



Treasury Committee

Oral evidence: [Prudential Regulation Authority: Annual Report and Accounts 2013-14](#), HC 727

Wednesday 22 October 2014

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Members present: Mr Andrew Tyrie (Chair); Steve Baker, Mark Garnier, Jesse Norman, Alok Sharma, John Thurso

Questions 1-29.

Witnesses: **Andrew Bailey**, Deputy Governor, and Chief Executive, Prudential Regulation Authority, **Iain Cornish**, Non-Executive Director, Prudential Regulation Authority, and **Charles Randell**, Non-Executive Director, Prudential Regulation Authority, gave evidence.

Q1 Chair: Thank you very much for coming to give evidence this afternoon and welcome to Charles Randell. I think it is your first time before the Committee, isn't it?

Charles Randell: It is. Thank you.

Chair: We have known each other a long time. Iain Cornish, of course, acts in a different capacity for the Committee and we are very grateful to see you as well. Can I begin with a question to you, Mr Bailey? Why have you cast your net more narrowly for the senior managers' regime than the FCA?

Andrew Bailey: There are two reasons for that, one of which lies in, arguably, the different nature of prudential and conduct supervision. We regard prudential supervision as very focused on the objective of safety and soundness, and the things that can go wrong in prudential supervision we want very clearly to be seen to be the responsibility and to be held as the responsibility of senior management. I am not a conduct supervisor, as you know, so I am not going to comment too much on this, but I think there is an interesting debate as to whether conduct supervision and conduct issues are, by their nature, more widespread across the institution in terms of the nature of them and where they turn up. That is one thing.

I am not sure how much this is a difference with the FCA. You would have to ask them, but the way I interpret the Parliamentary Commission, which you chaired, and what its intent was was that this was a means of establishing clear presumption of responsibility.

By the way, it is not just an interpretation; I agree with it strongly. My view is that that should be narrowly focused on those who, first, genuinely should take responsibility and, secondly, who are responsible in the institution, through that responsibility, for inculcating in the institution the principles and the behaviours. I am very firmly of the view that it is not our job as supervisors to do that throughout an institution up and down. That is the job of boards and management and I do not want to substitute for that.

Those are the two things that, for me, lie behind wanting to keep it focused on the people who take responsibility and should take responsibility and, of course, finally, as you know, in doing that, counteract what we saw during the crisis where the people at the top of institutions did not take responsibility.

Q2 Chair: Does casting a wider net pose problems for your work as a prudential regulator and, if so, how?

Andrew Bailey: I think there are two parts to that, one of which is more of an issue for us than the other. The net is cast wider, first, in terms of coverage of boards. Our approach has been to say that there are certain positions on boards which, in the way that a modern board is constructed, hold particular responsibilities. That is obviously the chairman, the senior independent director and the chairs of the major committees: audit, risk and remuneration typically. I must watch not to be pejorative here, but they can be distinguished from the generality of non-executive directors and we think that is appropriate.

I have discussed this with a lot of different audiences and different groups. I was doing this very thing last night with a group of lawyers and they made the point to me, “How does that square with the principle of a unitary board?” I think that is an interesting issue, but I do not think, given the way modern boards work and the fact that these roles are quite precisely defined, as they should be, that it contradicts what we are trying to do.

There is a difference. I think it is important that that distinction is drawn and I suppose, in answer to your question, if this were to cause confusion over the position in the generality of non-executive directors then that would be an issue. I expect that this will be an issue that will be quite to the fore in the responses to the consultation document and I think it is something—

Q3 Chair: Could you just unpack that sentence you came out with—
Andrew Bailey: Yes, certainly.

Chair: —that this will be an issue among the generality of non-executive directors?

Andrew Bailey: You have seen quite a bit of recent coverage, with a particular issue around HSBC, but you have seen quite a bit of recent coverage. I talk to a lot of boards and I talk to a lot of non-executive directors. I do get the comments about the burden of responsibilities and expectations on non-executive directors. I think it is important that we expect more from non-executive directors and boards than we saw in many cases during the crisis—it is a role that has at its heart effective challenge—but I also think that we have to balance that carefully with not turning them into effectively full-time servants of

the institution. I am very alert to this because we have increased the burden on them and a good part of that was quite reasonable, but there is a balance to be struck. As I said, I would expect this to be an issue that is raised in the responses to the consultation and I think it is one that we collectively need to take very seriously in thinking about how the eventual rules are put into place.

Q4 Chair: The consultation is not one consultation but two in a number of important places, a PRA document and an FCA document. Is that correct?

Andrew Bailey: Yes, but, as you rightly said in your question, they have to sit together.

The second thing I said I would mention, for us the certification regime is less the issue. As you probably know, we have drawn the certification regime for our purposes in a considerably narrower fashion. We have used as the anchor for that the definition of “material risk takers”, which is in the remuneration guidelines. The FCA has gone much broader. I think that comes back to this question about the difference between conduct and prudential supervision and I would expect that, too, to be a major issue in the response to the consultation.

Q5 Chair: The Banking Commission defined those that should be covered but what is now known as certification as those who could do serious harm to the institution, to the bank, to their customers or to markets. Do you think that definition is likely to go wider than that of material risk takers?

Andrew Bailey: I think there are certainly arguments from a conduct point of view to say that that is the case and an obvious one would be if you are in a position where you are responsible for an extensive part of the selling operation of an institution you would not be a material risk taker in a prudential sense but you would potentially be a material risk taker in a conduct sense.

Q6 Chair: These issues all go to the heart of whether we are going to have more LIBOR-type scandals where we are unable to or we find it difficult to act against people who we feel have behaved badly? That was the purpose of certification, that it should catch such people who clearly are material risk takers. The same goes for the MMR. Just as the APR in theory was quite a useful tool, in practice it left people like Fred Goodwin and Lord Stevenson still able to practise.

Andrew Bailey: That is the point about responsibility. LIBOR is a good example because, again, individual actions have been brought against people down the chain who have been responsible for the LIBOR submission or the trading, but the same question that comes back is the question of responsibility up the chain, it seems to me.

Q7 Chair: Yes. What about the conduct rules? You also seem to have drawn those more narrowly. I think the PRA is proposing to apply those only to those already captured by the SMR and certification.

Andrew Bailey: That is correct, yes.

Chair: Whereas the FCA are going to include virtually all bank staff.

Andrew Bailey: Yes, that is my second point, which is the application of those rules. Again, from a prudential supervision point of view, and given an objective of getting the right incentives for senior management, we have applied those rules at a high level. We think that is appropriate for prudential supervision. As I say, you have to ask the FCA. They take a different view from prudential supervision.

Q8 Chair: These may seem recondite subjects, but in fact they go to the heart of whether we are going to be able to develop personal responsibility in banking.

Andrew Bailey: They do. They reveal what I regard as two somewhat different philosophies of going about this: whether you take the prudential approach, which would be to say, “We want the people at the top to take responsibility”, and, through that, incentivise them to manage their institutions, or whether you say, “I may want that but what I also want is the power to go in at all levels”. As I said, that may be down to a fundamental difference between prudential supervision and conduct supervision, we could debate that forever I suspect, or it may just be down to two different approaches with two institutions, but that is an important point.

Q9 Jesse Norman: Mr Bailey, I want to ask you about ring-fencing, and the consultation you just put out. Can you just briefly summarise what the state of play is on this extremely fiddly situation so that we get a public understanding of where you think we are?

Andrew Bailey: “Fiddly” is one word. It is a very big undertaking because, to use a phrase, the devil is in the detail. We have put out the first consultation paper. There will be a further one. The first consultation paper had two intents behind it. We have covered a range of issues which, in some ways, are to do with the height of the fence more so than the positioning of the fence, and we have obviously gone into issues to do with governance and structure. To give you an example, it nails down quite clearly what we call the sibling structure, that the ring-fenced bank cannot be a subsidiary of the non-ring-fenced bank, which was back in some of the earlier versions but has now, thank goodness, been sorted out.

We then tried to give a broader general steer as to where we think this rather detailed process is heading to because we have asked firms to give us their first plans by the end of this year. Now, I should say, we recognise that it will be an iterative process because, precisely to your point about it being fiddly, it is not going to be sorted out in one go. We have put the first consultation out, which raises a series of issues. It has a series of issues, for instance, around board membership, cross-membership of boards and how we achieve what we think is the appropriate degree of separation to make the whole philosophy and objective of ring-fencing work. We will be following that up with further consultation because I can tell you this is a very extensive undertaking for us to get this into place and get it right.

Q10 Jesse Norman: Just to pick up one question on that. When a bank puts in a plan, and you are sending a very demanding schedule, first of all is the schedule too demanding and, secondly, are you expecting these early plans to be vague but binding or indicative?

Andrew Bailey: We have been talking to the banks. We have been having conversations with the banks ever since the commission chaired by John Vickers was coming out with its proposals, so this is not the start of the conversation. I hope it is helpful to them. It certainly is to us. The pragmatic answer is we recognise that the banks will reasonably say to us there are things that they do not know yet that they need to know to get the final plans in place. I hope, however, that we can give them sensible steering to say, “It is reasonable progress to date and we can have a sensible and helpful conversation as to whether it is on the right track”. I think that is the way to look at it. If we waited to get all the consultation and all the rules out there and then said, “Now let us start talking”, I think that would delay implementation, because there would be a huge amount of detail to sort out thereafter.

The approach we have outlined in the consultation is one where there are two ways, essentially, of coping with some of the detail. What we have done is to say we will set down a set of rules and then we will be prepared, where it is reasonable and sensible, to give waivers against all those rules to deal with idiosyncratic circumstances. I think that is preferable to trying to write the idiosyncrasies into the rules, which on the whole is prone to failure and overload.

