

Treasury Committee

Oral evidence: [Bank of England Financial Stability Report July 2016](#), HC 549

Tuesday 12 July 2016

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Members present: Mr Andrew Tyrie (Chair); Helen Goodman; George Kerevan; John Mann; Mr Jacob Rees-Mogg; Rachel Reeves; Wes Streeting.

Questions 1-119

Witnesses

I: Dr Mark Carney, Governor, Bank of England, Sir Jon Cunliffe, Deputy Governor, Financial Stability, Bank of England, Donald Kohn, External Member, Financial Policy Committee, Bank of England, and Richard Sharp, External Member, Financial Policy Committee, Bank of England.

Examination of witnesses

Witnesses: Dr Mark Carney, Sir Jon Cunliffe, Donald Kohn and Richard Sharp.

Q1 **Chair:** Thank you very much for coming to give evidence today. This is an important hearing. It is the first opportunity we have had to cross-examine the Governor and some externals from the Bank after the EU referendum. There is one point I would like to make sure everybody knows about. You are in MPC purdah, are you not?

Dr Carney: That is correct.

Q2 **Chair:** So I won't ask you to go too far forward in any answers—and I think that applies to Jon as well—on forward guidance and the forward guidance you have already given with respect to monetary loosening. I think you said—in a personal capacity, I presume, Governor—something like, "Some monetary policy easing will likely be required over the summer," so you have already signalled monetary policy loosening will be necessary, in your view. It is possible we may come back to that later on this morning, but I quite understand that both of you are in purdah and may not want to take that discussion much further, if at all further.

I would, however, right at the beginning, like to address the very robust assault on the Bank's credibility and integrity as an institution that took place during the EU referendum. I think this allegation is a very serious one. In a nutshell, the allegation is that there has been a deliberate attempt to frighten the voting public by the Bank, with a political motive. If this is true, it seems to me that it's pretty much an end to Bank of England independence, which we have had since 1997. It certainly cannot be recovered by this Governor, and it probably cannot be regained by the Bank of England for many years. It is the duty of this Committee either to substantiate those claims or to demonstrate that they need to be set aside.

I think it is important to remind the people watching this hearing what we are talking about. Here is a letter from two former Chancellors and two former leaders of the Conservative party: "There has been startling dishonesty in the economic debate, with a woeful failure on the part of the Bank of England...to present a fair and balanced analysis. They"—that is, the Bank of England institutionally—"have been peddling phoney forecasts and scare stories to back up the attempts of David Cameron and George Osborne"—this is the political motive—"to frighten the electorate into voting Remain."

That is a very serious allegation indeed. Do you agree with that, Mr Sharp?

Richard Sharp: I sit on the Financial Policy Committee, where we look at financial stability issues. I have had a series of meetings with you around this—both at my reappointment hearing and subsequently—and one of the issues that was clear to us, and what was certainly demonstrated in the



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markets, is that this event indeed transpired to be a significant domestic shock.

As we know from the past—2008—there are fragilities in the global economic system that lead to unpredictable consequences, and we benefited from the analysis with respect to the potential consequences of a remain versus a Brexit scenario for the economy. We also benefited from the markets trading in advance as opinion polls moved, giving us a sense of potential parameters of instability. In addition, we then had the benefits of a model created by the Bank of England economists, albeit from the MPC side of the Bank. They demonstrated that this is and has been a profound shock to the economy. Certainly, if you look at the significant fall in the value of Bank share prices, which are trading significantly below book, and at house builders, which represent a significant driver of the domestic economy, you can see that much of what was articulated in the model has transpired.

- Q3 **Chair:** Okay. I want to get to the heart of this. I am sorry to ask binary questions, but I think this gets us closer to what is needed. That was a very interesting reply, and I think it is important you should have been given the opportunity to put that on the record. Has there been “startling dishonesty” by the Bank of England, in your view? You are an independent member; you are there to police exactly this sort of concern, and that is why I have turned to you first.

Richard Sharp: Absolutely not. I interrogated the models, and I was satisfied that they were created on the basis of independent economic assumptions by economists trying to determine the best outcomes under different scenarios.

- Q4 **Chair:** And therefore you also reject, do you, the “peddling phoney forecasts”?

