HOUSE OF COMMONS

Treasury Committee

Oral evidence: Bank of England financial stability report, HC 148

Wednesday 19 January 2022

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[Watch the meeting]

Members present: Mel Stride (Chair); Rushanara Ali; Harriett Baldwin; Anthony Browne; Dame Angela Eagle; Kevin Hollinrake; Siobhain McDonagh; Alison Thewliss.

Questions 62-129

Witnesses

I: Andrew Bailey, Governor, Bank of England; Sir Jon Cunliffe, Deputy Governor, Financial Stability, Bank of England; Dame Colette Bowe, External Member, Financial Policy Committee; Elisabeth Stheeman, External Member, Financial Policy Committee.

Examination of witnesses

Witnesses: Andrew Bailey, Sir Jon Cunliffe, Dame Colette Bowe and Elisabeth Stheeman.

Q62 **Chair:** Good afternoon and welcome to the Treasury Select Committee and our hearing into the Bank of England December 2021 financial stability report. I am very pleased to be joined by four witnesses this afternoon. I will ask them to very briefly introduce themselves to the Committee, although they are all very well known to the Committee already, but for those viewing.

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

Sir Jon Cunliffe: I am Jon Cunliffe, deputy governor for financial stability.

Dame Colette Bowe: I am Colette Bowe, external member of the Financial Policy Committee.

Elisabeth Stheeman: I am Elisabeth Stheeman, external member of the Financial Policy Committee.

Q63 **Chair:** Welcome all. Thank you for coming. Can I start with inflation, Andrew, as my first question to you? We have just had the latest release for the 12 months to December. It is 5.4%, which is a bit more than the market and some economists were expecting. It is not wildly more, but a bit more—0.2%. Nonetheless, we are still on an upward trajectory and your own predication is about 6% in April.

Can I come back to this discussion that we have had on this Committee many times before around transitory versus more permanent inflationary pressures, particularly in light of the latest data on the labour market, which, while real wages appear to be falling or have fallen in recent times, none the less, is very tight at the moment? I just wonder if you could share your thoughts on that to start with.

Andrew Bailey: I am happy to do so. To put it into a bit of perspective, we are just, as of yesterday, in the early stages of doing the next forecast and the next monetary policy report, and we will be publishing those two weeks tomorrow. We have a hearing in about a month or just over a month's time. I cannot comment on that at the moment, but what I can and will happily do is put it into the context particularly of the decision we took in December and I might draw out one or two points from that.

I get asked quite often, "How long is transitory?", to which the answer is that there is not a fixed length of time. It is more a description of a condition. You are right to say that there are some aspects of this inflationary pressure that ought to be transitory. The two that ought to be transitory are related, first, to commodity prices, including energy prices, but I will come back to that in a moment, and, secondly, to global supply chains, and I might come back to that briefly.

Those are what sometimes get called first round effects in inflation. Second round effects, which is where we particularly come in, are things that build off that and are not necessarily going to go away of their own volition. I draw two things out there that can cause those and they are closely related. One is higher inflation expectations, which can become embedded. The second one is the labour market. In the labour market, often, it is related to the effect that can run through inflation expectations into wage bargaining.

The point I would draw out here was certainly in my own mind in terms of the interest rate increase we did in December. It was very prominent in my thinking and something we had discussed at this Committee previously. It is the pressure in the labour market. Let me draw out a couple of points there.

We were, as we said before, quite uncertain about the effect of the ending of the furlough scheme, not least because of the number of jobs that were furloughed right up to the end of it, which was a lot more than we thought there would be, but we have now seen the evidence and, frankly, the ending of the furlough scheme did not have any real impact in terms of an increase—

Q64 **Chair:** That is a judgment call that you got wrong, effectively, in terms of then thinking about what you might do about interest rates.

Andrew Bailey: That is a hindsight judgment, if you do not mind me saying so. We wanted to see the evidence one way or the other of the end of the furlough scheme. It was obvious by December. We could see that evidence and that it was not leading to any sort of dislocation in the labour market. That was an important point behind our decision to raise rates.

The second point I would make about the labour market, which was true then and is true today, is that it is very tight in terms of labour supply. I am sure you get it when you discuss it with businesses in your constituencies. I get it when I do visits around the country. Labour supply is the first, second and third thing that businesses want to talk to me about. It is a very tight jobs market at the moment.

It is interesting, just very briefly, to look at what is driving some of that. As we can see from the numbers that were issued earlier this week, unemployment is now broadly back to where it was pre-Covid. Inactivity, which is people who do not have jobs and are not searching for jobs, is higher. The same is true in the US, interestingly, and it is now concentrated among older people more, who have withdrawn from the labour market. We do not know, frankly, whether people are going to come back into the labour market or are going to retire earlier than they perhaps anticipated they would, but participation is down.

The public sector has expanded, so that is creating more competition. Public sector jobs were probably about 400,000 higher during the course of Covid. The total labour force is not easy to measure, but we think it is probably smaller than it was anticipated it would be now. We cannot, I am afraid, separate out the effects there of Covid and Brexit, because they are both probably restricting the inward supply of labour, but we do not know, frankly, what the effects are.

If you put those things together, you can see that it is a very tight labour market and that is a concern. It is good news from the unemployment point of view. I do not want to, in a sense, suggest otherwise, but it is putting a lot of pressure on the labour market and it has the potential to put a lot of pressure on earnings and on wage negotiations.

If I could finally come back to the energy point and transitoriness, the other thing that has happened really since we had our December meeting is that wholesale natural gas prices are very elevated. They are somewhere between 3.5 and four times the level pre-Covid. They are very volatile. Over the Christmas period at one point the price was below 200 pence per therm. At another point they were 400 pence per therm. It is a very volatile market.

The thing that has changed that I would emphasise is that, when we were last here probably and certainly when we did the November monetary policy report, the profile of market prices of natural gas had it coming off really next summer, so it started to go back in the market pricing towards where it was pre-Covid. Now it does not come off until the middle or towards the tail end of next year, so that is a big shift and it is relevant to your point about transitory shocks. In terms of market pricing, that is a much longer elevated price of natural gas.

I am not an expert in that market. If you ask me what has happened in that period that has caused this, I would mention the tension on the Ukrainian border with Russia. This is the thing that has really elevated during that period and that is a concern. I have to be honest with you. That is a very great concern, if we are going to have a more elevated energy price. The oil price, by the way, is also up. It is up about 12% since the start of January, so that is another contributor.

If you think about the relationship between transitory and then these second round effects that can make it much longer, that again is a source of pressure in this story, which is a concern, I have to be honest with you. Sorry for the length of the answer.

Q65 **Chair:** No, it was worth listening to. On the labour market point, it is tight, as you say. What are you picking up in your surveys and the data that you are looking at there? Is there anything to suggest that wage price pressures might start to emerge?

Andrew Bailey: The earnings numbers are very noisy because there are a lot of base effects from the year before last, but what we pick up is that the so-called quit rate, so the number of people moving jobs, has gone up. Again, you see the same thing in the US. Certainly, when I talk to firms and employers they talk about evidence of people moving as a route to increase earnings.

In terms of pay settlements, the last numbers I looked at were interesting because they suggested quite an increase in the dispersion of pay settlements, by which I mean some pay settlements are very elevated and some are not, and the dispersion has got bigger than it normally is. That may not be surprising, because it is telling us that there are particular pockets of the economy and of the labour market that are very tight and others that are perhaps less tight.

What I would say with the quit rate point and this turnover point, which we see and a lot of organisations see, is that, if that leads to a situation where you have people within your organisation doing broadly similar jobs but if they have been hired recently they are on a different level of pay to those who have not, you can withstand that sort of pressure for so long, and then it does get difficult within the organisation once people work out what other people are earning. The risk is that it leads to an upward drift in earnings.

Q66 **Chair:** You have your hotspots in the labour market where higher wage increases are occurring and then there is a question as to whether that spills over, perhaps through inflationary expectations being de-anchored, as it were. Do you see any evidence of that? Is it something you are concerned about?

Andrew Bailey: Yes, I am concerned about it.

Q67 **Chair:** I know theoretically you are concerned about it, clearly, but is it something you are concerned about because you are sensing that wages might more broadly be in a more difficult place for inflation?

Andrew Bailey: There is a concern that could happen, yes.

Q68 **Chair:** What drives that concern? What is it that you can point to?

Andrew Bailey: One source of what drives that is the evidence we get from our regional agents. They do an annual survey of this and they are currently in the process of doing it. They tell me at the moment they are beginning to see some evidence of this. We will be able to pull this together and refer to it in our publications. I would imagine by the time we have the hearing in February we will probably have the results of that and be able to talk about it.