Q11 Jesse Norman: That is helpful. Obviously these are intended to be implementations of the Vickers Commission’s initial conception of ring-fencing.

Andrew Bailey: Yes.

Q12 Jesse Norman: Can you indicate quickly areas where there is a large divergence from that and whether or not you have been easier in your approach or harder in your approach versus the original conception?

Andrew Bailey: I do not think we have diverged from the conceptual principles of the Vickers Commission. As I mentioned in my earlier example, the Vickers Commission left open, for instance, this question about sibling structures and we have sorted that out. As I think we have probably discussed before, where the issues come is in the positioning of the fence because, as you know, what Vickers essentially said was there is a set of activities that must be inside the ring-fence and there is a set of activities that must not be inside the ring-fence, but there is quite a substantial middle ground where there is optionality. As you can imagine, the discussions with the banks are around where in that middle ground they are going to place it.

Where the banks come from on this depends obviously on their business model. You have some banks, who are obviously what one might call global, universal banks, who are saying—and I am not using this in a pejorative sense—from the point of view of private interest, “Do I have a larger ring-fenced bank or not?” Then you have another set of banks that are essentially UK domestic banks, which will have a small amount of activity that cannot be inside the ring-fence. Of course, their real objective is not to have a non-ring-

fenced bank, but their objective is to minimise the non-ring-fenced bank and so you have some different constituencies and some different discussions going on.

Q13 Jesse Norman: If you are following the Vickers lead, it does not sound like you are much minded to follow the request from the Banking Commission for you to electrify the ring-fence.

Andrew Bailey: No, sorry, that is in there as well. I referred back to Vickers only because Vickers was obviously the origin of it. You should not interpret anything I have said as going against the wish of the other commission.

Q14 Jesse Norman: I am glad to hear that. How is electrification being realised in your conception of ring-fencing?

Andrew Bailey: Electrification will be another part of the rule-making. I think it is pretty well understood what it is. It may not be particularly popular in some quarters, but it is well understood what it is and it will have to feature. I give you my assurance on that.

Q15 Jesse Norman: That will be part of your second consultation, will it?

Andrew Bailey: Yes, I think that would be right. We are a little bit uncertain as to whether we will have a third one as well, but it will either be in the second or third.

Q16 Jesse Norman: With a large no man's land of argument between you and the banks, the scope for gaming both in setting the initial argument and then in manipulating the rules thereafter is enormous.

Andrew Bailey: Yes.

Q17 Jesse Norman: What are you going to do to stop banks defying the spirit of the regulation?

Andrew Bailey: The starting point for that is that we spend a lot more time as supervisors looking at business models of individual institutions and looking at why they have particular business models and where and why the choices within those business models can sometimes be directed exactly at what you have said. We will have to do more of that in the context of the ring-fence because it will introduce some more detail into it and some more separation. As I always say to the supervisors, we are just going to have to be very alert to this.

One of the things we also do, which I think is new, is that across the piece we regularly assess where we think and observe there is arbitraging of our policies going on because it is very important to supervisors that you just ask yourself these questions and force yourself to answer these questions repeatedly. It is a very dynamic industry. You force yourself to look at those questions and say, "Do I understand what is going on and can I explain it and can I justify it against our set of policies?"

Q18 Jesse Norman: You have been very clear that your expectation is that a ring-fenced bank will not have an ownership interest in prohibited activities and you have set out various ways in which that might be the case.

Andrew Bailey: Yes.

Q19 Jesse Norman: Just to be clear, because I did not see it in there, I take it you are alert to the possibility of them having an indirect interest through manipulating the covenants on debt as between the two entities?

Andrew Bailey: Yes. We are aware that that will have to follow as well, that there are intra-group financial contracts, which is a slightly broader phrase for the term you raise or another area, yes. The other thing that we are aligning this with is the whole question about resolution planning and operational continuity because the point you just raised is exactly germane to resolution planning as well.

Q20 Jesse Norman: How are you going to stop the bank from essentially funding the riskier parts of the business from a ring-fenced bank?

Andrew Bailey: By observing how it is running its funding model. We have had to increase the understanding and scrutiny of funding models substantially relative to the practice of all banks.

Q21 Jesse Norman: Banks would be unbelievably ingenious in presenting relevant cases for funding from one to the other.

Andrew Bailey: They certainly can be and, of course, it is relevant because if you go back to my point about what I might call optimising the private interest of the bank and what you described as the no man's land, one of the issues that they will be looking at—if you go back to my point about Vickers saying, “There is a pot of things that have to be inside the ring-fenced bank”—is, “Is that pot of things generating a funding surplus?” For some banks there is no doubt that it does. Then I think the question goes to your point, which is, “What choices do I then make about the assets in the ring-fenced bank?” given the point about what you call the no man's land, “or, secondly, do I do some rinky-dinky funding across the group?” We are going to have to be very alert to that, I agree with you.

Q22 Jesse Norman: Thank you. Just a couple more areas to touch on. One of the proposals you have made is that at least half of these bank boards should be composed of non-executives.

Andrew Bailey: Yes.

Q23 Jesse Norman: It is not like the non-executives absolutely covered themselves in glory during the recent banking crisis. Why should we have any reason to think that that

measure would make any difference and what are you going to do to make sure it does make a difference?

Andrew Bailey: Sadly, of course, you can say that about most governance structure before the crisis. The point here is, and it is one we come across in other contexts, if you think about this, these ring-fenced banks will be subsidiaries and I think where we are going to end up—and I think the resolution and loss-absorbing capacity work is taking the exact point—we are going to have banks with holding company structures. The UK today is a bit of a hybrid. The US, as you may know, has a very well-established holding company structure. Continental Europe does not have a holding company structure. We are slightly in the middle on that. HSBC is a bank that has a holding company structure that looks distinctively like a holding company structure. Some of the others have holding companies that are not active companies, but I suspect where you will end up is far more in the holding company mode.

What we are talking about now, just a long preface into your question, is the governance structure of the subsidiary, which is the ring-fenced bank or the non-ring-fenced bank. The reason the non-executive point is relevant is that one of the things that we observed during the crisis was that subsidiary board governance—and this is very common with overseas institutions operating as subsidiaries in London and Lehman is an absolute classic of this—was a board made up of executives not exercising a governance function and not working. We have, over the period since the crisis, pushed for institutions to have stronger non-executive presences on these boards because of the problems we observed of executive-only boards in subsidiaries, because they just do not do the job and they delegate it effectively. That is one of the things that lies behind the point about having non-executives but, you are right, you have to make it work.

Q24 Jesse Norman: Also, you are going to have tremendous difficulty recruiting high-quality people because the incentives will be “recruit failed public figures and populate your boards with them”. I would not think of a non-executive as offering any enormous resistance to a strong executive.

Andrew Bailey: No, you are right. Although we have pulled back in terms of the application of the so-called SIF interview process to—I am going to use the slightly pejorative term again—the generality of non-executive directors, we are still very watchful of the makeup of boards and the effectiveness of boards because it is highly relevant.

Q25 Jesse Norman: That is interesting. When are you going to announce capital requirements and expectations about capital for these institutions?

Andrew Bailey: For the ring-fenced banks?

Jesse Norman: Yes.

Andrew Bailey: I think that will come in a few stages. The risk-based capital requirements, in one sense you can see those as emerging out of the implementation of Basel III and CRD IV. Then obviously the leverage requirement is something that will come out of the work that the FPC is currently consulting on because, as you know, that was a specific recommendation.

Q26 Jesse Norman: You are not concerned that events in European banking regulation are going to unhorse some of the things that we are doing or potentially leading on?

Andrew Bailey: Let me just stick on leverage for a moment. We do not know how Europe is going to implement Basel. Now, Basel itself has not implemented a leverage ratio properly yet. It has set up a definition of the leverage ratio and it is in a monitoring phase. Basel itself has not adopted that. I do not know yet how Europe will implement the leverage ratio and, frankly, it is pretty hard to know. There has not been a lot of discussion of that yet. That will obviously be crucial because, if the European implementation of the leverage ratio were to be maximum harmonising, that would knock into the question of how leverage ratios are set. That is one we have to watch carefully.

Q27 Chair: Do you think that the banks believe full separation might befall them if they gain these rules?

Andrew Bailey: Sorry, might?

Chair: Might happen to them if they gain these rules?

Andrew Bailey: I do not know definitively. I think that what—

Chair: Is that not what you need to keep them on-side?

Andrew Bailey: Yes, it is.

Q28 Chair: Is that not that at the heart of it and is that not why it is crucial that the consultation you do on electrification be in a form where electrification is seen to be extremely robust?

Andrew Bailey: It is depressing to say this but I suspect that if any institution thought it was facing this you would get a very large amount of lobbying going on, which reinforces your point.

Q29 Chair: There would be a large amount of lobbying and that is why this proposal was created.

Andrew Bailey: Absolutely. It reinforces the electrification point.

Q30 Chair: It is going to be absolutely crucial in your design of this consultation paper?

Andrew Bailey: Yes.

Q31 Chair: There are a good number of points that come out of the evidence we have just heard. Did I hear you say we are going to have two more consultations?

Andrew Bailey: You heard me say I think one, but it possibly could be two. We have not decided yet. It is a little bit of a pragmatic thing about how indigestibly long you make one consultation paper, so that is still an open question.

Q32 Chair: This is going to go on a long time, isn't it?

Andrew Bailey: We know the programme and the timetable for implementing, so we know when we have to hit this thing. Obviously that has been decided. Just to recap two points. First of all, as I said earlier, it is abundantly clear when you get on to this work on the ring-fence, and I do not say this to criticise it by the way, the devil is in the detail in this stuff. This is very detailed stuff to put into place, to do structure like this.

