know how big this tail is. It will reduce to very small probabilities of really bad things". To design regulatory systems that would cover all of that, right out into the really far reaches of the tail, would be very costly and inefficient. There is a natural boundary where you say, "Actually, we have to use other tools at that point", and the other tools are central bank intervention at that point. There is a role for it.

The reason I say this is that, in thinking about regulation and about what happened in the LDI incident, where you draw the boundary as to where it makes sense from a cost-benefit point of view to say, "Regulation covers this amount, but beyond that it might be more efficient for you as a central bank to come in if there is an emergency and do these things", is an important decision to make.

I am not suggesting that we deregulate to the point where you assume the Bank of England will just come in any old day and mop stuff up, because that is not efficient either. It creates all sorts of other issues about moral hazard, for instance. But there is an important boundary to be drawn here, and putting this facility in place helps us to deal with that far end of the tail of events.

Q30 **Yuan Yang:** I was wondering if you could play out as well—because obviously this is for severe dysfunction and not something that you will use day to day—what it would look like in terms of timeline and who makes the decisions about intervention if it were used.

***Andrew Bailey:*** Nat made a key point. The banking facilities we run—I referred earlier to the repo operations—are available every week, and banks can come to us and bid for liquidity. In this operation, as Nat said, we are not opening ourselves up and saying to non-banks, "You can come and get liquidity from the Bank of England whenever you fancy it". As Nat said, only we would decide when it is available. We would decide, "Are we now in an emergency?"

Q31 **Yuan Yang:** How would you decide?

***Andrew Bailey:*** We would have to assess the conditions.

***Nathanaël Benjamin:*** We continuously monitor markets.

***Andrew Bailey:*** It is this point about dysfunction in markets. Are we now at a point where we do not think the natural distribution of liquidity is going to solve the problem?

Q32 **Chair:** Are you saying it is a judgment issue?

***Andrew Bailey:*** Yes, it is.

Q33 **Chair:** So you do not have a set process you go through.

***Andrew Bailey:*** Well, we have a lot of process behind it.

Q34 **Yuan Yang:** Are there any instances in modern history where you think this would have been used?

***Andrew Bailey:*** We did it with LDI, but we did not have this facility. We had to sit in the middle of the night with a whiteboard and cook it up. Coming out of that, we decided it is much more sensible for us to have this there when needed, but it is not what we call a standing facility in the sense that it is always available; it is only available if we think the conditions require it.

Q35 **John Glen:** I have three questions. One is talking about domestic things, one is about international, and one is about this issue of the tail. Governor, you helpfully set out some of the things over the last few years that you have done, so strong and simple changes to help the smaller banks, and Solvency II changes to create more pools of capital to be invested. In your letter to the Chancellor, you also talked about the FPC's decision a few years ago to withdraw the affordability test.

In so far as this Committee is trying to create a bridge between our constituents and quite complicated regulation, something that has been speculated about in recent days is what more can be done in the mortgage market in terms of removing the stress test. It is speculated about, and I had this too. Is that a way forward? Does it open up a growth opportunity in the world that we now live in? The question behind it is that historically we have been too conservative, and we are now 17 years away from the financial crisis. It is time to be a bit more reasoned in that.

***Andrew Bailey:*** Can I paint the opposite picture, and then by doing that set out the very sensible challenge you put down? We have been through some very big economic shocks in the last five years, such as Covid and Ukraine. We have raised interest rates from basically zero to 5.25%. What has not happened? We do not have large arrears in the mortgage market. We have not had the housing repossessions that we had if you go back to the financial crisis or the early 1990s. We have not had people having their houses repossessed. I do not think we are creating a legacy of mortgage prisoners. These are the sorts of things you and I had to talk about in the past when we were in different roles. That is a good thing. It is a good thing.

The question to your question is, "Where do you strike the balance between the two?" The rules that were put in place on this front, the FPC's affordability test and the FPC's loan-to-income ratio policy, have helped in this respect. They have helped to avoid the creation of a large tail of mortgages that, when we have the inevitable cyclical downturns or shocks that hit the economy, turn out to be a real problem of the sort that we have seen in the past. That has been beneficial.

Does it restrict entry into the mortgage market? It is an interesting question. We have not seen a decline in first-time buyers in the mortgage market, either as a proportion of the total or in aggregate, but there are people who do come forward and say, "I cannot afford to get into the housing market". There are clearly people in that position. There are clearly people in the rental market. I do meet them when we go around the country doing panels.