Q69 **Chair:** Does that mean that the Bank's current view, which is always shifting as more data becomes available, is shifting more towards feeling that wages might be more broadly taking off in a way that you had not hitherto expected?

Andrew Bailey: I am going to preface this by saying we are at such an early stage of the round and nothing I am going to say here should be taken by anybody who is listening as a view on how I intend to vote, because we are nowhere near taking views on that.

There is an argument that goes in the opposite direction. This is a hard thing to say, but it has been in the news quite a bit recently. If you get pressure on cost of living and on real earnings, that will tend to restrain demand in the economy. This is the argument that higher inflation restrains demand in the economy in that sense and that could lead to an output gap opening up. It could eventually lead to higher unemployment and that would bring inflation back down again. That has happened before. It is not like it has not happened before. It is not an easy thing to contemplate, but it is one route by which it could happen.

I do not want to suggest that, therefore, were we to consider it necessary, we do not have to take any action in terms of the Bank of England's action on interest rates. We would judge that ourselves, but there is another channel there that would weaken demand in the economy.

Q70 **Harriett Baldwin:** This is on labour market pressures. I can appreciate that, going into the end of the furlough scheme, you did not know what would happen, but now it has happened. I noticed that the top story yesterday on the BBC News was that bin collectors in Eastbourne had gone on strike asking for 20% and they had settled for 11% and 20%

over two pay rounds. These are really significant pressures. Now that they are evident and we can see that redundancies are at a record low after the end of the furlough scheme, it will be harder for people to forgive the Bank of England for not acknowledging quite how significant some of these pressures have become than it has been up until now in the unprecedented conditions that we have found ourselves in.

Andrew Bailey: Please do not think that we do not think these are serious pressures. They are. I would not want you to think that at all. I would just come back to what I said also about how this reflects on the labour supply. As I say, this is a very tight labour market in terms of the balance between demand and supply.

Q71 **Chair:** Would it be a fair summary of our discussion to say that the Bank's view of the likelihood of wages taking off in an unhelpful way more broadly has been sharpened over recent weeks?

Andrew Bailey: We are about to go into detail on this in the forecast process literally. Again, I will be much better placed to answer that when we come back in February and I can answer that question in the context of the report, the decision and the forecast.

Q72 **Kevin Hollinrake:** The Bank's central prediction for inflation for 2024-25 is 2%. Is that still the case based on what you are looking at now?

Andrew Bailey: We are at such an early stage of the forecast that I am not going to move on from the one we have published in that sense. We have to then use the forecast and all the other inputs to set policy to return inflation to its target, which is 2%, so that will be the decision we have to take. There is a reason why it tends to come back to 2%. That is the objective.

Q73 **Kevin Hollinrake:** Professor Miles, when he gave evidence and we interviewed him about his role on the OBR, said that he could see interest rates having to go to 3.5% to be able to control inflation. That is a scary thought for many households and many people who are trying to budget.

Andrew Bailey: I did not hear what David Miles said exactly, but I would just say, going the other direction, that there is a structural reason why interest rates have been and are as low as they are, not just in this country, but in the world economy. We often talk about that in terms of the equilibrium real interest rate. It is to do very much with the consequence of ageing populations in the world, the balance of saving and the demand for investment. It is also to do with low productivity in the world economy.

Our view is that we do not at the moment see developments in the world economy, including here, that change that structural story. When I see people saying, "We are going to back to the old pre-financial crisis days", I would counter it by saying that would require quite a change in the story on the equilibrium interest rate and we do not really see that story at the moment. That is not to say that interest rates will not rise. It is to put it into context of how much.

Q74 **Dame Angela Eagle:** I am just wondering, Governor, whether you worry about the weakness of monetary policy, given that interest rates are so low, and whether you have the firepower to deal with the kind of rise in inflation we have seen, especially if it were to persist. Your judgment to date is that it is going to be a temporary phenomenon and it is going to come back down. Given the historically low level of interest rates, do you think that monetary policy is going to be robust enough to deal with any unexpected persistence of inflation going forward?

Andrew Bailey: In a way, it is an asymmetrical story. We have far more potential to raise interest rates in terms of the starting point without getting the issue that we go the other way on the lower bound question. The issue I would come back to there is a slightly different version of that issue. A number of these important underlying issues, as many commentators say, monetary policy will not address. I am afraid we cannot bring the gas price down. Monetary policy will have an effect on the balance of supply and demand in the economy. In terms of the supply of labour in the economy, we can do some things there, but we cannot affect more structural things. Again, in terms of global supply chains, that is not something that UK monetary policy or anybody's monetary policy is going to directly affect.

Q75 **Dame Angela Eagle:** Do you also plan or worry about QE, the level of it and, if and when that begins to unwind, how that will affect the way that you deal with inflation?

Andrew Bailey: We have spent a lot of time on that question over the last year or so. We announced last summer that, when bank rate gets to 0.5%, so another 25 basis points, our intention is to cease reinvestment, in other words to start the natural unwind. When and if it gets to 1%, to change the verb here, we will consider the case for active sales.

In terms of that as a tightening tool, our view is that QE is quite state contingent in terms of its effect, so it works much better in some states of the world than others. It particularly works when you have financial market disruptions, as we had in March 2020. It is not that it does not work at other times, but it has more effect.

Although we have very little experience around the world to draw on in terms of QT, i.e. quantitative tightening, which, by the way, the Bank of England has never done, we start from the principle that it is reasonable to think it probably is symmetric. We would not do QT during a period of financial instability. If we are doing it in periods of what I might call relative calm in that sense, the impact of QT is probably going to be less than that. It will not be nothing, but it will be less. We will factor it in, but, if we are doing it in what I might call relatively normal times, it probably will not have that big an impact. We certainly cannot rely on it on its own.

Q76 **Rushanara Ali:** Governor, you were talking about unemployment being a route to bringing down inflation. From a policy perspective, it is not a price worth paying.

Andrew Bailey: As an economics point really, yes.

Rushanara Ali: Yes, absolutely, or indeed even economics, given the pressures in the economy. We have less scope for migration to tackle the labour shortage and the pressures on wages. I also wanted to observe that inflation rates had already gone up without the wage pressures kicking in, so to associate wage pressure with where we are now seems odd. If we continue in that trajectory, we could associate it. After 10 years of wage stagnation, is it appropriate to assign wage pressure as the reason why we are where we are?

Andrew Bailey: As I said earlier, there is a lot of noise in the earnings data, but with best effort at stripping that noise out, the underlying level of increase is around 4% to 4.5% and has been for a while. That is quite high given the state of the economy we have been in, so there is some pressure in there. As we were saying, whether it is in Eastbourne or wherever, you have this very dispersed pattern as well of settlements.

Q77 **Rushanara Ali:** We also have a vicious cycle of inflation then knocking off the value of the negotiated wage increases. It seems like the Bank is in a very tight corner now. Do you see a way out without policy interventions from Government to address these interacting challenges that you face? It looks like it is going to be really difficult for the Bank to be able to resolve this without policy interventions to take the pressure off price increases on consumers, for instance.

Andrew Bailey: We can and will do everything we can do. I can assure you of that. This is not something that is just for the UK. The gas price story, which is a European story, is not something we can deal with. I am not saying the UK Government could deal with it on their own, but it is a very serious issue. When it was 5.2%, we reckoned about 1.5 percentage points of that was coming from that source.

Q78 **Rushanara Ali:** The UK Government can take pressure off consumers who are facing the brunt of this sudden increase in inflation and the cost of living pressure.

Andrew Bailey: As you will understand, that is not for us to decide.

Rushanara Ali: I understand that.

Andrew Bailey: Choices can be made. I know it is a very active debate at the moment. I agree with you that the impact of this, which is something we do look at, is far bigger on low earners. It is very interesting that, if you take the family survey, you split it up into deciles by income and then you look at energy costs as a percentage of the income by decile, it is hugely asymmetric. The lowest decile has a much bigger share of energy costs in its spending than any of the others do.

Chair: Thank you. We are going to move on. I should have mentioned earlier that there will be some divisions at 4 o'clock, so we are going to crack on at pace.

Q79 **Kevin Hollinrake:** I will probably address the question to Sir Jon initially. Looking at how much we can read into the solvency stress test based on the amount of money the Government have put in to support the economy and how relevant that is, the FPC said that the banking system is resilient to outcomes for the economy much more severe than the MPC's central forecast, but it did not really take into account that the Government have put in a huge amount of money, £500 billion, to support the economy. How much can we read into the solvency stress test on that basis?

Sir Jon Cunliffe: It might be helpful if I explain the rationale behind the solvency stress test and then how much comfort one can take from it. The solvency stress test is not our normal annual stress test. At that point when we started it last year, in the Covid crisis, what we wanted to know was not how the banks had fared over 2020 with large Government support, but what would happen if there was another Covid hit as bad as the first one with no Government support.