Q33 Chair: When you are looking at this, you do not think that this is making the case for full separation?

Andrew Bailey: I have never been in that camp myself. That is the thing we go to. I have supported the electrification proposal because I think that has the right incentives in it, but I have never been in that camp, no. There are two reasons, for me anyway, why the ring-fence makes sense. First, each of them comes out of each of the two commissions.

The origin of the first one came out of the Vickers Commission. I think the logic of the Vickers Commission is still there and it is still there even assuming, as I do and hope and expect, that we get an outcome on "too big to fail" through the Financial Stability Board process that Mark Carney is leading. I hear people say sometimes, "Well, if you get that then you don't need the ring-fence". I don't think that is true because what the ring-fence gives you, even when you have that greater confidence over resolution, is the ability to say, "Well, if the bank gets into trouble I have options to deal differently with the critical things that are inside the ring-fence and the non-critical things that are outside". That still holds.

I think the second thing came out of your own commission. This is my interpretation of what you did anyway, but you can correct me on this. I think that is far more in response to conduct issues, because it was set up in the wake of LIBOR, and that holds, too, although sadly, of course, we have had misconduct on both sides of the ring-fence in terms of the history of the banking industry. But, again, you can hope that you would set different incentives for these two sorts of institutions because they are doing different sorts of things and that further reinforces the argument for having it.

Q34 Chair: The more credible the resolution arrangements the more likely it is that electrification is also going to be believed. Is that not the case?

Andrew Bailey: Sorry, electrification is going to be needed?

Chair: Will be believed by the banks.

Andrew Bailey: Yes, absolutely.

Q35 Chair: If you can resolve a bank in difficulty, you can resolve it when it is not in difficulty even more easily.

Andrew Bailey: Exactly, because alongside the work on loss-absorbing capacity in resolution goes the whole work on the ability to achieve operational separation, which, exactly to your point, makes the implementation of electrification easier, yes.

Q36 Steve Baker: I would like to move on to conduct fines but, before I do, can I just pick up on some governance points that came out of Mr Norman's questions? We have done something that happens very often in Select Committees. We have listened to Andrew Bailey a great deal and we were particularly talking about non-executives, so can I ask Mr Cornish and Mr Randell if they would like to add anything on this perspective of the ability of non-executive directors to hold executives to account.

Iain Cornish: I think it is a very important point. One of the observations we have made surveying our regulated firms over the last year is we have made very good progress on liquidity but one of the constant themes that comes through when you look at firms collectively is still a long way to go on board governance and a long way to go on risk management. That is quite a thematic issue. I think it is very important not just with things like the senior manager regime—we should put more effort into setting out expectations and communicating those expectations alongside the capital and liquidity issues.

Charles Randell: I absolutely agree with that and I would just say, on the subject of the ring-fencing, one of the advantages that comes out of it is that the non-executives of the ring-fenced bank are holding to account a structure that is, we hope, substantially simpler for them to understand and give challenge in respect of than the job that currently is faced by some of the non-executives on the holding companies of very diversified and complex groups. At the level of the operation of the ring-fenced bank, we hope that the quality of challenge will be facilitated by this structure.

Q37 Steve Baker: Before I move on, could you just tell me a little bit about the quality of challenge that you feel you are able to offer within the PRA, because I feel many of these conversations could be turned back on the regulator themselves?

Charles Randell: It is absolutely the right question to ask. We are substantially engaged in sampling the activities of the PRA in addition to attending board meetings and reading papers, so it may be helpful to explain how we spend our time. The work of the board predominantly relates to the oversight of supervision. We have policy-making roles, but the minor part of our time is spent on policy-making and quite a lot of our policies are in fact made elsewhere. Our job is to oversee the quality of supervision. That is the biggest part of our job and we take the view that we cannot do that simply by sitting in board meetings and asking questions.

We spend a lot of time going out, spending days with supervisors, seeing what they do, sitting in on some of the routine staff meetings to see how this is done in real life in the institutions, so that we are not just receiving a channel of good news from management, not that, of course, they would do that. I think that then does enable us to ask questions

about: are we getting the right type of information at the board, are staff spending their time on the right things, and various questions of that sort. I think I am satisfied, looking back on our early period of operation, that there are a reasonable number of areas where we have helped shape what happens at the board in a reasonably significant way.

Q38 Steve Baker: Could you give me an example of one of those significant ways?

Charles Randell: When we first took up our role I think it is fair to say that we were not entirely happy with the quality of information that we were getting about what was happening in supervision and it has massively improved. I think we also felt that the board agenda was not necessarily shaped to direct our attention sufficiently to issues of risk oversight and so on and we have made progress in there. We were also not completely happy that the way in which the PRA integrated with some other aspects of the bank, including the rhythm of work with the FPC, was as optimal as it could be and I think we have made some progress there. Then obviously we challenge on individual firm decisions, which we cannot sensibly talk about here.

Iain Cornish: I think it is fair to say the way we operate is not the way the board of the FSA operated. It was, by design, not involved in the supervisory process and not involved in much oversight of how supervision is done. It is probably fair to say that when we first came into the PRA, because that was not custom and practice, some of the disciplines that are required to be more intrusive as a non-executive were not there, which is not to say there was any resistance to establishing those. They just were not custom and practice.

As Charles has said, we did a lot to put in place basic disciplines by making sure, for example, we had a much stronger dialogue with the bank's internal audit function, by making sure that the supervisory oversight function, which oversees the quality of supervision, reported into us rather than into the line, and all the other examples that Charles has catalogued. The other key thing that we were very insistent we should do is a thorough board effectiveness review after a year of operation and we are engaged in that process via the court at the moment. If there are opportunities to improve our non-executive governance, that will be an effective process to identify those.

Q39 Steve Baker: Thank you very much. I would like to just go on then to conduct fines. Andrew, you recently expressed concerns about the prudential risk arising from large fines. Is it the fines coming from the US in particular that are the greatest threat?

Andrew Bailey: There is no question but that the largest fines come from the US. As I think I said in my remarks when I made them, I do not make any of these remarks in any sense to condone misconduct. What I do think is that there is obviously a point where either one of two things can happen: either the scale of the fine or, moving away from fines for a minute, the nature of business restrictions that are imposed as part of a finding could have prudential implications. It is obviously always hard to predict those points because they are very much dependent on the state of the world at the point at which a thing happens and the reaction of counterparties and customers and creditors to the news.

One of the points I made strongly was that in a world where that happens there has to be strong co-ordination between the authorities involved, including the prudential authorities,

because we have to judge and be able to advise on how these things can be handled without disturbing financial stability and disturbing safety and soundness. I regularly get told it is not the intention of the authorities imposing these measures to cause firms to fail and indeed that has not happened to date.

Occasionally I get asked where the cliff is, as it were. I cannot tell you that in any absolutely objective sense because it is very much state contingent, as I said, and it depends on having strong co-ordination, strong dialogue and a strong understanding of what measures can be taken safely where there would be problems. I would like to see stronger co-ordination than we have sometimes had in the past. That is no secret.

Q40 Steve Baker: Can I ask Charles Randell, would you agree that we need stronger international co-ordination on the prudential aspects of fines?

Charles Randell: I think we need stronger international co-ordination generally, but one of the things that is becoming clear, as Andrew says, is that if conduct issues are the cause of a firm's failure we need to ensure that the cross-border resolution effort has a way of dealing with that. At the moment there are some challenges in trying to work out what the answers will be to that, but cross-border co-operation generally is very important.

Q41 Steve Baker: I wonder if you are all advocating a banking union across the EU or even across to the United States.

Andrew Bailey: No, I do not think so. I think there are perfectly good models of co-ordination among authorities that work without having to go to a banking union. I do not think that is necessary. Of course, the US has to have its own form of banking union given the number of authorities. One of the challenges we always have dealing with the US is that you are facing off to a number of authorities that sometimes you can count on the fingers of two hands and sometimes you can't.

Q42 Steve Baker: Do you think the fines being imposed by the US are out of proportion to the nature of the misconduct?

Andrew Bailey: There is no question but that the scale has risen. I think this would be more true of the fines levied against US banks domestically than foreign banks, but some of those are related to misconduct domestically and some element of redress. There is no question but that the scale of fines has risen. As a prudential supervisor, I do start from the perspective, "Look, if there is a problem we have to fix it", and I would rather see firms fix their problems than go through lengthy procedures that lead to outcomes that may incentivise them then to fix them, I warrant. I do not want to deny there is not an incentive effect from fining people because, of course, we do it broadly in society, but my natural reaction says, "Look, if we think this firm has a problem then let us just get on and fix it, please, rather than go through a lengthy process". There is a bit of a difference there.

Q43 Steve Baker: We are in the midst of a set of negotiations called TTIP which presumably you have—

Andrew Bailey: Yes.

Q44 Steve Baker: Would you see that there is a need to establish a set of rules of engagement with the United States and do you think that that should be rolled into TTIP since the negotiations are ongoing?

Andrew Bailey: I have to be honest with you; I am not close to TTIP, so I can't give you an answer as to whether that would be an effective way of doing this, but I would definitely say that, one way or another, I hope we can come out with a better set of what I might loosely call rules of the game. Now, I should say that I have in recent weeks and months spent quite a bit of time in the US. I have met most of the people involved and talked to them about this, including some of the ones who we see most often in these cases, but I also recognise that there are quite strong domestic pressures on these authorities. In some cases there are quite difficult processes with Congress at times relating to these cases, some of which we have observed quite closely. I do not know whether it was an invite or a summons—I am not a US citizen, so I do not think they can summons—but on one occasion I was invited to appear before a congressional Committee, but I said I would rather stick with the Treasury Select Committee. This is pretty difficult politics. I do not know whether that is a compliment to you or not, but it is meant as one.