I am very open to this question about the affordability test. By the way, we dropped our test because it overlapped with the FCA's test by such a large part that, again, it was a good example of where regulation was inefficient.

I am very happy to have a very open, public debate about how you balance getting these better outcomes, in terms of people not having their houses repossessed and so on, with the effects the regulations have. That is the debate we should have in thinking about where the right place to put regulation is.

Q36 **John Glen:** If I just quickly follow up on that, if there is a stress test that implies that you have to have a margin above the prevailing base rate, that still exists, but, if you have a higher renormalised base rate now, is that artificially high? I realise this is the nub of the issue and you are not going to tell us now, but the point is that everyone was lobbying me during my tenure in office and will be saying it again now: is it not time to look at that again?

***Andrew Bailey:*** We review the test quite frequently and we will do it again. We review this part of our framework more frequently than any other part, for the reason—to your point, really—that this affects people very directly. We are very conscious of that, and that it needs to be reviewed. We will do that. We have not set the date, or have we? We will certainly do it.

***Nathanaël Benjamin:*** As the Governor said, in 2022 we removed the additional affordability test that was in place. That was removed because we judged it was not necessary. In terms of the other test, we very recently lifted the threshold above which the loan-to-income test applies, which means that more lenders are now exempt from that limit. Importantly, in terms of that loan-to-income test, there is still plenty of headroom within that limit, which means there is a large number of mortgages that can still be lent on a flow basis within that limit. That is not a barrier. As the Governor says, we have been keeping all our tools

under review on a regular basis, but in terms of affordability we have already removed the one that was in place.

One thing I would say is that, if there is a material increase in the number of new mortgages that are granted, and if that does not happen at the same time when there is an increase in the amount of new homes that are made available, the risk is that the immediate effect will be an increase in house prices, which will make it even more difficult for a household to get on to the housing ladder. Those two things need to be considered in the round.

Finally, in terms of first-time buyers, to pick up on the point from the Governor, if we consider the stock of new mortgages, within that stock the proportion of those given to first-time buyers is at its highest level now since 2005.

***Andrew Bailey:*** To reinforce what Nat said, in all the surveys that are done, when you ask people what the major impediment is to getting into the mortgage markets, it is affording the deposit.

Q37 **John Glen:** Can I move on to a second question on the international scene? You have collectively said there is a degree of uncertainty over what our US friends will be doing, but we have seen some really tangible changes, such as this $82 billion of gold that has been shipped to New York. Traders are now waiting several weeks rather than a few days to access their gold. There is also a live discussion about what the forward moves of the US regulators will be in terms of financial regulation and the delay to Basel 3.1 implementation.

What do you see in terms of consensus or not in international attitudes to banking regulation? With that delay in the Basel 3.1 implementation, as I understand it, you agree it at a global level and then each jurisdiction makes its own interpretation, but you are anxious to do it in a way that is competitive with the other jurisdictions. How do you see the risks, and what do you see as the path through this? You are obviously a very experienced player on the international scene, Governor.

***Andrew Bailey:*** Yes, I am very heavily involved in the global Financial Stability Board, so this is obviously a very major subject. First of all, Basel serves two purposes. As you said, it is the prudential regulatory framework, but in being that it is also the basis for competition. It provides the level playing field, if you like. It is very important. I would stress to all those involved in this process that it is not just about regulation for the sake of regulation and prudential standards. It is also about creating a level playing field for competition, so it is important.

We do not know yet where the new US Administration are going to go on this, because the key appointments are not yet in place. We do not know, and we need to give them time to do that. It is important to let that happen, which is one reason why we took the decision that we announced a week or so ago.

What I would say—and I will be saying—is that Basel is very important for the two reasons I gave. When I talk a lot to institutions and banks in the US, they do understand this. It has become controversial in the US. There was controversy around the Federal Reserve's original proposals for implementing it. When I started seeing adverts on television about Basel, I realised we were in a different world.

**John Glen:** Like with Solvency II.

**Chair:** Everything becomes mainstream at some point.

***Andrew Bailey:*** There was that famous television debate among candidates to lead your party that got on to Solvency II one evening. I thought, "This really is a surreal world that we are living in", as much as I love Solvency II—not really. What I do hear from the banks is that they understand this point and they want it to be done because it provides the basis of competition and of a level playing field. In that sense I remain optimistic that we will get agreement on it and we will get through this, but, to be fair to the new US Administration, we have to give them time to get into place.

Q38 **John Glen:** How do you view the $82 billion stockpile of gold in New York, the changes in behaviours we are seeing, and anticipation of tariffs or not, in terms of risks?