The solvency stress test took the balance sheet positions of banks at the beginning of 2020 and applied pretty much another full Covid stress, so unemployment goes up to 12% and the cumulative loss of GDP is double what had happened up to that point. We assumed a vaccine-resistant variant that would cause us to go back into lockdown and the same sort of economic stress that we had seen in 2020, but we assumed no Government support, so the stress was really to test exactly the point you are making, with no Government support and a second Covid stress of equal or greater magnitude, which was not the MPC's forecast. The MPC's forecast was for the economy to recover. To go back into that short and sharp recession in the same way as in 2020, could the banks then handle that without Government support?

The banks started with a high level of capital at the beginning of 2020 and they had the level of capital to pass the test with some to spare. I have seen comments that the test does not tell you much because of all the Government support. We deliberately turned off the Government support and turned on another very severe Covid stress to say, "What would happen?" You can take comfort or we could then take comfort at the end of last year from that position.

Q80 **Kevin Hollinrake:** It is your understanding then, from that, that the banks have the wherewithal to withstand that kind of economic shock.

Sir Jon Cunliffe: Yes.

Kevin Hollinrake: Are there any other thoughts from other panel members on the same basis?

Elisabeth Stheeman: I am happy to add to that and perhaps to step back to where stress testing came from. It has evolved significantly during the crisis. As you will appreciate, previously we would have done an annual cyclical scenario—ACS. We initially in 2020 did the reverse stress test, to see how much certain numbers, such as unemployment and GDP, would have to go down in order for banks to get into difficulty. As Sir Jon just explained, the solvency stress test then took that one step further.

Now that we think there is some normality coming back, we will return to the ACS in 2022. We have not yet set the parameters. That is what the FPC gets involved in, looking at the different parameters and then deciding what scenarios we should use. Then together with the Prudential Regulation Committee—PRC—we will look macro for the FPC and then PRC bank by bank. That will come back to some, as I say, kind of normality in 2022.

Q81 **Kevin Hollinrake:** Let me ask you, Andrew, in terms of potential scenarios. Lots of these things we have been talking about in terms of inflation and potential interest rate rises are global issues, not domestic issues. Inflation is higher in the US and in Germany than it is here. What assessment have you made in terms of stress testing for a global shock based on these kinds of issues of an embedded level of inflation and interest rates?

Andrew Bailey: All our stress tests have global shocks built in, so they are global scenarios in that sense. They all feature a reduction in global GDP. That is relevant for two reasons. One is that the coherence of the economic shock requires that. You cannot really just run a UK-only shock. The second thing is that our banks have exposures around the world. As is well known, we have two banks that are particularly exposed to one part of the world, so we have to focus on that. We have to build global scenarios to run these stress tests and always have done.

As Elisabeth said, we are going to go back to an annual stress test this year, because the FPC judged in its last round of meetings that we are back into what we tend to call a standard situation. Broadly, you can run two sorts of stress tests in terms of interest rates. You can run what we tend to call a rates up scenario, where you simulate an increase in rates. The 2017, 2018 and 2019 stress tests were rates up scenarios and they all had the property of taking the bank rate back to 4% or to 4%. You can run a low for long scenario, which we have done as well.

We have not finally decided what we are going to do this year, but I would venture to suggest that one of those two is much more relevant to the situation we find ourselves in at the moment, so my best guess is that we will end up with a rates up scenario again.

Q82 **Kevin Hollinrake:** A global recession is a possibility on the back of inflation and interest rate rises. Looking at the scenarios you considered, what level of global recession would it take to bring about a banking crisis in the UK?

Andrew Bailey: Can I just define what we mean by "banking crisis"? The way we test this, we are not testing to insolvency because we want them not to get there. In fact, we do not want them to get beyond the point where they cannot lend to support the economy and that is a level quite well above any level of insolvency. That is why, as Elisabeth was saying, in the reverse stress test, where we have to impose a level of loss into the system, we used the 2019 calibration. It was just over five percentage points off their capital ratios.

On the one we did last year, the starting point for the banks, because they had quite a high capital ratio, was about 15.8% or something like that. We took about five point something off and it came down to about 10 point something. The threshold is about 7.6%, which is the so-called reference point, but we do not want them going below levels where we do not think they can support the economy, because that is what financial stability is all about.

Sir Jon Cunliffe: I will make maybe two points. It is not just the level of the trough and how much global GDP goes down. It is how long it lasts for. The stress tests we did up to 2019 were pretty much modelled on a business cycle recession or the financial crisis, where the recovery was very slow and that stresses banks quite considerably for a number of years.

The SST stress test we have just run was much more a Covid shock, where you get a very sharp drop in GDP. The drop in GDP was 10% of world GDP in the first quarter of 2020 in that stress test, but it recovered quickly. So 10% seems a huge amount and some people have said, "Well, 10% has never happened; it was only 3% in the global financial crisis", but that then comes back very sharply, because that is the profile of a Covid-type shock, which is what we were testing against. In previous stress tests the drop has not been as great, but it has gone on for longer, so it is quite difficult to give a number. You have to give a profile for the test the whole way through.

You could ask, "Why are we moving from one to another?" The answer is the that reason we do the stress tests is to ensure that banks are capitalised against a tail event. We have just had a tail event. Banks were capitalised against it. You could say there was Government support. We have just run the experiment of turning off Government support. That is before you hit a stress.

When you hit a stress, if you then say, "We are in a stress and we want you to be capitalised to a further tail event; we are already in the tail of probability and now we are going to a further tail event", we would be asking banks to raise capital in the middle of the stress. That is the way to stimulate a credit crunch. The judgment for the FPC is to what extent I need to reinforce bank capital in the middle of a stress, knowing the impact that will have on credit, or to what extent the banks have enough capital to continue, as Andrew says, to support the economy.

In June 2020, we did a very quick desk-based test against a scenario of Covid, because none of us knew at that point how long lasting, indeed, Covid would be. Three months later we did the reverse stress test of the sort you mentioned to say, "We think they are okay on that scenario. How much worse would Covid have to get to exhaust their regulatory buffers?" Then six months later we do another test that says, "Okay, now let us assume another dip of Covid".

That is how we navigate through the period of stress, being able to make the judgment that we do not have to ask the banks to raise capital, because, as we saw in the financial crisis, asking banks to raise capital in a stress, which you may have to do, really could result in a withdrawal of credit, which you want to avoid because that then drives the economy down and drives more bank losses. That is how we navigated through the stress with different types of stress tests to try to inform that judgment about whether they had the capital to support the economy.

Q83 **Kevin Hollinrake:** On QE, the IEA had a presentation from Professors Congdon and Castañeda yesterday. They were saying inflation is being driven by money growth. It is too high. It is 6.8% now. It was over 15%. It needs to get below 5%. Is that your intention?

Andrew Bailey: It is not that we do not regard inflation as a monetary phenomenon, but the relationship between money growth and inflation is not very good. We could debate this for hours.

Chair: Let us not do that. That is a short, sharp answer. Thank you very much, Governor.

Q84 **Dame Angela Eagle:** I am going to ask about the countercyclical buffer rate decision. At the beginning of the pandemic, because of the uncertainties around Covid-19 variants and the economic outlook, the Financial Policy Committee took the rate down from its normal 2% to zero. You have now decided to increase that to 1% with a potential for a further increase to 2%. In order to do that, you would have to think that the vulnerabilities that can amplify economic shocks are now at a standard level. Do you think that at this stage of the pandemic that is a correct judgment? Can you tell me a bit about what you brought to bear to make that judgment?

Andrew Bailey: When Covid hit we had announced we were going to move it from 1% to 2%, but it had not taken full effect. It would have done otherwise. We had to take a decision in the last round of the FPC, towards the end of last year. From the point of view of the banking system, conditions have returned to quite a lot of normality in terms of the positions they have faced so far. While they took very substantial impairment provisions, they have not experienced large impairments. Going back to Kevin Hollinrake's point, there was Government action involved in that as well. Moreover, the depletion of the banks' capital has been very small to none. We were faced with the decision: "Now seems like the right time to start to rebuild the buffer". I should say, by the way, the banks have this capital.

Q85 **Dame Angela Eagle:** Yes, so you are just asking them to set it aside.

Andrew Bailey: The question really was whether we go straight to 2% or whether we go, as we did, to 1%, but announce that, if things remain as they are and we do not see another shock coming along, our intention is to go the whole way back from 1% to 2%. We decided to do the second, largely because omicron started to come on the horizon and there was uncertainty. There still is residual uncertainty about the path of Covid thereafter, but it was very clear, speaking to the Committee, that we wanted to give a signal at this point that, unless there is a bad outturn that we see, we will go to 2%. It was deliberate to take it in two stages, but give the signal now that we are going to the second stage unless—

Q86 **Dame Angela Eagle:** You are likely to do that in second quarter.