Chair: We are not taking it that way at the moment.

Andrew Bailey: I will stop digging. As you may be aware, these are difficult processes. They do not face easy tasks.

Q45 Steve Baker: With that in mind, by when would you have expected to make some real concrete progress? Particularly bearing in mind some of the things I have recently read about the Co-op, it seems to me that it is material to prudential risk. I am hearing it is very difficult, that there is a wide range of people with whom you need to face off, but by when would you expect to make progress?

Andrew Bailey: Honestly, I cannot give you an answer to that; I wish I could. We have put the issue on the table. I have made public remarks on it. It is not just that. We are also pursuing it through other channels. We have had to do it carefully because, as I said earlier, you can easily be misconstrued as special pleading. You have to be very careful about how you handle these things to get the right message. We have spoken to a lot of the principals involved in the US, but I do not feel confident enough to give you a sense as to whether and when this would come to fruition. It is too uncertain at the moment.

Q46 Chair: In your application of these rules domestically, are you entirely impartial between domestic and overseas financial institutions?

Andrew Bailey: Yes.

Q47 Chair: Do you think the Americans are?

Andrew Bailey: People say that the fines are higher for foreign banks than US banks, but that is not consistent with the evidence. This is the point the US banks will make very firmly and I think that is fair enough. What does tend to happen, and this is due to the patchwork of regulation that exists in the US, is that sometimes the mix of authorities involved with a foreign bank is different from the mix of authorities involved with a domestic bank. It is not always the case, but sometimes.

Q48 Chair: What conclusion are you drawing from this variation in the mix?

Andrew Bailey: Well, you can sometimes find you get different processes and different outcomes that way.

Chair: I realise this is a sensitive subject to discuss in a public session, but it is still worth at least asking the questions. I am sorry.

Andrew Bailey: Yes.

Q49 Steve Baker: If we could think about the range of tools at your disposal, because it feels like you cannot reasonably withdraw the authorisation of a systemically important institution, do you have the right range of tools at your disposal?

Andrew Bailey: It is not our tools I worry about. I think we have a sensible range of tools and we can do a range of things in terms of institutions. I do not worry about that. It is how other authorities use the tools. One of the reasons why this comes to a head with the US authorities is because of the access to dollar clearing. To be an international bank, you have to have access to dollar clearing. The dollar is still the largest currency in use around the world. Therefore, to do business you have to have access to dollar clearing, so the access and the dollar clearing and the licence that goes with it are crucial.

Q50 Steve Baker: Just thinking about the quantum, these fines have now become so commonplace it feels like reputational risk is relatively low from these fines, possibly because people's reputations are now so tarnished they almost cannot slip any lower. Speaking as a politician, I suppose I know the feeling. Where do you feel all of this leads? If we have got to a point where banks' reputations are not further tarnished by fines, where do you see that heading?

Andrew Bailey: It is easy to say this as a prudential supervisor. It obviously is painful as a prudential supervisor to see capital going out of the door, and that is what happens with a fine. If you look across the board, as we have discussed many times before, as we have been getting the banks to rebuild their capital we have faced a quite substantial headwind in terms of capital going out the other way from fines, for instance. That is certainly true. One thing I would say is that there is a range of things that you can do that do not have to involve taking the licence away, which can involve fines but you can do other things. We have quite a broad range of tools in our kit.

Q51 Steve Baker: We have this issue of criminalising reckless leadership. You were talking earlier about two philosophies, senior responsibility and incentives versus interventions at all levels. You may know I introduced a Bill that upset some bankers because the proposal was to have strict liability for bank directors, strict commercial liability for losses, plus personal bonds, plus the bonus pool used as capital for five years, in order to have a tight set of interlocking incentives that defeated moral hazard. I decided to set out a fairly extreme point of view. Have you given consideration to how these moral hazard issues might be dealt with, not through criminalising reckless behaviour but by exposing people at the top of banks directly to their commercial losses?

Andrew Bailey: Well, let me say two things on that. It is true that there is a criminal sanction in there. I think we have to be careful. I read articles commenting on this. If you read them and you did not know anything else, you might conclude that the only sanction we have was a criminal sanction. That is not true. That is not what you proposed in the Parliamentary Commission. That is not what we are implementing and I think it is important to get that into perspective because I do see quite often a loss of perspective. The anchor of this is a presumption of responsibility, but the criminal element is not founded on that. It is founded on a test of beyond reasonable doubt.

Secondly, I agree with you in the sense I think you were leading towards saying should there be more personal—what I call skin in the game—via deferred remuneration. Yes, I firmly believe that because incentive-wise it goes in the right direction.

Q52 Steve Baker: Should more people be criminalised in cases of misconduct, for example LIBOR? Do you think that there would be prudential consequences to broadening the range of occurrences in which fraud is applied?

Andrew Bailey: I do not feel an expert in the field of the incentive effects of applying criminal sanctions versus regulatory or civil sanctions. I naturally tend towards the position I mentioned earlier, which I think was the position of the Parliamentary Commission, which is criminal sanctions in this field of activity should be the severe sanction that you have in reserve but it is not the main tool. Obviously, you staked out the other position. I will have to be honest with you; I naturally would tend towards the other position, which is you have it in your toolkit but it is the stick in reserve, as it were.

Q53 Steve Baker: If people have, say, obtained a pecuniary advantage by deception, which was the old language for a fraud, we do not think that that should necessarily be a criminal offence?

Andrew Bailey: I have a lawyer sitting next to me. He always claims he is a retired lawyer whenever I talk to him, but he has been a lawyer for a long time.

Steve Baker: Well, shall I perhaps save your voice then for a moment?

Andrew Bailey: Fraud is fraud to me, but I will hand over to an expert.

Charles Randell: Yes. I am not an expert, particularly in fraud, but there are a number of offences under the Fraud Act that can be committed in the sort of circumstances that you are referring to. My sense is that when you read through the Bloomberg chats of the

people who did these things, if you had asked them, “Did you think you were breaking the law?” they might well have said, “Yes”. What they cared about, though, was money. Therefore, I think attacking them through the incentive structure is likely to be hitting them where it hurts them most.

I would say I think there is a link between this and the question of the fines that you were talking about. One of the possible reasons why the fines have escalated in the way that they have is because authorities are very frustrated with their inability to hold individuals to account. If we can get to the bottom of that problem and we can say to a set of authorities in another jurisdiction, “The guilty people have been marched off the premises. The management has changed. It makes little sense to fine the new shareholders for the misdeeds of the old management”, we will end up having a much more constructive discussion than we can have at the moment.

Q54 Steve Baker: This is the heart of where I was driving to. We have a set of circumstances where there is a material prudential risk through the level of fines and it could be argued that individuals could be criminalised for a range of fraud-based offences instead. Would that not mitigate the prudential risks at banks while also incentivising individuals to behave?

Andrew Bailey: The only place where I might differ from you is that I think before you get to that point there is a point to say to individuals, “You will lose your job”. The big point is: is the right penalty against the institution or against the individual? I think you are absolutely right to make this point. The only thing I would add is I think there tends to be a step before you get to the criminal point, but otherwise it is a good point to make.

Steve Baker: I am conscious I should move on. Stress test, Mr Chairman, or would you like to hand over?

Chair: Have another quick shot, Steve, and then I think we will have to move on.

Steve Baker: I have a fair bit on stress tests, so if I may can I park stress tests for a moment?

Q55 Alok Sharma: Mr Bailey, you made reference to deferrals when starting to talk about incentives for bank staff and I think we all agree and the commission agreed that the incentives were wrong in the previous structures that we had. Looking at deferrals, you are proposing seven years for senior managers and five years for material risk takers in your consultation paper. Would you agree that your paper also identifies closer to 10 years as the range for business cycles and all the rest of it? Therefore, the question is: why have you gone with a lower number than 10 years given what you have just told us?

Andrew Bailey: It is interesting. We say in there that we could take a decision to extend it to 10 years for the senior people, not for the others, where we had evidence or a belief that there were particular things going on that wanted us to put it at risk for longer. That was deliberate because there is a certain relevance to 10 years. The counter to this and the reason we have to think about the balance is the point we make, or I make anyway, about the EU bonus cap.

Alok Sharma: We will come on to that.

Andrew Bailey: I know, I am just using it as a general point. If you set the sort of incentives too far the other way, then it migrates into fixed pay. That is a general point. It is a point you can make about the EU arrangement, but it is also a point you can make about deferral, that if you get the deferral too long then the firms will be incentivised to say, “I am not having any of this and I will stick it into fixed pay”. We were and are conscious of that.

Q56 Alok Sharma: I understand that. In which case, how did you come up with this balance of seven years and five years? Was there a particular logical thinking to it or did you just think, “10 years is too long, why don’t we just settle for a lower number”?

Andrew Bailey: We wanted to introduce the distinction between senior managers and other material risk takers. We wanted a shorter time for the second group than the first group. We thought 10 years for the extendable proposition, and so after a bit of iterating we arrived at seven and five. I cannot tell you there is blinding science to this, by the way.

Alok Sharma: That is why I asked the question.

Andrew Bailey: No, there is not.

Q57 Alok Sharma: Clearly the Banking Commission but, of course, many of our constituents feel that certain bankers behaved incredibly badly, in a criminal manner, and were rewarded for that. I just go back to this point: what do we say to our constituents when they turn around and say, “Isn’t 10 years’ deferral a better period?”

Andrew Bailey: One thing you can say is that we have looked quite a lot, because sadly we have had a bit of experience of this, at what the elapsed time is for problems to emerge. Five and seven did not seem unreasonable when we looked at it that way. As I say, I would caution that your constituents might be pleased if 10 years or longer was set, but they would not be pleased if the response to that was just for bankers to get more and more fixed pay. I do not think that would please them at all, I suspect.