Richard Sharp: Yes. As I mentioned to you in our last meeting, Chairman, I did not agree with all the assumptions. Throughout my business career, I have had to deal with the challenges—the entire financial community does—of making forecasts. We know that forecasts are unpredictable, and that reasonable people can make different assumptions.

- Q5 **Chair:** Fine. What about “scare stories to back up the attempts” of the Prime Minister and the Chancellor “to frighten the electorate”? Does that resonate at all with you—with anything you have seen in the Bank of England?

Richard Sharp: No.

- Q6 **Chair:** I am asking you partly, also, because you gave the impression of being somewhat more sceptical about the UK's membership of the EU. I am not asking you which way you voted; I am just pointing out that you gave that tone in earlier evidence.

Richard Sharp: When you met with Mr Kohn and me a few weeks ago, you got two different nuances. We are two external members—



Q7 **Chair:** Well, that is what external members are supposed to provide.

Richard Sharp—and my assumptions concerned certain components of the capital structure, in terms of the credit-worthiness and the investability of the UK, that provide some resilience. Even subsequently, looking at the models and the effect of the strength in the debt markets, those are smaller components to GDP, and I do not think we should be relaxed about the fact that a lower GDP leads to unemployment. It leads to uncertainty and to a loss of livelihood for many people.

Q8 **Chair:** The Fed, Mr Kohn, does occasionally seem to get a bit closer to politics than the Bank of England would like to. I am not going to go into great detail on that point, but I think there is a good deal of historical evidence in memoirs to support it. You are well capable, from your vantage point, and as an external member, of examining these issues and coming to a view. Have you anything that you would like to add?

Donald Kohn: I agree with Mr Sharp. We had, at the end of March, a robust discussion in the Financial Policy Committee on potential risks to financial stability. We looked at the potential risks that might emerge from a vote to leave, and we all agreed that it was the largest near-term domestic risk to financial stability. We looked at the channels through which this might be communicated to financial stability—through the commercial real estate market, the banking sector, market functioning, household indebtedness and the effects on the economy—and we were very clearly focused on risk to financial stability. I felt that there was a very full and open discussion, and I did not feel any pressure to come out one way or another.

Q9 **Chair:** Did you think you were being led in any direction?

Donald Kohn: No.

Q10 **Chair:** This was a very balanced discussion then, with arguments on all sides coming round the table.

Donald Kohn: Yes.

Q11 **Chair:** Notwithstanding the differences of view, a consensus was capable of being formed, and what was said publicly represented that consensus. Is that what you are telling the Committee?

Donald Kohn: Yes, that is what I am telling the Committee. The statement we put out at the end of March represented a consensus of the committee after a good discussion.

Q12 **Chair:** Governor, you are ultimately in the frame for this. Of course, it is quite possible—you are an extremely skilled operator—that even though you left no trace, these people around the table were led in the direction in which you had already decided to take them, and that this was part of a plan or a discussion that might have taken place with the Chancellor of the Exchequer. I think it might be helpful, first, if you could give your view, or your response to that allegation.

Dr Carney: Which allegation?



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Chair: The allegation that you guided the committee in that direction, and that you were very good at it. I am just trying to go through the various permutations that come from this extraordinary set of allegations that have been made by two former Chancellors and two former leaders of the Conservative party.

Dr Carney: I agree; the letter you quoted is extraordinary in all senses of the word. That is not the way the committee works. The chair does not guide to conclusions. The committee is presented with a series of analyses. It has, as my colleagues referenced, robust discussions about where we see the risks, what we should do to respond to those risks, and whether we catalyse that directly, in terms of actions of the FPC, other parts of the Bank of England or other bodies, be they the Treasury, other foreign central banks, the FCA or others. That is the way it worked. Specifically in the case of the assessments in March, they were taken under our statutory responsibility to identify risks to financial stability—W9 of the Act.

Q13 **Chair:** Before you had that meeting in particular—the key meeting that we are now discussing—did you have any discussions of a general nature with the Chancellor of the Exchequer about where this issue might be taken—that is, about any public statements by the Bank about the effects of Brexit?

Dr Carney: Not prejudging views of the committees, no.