Andrew Bailey: Yes.

Q87 **Dame Angela Eagle:** What sort of thing happening would make you perhaps look at that again? What things would you be keeping an eye on before you made that final decision?

Andrew Bailey: We would come back to some of the events we see in the stress test, for instance, that would have to disturb the performance of the banking system via an economic shock.

Dame Angela Eagle: Sir Jon, do you have something? You have ripped your mask off, so I am expecting you have something to say.

Sir Jon Cunliffe: It is quite difficult to know, with the mask etiquette.

Andrew Bailey: It is not very subtle really, is it?

Sir Jon Cunliffe: It is not. I will put it back on again. It was quite a recent decision to run in a standard environment with a 2% CCyB, but the reason is that you do not always have warning of when a crisis is going to strike and you want to have some capital that you can release if you get a sudden shock. That was the reason for 2%. It turned out that the shock, as Andrew said, did not consume bank capital, because of Government support, vaccination and other things, in the way that one might have thought in March 2020. We also have to tell the banks the earliest point at which we will turn it back on again, because, if they feel we are just going to reimpose it quickly, they will not use that capital to maintain lending. They will say, "It is going to come back in six months' time no matter what the Bank of England says".

Q88 **Dame Angela Eagle:** It is a very blunt instrument, is it not? You have to get the timing of the buffer. The Bank's executive director for prudential policy, Vicky Saporta, recently said that there may be stigma associated with the use of a regulatory buffer and banks are unwilling to be seen to be dipping into it. Does that mean that the whole concept of having a buffer is not as effective as you think it should be and are you worried about that?

Sir Jon Cunliffe: For the countercyclical buffer it is the opposite. It is because we release it and it is no longer a requirement for capital that is available to banks. There is no stigma. They automatically have the 2%. It is now no longer required for regulatory purposes and they can use it.

For the other buffers, and the capital conservation buffer in particular, a bank can dip into it, but it is an individual bank that takes that decision and there is some evidence of stigma. Nobody wants to be the first to do that. It means banks will defend the capital ratios above the buffers that, if you like, they control.

One of the reasons for putting more into the countercyclical buffer is that it takes away that problem, because we just release it for the system as a whole and there is no stigma. For the other buffers, whether they are usable to support lending is a question that has arisen during this crisis and that internationally is being looked at.

Q89 **Dame Angela Eagle:** Perhaps you could answer this as well, Elisabeth. Listening to Sir Jon's explanation, which makes sense, does that mean there is an argument for having larger countercyclical buffers to ensure that there is more of a capacity in a more volatile world to respond quickly without putting particular banks under stress or pressure from their shareholders?

Elisabeth Stheeman: I am happy to have a go and then let others come in. Almost three years ago, we went through a process of just looking at how buffers have evolved since the financial crisis. We realised that it takes quite a long time for banks to build buffers and that is where the original discussion came in from thinking that really the standard level should be at 2%. As Sir Jon said, it is something that can be released very quickly.

The point I was going to make, which took me some time to get my head around, is about when you are building the buffer. Given that we said in December 2021 that we wanted the buffer to go up to 1%, it has a one-year time lag, so the 1% would only come into effect in December 2022. If we were to then bring it up to 2%, say from second quarter, again, that would take another year, so it takes quite a bit longer to build the buffer.

Releasing we could do at any time, as you see in the second half of March 2020, where we released the buffer to zero and then immediately the capital was available and could be lent to the economy. It is a really interesting question whether countercyclical buffers should be higher, because to some extent they are more flexible in terms of being able to release them much more quickly, hence no stigma or less stigma.

Andrew Bailey: There is an issue within that as to whether we should raise the countercyclical buffer on its own or, to Jon's point earlier, whether we should look at the composition of the buffers as a whole and say, "They would be more useful if they were consolidated into the countercyclical capital buffer". As Jon said, it is already now subject to international review.

When we were giving the numbers on the stress test, I said the Bank started with 15.8% and the stress test took 5.5 percentage points off to leave them with 10.4% or something. You could well come back at me and say, "So implicit in there is an assumption", and I said that the whole point of this is to ensure they continue to lend, so the implicit assumption is that they are prepared to see 5.5 percentage points go down and continue to lend, because if they are not, and they are protecting these buffers, there is an obvious flaw in the process.

Dame Colette Bowe: I was going to make another point in response to Angela's question. Angela, you said something about the CCyB as a bit of a blunt instrument. I was at that time a new member of this committee when the pandemic struck and I was very interested to see that the Bank had the ability to order the release of this buffer immediately. In my book, that is the definition of quite a sharp instrument for a central bank. It is not a particularly blunt one. It is something that you can do like that. I just want to put that bit of nuance around this discussion. It is something that the Bank can do at speed, which means it is an important part of its crisis response toolbox.

Q90 **Dame Angela Eagle:** I just want to ask one more question. I am conscious of time. It is about household indebtedness. Given that there is a cost of living crisis looming very fast and large in front of all of us, and we have seen a lot of evidence that low-income households have increased their debt burden in recent years and, in fact, also suffered much more than others in terms of income loss and indebtedness during the pandemic, is there any sector of the financial system particularly exposed to increases in this indebtedness among low-income households and do you worry about that from a financial stability point of view?

Andrew Bailey: First, it is the consumer credit industry. The evidence from the economics would suggest that households will prioritise mortgage payment servicing over other debt servicing, so that would suggest that it is consumer credit that is the more exposed element of this and history would reinforce that.

Q91 **Siobhain McDonagh:** Talking mortgages, following a recent review, the Financial Policy Committee is proposing to consult in the first half of this year on withdrawing its affordability test recommendation while retaining the loan to income flow limit recommendation. What exactly from this review in comparison with the other three carried out previously led you to conclude that the affordability test was less effective? What is the timetable for the consultation and what kind of responses are you looking to receive?

Andrew Bailey: I will start, but others can come in. We review the housing tools frequently and the reason for that is that they have a much more direct impact on people than the countercyclical capital buffer, for instance, which is a bit removed from everyday life for people. We are very conscious that these things have direct impacts on people and, therefore, we feel it is our responsibility to review the tools pretty frequently, which we do.

The point I would draw out is that we introduced these tools, I think I am right in saying, in 2014. We now have more evidence to draw on, and particularly on the question of what the additional benefit of the FPC having its own affordability test is over the two other elements of this structure. One is the FPC's loan to income flow limit and the other is the FCA's consumer protection mortgage affordability test, which is at a lower level. We concluded that the marginal additional contribution of our affordability test is not very large.

Among the two tools we have, it is the LTI flow limit that does the real work. The combination of the flow limit and the FCA's consumer credit affordability test really got us most of the way there, so that is the basis. Underpinning that is a view that we have to regulate efficiently. We are under a duty to regulate efficiently, and so the proposition that we are going to put forward is that it does not add enough to warrant having it on its own.

Sir Jon Cunliffe: I would just add a couple of points. As to what we learned over this period and why we did not learn it in 2016 or 2017, this question of the role of the affordability test was coming up in the last review before this one and we decided to wait a bit.

First, the affordability test is keyed off reversion rates, so when you come to the end of the mortgage you are supposed to be able to withstand a 300-basis point increase on the reversion rate when the mortgage was set. Even though mortgage rates have come down and the spread between mortgage rate and bank rate has narrowed, reversion rates have proved remarkably sticky since 2014, so they are still running at about 4%. If you take out a mortgage today, you might take it out at 1.6% or 1.8% on an 80% LTV, but your reversion rate is 4%, which is where it would have been when the mortgage rate was much higher.

We do not know how banks will respond if interest rates go up. Will they put the reversion rates up in lockstep or will they still stay at 4%? This question of the behaviour of reversion rates means the affordability test's stringency is unpredictable, because it depends on the behaviour of the thing it is based on, which we cannot determine in advance. That has become more apparent over the period. As mortgage rates have changed, we have just seen the stickiness of the reversion rate.

We cannot observe the affordability test directly, because it has millions of decisions about individual borrowers and it takes into account the income of the individual borrower, but also their expenditure commitments. It is done on an individual basis. We have had to put together information from a number of surveys, such as the wealth and assets survey and the English housing survey, and build quite complicated models to try to get at what the affordability test is doing.

For those of you who have lots of spare time, I would refer you to the section in the FSR that sets out how the modelling has worked and the different stresses we put it under to try to get a view for that, but we really needed a run of years to be able to do that. We are using survey data, of which some is now a couple of years old, that we did not have a couple of years ago because the surveys lag to some extent.