***Andrew Bailey:*** This is not a big thing. First of all, gold does not play the role it used to play. Had we been having this discussion 100 years ago, we would have been in a very different world, because we were on the gold standard. We are not on the gold standard any more, so it does not have a significance for policy in that sense. As you are implying, there may be some anticipation of some effects around tariffs or not; I do not know.

What I would say is that London remains the major gold market in the world. It is the world's leading gold market. If you are involved in that market and you want to trade or use your gold, you need to have it in London. Gold does flow in and out of London, though. We will see, but I do not want to dramatise this story, in a sense. Gold does move and it does not play the role it used to play.

Q39 **John Glen:** Can I turn to my third question? Dame Colette, you talked about being concerned by the tail, which I thought it was a fair way of presenting it. The Governor has talked about insuring against the whole of the tail, but one of the concerns that people in financial services would perhaps note is that our regulatory framework and institutions, including you, would be so focused on the tail that it wags the dog, if you like. It changes the fundamental level of regulatory normalcy against competitiveness and growth.

When I was a Minister I did not really accept that, but I was always having to raise that challenge. What can you say about us in the UK with respect to how we quantify and make real the coverage of the risks in our

financial services sector?

***Dame Colette Bowe:*** When I am talking about the tail, I am not talking about dogs wagging them; I am talking about distributions of outcomes. That is just to make a Bayesian point there for a moment, if I may.

Q40 **John Glen:** You see, clarity of communication and the way we can make this real to the people who watch this is important, so thank you.

***Dame Colette Bowe:*** Thank you for that correction, Mr Glen. I accept it. We are talking about two slightly different things here. When I was talking about the tails of the distribution, what I was talking about is the role of this committee that we all sit on. Our job is to think about the unthinkable. It maybe sounds a bit over the top, but we have all lived through a period when the unthinkable nearly happened. It is our job to not forget about that, and to reflect on mistakes and failures of apprehension that our predecessors made in 2008, which are all very well documented. Part of our job as a committee is to think, "What if?" That is one thing.

Your question is more about whether the thrust of regulation is to focus on things that are very unlikely to happen and to try to stop them happening. It will not surprise you to know that I do not accept that as a characterisation of the work that the Bank and the other regulators do. I too have worked in the financial services industry. Although there were quite a lot of times when we felt that things such as the requirements about the capital of the firms that I was associated with were maybe excessive, that was really where the focus was. It was not in the kind of work that the FPC does, as my colleague Nat was saying a few minutes ago, in testing the resilience of the whole system.

As you know, when you are working in one institution you tend to think about all these onerous things we have to cope with. Our job is to think about the system as a whole. As Nat has described, one thing we have to do is test the resilience of that system as a whole. Now, if you are sitting in the system you do not necessarily like that very much, but, frankly, we are here, as you are, to act in the interests of the people of the UK. That is our job. Sorry, here endeth the first lesson.

***Andrew Bailey:*** I just want to quote Tony Blair for a moment, if you don't mind.

**John Glen:** I certainly don't.

***Andrew Bailey:*** I thought you were going to start laughing at this point. I do not personally know him very well, but he would not mind me saying that he made quite a number of speeches and there was quite a bit of policy intervention before the financial crisis in favour of light-touch regulation. The reason I am quoting him is that one of the things he said after the financial crisis had happened was, "Well, if the regulators had actually laid out the risks I would have responded". I take him at his word; he is right on that.

The reason I say this is that it is very important. It is right to have this debate about the balance between growth and regulation. Our key job is to lay out the risks and vulnerabilities, so that not only the public can see them, but you yourselves can see them, you can hold us to account as to what we are doing, and, in a sense, we pushed to explain ourselves and say, "This is what we think the risks are. This is what you need to know". It is really important, and I don't think it is by the way, that that is not inhibited.

Q41 **John Glen:** My final question is on the interaction between you, what you do in terms of the stability and systemic risks, and the FCA. For many people, they will hear that the Government have asked the regulators to come forward with ideas of things that can enhance growth. Clearly, you underpin some of those decisions. Could any of you say something to help us clarify the relationship between your work and that of the FCA? What happens if there is a difference of opinion as this imperative for regulatory changes to induce growth becomes more intense?