Chair: You seem to be limiting—

Dr Carney: As Governor, I have discussions with the Chancellor on a wide range of economic and financial issues, as you would expect, but the views of the FPC are the views of the FPC. As for the views of the MPC, each member is individually accountable for those views. If a consensus forms in the MPC, then they subscribe, or if members of the MPC disagree—and this also holds for the FPC—then those disagreements will be recorded. So what was in the March record and in the July FSR are the views of the FPC. They are not prejudged or predecided; they are based on analysis and robust discussion.

Q1 **Chair:** I am just asking you whether you had any discussions with the Chancellor about the likely line that the Bank of England might take in connection with the risks of Brexit.

Dr Carney: I did not have a discussion in terms of the likely line of the Bank of England.

Q2 **Chair:** You did not have any such discussions.

Dr Carney: As you would expect, we had discussions about the most important economic and financial issues. The lines of the Bank of England with respect to these issues are not the lines of the Bank; they are the lines of the independent policy committees. That should be absolutely clear.

Q3 **Chair:** I understand that. I am just asking you about your discussions

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with the Chancellor.

Dr Carney: I did not prejudge the lines of those policy committees—nor could I. That is not the way the system works. That is not the way the system is set up.

Q4 **Chair:** Are minutes kept of your meetings with the Chancellor of the Exchequer?

Dr Carney: For financial stability discussions, there are minutes kept, and they are publicly released, yes, as is required under the remit of the Act.

Q5 **Chair:** Are any other records kept of your private conversations with the Chancellor?

Dr Carney: Firstly, I think it is important that Governors and Chancellors are able to have private conversations about important economic and financial issues; we would be derelict in our duties if we did not. I would expect that notes are taken by private secretaries of those discussions.

Q6 **Chair:** I think there might be merit, to allay public concern, in those being examined on behalf of the Committee by a senior staff member of this Committee. Would you be agreeable to that?

Dr Carney: I would say a couple of things. First, I would be very wary about establishing a precedent that limited free-flowing discussion between future Governors and future Chancellors. I would appeal to “extraordinary circumstance”. I would not want to create a situation—nor do I think it is in the interests of the functioning of the system to do so—where every conversation and every discussion between the Governor and the Chancellor, wherever, is minuted, recorded, or tweeted in real time. That is not in the interests of monetary financial stability.

Chair: I don’t think anyone is disagreeing with that.

Dr Carney: I think that, for the purposes of this discussion, we should make that absolutely clear.

Q7 **Chair:** We have in the past—there are precedents—successfully looked at a number of documents to give the public reassurance. They were highly commercially confidential documents. In the last Parliament, that was undertaken on several occasions—

Dr Carney: Yes, I am aware of that.

Q8 **Chair:**—successfully, and without undue concern being raised. With respect, I think there is merit in going down this road in, as you say, these extraordinary circumstances, with regard to the exchanges you have had with the Chancellor. I would be grateful if I could have your confirmation that you will co-operate with that process.

Dr Carney: I think if we can create a process that relies on the discretion of you as the Chair, and of the Committee, so that we are not putting things into the public domain that can be immediately commercially sensitive—



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Q9 **Chair:** I think that is a reasonable reply. I suggest that rather than prolonging this exchange on this point of process, if you could have a discussion outside this meeting with me or the staffers, we could set up a framework for doing this and agree it in an exchange of letters, as we did last time.

Dr Carney: We will do that, Chair. To be absolutely clear, the assessment of financial stability in March, and my comments as chair of the FPC, which were entirely consistent with that assessment of the committee, and the assessment contained in today's record, released this morning, and this FSR, are the assessments of the FPC. It is an independent body. It is not based on whim or prejudice; it is based on analysis, robust debate, and assessment. It is our responsibility to give these assessments.

The point I will finish with is that we have an obligation to make these assessments. The debate cannot be about whether we should have made an assessment. If we view something as the biggest risk, we have a statutory obligation to make that clear to Parliament. We have an obligation to the people of the United Kingdom to come straight with them. It catalyses action. Hopefully, we will have a chance to discuss what was done in response to this that has helped to mitigate the risk, so that the debate can be about whether we made the right assessment—which is an entirely legitimate debate—and not whether we should have made the assessment.

Q10 **Chair:** I understand. I do not know how much comfort you take from it, but one of the most prominent Brexiteers, Boris Johnson, is claiming that you have done a superb job. I am sure that makes you feel good.