It is a combination of seeing how the banks have behaved over the period and then just having the comprehensiveness of information to put together the modelling to do something that we cannot observe directly, whereas we can observe the 4.5 limit directly because we know how many mortgages are at 4.5 and how many are not. We do not know how many people have been turned down on the affordability test or how it is supplied to individuals. That is really why we have had to wait until we have had this body of evidence.

Q92 **Siobhain McDonagh:** One in 10 adults owns a second home while four in 10 do not own their first. What impact do you think that low interest rates and high deposits have on the housing market for first-time buyers in comparison with those who are already homeowners?

Sir Jon Cunliffe: The biggest constraint on first-time buyers is the deposit, the size of which has increased markedly over the last 20 years, for two reasons. First, house prices have grown more quickly than incomes and, therefore, the number of years you have to save out of your income for a 5% deposit has grown. The other reason is that there have been periods when 95% mortgages and above have not been available. If your mortgage is 80%, your deposit is four times as great. It is going to take you four times as long to save.

We published some charts. If you look at what happened in the two great periods of housing boom in the UK, from the mid-1980s to the early 1990s and then from the late 1990s to the financial crisis, it is in those periods when house prices are growing at double the rate of incomes that you see the decline in first-time buyers and in home ownership as well.

Since we introduced the test in 2014, the market has been stable. I should say there are many reasons why the market has been stable, but there is some evidence to suggest that some of it is to do with the housing measures and the way the banks have implemented them. The biggest constraint is the deposit and not these particular tests.

The reason why deposits are out of the reach of first-time buyers is the growth of house prices relative to income and, as I say, since 2014 we have seen a much more stable period. We have seen the share of first-time buyers in mortgages rise slightly for the first time, but the decline has stopped. This is really a question of the affordability of housing and the role that the necessary deposit plays in access to housing.

Q93 **Siobhain McDonagh:** Do you think the stamp duty holiday announced during the pandemic helped or hindered the divide between those who own and those who do not?

Sir Jon Cunliffe: We will have to see what happens to the housing market going forward. We started to see an increase in house prices three-quarters of the way through 2020 and at the time the question was how much of that was to do with stamp duty. We have put out some research on this and it now looks as though a fair proportion of the increase we have seen in house prices has not come from stamp duty. It has come from changes in people's housing preferences, the so-called race for space, the preference for houses over flats and the preference for areas of the country away from the normal areas of house growth, like London and the south-east. Some of the pressure on the housing market in that period also came from the stamp duty holiday and you can see that in the rush to get transactions through or not.

Q94 **Siobhain McDonagh:** The reluctance on the part of the banks to provide 95% mortgages, given the amount of work that is involved in them, and attempts to get through before the end date for the scheme were all putting pressure on those who have against those who do not.

Sir Jon Cunliffe: Yes. I would say one thing about the banks, though. In a period when you did not know what was going to happen to house prices, because one did not know about the pandemic or how long the Government response to the pandemic would last, banks would prefer to have a bigger equity cushion when they lend an 80% mortgage than a 95% mortgage. If you get, as in our stress test, a 33% drop in house prices, the bank is much more at risk.

We will not know for a number of years what role the stamp duty holiday played. The market had effectively shut by the middle of 2020, so you can see the reasons why from a Government point of view, trying to smooth the path of the pandemic, this seemed a sensible thing to do, but we will only know how it has affected the market when we look back over a couple of years.

Andrew Bailey: We saw a withdrawal of high LTV lending by the banks in the early part of the Covid crisis and then a pretty strong return of it last year.

Dame Colette Bowe: Adding to Siobhain's question, this is not either a financial stability point or a comment on Government policy, but it is undoubtedly the case that, for renters who are trying to get a deposit and everything else together to get on to the housing ladder, the stamp duty holiday must have helped.

My colleague Jon has just given you a very learned account of what the research has shown us and everything, but we probably all know anecdotally that for a lot of younger people who were desperate to get into the market, undoubtedly, the stamp duty holiday helped them. Whether long term that is good, bad or indifferent, I am not sure, but certainly, when you look at the problems that those younger people have trying to get a deposit together, particularly in London and the south-east, it must have helped. That was part of the underlying thing of your question, was it not?

Q95 **Siobhain McDonagh:** I have a different point of view. I believe that banks withdrew those mortgages that particularly helped first-time buyers because they had so many people who already own their home and who wanted to take advantage of the stamp duty holiday to buy their second home or a home that suited their needs, as they perceived them, more. Therefore, the availability of the mortgages that supported first-time buyers reduced.

Dame Colette Bowe: As Jon says, time is going to tell, but we ought to keep talking about this, because this is one of the biggest issues facing not just people like us worrying about financial stability, but all of us when we think about what is happening to our young people. I will stop this short sermon about young people now.

Q96 **Anthony Browne:** Can I ask a follow-up question on housing? I have had a long-term interest in home ownership rates and housing economics. I just want to follow up the point Sir Jon made that the main barrier for first-time buyers is increasing deposits, which are because of higher house prices, but also because of fewer high LTV mortgages. Is the reason for fewer higher LTV mortgages partly the capital restrictions imposed on banks? There are other factors, and Andrew mentioned the change when Covid came in, but are the requirements on banks to be more prudentially stable not part of the reason? Andrew can answer if he wants, but you are the one talking about it.

Andrew Bailey: He took his mask off first.

Sir Jon Cunliffe: I am sorry. I have to get used to mask etiquette.

Anthony Browne: In short, is prudential policy not part of the reason why we have had a decline in home ownership rates?

Sir Jon Cunliffe: Yes, but prudential policy is one of the reasons why banks can withstand a big shock to their mortgage books and one of the reasons why you go into this crisis with stronger banks than otherwise. There is some evidence the banks are setting limits. We have not put any limits on loan to value. We leave that to banks to decide. The withdrawal of high loan to value products following an economic shock, as you saw after the great financial crisis, is not so much to do with bank capital, but much more to do with banks being concerned about the equity cushion that they have. In 2009-10, there were mortgages at 90%, 95% and above. There were some crazy ones before.

Anthony Browne: Over 100% at one point.

Sir Jon Cunliffe: Over 100% if you were with Northern Rock, but those get withdrawn very sharply and the withdrawal that we see in the first nine months after the Covid shock is very much a withdrawal to do with—

Q97 **Anthony Browne:** Does prudential policy not incentivise that now in a way that it did not before the financial crisis?

Sir Jon Cunliffe: I would put it the other way around and say prudential policy and banks' own risk management now recognise the risks in housing, so they do not take the losses on housing that they have taken in previous episodes.

Andrew Bailey: I would just make two observations. Touch wood, we have come through quite a severe economic shock and not had a housing crisis and a mortgage lending crisis, which is not true of the past. Secondly, as you know, we are still dealing with mortgage prisoner problems created by some of these lending practices in the past. It is not something that comes and goes without leaving its mark.

Q98 **Kevin Hollinrake:** Precisely on that point, you seem to be swapping a very specific affordability test requirement you have for something far more open to interpretation that lenders might have. The requirement is that lenders consider the impact of likely future interest rate increases. They might just say, "I do not think there is going to be any and, therefore, we can just lend irresponsibly again", which has been the cause of two major crises in economies.

Andrew Bailey: The loan to income flow limit is, in our assessment of all the evidence, a much more powerful tool among the two and we are not changing that.

Sir Jon Cunliffe: For the FCA rules, I would make two points. First, they are for the mortgage conduct of business, so some of this is to protect borrowers against lending practices that lead them into taking on more debt. It is not really a financial stability point, but there is a floor that they have to test. The rules are that you test against the market rate, but there is a minimum of 100 basis points, so they cannot just wave away the test.

Q99 **Alison Thewliss:** Moving from the household side to corporate indebtedness, from your report being published, business insolvency figures that came out this week said that they were 20% higher than the number registered in the same month the previous year and 33% higher than the number registered two years previously, so December 2019. It is perhaps a question for Sir Jon. Could a significant increase in insolvencies, as we are seeing in some of these figures, have an impact on financial resilience more widely?

Sir Jon Cunliffe: The aggregate picture for the corporate sector, taking large corporates and small and medium size together, is that they have come through the crisis with a relatively small increase in indebtedness. It is about 3.5%, which is an increase of £45 billion or £46 billion. If we are thinking about the aggregate resilience of UK corporates, we have not seen really any deterioration in interest coverage ratios at that level and we have not seen a big increase in debt.

The aggregate hides a number of things. The issue is much more around small and medium-sized businesses, particularly in the worst Covid-hit sectors, like hospitality and personal services. SMEs have built up cash balances. Much of it has been Government-guaranteed and the repayment is over six years, with pay as you grow provisions for firms that cannot meet that, so the chance of that turning into something that is big enough to trigger a financial stability problem is quite small.