***Nathanaël Benjamin:*** We have a very close working relationship with our colleagues at the FCA. Indeed, Nikhil Rathi, the CEO of the FCA, has a seat on the Financial Policy Committee. I would give two examples of that. For the first one, we talked about our stress test. Specifically, we run this first-in-kind system-wide exploratory scenario. We did this in partnership with the Financial Conduct Authority and the Pensions Regulator. There is complete confluence of interest, given that they oversee and supervise a number of players in the non-bank sector, in finding out what the risks are and, as the Governor said, surfacing what the facts are, so that everyone understands them and so that the market itself can prepare for shock. That is the first angle. We have great collaboration with our colleagues there. The other one is what we were discussing before in terms of mortgages and households. We have a very close working relationship on that side of things.

Q42 **John Glen:** There will not be any arbitrage between you; you are collaborating on an ongoing basis.

***Nathanaël Benjamin:*** Yes.

Q43 **Yuan Yang:** I just want, Mr Benjamin, to go back to this scenario that John Glen illustrates, about how regulatory focus on the tail can sometimes change the behaviour of groups in the main. For the new non-bank lending facility, what would you say to the concern that hedge funds—which, as the Governor said, have taken large positions in gilts—have a win-win mentality, where there is no downside risk and there is significant moral hazard for those hedge funds?

***Nathanaël Benjamin:*** Just to be clear, the facility is open for applications for insurers, pension funds and LDI funds. For the time being, that is it. As you know, the Bank of England and the PRA regulate insurers. In the case of pensions and LDI funds, there has been a substantial strengthening of their own liquidity buffers on the back of the

LDI episode. The counterparties of the Bank have some strength in that particular case. The scope of the new tool that we have is for that segment of the non-bank population. We will keep things under review. We will be informed by the system-wide stress tests that we do, but at the moment that is what it is.

***Andrew Bailey:*** I should also say, this money will not be cheap. To go back to Walter Bagehot, he said you lend at a penalty rate in these circumstances because of exactly the point you make.

Q44 **Dame Harriett Baldwin:** I want to get back to the subject du jour, which is growth and the Chancellor's speech. There was something very striking that you said right at the beginning, Governor, about the way in which growth in this country has been at a slower pace since the financial crisis, as if you were pinning some of the blame not only on that, but perhaps also on some of the steps that have been put in place since then. It made me think of a phrase from the Chancellor's Mansion House speech last year, where she said that the reforms to the financial regulation post crisis have "resulted in a system which sought to eliminate risk taking". She said, "It has had unintended consequences which we must now address". I would just like to ask each member of the panel to name an unintended consequence that you think you are now addressing.

***Nathanaël Benjamin:*** The way I think about this is in terms of the benefits from a growth perspective of the measures that have been put in place in terms of the number of shocks that have happened over the last few years, which the UK financial sector has been resilient to. There have been a number of them. A number of foreign banks and foreign hedge funds have failed, for example, and yet that has not affected financial stability in the UK and therefore it has not affected growth in the UK.

Q45 **Dame Harriett Baldwin:** Do you agree with the Chancellor that there have been unintended consequences? I would argue that sounds more like an intended consequence.

***Nathanaël Benjamin:*** That is definitely an intended consequence.

Q46 **Dame Harriett Baldwin:** Can you name one unintended consequence?

***Nathanaël Benjamin:*** I will have to think about that.

***Liz Oakes:*** I am also racking my brains to think of an unintended consequence.

Q47 **Dame Harriett Baldwin:** Governor, can you think of what the Chancellor might be referring to in terms of the unintended consequences from the changes that were put in place after the financial crisis?

***Andrew Bailey:*** To be honest, I am not sure to what extent the Chancellor is referring to financial regulation. She was making a comment about regulation as a whole, so I do not know quite what she had in mind at that point.

Can I start by saying, when I made the comment you referred to, that I do not think regulation is innocent? However, I have to say that the reason I made that comment very deliberately is that the financial crisis itself is actually far more responsible for the cause of low growth than the response to the financial crisis. We had stronger growth pre financial crisis, but it was unsustainable in some respects. I am afraid the financial crisis damaged not only this economy but other economies very badly in that respect, and we have had to respond to it. It is hard to pin consequences of regulation precisely in terms of growth. The Chancellor has spoken about this; the previous Chancellor has spoken about it; I have spoken about it.

The question of pension funds holding risk assets is an important one. First, UK pension funds hold a low share of risk assets compared to pension funds in other countries. Secondly, over time the proportion of risk assets that UK pension funds hold has declined a lot. Regulation is certainly not the only reason for it; it might not even be the major reason for it, but, wherever the reason for that sits, it is something on which I agree with Mr Glen—when he was in Government—the previous Chancellor and the current Chancellor. We really have to address this. This is an important question.