Dr Carney: Any port in a storm, Chair.

Q11 **Chair:** I am not going to give you the rest of the quotation—I think that will do. But as for these four very senior people, there has to be some explanation for their extraordinary outburst. Have you got one?

Dr Carney: I think it is a question for them, quite frankly. May I add that times have changed? The responsibilities of the Bank of England have changed; the demands of transparency have changed. The lessons of the past have been learned.

Q12 **Chair:** Things are different these days.

Dr Carney: Things are different. We don't keep things under wraps. We identify risk; we try to respond to that. We don't look to have exchange rate crises; we look to have exchange rate adjustments.

Chair: Yes, well, these four politicians are deeply and emotionally committed to a cause, perhaps. To misquote Gladstone, it is what happens when very senior politicians can briefly become inebriated with the exuberance of their own verbosity. That is my personal view.

Mr Rees-Mogg: Disraeli on Gladstone.

Chair: As a matter of fact, it's Disraeli in 1878 in response to the

Bulgarian horrors.

- Q13 Rachel Reeves:** I would have thought that events since the referendum fully justify the assessments that the Bank of England made ahead of the referendum that Brexit was indeed the biggest domestic risk to our financial stability. I also suggest that if the Bank hadn't given the warnings and assessment that it did, people would have thought that was very reckless and wondered why, with everything we are seeing in terms of the currency, investment decisions and stock market volatility since the referendum.

I want to come on to what is happening now in relation to financial stability and what the Bank of England are doing to ensure that it is maintained. I want to talk about the counter-cyclical buffer and the impact that the FPC decisions on that will have on financial markets and investment.

Dr Carney, how certain are you that the FPC's move to reduce the counter-cyclical buffer from 0.5% to 0% will generate £150 billion of additional lending? Is £150 billion of additional lending your central forecast or the upper limit? If it is the upper limit, what is the central forecast?

Dr Carney: The first thing to say is that ultimately, from a forecast perspective, it will be more the judgment of the MPC, but the FPC taking a perspective on this is that the determinant of credit growth in the economy for the next little while will be credit demand as opposed to constraints of credit supply.

For example, by way of reference, last year net credit growth in this economy at a time when it was growing relatively smartly and the financial system was functioning quite well was £60 billion net credit growth, secured and unsecured, so £150 billion of potential lending capacity is significant in those terms. If the economy slows in certain credit-intensive sectors of the economy, particularly around property, we would obviously expect less credit growth.

The point of making this adjustment was to take off the table potential concerns about credit supply. The message we are trying to send to households and businesses—individuals with viable ideas who want to engage in transactions—is that they should be able to get credit for those transactions. This is not 2007, '08, '09, '10. The financial system is there. It is well capitalised and working well.

What has likely changed—and this is the judgment of the FPC—is that the risk environment has shifted. I think we all recognise to varying degrees that we are in a situation of increased uncertainty. How long that will last is a subject for debate and will be influenced not just by this Committee, but by decisions of Parliament. But during this period, there may be reductions in credit demand, as we said—reductions in risk-taking. In that environment, we wanted to use the counter-cyclical capital buffer, exactly as it is supposed to be used. The banks are well capitalised; we wanted to create this capacity, which we have done.



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That is a long answer. The shorter answer to your question, in my personal view—we haven't done detailed credit forecasting on this yet—is that it will take some time for that capacity to be used up, considering what credit demand is in a normal year, and given that the risk environment may be more risk averse.

Q14 Rachel Reeves: Do any others want to come in on this or shall I carry on?

Donald Kohn: I think a very important point, here, is the build-up of capital before the event, and the actions of the Financial Policy Committee over the last five years to require higher and higher levels of capital coming out of the crisis. That capital is there exactly for an unknown event to cushion the effect on the banks, to keep them safe and to keep them doing what they are supposed to be doing, which is intermediating between savers and borrowers. Because we have been able to build that up, we are able to say to the banks, "If you have the demand, you can meet that demand without any constraint from the regulatory authorities." So the buffers are there to be used; it is an important signal.

Sir Jon Cunliffe: I would not want to put too much stress on this, but one of the things I think you saw in the crisis was that, when households saw what was happening to the banks, that then impacted on them and their behaviour on consumption and demand. So if you are in a position where the banks clearly have room and the authorities are saying, "You have built up enough capital to be able to continue to lend through a period of stress," you avoid getting that feedback mechanism between households that become scared if they see the banks are in trouble.