That does not mean there will not be insolvencies and, in some sectors, they may be quite high. Some financial institutions that are particularly concentrated on those sectors may have problems, although that is one of the things we looked at in the stress test and we did not see enormous concentrations that would do that.

Covid will leave a scar in terms of insolvencies and they have risen. They are above pre-Covid levels now. There was probably some pent-up insolvency because winding-up orders were suspended as one of the Covid measures. We will see that. I would not expect it to cause a financial stability problem, but, yes, I acknowledge there will be problems in some sectors and among some firms.

Q100 **Alison Thewliss:** Are you able to account for that pent-up insolvency rate? Is there a volume of insolvencies that you are expecting to see?

Sir Jon Cunliffe: No. To some extent, it depends on how quickly business comes back. It is a bit like furlough in a way. You do not know what is going to happen afterwards. It depends on the evolution of the economy, but it also depends on structural shifts. Are we less willing to go to pubs and eat in restaurants now? Once we get through Covid, will our preferences change? Will we be more interested in buying home exercise equipment than going on holidays?

Those shifts are difficult to map. We do not have a number, but when we looked at this at the beginning of the pandemic we thought the financial shortfall would be larger than it has been. A lot of that has been to do with Government support, but some of it has been to do with vaccination and other things that have brought the economy back more quickly than you might have expected in 2020.

Andrew Bailey: It is just worth repeating a point that in 2020 the banks made around £22 billion of expected loss credit provisions. In the first half of last year they released about £2.7 billion of those, but there is still a very large stock of expected loss credit provisions in the system.

Q101 **Alison Thewliss:** You had said within the financial stability report that SMEs, as you have said there, are more likely to have financial pressures. Do you have any sense of how that crisis has affected SMEs or any further detail on how that is distributed?

Sir Jon Cunliffe: We do not have sub-sectoral detail of SMEs, other than the obvious points that, where you see the drops in revenue, they are the areas you would expect. That is one of the unusual things about this stress. It has been very concentrated in particular parts of the economy, but we have not done a micro analysis within each sub-sector, no.

Elisabeth Stheeman: As Jon said, it has been very concentrated on SMEs and overall the debt levels of SMEs have gone up 25%, whereas, interestingly enough, in large corporates the overall debt level is now below end of Q4 2019 levels. It is quite interesting that there is quite a difference in terms of debt levels. SMEs clearly have borrowed more and, as you may have seen in the financial stability report, many of those SMEs had never borrowed before, which is also an important point.

Sir Jon Cunliffe: That is important.

Elisabeth Stheeman: That was the first time they had even built a banking relationship.

Q102 **Alison Thewliss:** Does that add a different level of risk if it is people who have not borrowed before?

Elisabeth Stheeman: It depends on the type of situation. For some of them, it clearly was a question of survival, otherwise they would not have been able to continue business. Then, depending on how the businesses come back and their ability to repay those loans, that will determine how they will survive in the future.

Andrew Bailey: It will leave them with a balance sheet that is not the one they were either expecting or used to, and the "used to" point is important there.

Alison Thewliss: Especially with other costs now being added on in terms of energy prices and other things as well.

Elisabeth Stheeman: Exactly.

Q103 **Alison Thewliss:** The crisis has seen a bit of a restructuring of the economy in some places in relation to the nature of work, such as working from home, which then has an impact on real estate and city centre shopping, for example. Marks & Spencer in Glasgow is closing one of its stores and leaving another great big gap there as well. What impact does that then have on those parts of the financial system to do with real estate and commercial property?

Sir Jon Cunliffe: The first thing, which may be an obvious point, is that we do not know how permanent some of those shifts would have been. The high street was being affected anyway before Covid by the move to internet shopping and by out-of-town centres. Both of those clearly suffered during the pandemic and we have seen a big increase in internet shopping. How much that will continue is not clear.

On the office space side, again, it is not clear because we do not to what extent people will come back to work, but if you put it together it is reasonable to say there will be less demand for commercial real estate, either retail or office, than there was beforehand.

In terms of bank exposure to commercial real estate, which we tested specifically in the stress test, a lot of commercial real estate has been funded from abroad. A lot of it has been funded outside the banking sector. It is an area where traditionally UK banks have made big losses. The losses on commercial real estate have been bigger than on residential property, which is why there is a 33% drop in commercial estate prices in the stress test, but we think the banks have the capital to absorb those losses. My guess is that we will see some pressure on that.

There are things that argue the other way. What one hears from the office side is that there is a demand for higher-quality office space. People are going to spend less time in the office. It is the low-quality offices that will be a problem. The high quality is there. The high street is trying to reinvent itself away from retail, but my guess is that there will be some strains in commercial property.

That is one of the reasons we do the stress test. I know there are some comments: "Why do you do the stress test if people keep passing them?" We do it to make sure that they do keep passing them. Commercial property is one thing we singled out specifically and the UK banking sector is resilient to quite a large commercial property stress.

Elisabeth Stheeman: Can I add one thing, given my professional interest in commercial real estate? I sit on a few boards that are involved in that outside the UK. The point Jon made in terms of commercial real estate, especially office real estate, is an important one. I have certainly seen that people who are looking for commercial real estate or looking to remodel their office space will use it very differently. People will not necessarily sit in long rows of desks with their computers, but breakout space where you use the space more creatively is more important.

One asset class within commercial real estate that has done really well through the crisis is storage. If you think about people buying things more online, they will need to find space where that needs to be stored. When I went on a regional visit to the midlands a few years ago just before the pandemic, it was really interesting that even then everybody wanted storage space and the local brokers found it really difficult to find it. Prices were certainly moving up then already and that has only intensified since then.

Chair: We have 30 minutes exactly before the Division Bell goes and three more members to come in. Do the maths. Just under 10 minutes would be great for everybody.

Q104 **Anthony Browne:** Short answers, please. I am going to ask about global vulnerabilities and then climate change. The global financial crisis started in the US and then moved to other parts of the world, including here. The mispricing of risk of securitised mortgages in the US led to the collapse of three banks in the UK. What do you see as the main global vulnerabilities now and what is the concern about them coming to the UK? I do not know who is the best placed to answer that.

Andrew Bailey: One thing that is interesting is that global debt levels have increased more rapidly than UK debt levels, particularly in the corporate sector, which I must say was not a thing I necessarily expected at the start, but it is interesting. As we were saying, larger UK corporates have not increased their debt levels. That is not true in other parts of the world. That is one thing that comes through all the indicators and early warning indicators that we see. There is a larger contribution to the early warning indicators from debt levels outside the UK, because those can spill over, as you were saying, Anthony. That is one thing.

The second thing we watch is China, particularly now. We saw last week that we are seeing slower growth in China. The authorities in China are very clearly trying to reduce the reliance on the property sector for growth. I do not want to speak for my colleagues, but the chart we were all most surprised about is a chart in the FSR that shows the proportion of Chinese property lending for what we could call second and plus homes. I just did not realise this.

Sir Jon Cunliffe: There is huge speculation.

Andrew Bailey: It is linked to this speculative property bubble. The ever-growing problem is extensively reported. I would say at the moment that we are seeing a fairly protracted resolution of it. We are seeing contagion within China, but it seems to be being kept under control. They are managing it by effectively preferring onshore to offshore creditors. That is one thing we do have to note. It is a concern to us and, as I was saying earlier, it is a concern to us when we look at the stress test because we have banks that are more heavily exposed in that area of the world.

Q105 **Anthony Browne:** I was going to ask, would the transmission mechanism in terms of financial crisis from the Chinese property market to the UK be through the banks—HSBC and Standard Chartered?

Andrew Bailey: It could be. It could also go indirectly, because it is not necessarily through direct exposure to our banks. It can go through other parts of the system as well, because this is a very large component of debt. We watch that very carefully. At the moment it appears to be being managed and it is consistent with, as I say, the slower rate of growth that we are seeing in China at the moment.

Q106 **Anthony Browne:** I want to ask in my strict 10 minutes about climate change as well. In the latest remit letter you had from the Chancellor, he asked the FPC to continue to regard risk from climate change as relevant to your primary objective of financial stability. How are you doing that, Jon?

Sir Jon Cunliffe: The Bank can contribute in a number of ways. First, we can ensure—I think that is the right word—that the financial sector itself is resilient to the impact of climate change over a number of years. That is really about the change in the valuation of their assets, as carbon intensive assets just become worth less and we have stranded assets there. The Bank has done a lot of work in that area. We have the climate stress test now for banks and insurance companies, which asks them to look at a stress over a much longer period than we normally would against three scenarios. One is no action.

Anthony Browne: No action getting to net zero, you mean.

Sir Jon Cunliffe: No action getting to net zero and a rise in temperature above two degrees. Then there are backloaded action and steady state, because all those will affect the price of assets and risks in different ways.