Q48 **Dame Harriett Baldwin:** What I am hearing is that that is less the financial regulation reforms and more changes to the pension regulations.

***Andrew Bailey:*** Certain parts of the pension industry are regulated by financial regulators, so we are not outside that world. There are consequences of financial regulation in that world. We are very aware of that point. We might be in the mix in that respect, but we are not the only thing.

Q49 **Dame Harriett Baldwin:** They were not particularly things that were focused on post financial crisis; it was the pension funds crisis that changed that.

***Andrew Bailey:*** You have things such as Equitable Life, if you go back in time as to what has driven insurance regulation. If you look at what has driven insurance regulation, it is probably more that than the financial crisis itself.

Q50 **Dame Harriett Baldwin:** Dame Colette, unintended consequences is what I am after.

***Dame Colette Bowe:*** Well, what I find a bit difficult in this bit of the discussion is attributing consequences to regulation. I say that because, again, as we all know, what happened in 2007-08 was a horrendous collective shock to the nation, to companies and to people in financial businesses, who thought they were all doing the right things and it turned out they were not. It is quite hard to attribute what might be a decline in risk appetite solely to regulation, because people have actually been scarred by seeing the consequences of excessive risk taking, such

as 120% mortgages with no evidence of income, the things that really happened in the run-up to the crisis.

Q51 **Dame Harriett Baldwin:** I am not hearing a very wholehearted agreement with what the Chancellor said in her Mansion House speech, which was that she felt that the reforms to the financial regulation post crisis, which included establishing this committee, have resulted in a system that sought to eliminate risk taking. I am not hearing a lot of agreement between you, the regulator and the Chancellor.

***Andrew Bailey:*** Going back to my experiences at the FCA, one of the most difficult areas is, "What is the approach to regulating investments and how much risk do we expect investors to take?" I have sat in this room, and other rooms, and had some quite difficult sessions with this Committee in my past life over this. What is the expectation of risk taking and investment, what is the regulatory system there to protect against, and do we have the boundary in the right place?

I would say that, at the moment, there is quite a questioning of whether the boundary is in the right place and whether the effect of the boundary being too far into the protection world is inhibiting investment. That is a very important question. This is a public policy matter, so both of us collectively need to reach some consensus, because we have to give a very clear message to the public on this. Your question is right. We can have a very reasonable questioning of this point.

Q52 **Dame Harriett Baldwin:** Thank you. We have heard one unintended consequence.

***Andrew Bailey:*** It is quite a big one, actually.

Q53 **Dame Harriett Baldwin:** People will be aware of my obsession with the advice guidance boundary as well, in terms of the potential unintended consequences that has had. The previous Chancellor had set out a range of reforms in Edinburgh, which were under way at the time of the election. I just wondered if the committee has a view on where we have got to on ringfencing, for example, and the review of the ringfencing regime. Is that something that is likely to change or is it just being reviewed?

***Nathanaël Benjamin:*** The ringfencing regime has been reviewed recently and has been adjusted. That is completed and there have been a few adjustments to ensure it remains proportionate. That has been done.

Q54 **Dame Harriett Baldwin:** We heard about the change in terms of some of the mood music from across the pond on cryptocurrency. There has been a very, very clear steer from recently inaugurated President Trump that they are not going to have a central bank digital currency, but it is still something that the UK is developing a blueprint for. I just wondered, from a financial stability point of view, whether any members of the panel would like to comment on whether that has any implications. Could there be a crypto boom or bust?

***Nathanaël Benjamin:*** A year ago, the Financial Policy Committee took stock of the state of development of the crypto asset ecosystem and watched two things very closely. We are monitoring this all the time. The first is the size of that ecosystem, and the second is the degree to which it is interconnected with the core of the financial system. When we did the assessment last time, we found that on both criteria there was not enough of a total size and degree of interconnection at the time for this to pose a threat to financial stability, but we made it very clear that this is something we are tracking and monitoring very carefully.

For example, one of the recent developments is that institutional investors now have a way of taking exposures to regulated crypto activity via exchange-traded products. There has been some pickup in that. That is an example of something that is small but increasing in terms of interconnection between the crypto world and the main sector. But, so far, our assessment is still that that risk is not there, although the connections are increasing.

***Andrew Bailey:*** First of all, let me say that crypto is not a homogeneous thing. I broadly divide it into two parts. There is what I call unbacked crypto, of the bitcoin sort, and I have made a number of speeches on this. The key thing I would say is that it is not money. It does not have the characteristics of money. It does not have an assured, nominal value, but it is an asset. It is an investment. Going back to the discussion we were previously having, I would warn people that it is a very volatile investment in terms of its value. Please go into it knowing what it is if you are going to invest in it.