Q58 Alok Sharma: No, sure. Perhaps turning it around a little bit, you will have some people who will say that the PRA and FCA remuneration proposals are some of the toughest that you have in Europe. This goes back to the whole issue of: is this going to damage the competitiveness of the City? Will it stop the City firms recruiting the best staff? What is your response to that?

Andrew Bailey: We have kept it focused, but we do believe that, for the most prominent risk takers, this incentive effect has to work. I am afraid we hold to the view that what I might call this skin in the game point is relevant. Now, the question is: are we going to see a broadly similar approach taken up in other parts of the world? I was quite interested by this. At the moment, I have to tell you that it is not particularly common. I was pleased to see on Monday that Bill Dudley, who is the president of the Federal Reserve Bank of New York, made a speech in which he advocated the incentive benefits of deferring remuneration. I would be very pleased if this was something that got into the US approach.

It would help for a lot of reasons: first, because I think it is a good thing; and, secondly, it would help exactly with your point about international comparisons. Obviously, the problem is that the EU approach, by virtue of the bonus cap, limits the ability to apply this because there is less quantum of remuneration to which this can be subjected.

Q59 Alok Sharma: I think you have made a speech to say that you think the EU proposals are wrong. Is that correct?

Andrew Bailey: Yes, essentially.

Q60 Alok Sharma: Can I then take you to this opinion that has just come out from the EBA? I understand you are on the management board.

Andrew Bailey: I am a member of the management board and the board of supervisors, yes.

Alok Sharma: Absolutely.

Andrew Bailey: For my sins.

Q61 Alok Sharma: What are your thoughts on allowances, because some people looking at this could argue that this is the banking sector gaming once again?

Andrew Bailey: I have said a number of times I do not regard allowances as a good thing per se. I am not surprised that they have come into existence, but nobody should regard my position or, indeed, I think any of my colleagues' positions as being yes, they are a good thing.

Q62 Alok Sharma: Did you agree with the opinion? I understand there was a vote on it.

Andrew Bailey: No, I do not agree with the opinion.

Q63 Alok Sharma: You do not agree with the opinion, so you did not vote for it?

Andrew Bailey: No, I did not vote for the opinion.

Q64 Alok Sharma: It was just that our understanding was it was a unanimous decision.

Andrew Bailey: That was incorrectly transmitted by the EBA. I sort of broke the rules by telling you how I voted. I am not going to tell you how other people voted. That is not—

Q65 Chair: I am sorry to interrupt. Could you just clarify what you mean by “incorrectly transmitted”?

Andrew Bailey: Yes. I was made aware, as you can imagine, very quickly—

Chair: Which way you had voted, yes.

Andrew Bailey: —because our press office was contacted to say that they had received communication from the EBA that it was a unanimous vote. Now, this was obviously a problem because, as you can imagine from everything that we have said, it would be unlikely that we would vote for that. I spoke to the EBA and said, “Frankly, I am very surprised that you have informed journalists of the vote because I thought that was the rules of engagement, that we did not do that. Moreover, you appear to have informed them incorrectly”.

Q66 Chair: Have you written to them about this?

Andrew Bailey: I have been in touch with Andrea Enria, yes.

Chair: I think it might be handy if we have a look at the letter.

Andrew Bailey: It was done by e-mail but I am sure I can—you can take it from me we were in touch. I spoke to him very quickly.

Q67 Chair: It is appalling behaviour on their part, isn't it?

Andrew Bailey: Yes, and, to be fair to him, he said, “Yes, that is a mistake”. Now, he told me he would correct it.

Q68 Chair: But it is not an accident, is it? You are going quiet.

Andrew Bailey: No, I am not.

Chair: Is it or is it not an accident?

Andrew Bailey: I do not know the circumstances in which it happened. We will have an EBA meeting shortly and it will be a subject for the meeting.

Chair: Sorry.

Q69 Alok Sharma: Chairman, you are absolutely right to come in there. Just to press you a little bit more on this—of course, you cannot say how others voted and all the rest of it.

Andrew Bailey: No.

Alok Sharma: But can you say if there were others who also dissented from this opinion?

Andrew Bailey: No, because that would be to tell you how others voted. I am not going to—

Alok Sharma: I am not asking you to tell me how individuals voted. I am just asking for a general—

Andrew Bailey: Look, I will tell you why. If we are going to make a point about the EBA's behaviour—no, this is serious—

Q70 Chair: All we need to know is were you alone?

Andrew Bailey: No, I am not going to tell you because I will tell you why.

Chair: Were you isolated? Were you a lone voice? Were you struggling against a wall of opposition?

Alok Sharma: Crying in the wilderness?

Andrew Bailey: It is well known that in the past I have been a lone voice on a subject, but I am not going to tell you that because, seriously, you have expressed your outrage at what went on. It is not going to help getting this point across if I go on to the wrong side of the line on this as well. That is the point.

Q71 Chair: Perhaps he would like to come by and say hello to us. He might have preferred to go to an American Committee, but he could come here at least.

Andrew Bailey: He has recently been to the House of Lords. You could invite him, I am sure.

Jesse Norman: Good idea, we will.

Chair: Yes, we might consider it.

Q72 Alok Sharma: One other quick point on this is that you are obviously not going to look to enforce the EBA directive. Let me put it more generally. What do you think the response should be to banks who are paying these allowances? As I said, some people looking at these allowances could argue that they do not meet the definitions of fixed pay.

Andrew Bailey: Two things on that. It is important that banks read that opinion and decide how big the difference is between the structure of their allowances and what is in that opinion. I think that is important to do that and we will discuss that with them. Then I think the banks need to form a view on what they will do. There is also a process we have to go through. It is a non-binding opinion and there has to be a decision on what we do with it. I would say this. My own view on this is that it is too far into this year as a matter of good practice to change anything this year, and I do not think that is the intention. The issue is what happens next year. That, too, is what you might call a holding pattern, because the EBA is going to have to produce new guidelines to implement CRD IV. This is an interpretation of the pre-existing guidelines, which predate the bonus cap.

Q73 Alok Sharma: Just one final point, if the Chairman will allow me, which is to do with this whole issue around the bonus cap. You are clearly against it. The reality is that the vast majority of high-paid bankers are based in London when you consider the position across Europe. If you say no to it, what message do you think that sends, first, to the public and, secondly, what does that do in terms of this international co-operation that you talked about when Mr Baker was asking questions?

Andrew Bailey: Let us be clear on why I think it is not the best approach. It is not because I think bankers should be paid even larger amounts of money. That is not the point. The point is what I might call putting pay at risk and putting a suitably substantial amount of what is very high remuneration at risk to create the right incentives. This is what we are talking about here. I had two points; that is the first point.

The second point is having a system that enables a material part of the remuneration to be varied over time if the firm gets itself into financial trouble and has a capital shortfall. There are two issues here. If you have a system where a substantial amount of pay is invariant for all time, then you reduce the flexibility of the firm to manage itself to achieve our objective, which is capital retention. That is the first point. The second point is the incentives around deferral and the application of malus and clawback.

Q74 Chair: Can we come back to this five years and seven years for a moment? The LIBOR trader will be a material risk taker, won't he?

Andrew Bailey: No, I doubt it.

Chair: He will certainly come within the FCA definition and certification.

Andrew Bailey: He will come within the FCA definition, yes.

Q75 Chair: He is clearly doing something that you, Mr Randell, think they know at the time they are doing it is wrong, even if it is not illegal. You used the word "illegal", but even if they did not think it was illegal they would be something just short of that. Correct?

Charles Randell: Yes.

Q76 Chair: A high proportion of what we have discovered about LIBOR so far took place more than five years ago, after it was discovered. You do not think there should be any deferral to deal with this?

Andrew Bailey: That is arguably one reason why, first, you would have the extension capacity and, secondly, you could make it wider in terms of its scope. If within five years you had a sense that something was wrong, then you could say, "Sorry, there is the evidence against you. This has to be investigated. Therefore, the deferral is extended". That would be the argument for it.

Q77 Chair: You do not see the case as strong enough for keeping some skin in the game, to use your phrase, for longer than five years?

Andrew Bailey: As I mentioned earlier, this is the balance between saying at what point do we tip them into saying, “I do not want any of this, I will use fixed remuneration” at which point, in the same way that the bonus cap has a problem, we then have a problem with our own regime.

Q78 Chair: We have a problem because the market is not sufficiently competitive to drive down those wages backed by shareholder pressure. That is the problem.

Andrew Bailey: Of course, the interesting logic you could argue, and this would be the complete reversal of the bonus cap, would be to say you want to mandate that a certain amount of remuneration is variable and deferred.

Chair: We might come back to this, but I am not entirely happy with the answer.

Q79 Mark Garnier: Can I come back to it straight away, if I may? I want to talk about leverage ratio, but can I pick up a couple of points on that? With this fixed pay and variable pay, you mentioned there were two reasons why you should have variable pay, one of which is managing the cash within a bank in a downturn of business and the other is the incentive, both directions. Is there a third reason, which is to do with the regulatory capital? Isn't it the case that if a regulated institution has to put a certain amount of its fixed cost aside to keep it going for 90 days after a failure, if you have a higher proportion as fixed cost, that is going to mean you are going to have to put aside more regulatory capital?

Andrew Bailey: Yes.

Mark Garnier: So that is a third reason?

Andrew Bailey: Yes, for those institutions that have that type of requirement upon them.

Q80 Mark Garnier: Do investment banks have that type of requirement?

Andrew Bailey: No, not typically because the capital regime is calibrated differently. You often have some subsidiaries that are non-banks, which will have that. It tends to be more the FCA regime that will have that function to it.