Secondly, the Bank has a role in supporting a smooth transition to net zero. That is about ensuring disclosure and that markets understand those parts of the economy that will be on the transition to net zero. Again, the stress test and the scenarios around the stress test help with that, as do our efforts internationally as well on getting consistent disclosure standards.

Anthony Browne: There are the climate-related financial disclosures.

Sir Jon Cunliffe: Yes, TCFD. This is something that has to happen internationally because you need investment to support transition. Investment supporting transition is not the same as necessarily divesting from carbon assets. It is understanding where assets sit on the transition path and the like. Then there is the exemplar effect that the Bank can have with its own actions and particularly there the corporate bond portfolio. We put out our proposals for the way we intend to tilt the corporate bond portfolio to those companies that are taking action to make the transition. There is a range of areas where we can have a direct impact, some of which goes to financial stability, and where we can support the Government attempt on the transition to net zero.

Q107 **Anthony Browne:** You had a letter recently from Sir Chris Hohn, who is the chairman of the Children's Investment Fund Foundation, which funds a lot of climate-related work, criticising you for not requiring banks to collect emissions data from their portfolio. What is your response to that? You do not do that at the moment, as I understand it.

Andrew Bailey: I have two things. Colette is going to come in, I am sure, on this. This goes to what Jon was saying. We need, clearly, standards for disclosure and reporting disclosure to do this consistently. We are doing it in the climate exploratory scenario, which is the stress test that Jon referred to. That is our own initiative. We have asked banks to do that for the 100 largest exposures, but to do this thoroughly we have to have an international reporting standard that provides the basis for doing that. The good news is that that was agreed at COP26 and the process is now taking place. It is the International Sustainability Standards Board, which Colette is involved in the governance of.

Dame Colette Bowe: Indeed I am. I am a trustee of the IFRS and, as you are interested, Anthony, in climate change, you will know that we have recently announced the setting up of the International Sustainability Standards Board, which is going to be chaired by Emmanuel Faber. We are pressing on very rapidly with the establishment of new standards. Going back to Chris Hohn's letter, which raises a very interesting and powerful set of points, we have to have some consistent standards about how firms do this. Otherwise there will be all sorts of scope for—

Anthony Browne: Game playing.

Dame Colette Bowe: You said that. I did not say that, but there we are. I would just like to add to Jon's point that the Bank has been highly supportive of the work to set up this International Sustainability Standards Board. The reason I am banging on about this a bit is that I cannot really exaggerate the importance of the establishment of this board, which has support from all around the globe for these standards, which capital markets, banks and regulators all need. We have a hope.

Q108 **Anthony Browne:** Getting agreement on international standards can take decades.

Dame Colette Bowe: It can, but we do not have decades.

Q109 **Anthony Browne:** No, quite. That is what I was going to say. When do you think we will get sufficiently consistent standards that they can start being implemented in the UK?

Dame Colette Bowe: We have plans to develop standards in the course of this calendar year. Their adoption in the UK is not a matter for me or, indeed, for the Bank. It is a matter for the UK endorsement board, but I can assure you that everybody concerned knows that we do not have much time.

Q110 **Anthony Browne:** If you develop the standards this year, they could be adopted.

Dame Colette Bowe: I would suggest you had better get the endorsement board in to ask.

Q111 **Anthony Browne:** The endorsement board answers to who?

Dame Colette Bowe: BEIS.

Anthony Browne: This is a question for BEIS then.

Dame Colette Bowe: Yes. I am not saying this to make a smart point, but everybody knows that this is of the utmost importance. There is enormous support for this. You saw what happened at COP. Everybody is behind this. I hear what you are saying about how IFRS standards take a long time.

Anthony Browne: In other areas, they do take decades.

Dame Colette Bowe: In this case they are not going to, because we do not have decades.

Andrew Bailey: They do have to report back to the G20, Heads of Government and financial stability boards. That is where Jon and I come back in again.

Q112 **Anthony Browne:** The other criticism from environmental groups in particular is that some other regulators already require these emissions disclosures. The European Central Bank does, for example, as in some other countries. I do not know what standards they are basing it on.

Dame Colette Bowe: Let us just note the fact that the ISSB has widespread global support and that existing standard setters in the field have already joined in the work of the ISSB, so you can take it that there is massive convergence. We are not going to see competing standards here.

Q113 **Harriett Baldwin:** I want to ask Jon about the point you made about crypto assets. You highlighted crypto assets in your report. They are growing quickly. You say that this could feed through into financial stability. Could you elaborate for the Committee, please?

Sir Jon Cunliffe: The first thing I would say is that crypto is a technology and can be applied in lots of different ways, in the financial sector and outside, as a recordkeeping, verification and trust type technology. It is clearly being used in lots of different areas, so the question is which areas where we see crypto now in the financial sector could be a financial risk.

Some 95% of the crypto assets out there are unbacked speculative investments, like bitcoin and crypto coin of that sort. That has got to about $2.6 trillion, which is 1% of global assets, so it is not big at the moment, but it has grown very quickly. Since the beginning of 2020, investment in crypto assets has grown about 10 times.

Q114 **Harriett Baldwin:** So it is not a financial stability risk at the moment.

Andrew Bailey: It is not.

Harriett Baldwin: It could be in the future. What sort of level would it have to be at before it became a financial stability risk?

Sir Jon Cunliffe: It depends on two things. One is how it connects to the global financial system. Subprime was not a huge amount, if I can put it that way. It certainly was not $2.6 trillion, but it was connected to the financial sector through leverage, long transaction chains and insufficiently capitalised entities, so when its price dropped very suddenly that transmitted a shock. It will depend on how quickly crypto assets grow in scale, but also the extent to which they are taken on by leverage players and fed into the financial system.

Q115 **Harriett Baldwin:** How would you mitigate the risks around leverage in the crypto asset market?

Sir Jon Cunliffe: You can mitigate the impact on the traditional financial sector. The Basel Committee has put out some proposals for the capital that banks should hold if they take crypto on to their balance sheets. Some banks were thinking of doing brokerage services, which would bring crypto on to balance sheets. You can bring them on to recognised exchanges and clearing houses, for which marginally you can control the leverage with the rules for the established financial system.

The more difficult thing is that, as well as the connection to the existing traditional financial sector, there is a crypto financial sector that is starting to grow, which is really about trading in crypto coin for crypto assets and crypto derivatives on crypto exchanges. Some of this goes under the name of decentralised finance. There, it is more difficult to know how to get a grip on it for two reasons. First, we do not have good information. This is outside the regulated sector and a lot of it is pseudonymous anyway. Secondly, these are not recognised intermediaries that are within regulation. The answer is to extend the regulatory regimes that exist for certain economic functions to that world.

To give you an example, if the economic function you are performing is transferring settlement assets to make payments at a systemic scale through the payment systems, the rules that apply for the security and robustness of payment systems using commercial-backed money need to be extended, so they cover when crypto is being used to make payments in the same way. The international committee that I chair on payment system standards or whatever has just put out consultation for how we apply that regulatory regime to this world, bearing in mind that you might not apply it in the same way, but you want to have the same level of resilience for that economic function.

Q116 **Harriett Baldwin:** You also published a discussion paper back in June setting out your thoughts on new forms of digital money, including stablecoins. Where has that consultation got to? Are you going to respond?

Sir Jon Cunliffe: We are going to respond and, in particular, the Treasury has said that it will legislate now to bring stablecoins within the regulatory ambit. The consultation document I mentioned, setting international standards effectively for stablecoins used in systemic payment systems, will go to issues like what the backing assets should be—we put out a number of options—and what protections individuals should have to redeem their stablecoin at par on demand in the way that they can redeem commercial-backed money.

Q117 **Harriett Baldwin:** When are you going to reply to that?

Sir Jon Cunliffe: We will reply to that in the first half of this year, but it will come along with the Treasury proposals for bringing stablecoin under the regulatory ambit.

Q118 **Harriett Baldwin:** You saw the House of Lords report that came out last week, "Central bank digital currencies: a solution in search of a problem?"

Andrew Bailey: Jon and I had the pleasure of appearing.

Sir Jon Cunliffe: We did indeed.

Harriett Baldwin: You have obviously enjoyed reading that. How do you reply to the central thesis that it is a solution in search of a problem?

Andrew Bailey: Can I make one point? The report is interesting; do not get me wrong. It was reported in some quarters that Jon and I, because we gave evidence, had been there to advocate central bank digital currency and had not convinced them. We were not at all. We are in the process of examining and evaluating the case. We did talk at the hearing in those terms—"Let us be clear what problem we are trying to solve here"—not from the point of view of saying there may be no problem we are trying to solve, but because you have to ask that question and it is still very much an open question in our thinking.