Q15 Rachel Reeves: I can definitely see that the build-up of capital since the last financial crisis has put the banks in a stronger position this time and that there is indeed capital that now can be used to lend, but I am still worried about whether there is going to be any impact on actual lending. It could be that reduction in this buffer could mean no extra money in the economy, if people don't want to borrow it. Is that right?

Dr Carney: Well, reduction in the buffer makes it more likely that money will be borrowed, but what will govern the amount of money that will be borrowed will be demand for credit; you are absolutely right.

May I make one other point on this? One of the things that we had concern and the PRA had concern to shut off, was the possibility that by reducing this buffer, we would create the possibility for banks to pay out that capital in dividends or other distributions to shareholders, so there is specific regulatory guidance put in place, as you may appreciate, to prevent that. That is capital that is freely available on the balance sheets of those institutions, and it is available for demand if the demand is there.

Q16 Rachel Reeves: So essentially, additional lending of between zero and £150 billion could be the result.

Dr Carney: That's the capacity. Can I make one other point, which is that the banks also have found they have balance sheet capacity, even if we



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had not done this? Even in a stress scenario, they would have balance sheet capacity, so this is adding more balance sheet capacity. I just reinforce the point that Sir Jon just made, which is that we really do want to make it as clear as possible to households and businesses that credit should be available for the right ideas and the right transactions, be it a mortgage or a new business. That is not going to be the issue.

Q17 Rachel Reeves: The two worries, then, I guess that I would have—and I want to see whether you share them—are, firstly, one that we have touched on already, that there is no demand there, or there is limited demand, so you do not get very close to the £150 billion.

Then I also worry—when quantitative easing happened there was obviously a worry that money did not really feed into the real economy. It did not get lent on to businesses. I guess my worry at this time—and tell me if this is misplaced—is that banks might still be worried about lending the money, even if the capital is there for them to lend, because they might be worried about the credit-worthiness of the people they are lending to, because of fears about recession, investment, single market access and all the rest of it. So as well as the demand not being there because people are wary about making investments, are you worried that banks might not want to lend this money anyway, because they are worried about the risk—or is that misplaced?

Dr Carney: You make two important points in there. First, on the comparison with quantitative easing, this isn't a monetary policy measure; it is a financial stability measure. You can think of this as being much further down the transmission mechanism. It is right on the balance sheets of banks and therefore closer to the real economy, so in that regard it potentially has more immediate power. That is my first point.

The second point is—you are absolutely right—that these are private institutions. Their expertise is risk and the amount of risk they are willing to take. How they price credit will be a function of their view of the general economic environment. That will be influenced by a number of elements, which you referenced. There is a monetary policy question that comes with this and which obviously I will not go into because of purdah, but that possibility needs to be taken into account by the MPC. If the economic output softens with less demand for credit for various reasons, and if the outlook has worsened in the judgment of the MPC, there could always be a monetary response if that is consistent with its remit.

Q18 Rachel Reeves: So it is not impossible that a crunch could still happen in terms of lending if banks decide they don't want to lend because they are worried about credit-worthiness.

Dr Carney: I am wary of using the terms of 2007-08 because we are in a very different situation. That would be a judgment about the economic situation. I will say that, as you would expect, we have been talking to the banks: Sir Jon and I and the head of the PRA with the CEOs of the major banks. Their orientation is outward-facing. Their balance sheets are in a strong position and they are in the business of taking on risk. If they have to, I am sure they will adjust their risk profile, but they have a lot of



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capital and they will need to put that to work so, again, it will not be supply constrained or a credit crunch; it will be a function of the overall economic outlook, which will be determined by decisions away from the financial sector. That is the way I would frame it.

Q19 Rachel Reeves: When you say the banks might address their risk appetite—did you say that?

Dr Carney: They might address their risk appetite, yes.

Q20 Rachel Reeves: So a bank might decide to take more risk at the moment, going into a recession. I can see that overall for the economy it might be good if they all did that, but why would one bank decide to do that?

Dr Carney: No, I said they could adjust their risk appetite. It could go in the other direction.