In a sense, that has one set of regulations around it. It goes back to your point about advice and guidance in some parts. Then there are so-called stablecoins. They are rather different, because they do purport to be money. We do not really have them in sterling at the moment to any great extent. They do exist in dollars. There is a big question around, "If it purports to be money, what is the regulatory framework that should sit around it to give people the assurance that it will have the characteristics of money?" We came out with a discussion paper. We are going to issue a consultation paper before the summer, actually, and we envisage having a regulatory framework. We are responsible for so-called systemic stablecoins, so what might be the big things.

The interesting thing in the US is, "How is that regime going to develop there? Are we going to see dollar stablecoins take a bigger role in global payment systems? What framework are they going to put around them?" At the moment, they do not really have a framework around them. The previous Administration were using legal enforcement routes in courts to try to create a framework, but in my mind it was not working very well, because the courts would sometimes win cases and sometimes lose cases, and the result was, frankly, a bit hit and miss. We are very keen and interested in how that stablecoin world evolves and what the sensible protections are to have in place.

To finish on central bank digital currency, yes, we continue to evaluate it and we will take a decision with the Government. We have said, of course, that it will have to come to Parliament, as it should, if we decide to go ahead with it. The key issue there, as I have said in a number of speeches, is not whether we should have digital central bank money; it is actually how we exploit the very real benefits of digital technology in the payment system. Is it best done in the commercial bank payment system or the central bank world? We will see. There are real benefits to digital technology, which we should want to get and harness.

Q55 **Dr Sandher:** I was interested, Governor, in something you just said about the recovery from the financial crisis. I have two questions. The first is that after the financial crisis you pointed out that we had a slower recovery across OECD and the G7 nations. Do you think fiscal policy had a role there, because, as some would say, it was constrained or because, as others would say, Governments did not react accurately, given the zero lower bound? Do you think fiscal policy had a role in why those recoveries were so slow?

***Andrew Bailey:*** I am not going to offer a comment on that. I could imagine where that was leading to, if you do not mind me saying so, in terms of the policies of the coalition Government at the time. I do not really have a view I can speak to.

Q56 **Dr Sandher:** Basically you either buy the argument that fiscal policy was constrained for a reason, or you say that they constrained it themselves. In a world where, let us say, fiscal policy was looser—because either it could be or it should have been—would you have seen the recovery being quicker?

***Andrew Bailey:*** If you remember at the time, fiscal policy was highly constrained, as you say, because the obligations that came to pass from the financial crisis were very substantial. A huge amount of money had to be put into the financial system to support it. Of course, we also had quite a deep recession that followed it and there were consequences for fiscal policy of that. The Governments at the time were evaluating what the best course of policy was in the light of that. I am not going to second-guess them in that sense.

Q57 **Dr Sandher:** Whatever the outcome, constrained or otherwise, do you think that had an impact on growth in the following years?

***Andrew Bailey:*** The issues are probably more structural than that. What we observe is that there was quite a substantial fall-off in investment.

Q58 **Dr Sandher:** Do you think fiscal policy had an impact on that?

***Andrew Bailey:*** I do not think it was the major thing. The growth rate of productivity before the financial crisis was actually very impressive. The question is whether it was sustainable or not. It turns out to not have been. How much of that was due to things that caused the financial crisis? Again, we could debate it at length. What we have seen since the

financial crisis, for 15 years now, is a low rate of investment. Both the previous Government and the current Government shared a view here. There is not much difference between them in saying, "We have to raise that rate of investment".

Q59 **Dr Sandher:** I am not making a political point. Earlier you talked about the operation of the APF or quantitative tightening and how that does now have fiscal implications. The Bank has a secondary objective to support economic growth. The question I am getting to is that, if you think the APF is impacting fiscal policy or fiscal rules, as you stated earlier, it is also having an impact on economic growth. How are you incorporating that within your action at the moment?

***Andrew Bailey:*** If you go back in time—not so much now—we used to read a lot of this stuff about the APF. To do an overall cost-benefit analysis on that policy, which is the only sensible ultimate thing to do, you have to look at the consequences, as you rightly said, for policy over the last 15 years of that policy.

One of the things I would point to is that it has had beneficial effects. It is only one contributor to this, but we have had a much lower rate of unemployment during the last 15 years than we have historically had and that most organisations, including the Bank of England, forecasted that we would have. There are real benefits in terms of the policy framework that was in place.