Q81 Mark Garnier: It would be wrong of me to say, then, that because of the way a bank works, it is not going to detract from lending money—

Andrew Bailey: If my colleagues tell me I am getting it wrong I will write to you later, but I do not think that mechanism would work for banks.

Q82 Mark Garnier: Fair enough. You have clarified something that I have been using. The second one was in relation to something that Steve Baker was asking about, which is these fines. You may not know the answer, in which case just say. There has been some criticism that these fines that are being levied on banks where they find themselves money laundering for a drug cartel or whatever it happens to be, where they stumble across this type

of problem in more exotic banking environments, shall we call it? That is putting banks off getting involved in third world and developing countries. Is that the case? Is that now creating this situation where we are effectively starving the third world of development capital?

Andrew Bailey: I am aware of it. I have had a number of conversations and been approached on this in a number of contexts. We have had some quite plausible evidence, it seems to me, put in front of us that some of this is going on. Yes, I think it is an issue. You could find parts of the world more cut off from access to the mainstream banking system and I think you could find a situation that would increase the temptation then to use channels that are less robust in terms of being able to achieve the desired ends of anti-money laundering and financial sanctions. I think it is right. It is possible and, as I say, I have certainly seen evidence of it happening. What I cannot tell you is just how pervasive it is at the moment.

Q83 Mark Garnier: Yes, an interesting argument is developing. Back to the leverage ratio. You gave evidence to this Committee in July and you said that you had not yet reached a view on whether the leverage ratio framework should mimic the complexities of the capital framework. Have your views changed over the intervening months?

Andrew Bailey: Yes, in the sense that we have obviously had a process of consulting. We have had responses back and this is something that is being considered by the FPC. When I say yes, my view is that I think it is sensible to keep the leverage ratio as simple as you can. As you know, the PRA has supervisory guidance, in the nicest sense of the term, with a leverage ratio in place. We have put the 3% leverage ratio in place for the major firms. I think you learn a lot from it and you learn useful things from it. I should say that I am very much a believer that we have a risk-based capital system, we have a leverage ratio and we have stress tests, and those three prongs of the system are all valuable because, in fact, they all tell us useful things. There is no one magic bullet that ever gives you the right answer.

I do think that most of what you learn about the leverage ratio you learn from a relatively simple form of it. There are some elements that you need to calibrate in a sense because you have an adding-up process as well to achieve a meaningful leverage ratio, but I would not advocate including all what I might call the complexity of the buffer system of the risk-based ratio to mimic it into the leverage ratio. I think there is a bit of a logical issue you have to face then because if your critique of the risk-based system is its complexity, then having a leverage ratio that is kept relatively simple but nonetheless gives you in a diagnostic sense the meaningful read is the right approach.

Q84 Mark Garnier: The BBA and the Building Societies Association have both been complaining in their responses to the consultation about this complexity. You are responding to that.

Andrew Bailey: The FPC will produce its response to that. We have read the responses. We have had quite a range of responses. They have been very useful responses in my view and we will respond to that.

Q85 Mark Garnier: You also mentioned the level set at 3%, which is the current level. I think the FPC has reached an appropriate view on what that should be, which it expects to publish at the end of this month, so I am not necessarily asking you to pre-empt that.

Andrew Bailey: I think I am actually in purdah on this decision at the moment and it is wonderful since I—

Q86 Mark Garnier: Are you allowed to say whether you agree with it or not in anticipation?

Andrew Bailey: I can tell you I agree with what has been decided, yes.

Mark Garnier: I will not press you any more on that.

Andrew Bailey: Whatever that is.

Mark Garnier: It could be anything, couldn't it?

Q87 Mark Garnier: Just on a wider point, the consultation paper contained little detail on the impact to the wider banking services that are provided. Now that it is finished, what is your understanding of the effect that the leverage ratio is going to have on banking services?

Andrew Bailey: The thing we have to watch for here, and this is why the leverage ratio is a tool but it is not the only one, is there are two points about the risk-based system. One is to do with the complexity of the risk-based system and, of course, that is particularly a point about internal models. There is no question but that they are complex, although you get closer to the way in which the firm runs its own business and takes risk, which is why I have said a number of times that I am in that camp of people who still thinks we should look at internal models.

The second point is that if you were only to use your leverage ratio, you would create quite difficult incentives because you would incentivise institutions to go up the risk curve for a given unit of assets. I think that we saw some of this going on in the run-up to the crisis.

Q88 Mark Garnier: Are you saying that if you had the leverage ratio at 3% then they would be pushing to go to 3%?

Andrew Bailey: No. Let us say I only had a 3% leverage ratio. As an institution, I could make a mortgage loan that had a 40% loan to value ratio and I could make a mortgage loan that had a 90% loan to value ratio. The leverage ratio is indifferent to the difference between those two things. I would get a higher return on the 90% loan to value ratio, of course, but the reason I would do that is I am taking more risk. The leverage ratio is invariant. I do think you see some evidence in the run-up to the crisis, by the way, because people often say Basel II caused the crisis.

Q89 Mark Garnier: What you are essentially saying is, given you have a finite amount of leverage you can use on the bank, you are going to rev that up as much as you possibly can to get the biggest return?

Andrew Bailey: Yes, which is why you need both. For almost all the pre-crisis period, the industry was operating on Basel I. Now, Basel I was obviously a hybrid but it was nearer to the leverage ratio. All mortgages had a 50% risk weight. Now, you see some evidence. Some of the mortgage institutions that failed went up the risk curve; Northern Rock, classic case in point. That is the risk of only using a leverage ratio where the incentives are not aligned. I say that not to dismiss the leverage ratio. You can learn a lot from the leverage ratio, but you would not want to have it on its own. You have to be alert to this question about how you skew the incentives.

Q90 Mark Garnier: The building societies seem to be complaining very heartily about the fact that they can be disproportionately affected by this. Do you think that is a fair complaint?

Andrew Bailey: Most of the building societies today, except for a handful of the larger ones, are on the standardised approach. This is a discussion we have had in the context of competition because you raise another issue that we will come to. The standardised approach tends to lead to higher capital requirements than the risk-based system and that, therefore, tends to be easier to meet the leverage ratio. Of course, that is all subject to where you pitch the leverage ratio in terms of levels.

Q91 Chair: Have you considered that a leverage ratio might be needed for shadow banks?

Andrew Bailey: One way in which you look at shadow banks, if you look at hedge funds for instance, you look at leverage. You could do that. We look at that in terms of the assessment of the shadow banking system. There are, as ever, a number of ways of looking at it. Then, of course, if you were concerned enough about a shadow bank you would then have to take the decision whether you wish to bring it inside the regulatory perimeter. I am sure you know there is a process in the legislation for doing that. If you did that, then I think, yes, a leverage ratio would feature as part of the toolkit.

Q92 Chair: Can I ask a few more questions about ring-fencing? Who should be appointing the ring-fenced bank independent directors?

Andrew Bailey: I think the holding company board and chairman would do that. That is the normal process for doing that.

Q93 Chair: Is the ring-fenced bank independent in that case?

Andrew Bailey: I think there is an important job for us, because if we felt that the board of the ring-fenced bank was not independent then we would have to act.

Q94 Chair: It is going to get quite difficult, isn't it?

Andrew Bailey: Yes. I do not think it is easy to say that the ring-fenced bank is such a different animal that you have to have its board appointed from outside. I think that would be quite difficult.

Q95 Chair: What about the consolidation of accounts for the ring-fenced bank in the parent? Who is signing off on these accounts?

Andrew Bailey: You would have both subsidiary and consolidated accounts because the subsidiary would be its own legal entity. It would have to have its own accounts and they would have to be signed off and its board would have to be signing off.

Q96 Chair: These are questions that we posed to Vickers and we did not get full answers on them then. Do you think they have been thought through further since then?

Andrew Bailey: I think the answer to that flows from the accounting and company law treatments because the whole point about it is these things are their own legal entities. Obviously, with a subsidiary, it is a subsidiary. There is a certain amount of constraint on it, but it is still a distinct legal entity and it has to have accounts.

Q97 Chair: This consolidated accounts issue is not straightforward. It is quite an awkward wrinkle. We might come back to you on it in writing.

Andrew Bailey: Yes, that will be fine.

Q98 Jesse Norman: Can I pick up on a couple of points that were raised by Mr Sharma? In relation to your position with the EBA, can I ask that you make a formal request to the EBA as to how the miscommunication as to the vote took place?

Andrew Bailey: Yes, certainly.

Q99 Jesse Norman: Can I also ask that you specifically inquire whether that miscommunication was authorised and, if so, by whom?

Andrew Bailey: I can do that.

Q100 Jesse Norman: It seems to me that is an important issue—thank you. On the issue of clawback, which we have discussed, and retention of bonuses, I just want to say one thing. You do not think that clawback is a genuine way that a bank can use for capital retention, do you? If it is meaningful amounts of money and you are anywhere near a position where your capital is at risk, people are going to be contesting this very vigorously in the courts.

Andrew Bailey: Sorry, perhaps I was not clear enough when I answered Mr Garnier's question in terms of the two things. No, I do not regard clawback as a way of improving the capital position.

Jesse Norman: I did not think you did. I just want to be absolutely clear.

Andrew Bailey: Clawback is a quite high bar to cross in terms of the legal arrangements. The point about capital retention, therefore, is not to do with clawback. It is to do with being able to vary remuneration from now onwards.

Q101 Jesse Norman: I was sure that was true; I just wanted to be clear—thanks. There was a recent IMF paper that wrote, “Should a large cross-border bank fail today, it appears unlikely that the pitfalls and misaligned incentives that undermined co-operation in the global financial crisis could be avoided”. That is obviously a very significant conclusion. Do you think that means that the problem of “too big to fail” is as acute now as it was?