Rachel Reeves: Exactly.

Dr Carney: Exactly. That is what I was referring to. Giving them more capital headroom by reducing the CCyB reduces a risk that banks worry about: the possibility that their capital would be depleted in a more difficult economic environment and then they would have to reduce distributions to their shareholders. The consequence of giving them more capital headroom, which we can do because, as Dr Kohn said, we have built up capital over the last seven years, is to give them more flexibility. It should make them less risk averse, if I can use a double negative, but that really is the environment we are talking about, and ensure that credit supply is not what is constraining this economy.

Q21 Rachel Reeves: Will you monitor what this £5.7 billion turns into?

Dr Carney: As you know, capital is fungible. We monitor extremely closely all credit aggregates.

Q22 Rachel Reeves: Can you look at the marginal impact?

Dr Carney: We will have discussions about the marginal impact. This is not a Project Merlin or something like that where banks have set aside a certain amount. This is a big macro-financial decision which creates a lot of headroom for the institutions on top of the headroom they already have. What we are trying to do in an environment of uncertainty—we all understand the reason for the uncertainty, which will gradually be cleared up—and potential risk aversion because of that uncertainty is to remove one element of that uncertainty, which is a big element: credit supply, which is the one we can most directly influence.

Q23 Rachel Reeves: One final question. In December last year, when you were talking about the one percentage point increase in the counter-cyclical capital buffer, you said that forecasts would suggest that that would have a 0.1% impact on GDP growth and the level of GDP after three years. Is your view that a 0.5%—what impact do you think that the decision you made would have on GDP growth?



Dr Carney: One of the questions is about the asymmetry of capital rules. In an environment where there is a lot of risk taking, a relatively constructive risk environment, the economy is growing, people are feeling positive about the future, banks have been building capital and they have headroom and there is reasonable credit growth, our estimate—and it is only an estimate but it is based on past history, not only in the UK but elsewhere—is that when you increase capital, it has a relatively modest impact on GDP because it basically becomes the impact on the marginal cost of lending or of holding additional capital. The converse is some evidence—we will see to what extent this is true, and we will be monitoring this—that when capital potentially becomes a binding constraint, or in other words when a bank may be coming down into its buffers, and may interpret its buffers as being binding, which is what we don't want them to do—

Q24 **Rachel Reeves:** I am sorry to interrupt. You were saying previously that even without making these changes to the counter-cyclical buffer, banks would have money available, so it is not at the margins—

Dr Carney: Exactly. So they do have money available, even in a stress scenario, before they get to those buffers—not in extreme stress but in a mild stress scenario. This gives them more room and makes it less likely that they start restraining their activity now in order to avoid hitting those buffers and those constraints in the future, so potentially this has a bigger impact. Isolating that impact relative to all the other effects in the economy will be difficult, but directionally it is stimulative to the economy.

Q25 **Rachel Reeves:** I can see directionally that it is the right thing to do. I just worry that it is not enough.

Dr Carney: I understand your point. The point I make is that we wouldn't represent this as the single silver bullet. It is part—and should be seen as part—of a series of measures including contingency planning and things that other parts of the Bank of England could potentially do that would provide the right type of response to the situation. But measures of the Bank of England are not what is really going to make a difference in this situation. We are going to make sure, to the extent possible, that the financial system supports the necessary adjustment in this economy and helps this economy move forward, but other decisions are going to be much more important in determining the pace of that.

Q26 **Chair:** There are three things that you have done, or maybe you feel that there are more than three. There is the counter-cyclical buffer, there is the additional liquidity, and there is the signalling through forward guidance on monetary policy, with which I opened the meeting. Are there other things you are referring to?

Dr Carney: One thing I would draw the Committee's attention to is that one of the issues that was flagged by the FPC and MPC was potential current account adjustment movements in sterling. That was back in March, in the first quarter of this year. The question was how well prepared our financial institutions were for that potential volatility. The PRA—this is an important point—who are the supervisors of these

institutions had much more intensive supervision about foreign exchange risk in the run-up to the referendum.