Q60 **Dame Harriett Baldwin:** Recently we have had a lot of volatility in NVIDIA share prices and therefore, through artificial intelligence, we have seen some structural instability. I wondered, both directly through the stock market movements and indirectly through the impact of artificial intelligence generally on the financial markets, whether you have changed your view of the risks that artificial intelligence potentially poses for your committee to supervise.

***Nathanaël Benjamin:*** There are two different things. The movements that we have observed in financial markets are movements in the equity prices of technology firms that are investing in artificial intelligence. I do not think those movements have been caused by artificial intelligence itself.

Q61 **Dame Harriett Baldwin:** I did not mean to imply that.

***Nathanaël Benjamin:*** Those are two different things. There are views that the market takes on the prospect of those companies, given developments that are happening. That is one thing.

Separately, in terms of artificial intelligence itself, the committee is soon going to set out its thoughts on the way in which it can impact financial stability from a system-wide perspective. I would distinguish two things in terms of how it has developed over time and where it is at the moment.

You have two phases. The first phase is how financial actors in the system use artificial intelligence to automate what they already do. The second one is the next step, which is to then use artificial intelligence to make decisions, make judgments and take trading or management decisions. There is a different degree of maturity in terms of where the financial sector is on those two fronts, but what is very important is that we focus our monitoring on the key system-wide impacts of artificial intelligence, for example, the extent to which management decisions and business decisions could cause some herding in financial markets of positions and concentrations because of that.

Another issue is the extent of potential reliance on critical but less well-known third parties that are common to different actors using the same tools, or the extent to which an individual player in the ecosystem may adopt an artificial intelligence-based strategy, without understanding what the ultimate consequences might be on the market and the economy as a whole.

Q62 **Dame Harriett Baldwin:** All this could amplify instability.

***Nathanaël Benjamin:*** It could, absolutely. It could amplify shocks. It could amplify instability. The focus we have at the moment is to monitor how those channels could affect financial stability and to understand what those channels are. That is the stage we are at. We are asking those specific questions.

***Andrew Bailey:*** Can I add one point? I just want to comment on this week's events, actually, and the financial stability implications, because it is very interesting. One of the things we highlighted in the financial stability report—and have done for a while, actually—is that, as Nat was saying earlier, we are very, very focused on what I call the uncertainties of the world and the geopolitical risks. However, against that, as we highlighted in the report, we have this compression of pricing of risk. You see that in credit spreads and you see it in equity prices.

One of the risks and consequences of that is that, when you get a shock to the system, with this contradiction of your worries about the world and the pricing of risk, you could get a much more volatile reaction than you normally would. We have just seen that happen this week. It is an example of quite a volatile market reaction to a piece of news.

The other thing I will say is that, from the economics of it, if I was in the AI industry, I am not sure how big this news really is. There is something called the Jevons paradox in economics, which essentially says that, if you get a piece of news that cuts the cost of a technological innovation, you will actually increase demand for it. If you are in the AI business, this is not necessarily bad news.

**Dame Harriett Baldwin:** Whose law is that?

***Andrew Bailey:*** It is the Jevons paradox.

**Chair:** It is not Jeevun's paradox.

***Andrew Bailey:*** It is named after a 19th century economist, William Stanley Jevons. He originally did it for the coal industry. You cannot completely take me out of economic history.

**Chair:** You are in good company in this room.

***Dame Colette Bowe:*** I am going to bring the level down a bit now from the erudite comments of the Governor. Dame Harriet, I have just been reflecting on your question about unintended consequences, the abolition of risk and all that. Thinking about the things we have been talking about in the last few minutes, we have talked about crypto and we have talked about AI. We have not really touched much on cyber, but that is underlying this. When the FPC first got going in 2013, I do not think any of those issues will have been even on its agenda.

What that is telling us is that this is a very complicated system, which is really important to our fellow citizens. Its ability to change, but its openness to all sorts of risks that we might not have envisaged, is very considerable. When you think about risk and the consequences of regulation, you have to think about all the other things that cause risks and, if you were running a financial services business, all the things you would have to worry about. I do not know quite where regulation would be on your dashboard, but when you think about things such as cyber, AI, crypto, and all of that, it might not be very high. That is just my observation.

Q63 **John Grady:** Dame Colette, when we were talking about the international situation, what that leads to on those big risks such as climate change and potentially cyber is a situation where it becomes much more difficult to work with people we must work with to manage the very many risks that you identify in this wonderful report, which I was reading in the midst of the tempest in Glasgow on Friday.