Andrew Bailey: I think it is a fair statement today. We are coming to a major milestone next month, which is the G20 summit in Brisbane. At that summit, what has been put together on what is now wonderfully called TLAC—total loss-absorbing capacity—which is what you might call gone-concern resolution loss-absorbing capacity, will be put forward. You may know all of this work has been led by Mark Carney in his capacity as chairman of the Financial Stability Board. It has to be an international agreement. It has to involve the authorities responsible certainly for that population of banks that have been designated as globally significant. I do not want to jinx Mark’s endeavour. I think the work has made huge progress. I have said on a number of occasions that I am optimistic about the outcome. This will be a big step forward but, of course, what will follow from that, then, is a very big implementation task. Getting the agreement on TLAC is a very big step forward, in my view. Implementing it is then the next big thing.

Q102 Jesse Norman: Just to be absolutely clear, it is not until it is both agreed and implemented that you would start to see any variation from the IMF’s position, which is broadly that “too big to fail” is as bad now as it was?

Andrew Bailey: You are right. I am sure the IMF would be prudent, I think a prudent interpretation is exactly that. You would not start to, in a sense, vary that language until you saw meaningful implementation.

Q103 Jesse Norman: That is very helpful. You are not making predictions about Brisbane but, as far as you can tell, we are on track or the Governor is on track in that capacity?

Andrew Bailey: A huge amount of very good work has gone into this. I can tell you it has been probably the major issue of this year in terms of the international landscape. Mark has put a huge amount of time into it.

Q104 Jesse Norman: You must see it from the other side. All your opposite numbers in countries are going to be sitting there panicking from the other states.

Andrew Bailey: I do.

Q105 Jesse Norman: You must have a pretty good view whether one is going to succeed from the other side. Is everyone falling into line? That is the question.

Andrew Bailey: If you go around the countries, the world has changed in this respect and obviously it is in response to the crisis. The understanding of the importance of having loss-absorbing capacity and dealing with “too big to fail” has transformed in that respect.

Q106 Jesse Norman: That is helpful. I think it is common ground that if there is going to be any genuine resolution of this problem or meaningful rollback of the problem, that is going to require levels of co-operation that are way beyond what has been hitherto achieved. Obviously, the regulator’s first responsibility is going to be domestic financial stability.

Andrew Bailey: Yes.

Q107 Jesse Norman: There is a potential conflict between that and international co-operation because you can get the financial equivalent of Smoot-Hawley where everyone is panicking about their own position and not contributing to it. The question is: is this kind of international co-operation going to be adequate to address those deep issues of misaligned incentives as between domestic and international?

Andrew Bailey: This is a vital question. I think there is no doubt that the experiences of the crisis—and we have all had bad experiences; we have had some particularly bad ones, obviously—have led to what tends to get called fragmentation. I always get asked this question and, I do not know, it is my human nature anyway. The way I describe it is if you cannot solve a problem you try to reduce it to a scale where you can solve it. That is a long-winded way of saying you bring it within your national borders and your national legal system. We have seen this. This is fragmentation within borders. It is subsidiarisation. It is trapping of capital and trapping of liquid asset buffers.

Getting an agreement on loss-absorbing capacity is a huge first step. Implementing it is a second one. You are right that the key test of this—and this is a real hope—is that we can then start to rebuild trust. With those tools in place, I hope we will get to a point where authorities can say, “Yes, I broadly know what would happen. If we got to this situation I could broadly predict how the thing would work out. I could broadly predict how the other main authorities involved around the world would behave”. To me, that is a big step that we have to take to rebuild trust, as you put it, and then to start to get some gains in terms of the return of broader international banking and particularly broader wholesale banking.

Q108 Jesse Norman: Of course, these agreements are only going to be as good, ultimately, as the political will/sanctions/culture, whatever it is that sits behind them. Arguably before 2008 people felt pretty relaxed about this because they felt that these institutions worked closely together over many years and there were good memoranda of understanding. It is not clear that anything has changed. You move from a memorandum of understanding with no legal force to a soft agreement, which is so soft that it never gets enforced because there is no enforcement anyway.

Andrew Bailey: The thing that has changed—or will change we expect and hope in terms of the toolkit—is that you could say that the problem with the pre-2008 world was that if people were getting on and feeling very confident, they were rather misplaced because they did not have a toolkit to deal with the problem. So there is the “too big to fail” problem. Credibly, you can only feel like that if you feel you have the tools in your hands to deal with the problem. That is the experience we have had domestically as well.

Q109 Chair: Could I turn to the war gaming that you have been undertaking with the Americans?

Andrew Bailey: Yes.

Chair: A decade ago we had some war gaming. All the details were kept secret. In retrospect it might have been better if the information had been in the public domain because we might then have acted on some of the things that were not acted upon and later turned out to be culprits for great difficulty in responding to the early stages of the crisis. What can you tell us about the war game and are you going to publish something that can be subjected to public scrutiny?

Andrew Bailey: Yes, one of the problems, I thought anyway, of the war games that happened before 2007—and I say this because my own background, as you might know, was in resolution of banks that got into trouble, banks like Barings and National Mortgage Bank—was that they tended to have a happy ending in the sense that they never played it out to the point of true resolution and failure and so you never got to the point that Charles and I had to deal with regularly over the crisis where we were confronting, in our respective roles, an institution that had failed.

We have gone beyond that now and the war games that we play now—and the one you heard about recently is a little bit different because it was more of a stylised, “What do we do if we are in this situation” type of exercise—are very much played around flushing out the problems and issues that you would always face in some cases around these exercises. They are in that sense more realistic. Looking forward, however, I do think, and colleagues think this as well, if we get a good outcome on total loss absorbing capacity—it goes to Mr Norman’s question—we must not lull ourselves into a false sense of security. We will always work and we cannot always just play the games out to a happy ending because the devil is in the detail with this stuff. Things can go wrong. There are important issues around how you communicate the outcomes of these exercises, for instance. You can get it right and you can get it wrong. We have had experiences of that. You have to constantly play out these scenarios, but I can tell you that what we are doing now is playing out scenarios where you do play to the bitter end.

Q110 Chair: I recognise the need for some confidentiality but it would be helpful to this Committee and to others who follow these things if something could be provided that can give us some confidence that this is a higher quality war game than the previous ones.

Andrew Bailey: If it is okay, I will take that away and have a think with colleagues and see what we could do for you.

Q111 Chair: The FDIC have put out at least some information—indeed that is mainly why we know about it.

Andrew Bailey: Yes. It was announced a few days beforehand as well.

Q112 Jesse Norman: Just a quick question on these war games. How much challenge is built into the structure of the war game itself? You can imagine war games where basically people are playing through certain scenarios in certain different ways and trying to see how they result, but what you want is a malevolent god figure who sits there and says, “By the way, while you are playing this out I am going to raise oil prices by \$50 a barrel” or, “I am going to do a global spike in this kind of commodity”. You want something that is going to unsettle. Do you build that into the situation? Maybe write to us and just tell us. This maybe is not a topic for now.

Andrew Bailey: The other way I was suggesting that you can do it, which is a little bit more like this one, is to say, “The following bad things have happened”, and then you are playing out the consequences. That is another way of doing it. You do not quite play it in real time. You say, “You are now settling down and the following things have happened. Your institution has failed. What do you do about it?”

Q113 Steve Baker: Can I just direct this to the external members? Is it acceptable that if a bank fails its stress tests there is only a strong presumption of further action rather than being a strict requirement of further action? Is that acceptable?

Charles Randell: Andrew has made a number of comments about stress tests in the run up to the current exercise in which he has emphasised that we do not see it as a mechanistic pass/fail regime. Stress tests tell you very important things, and I think it is fair to say that our experience so far in this stress test is that they have revealed all sorts of useful information that will help to inform our reaction as a supervisor, but they are ultimately just one scenario and we can be confident that that exact scenario is not going to happen. Some other scenario that may look a bit like it will happen. Trying to decide what the result of that stress test means for a prudential reaction is not a purely mechanistic exercise. It requires further judgment.

Iain Cornish: I completely agree. The whole essence of the way we supervise is we exercise judgment within broad parameters according to the circumstances of the institution and the reasons why it may have come close to the limits of what we want to see a firm doing under the stress.

Q114 Steve Baker: You simply cannot say in advance whether or not an exception would be made, whether or not a bank would be required to take further action?

Iain Cornish: No.

Q115 Steve Baker: You have just mentioned forward-looking judgment-based supervision is what you do. I recall looking at some work by an economist called Roger Koppel about big players and the economic theory of expectation. His argument in a nutshell is that if a regulator is a big market player, has the ability to shift markets, if they have discretion, ie judgment in the way they apply their power, and if they are relatively insensitive to the discipline of profit and loss, which I think is fair to say as a regulator you are, he looks at the evidence and suggests that the consequence of having these big players in markets with this kind of discretion is that it can produce herding, in other words financial instability. This worries me very much because the bank has become much more powerful. Is this even an area of conversation within the PRA? If it is not, I would suggest it should be.

Charles Randell: We had a board meeting this morning in which I can assure you that the word “herding” has been used, because one of the concerns that we have is that, if you drive everything through a set of models or through a set of scenarios that are fixed, you come out with a set of results that will tend to herd people into the same place. We are very alive to that, but it is one of the reasons why I think supervisory judgment and challenge of supervisory judgment is so important and that you ask yourself that question: are we herding people?