To give you a sense of this, we were able to come out on the morning of the referendum and represent the solidity of the liquidity position of these institutions. There was effectively £600 billion in liquidity across the major institutions. Also, importantly, they had no gap risk—in other words, they had no open foreign exchange exposure. So when there was a big change in sterling—and it was the largest change in sterling in the last 50 years, since Bretton Woods was put in place—our banks were able to shoulder it. They had no open position, and there was no amplification of that change. That's incredibly important for market functioning.

I close with this: in the run-up to the actual vote—perhaps people around here had a better perspective and were more informed—market expectations of the outcome of that vote were quite modest, in terms of the probabilities that were being assigned. That's a really risky situation; institutions could have been in a position where they had large open positions, caught the wrong wave—

Q27 **Chair:** Never trust a pollster; never trust a bookie.

Dr Carney: Prepare for the risk event, which is what was done. I would say that the ability of the PRA supervisors to prepare for that risk event was very much reinforced by the judgment of the FPC in March, which was made public. That made a big difference to the initial reaction, in my opinion.

Q28 **Chair:** Before I bring in John Mann on another subject, I want to come to something that I think Mr Kohn might be able to respond on. Are you aware of this report that has been prepared by Republican staff of the Committee on Financial Services in the House of Representatives about HSBC and prosecution?

Donald Kohn: I read a newspaper article about it last night. That's my only level of awareness.

Q29 **Chair:** Perhaps you can give us some guidance. In a nutshell, it is alleged by the Republican staff report that the Attorney General—this is Holder—overruled an internal recommendation by the DOJ's Asset Forfeiture and Money Laundering Section to prosecute HSBC, because of the DOJ leadership's concern that prosecuting the bank would have serious adverse consequences for the financial system. They go on to say that the involvement of the UK's regulators in this "appears to have hampered the US Government's investigations and influenced DOJ's decision not to prosecute HSBC".

My question to you is this: since this is a Republican report about a Democrat Attorney General, is this just par for the course—what you would expect—in the United States? You are very well placed to tell us. Should we put this report at a heavy discount, or is there something that we on this Committee need to look at carefully?



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Donald Kohn: To be very clear, Mr Chairman, I don't have any independent information on this. I think you are—

Q30 **Chair:** But you have a lifetime of judgment about such allegations, which I am asking you to call on.

Donald Kohn: You are correct to point out that the party issuing the report is different from the party that is being criticised. It is a contentious political situation in the United States right now. I think it would be appropriate to wait for—

Q31 **Chair:** You are a long way away—you are 3,000 miles away. I'm sure you feel able to give a full and independent view about whether we should be taking this seriously.

Donald Kohn: I think it would be wise to wait and see how people responded who had information in the Justice Department, or wherever, about what actually happened. I wouldn't pass judgment until I heard the other side of the story.

Q32 **Chair:** The allegation is that we not only still have banks that are too big to fail, but banks with people working in them who are too big to jail. That would be a very serious allegation, wouldn't it, Mr Kohn?

Donald Kohn: I agree, and one that has been discussed by the US authorities. I think the Attorney General in question himself said, at least some time after this, that he didn't think that there were banks that were too big to jail, but I don't have any information about the facts of this specific situation.

Q33 **Chair:** It seems clear that there was some kind of intervention. Were you aware of it? Did the Chancellor discuss this with you, Governor?

Dr Carney: No. I am not aware of—I mean, we have discussions. Can I speak in general terms?

Q34 **Chair:** Well, I would rather you spoke in specific terms. What I want to know is whether you discussed this case with the Chancellor of the Exchequer prior to the decision being taken by the Attorney.

Dr Carney: Which decision?

Chair: A decision has been taken not to prosecute HSBC.

Dr Carney: HSBC is under a deferred prosecution agreement in the United States.

Q35 **Chair:** In conjunction with a fine it must pay.

Dr Carney: Yes. We did not intervene with the Justice Department.

Q36 **Chair:** I wasn't asking you that. I was asking whether you had held any conversations or discussions with the Chancellor. The allegation here is that UK authorities have been meddling—I suppose I could summarise it as that. That is the allegation being made by this Republican report, and I am trying to get to these questions: were you aware of any such



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meddling? Did you have any such conversations with the Chancellor of the Exchequer prior to the decision being taken by the Attorney?

Dr Carney: No. 1, no; No.2, no. To get to what we are supposed to be discussing, which is financial stability, do we have discussions about potential prosecutions, issues around conduct, potential financial stability—

Chair: That's a general point.