Are you more or less optimistic that the Bank of England and our other regulatory bodies can work with our international partners and those we must work with to address these risks, which are many in this report, that require regular, repeated, patient working and reaching agreement? We have touched on Basel, but we have climate change; the emerging vulnerabilities at the intersection of PE and life insurance, where you mentioned arbitrage between different jurisdictions; and cyber. Are you more or less optimistic about addressing these things?

***Dame Colette Bowe:*** I feel fairly optimistic about that, in the sense that, as I have just said, if you go back to when this committee got going—well, we were not on the committee then.

***Andrew Bailey:*** I am afraid I was, actually.

***Dame Colette Bowe:*** Oh, we know who to blame then, if I may say so. But the risks that have emerged are not just ones that the Bank of

England can see; they are widely seen and shared among people who have these responsibilities in other jurisdictions. I feel optimistic that we can work together and we can collaborate with partners on addressing these risks. It is not easy; climate is one of the most difficult ones, but I feel optimistic about the shared conversation, if I can put it like that.

Q64 **Chair:** Governor, you rightly challenged us earlier in saying that public policy on risk versus growth is our responsibility—Parliament, this Committee, Government—as well as for you. We have been having quite an esoteric discussion at times here, and this is a pretty critical part of the agenda. We have had a good discussion around it. How would a member of the public understand the decisions at that margin and the risks to them? How would you put that into plain English?

***Andrew Bailey:*** That is a very tough question. We have to do more on this front. I do welcome these hearings. Colleagues have heard me say this, but I do have the concern—and I do not say this to denigrate monetary policy at all—that in our world monetary policy gets a huge amount more public attention than this stuff does, and yet this stuff actually has, if not a greater bearing, a very big bearing on people.

Embedded in this question about growth is the question about, for instance, how much risk people should take, how they should take it, and what the role of the financial services industry and of the regulators is in managing that process. Having what I would call a very open exchange on this to set expectations is important. The Chancellor has said this, and it is right.

I will say this from our point of view. When things go wrong, we know what happens. That is why, of course, you get some of the things that go on in terms of the way regulation develops, because if you come out and say, "This is always going to end badly", then the regulators will respond in that sense. We need to set that balance. As you rightly say, we have to communicate it, and that is really hard.

Q65 **Chair:** Do you think you could do better at communicating it? You have thrown us the gauntlet, so I will throw it back.

***Andrew Bailey:*** We should keep doing more and think about how we can do better.

Q66 **Chair:** If you are an average person in Hackney South and Shoreditch, Salisbury, Earley and Woodley, Loughborough or wherever, what would be the takeaway message about the balance between risk and growth? If you have someone tuned into personal finance they might be thinking cash ISA versus stocks and shares ISA, but for a lot of people that would be where it would begin and end; a lot of people would not even get that far. Is this something that you are thinking about?

***Andrew Bailey:*** It is. You get into the question of financial education, which we have a bit of a role in. I have to be honest: we do not regard ourselves as being in the lead and the only responsibility, but we will

certainly have a role and an assist on that. I am very open to the idea that we should try to collectively think, "What more can we do?" In resetting, or perhaps even setting, these principles and boundaries, it is very important that we include this issue in there.

Q67 **Chair:** Just going back to a point made earlier about mortgages, when Mr Glen was asking questions, would there be a point where the FPC might intervene over the FCA if you felt the mortgage market was getting too risky?

***Andrew Bailey:*** Yes, we can. We can give recommendations to the FCA.

**Chair:** From what you have said, that is not likely. You actually had quite a positive story on the mortgage market, Mr Benjamin. Can I thank you very much indeed for your time? In summary, we have heard a lot of useful things, but just to pick on some of the interesting headlines that have come out of today, we have heard about the new tool you have to provide lending to non-banks in the face of gilt market disruption, so it is heartening to hear that that is there, and you seem to be very pleased about that.

We have also heard that growth, of course, may come with simplification at the nexus of different regulatory regimes. We have been having quite a lot of discussions in the Committee about the risk regulatory function and growth, so that is quite interesting.

Governor, you noted that despite significant shocks to the economy and the financial system there has not been a significant increase in mortgage arrears, which may be a sign that the system is working, and also that loosening lending standards on mortgages—highlighted by Mr Benjamin—without building new homes may just lead to higher house prices. When we are talking about communicating to people in the real world, these are things that really matter. Thank you very much indeed for your time.