Q119 **Harriett Baldwin:** I recently tried to move some money back from the States. It was really hard and the transaction costs were very high for the retail consumer, so there must be some benefits in terms of lower transaction costs.

Andrew Bailey: Jon is leading the work in the world on this subject, so I will defer to him, but I would say this. Yes, that is a problem. For a very long time, it has been known that the cost and speed of cross-border payments is unacceptable. I would, though, say that simply introducing a sterling central bank digital currency would not on its own solve that problem. It might contribute to solving it, but it is not on its own a solution to it.

Sir Jon Cunliffe: Cross-border payments are 50 years out of date in terms of speed, reliability and cost. There are reasons for that. One does not need crypto technology or CBDC to make big improvements. There is linking up faster payments services and improving correspondent banking, but we should not ignore the fact that some of these new technologies, whether they are public sector through CBDC or private sector through stablecoin, if well and safely regulated, offer a real opportunity to get the cost down and the speed up. The work we are doing internationally is trying to operate on existing technologies, but also how to make new technologies robust enough to be used in that way, because technology will transform this whole area, whether it is public or private.

On the House of Lords, the Treasury/Bank of England taskforce is trying to see what the case is and how strong it is, both from a financial stability point of view and from a user point of view on CBDCs. We have not made up our minds, which is one of the reasons why the House of Lords report will be a valuable contribution to that endpoint.

Q120 **Harriett Baldwin:** There is already a Treasury/FCA/Bank crypto assets taskforce. Does the Bank work with that group at all?

Sir Jon Cunliffe: Yes. I am a member of it. It is chaired by the Treasury.

Harriett Baldwin: Are there any other thoughts on crypto assets from any of the panellists?

Elisabeth Stheeman: I am happy to come in here, perhaps also adding to what Sir Jon said, given that I am an external member of the Financial Market Infrastructure Board and that supervises payments and central counterparties. I would certainly say that, well regulated, they can improve innovation. In some ways you still might call it sustainable innovation, so it would be positive.

It is also to some extent a conduct issue, although not yet on a big scale. The FCA did some research recently and it said that, as of January 2021, 2.3 million adults owned cryptocurrencies. Having said that, these holdings accounted for less than 0.1% of UK households' net financial wealth, so at the moment it is relatively small. Having said that, if you look at other regions, say the US, these percentages are bigger. It is definitely something the FPC will keep a close eye on.

Q121 **Harriett Baldwin:** Do you see any other countries taking a more proactive approach? I am not sure that is the right adjective, but, for example, China brought in a central bank digital currency.

Andrew Bailey: China is introducing a central bank digital currency. I am not quite sure how many people are going to attend the Winter Olympics now, but the plan was to use it there. We talk to the People's Bank of China quite a lot on this. Their experience was that they found that their domestic payment systems were being substantially taken over by Alipay, WeChat and Tencent. They got very concerned that what they saw as the central monetary function of the system was being transferred out into these commercial entities. They did not feel comfortable with that.

They have taken, as you probably know, some pretty stern action against these companies, which is quite well documented. Alongside that, they see domestically, therefore, the case for substituting a central bank digital currency alongside what these companies were innovating themselves. They faced that challenge very directly.

There are big differences between the situations, but the point we made to the House of Lords Committee was that, if Facebook were to decide to introduce a stablecoin, that would pose a very big challenge to the system. Is it going to be a form of narrow bank? The House of Lords report raises these issues. What effect would it have on the existing system? Do we think that is the right way to go? Is it sensible to have that sort of innovation or is it more sensible to say, "No, we as a central bank will issue digital currency and you can use our digital currency"? That is an open question. The House of Lords Committee has rather dismissed that argument. I would not dismiss that argument. For me, that is central to the question of what problem we are trying to solve.

Rushanara Ali: My questions are about LIBOR transition. I have about eight minutes.

Andrew Bailey: We can talk about LIBOR for eight minutes.

Rushanara Ali: I thought so.

Andrew Bailey: It is one of my favourite subjects.

Q122 **Rushanara Ali:** It has been two weeks since the majority of LIBOR settings were due to be discontinued by the end of 2021. How has the transition gone and would you say it has gone as planned?

Andrew Bailey: Yes, I would. It has been six and a half years of pretty hard work. I co-chaired the international committee, until a few weeks ago, for all that period. When Jay Powell, chair of the Federal Reserve, and I originally set the deadline, when we were co-chairing it, it was pretty much the most optimistic deadline we thought we could set, given the fact that back in 2015-16 LIBOR was falling apart.

Q123 **Rushanara Ali:** You do not see any outstanding risks to financial stability following this transition?

Andrew Bailey: No. There is work still be done. The work to be done falls into two parts. First, in the non-dollar currencies, including sterling, substantially it has moved off in sterling's case to SONIA, the new benchmark. We have legacy contracts running on what we call synthetic LIBOR, which is SONIA plus an add-on.

Q124 **Rushanara Ali:** Until 2023—is that right?

Andrew Bailey: No, that is dollar. You cannot use synthetic LIBOR for new business. The dollar is the largest part. The dollar contracts end, as you said, mid-June 2023, so there is work to be done there. I must say, given the challenge and the issues we had to deal with, I am very pleased with the way it has gone. Just to tell you, in December, £13 trillion of derivative contracts in sterling were transferred over to SONIA. This is not a small activity that has gone on.

Q125 **Rushanara Ali:** Have you identified any operational risks to the transfer to SONIA so far?

Andrew Bailey: Originally, we identified a whole load of them.

Rushanara Ali: Are there any outstanding?

Andrew Bailey: No, it is okay at that moment. I am very pleased with the way it has gone.

Rushanara Ali: There is nothing to be concerned about.

Andrew Bailey: We monitor it very closely and the Bank is heavily involved in SONIA. SONIA is a much more robust benchmark. It has more activity. The problem with LIBOR was that there was hardly any activity left in LIBOR. It was essentially people trying to guess what the right rate should be.

Q126 **Rushanara Ali:** On this point about the temporary synthetic one to three months to six months provision, what risks, if any, arise from that situation moving from temporary to being prolonged?

Andrew Bailey: These are what we call tough legacy, where these are loan agreements. It is worth saying that a lot of people clearly wrote LIBOR into contracts because that is just what you did. It was just there. There was not a lot of thinking about, "What happens if it does get terminated?", and particularly what the co-ordination mechanisms for transferring the contracts on to another benchmark were, because these tough legacy contracts often did not provide for an alternative benchmark. It was easier to deal with the derivatives because ISDA, the international swaps authority, essentially helped us a lot on that front to make the transition. The issue will be now to make sure that these legacy contracts do get dealt with. There is not a problem with synthetic LIBOR, but we do not want them staying there, because there are some very long-lived contracts in there.

Q127 **Rushanara Ali:** The US deadline is to 2023. Mark Cabana, head of US rates strategy at Bank of America, was quoted in the *FT* as saying, "Telling people to stop using Libor is like reimposing prohibition. People will keep drinking right up until the last moment". I can think of a few other analogies. There are lots of drinking analogies around at the moment. What do you have to say to that?

Andrew Bailey: I need to give you the polite version now.

Rushanara Ali: Please do not feel the need to be polite.

Dame Colette Bowe: Think of something tactful.

Andrew Bailey: Thank you, Colette. There has been more resistance in the US. Let me put it this way. Anybody who thinks that using LIBOR is a long-run solution should look at what happened to LIBOR during the dash for cash and should ask themselves whether that is a fair way to do business. That is the politest thing I can say on that question.

Q128 **Rushanara Ali:** Earlier we were talking about indebtedness and the differential impacts on groups. You mentioned consumer credit. Is there more that could be done around taking the pressure off the high interest payments connected to interest payments? I know there have been some interventions, but what else could be done in that territory, because that is very much fresh in my mind?

Andrew Bailey: That is a question from my former world really. That is really a question for Nikhil.

Rushanara Ali: I will save it for Nikhil.

Andrew Bailey: He will thank me for that.

Q129 **Rushanara Ali:** Overall, you are not concerned about household indebtedness.

Andrew Bailey: Not as a financial stability issue. You know the FCA has been heavily involved in this over the years and it has been a real priority. It was in my time and I know in Nikhil's time the question of high-cost credit is a big priority, which will remain probably.

Chair: Well done to the Committee and to our panel for landing us exactly on the right time. Can I thank all four of you for appearing before us? It is always a pleasure and it is always very interesting to hear from you. Thank you also for juggling your masks so well. I always think an advantage of the mask, of which there are very few, is that nobody can see you yawning when you need to, but I can assure you that that was not a necessity today. It has been extremely interesting.

Andrew Bailey: I do not know what you find. They are not great when wearing glasses, I find.

Chair: It is not a great look, is it? Thank you very much indeed.