Iain Cornish: It is particularly relevant in the context of the stress test because the stress test is stress of the UK housing market and clearly some of our institutions are more exposed to the UK housing market than others. It is not the only way that we will look at capital. We look at capital, as we have already talked about, through leverage, through risk weighting, and then you form a judgment based on your assessment of capital and indeed other prudential metrics. That is how you reach an ultimate view about is an appropriate course of action for a firm.

Q116 Steve Baker: Just thinking about herding, at least two things come to mind. One is particularly setting up what actions they need to take, capital and so forth, and directing what they ought to do, but the other aspect is leading them to form economic expectations that tend to drive them in a direction. Do you also consider that aspect of herding, particularly in relation to monetary policy, that by deliberately setting people’s economic expectations you cause entire markets to—

Iain Cornish: We specifically require firms not just to look at our view of the economy. The guidance we give firms in relation to how they stress their own balance is to look at the economic cycles that they are exposed to, given the composition of their balance sheet, and to form their own view. We then expect them to look at the consequences of our view and we will challenge them in relation to our own view but a firm that did nothing other than run our stress test view of the economy through its models would find that its governance and its risk management systems would not be regarded as acceptable.

Andrew Bailey: If I could come in and just add one point to Iain’s points. It is very interesting to look at the stress test we are using at the moment on this very point you raise just to emphasise the diagnostic point. That stress test has a rising path of interest rates in it. We set up the scenario and the shock deliberately to create that path of monetary policy. What are the consequences of that? Well, two things, which tend to go in opposite directions. On the one hand, that would tend to increase impairments and losses through

the impairment channel. Going in the other direction, it will tend, if anything, to widen the net interest margin on lending and be of benefit to banks.

Our process is not going just to say mechanically, “Well, send us the numbers and that is it”. This has prompted a whole series of discussions with the individual banks about what we learn from that, about their response to it and how they view these things, how plausible the assumptions they are making about those two sets of reactions are, and what we learn about their own models, particularly on the whole question of asset quality. We learn a lot from these tests about how the models respond, often how point in time versus how far through the cycle they are. That is a richer conversation and a richer process for us to learn from, albeit at the end of the day you have to add the numbers up, but there is a lot that sits behind it.

Q117 Steve Baker: When you run these stress tests are you assuming a normal distribution of market events?

Andrew Bailey: It has embedded in it the output of a macro model. It is the product of a macro model but it is in the tail of the distribution. Essentially that is the difference with what the MPC is doing, where it is has a central case and it has a distribution. In a stress test case you are in one tail of the distribution.

Q118 Steve Baker: What concerns is that since Mandelbrot, whenever it was he did his market analysis, people have known that market events do not follow a normal distribution, that the tail is fatter. Yet it suited everybody, particularly in relation to levels of capital, to assume normal distributions in models. Again, this is about herding to me. If the regulator is using normal distributions and mathematical models that assume a relatively thin tail and in fact the real world has a fat tail, is that not a severe problem?

Andrew Bailey: That is a fair point. One of the things I would say is deep in the psyche of the Bank of England, from the MPC, is all these models are wrong. They are all wrong. Nobody should interpret that comment as being a criticism of them. That is a fact. You have to challenge constructively, take different views. Essentially you say, “Where could it be wrong?” Let us take an alternative view of the world. That is important. This is coming out of the monetary policy side of the bank, because they got there first in a sense with the history of the MPC and the whole MPC forecasting and modelling process. It is pretty deep in the psyche of the institution.

Iain Cornish: Can I just add to that? The issue around the assumptions on distributions is much more relevant to looking at capital through risk-weighted means where, through the advanced modelling approaches, firms have made assumptions about distributions of likely events. The whole purpose of stress testing is to explore the breakdown of those models when you get into tail risk scenarios. The other point to make is that this year we have looked at one scenario. We recognise absolutely risk can come from other sources and going forward this is a continuous programme, so we will explore other risks and other tail events.

Q119 Steve Baker: At the risk of verging on to one of my favourite subjects, I notice that the bank's assessment of the distributional effects of QE observes that the effect on equities markets has been broadly the same as on bonds. I forget exactly what the words are—the papers are here somewhere. When I look at the FTSE rising, until recently, almost continuously since QE began I am rather worried again, particularly bearing in mind what has been said about the pro-cyclical nature of IFRS accounting, that monetary policy will have led us into a position where these stress tests need to take into account the possibility that assets are very substantially higher priced than they might otherwise be.

Andrew Bailey: If you read the output of the FPC you will see a concern that we are currently in a world where, if you use the simple credit to GDP indicator that is in the set of core indicators, you get a reading that suggests that there should be no concern about credit extension relative to GDP, but we are still in a very weak condition. Yet, as you rightly say, when you observe financial market conditions and you observe the movement of risk-free rate in financial markets, albeit we have had some volatility in the course of the last week, you get quite a different story. Those things have to be balanced and that is what we do in the MPC, the FPC and PRA board. We are always at that.

Q120 Steve Baker: I will put this fairly directly. The Occupy movement has disappeared for the moment, but we went through a phase where people were fundamentally questioning whether capitalism is dying, whether it has all gone wrong. At various places, the paper talks about the PRA wanting firms to be exposed to the market and yet, when I look at the powers of direction, listening to the conversation, acknowledging herding and so on, it feels to me like we are now in an era where it is fair to say that the level of intervention in the financial system by authority is vast. If this system blows up again, who is going to get the blame? Is it going to be the regulator's fault or is it going to be the free market's fault?

Andrew Bailey: It is always the regulator's fault. Here is the dilemma. All the reviews this Committee did—and others have been done—about the pre-crisis period indicate a very different approach towards regulation in that period. It came to a nasty end and, as all three of us have said this afternoon, we have moved the approach to prudential regulation to what we call forward-looking judgmental regulation. You are right to say, "What does that mean? It sounds quite noble". Yes, it is us using judgment and it is us being prepared to intervene in ways that our predecessors were not. That does not come lightly. It should not come lightly because that is a very big power to have. I think that is why accountability is hugely important for us. We have observed the bad experiences of the past—that is the dilemma.

Q121 Steve Baker: What I am really trying to establish, which I think I have done, is that this is not an unhampered free market and very deliberately so.

Andrew Bailey: Parliament has, in a sense, determined the appropriate scope for regulation.

Q122 Steve Baker: Can I just turn to cyber, Chair, and then I will wrap up? Before we go into any of the detailed questions about cyber, do you think that the nature of the cyber

threat is sufficiently understood at senior levels, both in the banks themselves and among the various regulators?

Andrew Bailey: I think the appreciation of the cyber threat has risen substantially. For me there is always a danger as a regulator that you are fighting the last war. We still have work to do on the last war but there is no question but that, among the risks that we face today, that this one has come up the list very quickly and rapidly. There is absolutely no question but that it is now very high on the list and regarded as very important. You pose a very challenging question, because if you said to anybody, “Do you fully understand the scope of this?”, we would have to be rather humble about what we know.

Q123 Steve Baker: So with that in mind, what is the PRA’s role in cyber?

Andrew Bailey: It is the Bank of England as a whole, because this goes across more than one area of the Bank of England. We have set off a number of pieces of work. We were involved in an exercise that was called, I think, “Waking Shark II”, which was a wonderful name for anything, which was a testing exercise. We have introduced a form of what I might call disciplined penetration testing that firms are doing, which goes under the name of CBEST with a view to carrying out more active testing and that is what we have done. We have a certain amount of expertise in the Bank of England, but we rely on other services to assist us on this because we do not claim to be experts.

Q124 Steve Baker: Have you tested insurers?

Andrew Bailey: Not yet, but I expect we will move on to that.

Q125 Steve Baker: Can you show us any sort of concrete plans to do so? Is it just on the agenda to do at some time?

Andrew Bailey: We are in the banking system at the moment.

Q126 Steve Baker: Could you characterise the resources that you have available at the Bank? You have just mentioned you rely on outside contractors. Is it one set of resources right across the whole of the Bank of England?

Andrew Bailey: Yes, we have largely, but not quite entirely, pooled the resource across the Bank of England and that is because, as I am sure you know, we have a number of responsibilities that are relevant. The PRA has substantial responsibilities, but we are also the supervisor of clearing houses and payment systems, and those are vital parts of the financial infrastructure.

Q127 Steve Baker: As a software engineer, I very often worry that it is difficult to get good-quality software engineers who understand cyber. Do you employ people who have done some hacking and know how to break—

Andrew Bailey: We have some of those¹ but, as I said earlier, we have access to other agencies who have—

Steve Baker: Of course, I see what you are saying. I will probably leave it there, Chair. Thank you very much.

Q128 Chair: I just want to end with one question about the bank levy. If all the work you are doing on resolutions and ring-fencing becomes meaningful, doesn't the logic for the bank levy weaken considerably?

Andrew Bailey: That is a question you ought to ask the Chancellor.

Chair: I might do, but I thought I would ask you.

Andrew Bailey: The bank levy was originally introduced with a particular purpose in mind, so I think the answer to your question would be logical. I am not the person to comment on fiscal measures.

Q129 Chair: It would impact on the banks though. The levy is a major concern.

Andrew Bailey: It is, and they are very clear on that. The one point I would make, and you may have seen this in the material that has been released on deposit protection, is that the European directive on deposit protection requires a form of pre-funding of the protection scheme. Now, the intention of the UK Government is to use the levy as the means to achieve that pre-funding. In a sense the question would slightly come back in that context as how the UK Government would intend to do pre-funding if it did not do the levy.

Chair: That was a slightly different question. Thank you very much for giving evidence today, all three of you. We may have appeared recondite but it goes to the heart of whether we can give ourselves a better prospect of avoiding a repeat of what we have had in 2008-09. We are very grateful to you.

Andrew Bailey: Thank you.

¹*Note by witness:* i.e. software engineers, not hackers