Dr Carney: Well, it's not inconsequential, Chair.

Q37 **Chair:** And this is of considerable consequence to it. As the report says, the allegation is that acting against HSBC might have had serious adverse consequences for the financial system, and that judgment had a bearing on whether a prosecution took place. That is why I am raising it with you, Governor.

Dr Carney: Well, from my perspective and my experience, the judgments of the Department of Justice and other US judicial authorities—there are many—are black boxes, and they make their decisions based on their information. We—the Bank of England and the PRA—will have discussions, at their request, with US financial stability authorities in general terms about some of these issues, but we do not have discussions with the US judicial authorities about specific issues so that we can provide a financial stability perspective.

Q38 **Chair:** But just to be clear, prior to any decisions being taken on this case, you had no discussions with the Chancellor of the Exchequer about it. You have not had any input in any way, and you are not aware of any input from UK regulators—after all, it is the Financial Services Authority that is referred to—to counterparts in the United States.

Dr Carney: First of all, I have not read this report. I have not even read the journal or article referring to it, so I am two steps removed from this. Secondly, I have answered the question previously. Thirdly, in these issues, which are serious issues of alleged misconduct, we have to take into account the financial stability implications and manage them—that is not a judicial process; it is a financial stability process—which we do. On the parsing of when I spoke to the Chancellor about these issues, I speak to the Chancellor about a wide range of issues, whoever is the Chancellor.

Q39 **Chair:** I don't think this is parsing. It is a very straightforward question. Did you have discussions with the Chancellor?

Dr Carney: But I answered the straightforward question.

Chair: You have answered it, yes. If you think it is an unreasonable question, that is a matter for your judgment and others outside of this hearing.

Q40 **John Mann:** The risks associated with open-ended commercial real estate funds have been recognised previously, so why did you not make recommendations on them before?



Dr Carney: We did flag these risks in 2015, and the potential for these general risks in the previous year. We made the FCA aware of our concerns. The chair of the FCA is a member of the FPC, as you know. We welcome the FCA's steps. At the start of this year, the FCA said they would initiate a review of these liquidity provisions and investor awareness of those liquidity provisions. We welcome that. The FPC welcomed that in our March meeting. We also used this analysis to reinforce efforts we are making internationally to have better standards for liquidity management for financial stability purposes. Those recommendations were released by the FSB a couple of months ago. They were out for public consultation. They could form part of the G20 package later this year in the Chinese G20.

The other thing we did, Mr Mann, was assess the links between the open-ended commercial real estate funds into commercial real estate and back into the core of the financial system. We made an assessment of the exposure of the core banks to commercial real estate. We can go into that in detail if you would like, but the exposure of UK banks to domestic commercial real estate is quite modest, relative to history, certainly at this stage of the cycle. It is not immaterial—it is an important sector—but it is low, relative to history. That is consistent with our risk assessment.

Q41 **John Mann:** It does appear to have been a little slow to catch up with this problem, which has been well identified in the past. Are there other such open-ended funds—for example, in relation to infrastructure projects—that could be subject to large withdrawals?

Dr Carney: I would say that the open-ended funds with respect to commercial real estate are an extreme case of a more general issue. The more general issue is one that the FPC has been looking into—that there has been a general drift or trend in financial markets of creating funds that have daily liquidity and invest in increasingly illiquid securities. I will give you an example: emerging market corporate debt. That is liquid until it is not, but the investors in those funds have daily liquidity.

Now, it depends on the type of fund. If you're in a UCIT fund, which is a more conventional structure, there is a fairer allocation to the investor who pulls out, because the fund will sell, effectively, a so-called vertical slice of the fund and repay the investor, whereas with an open-ended fund, such as in this case, there is true first-redeemer advantage. The cash in the fund meets redemptions until there is no more cash, and then there is a series of illiquid.

If you had a spectrum of funds, this is at one end of the spectrum, in terms of the illiquidity of the underlying assets—it is hard to sell a building overnight at a fair price—and in terms of the fact that the nature of the redemptions out of those funds advantages those who redeem early. You could make an analogy. It is not too much of a stretch to say that there is run risk, effectively, on these funds. There are certainly spillovers in the area, which is why the committee had identified it. These funds are regulated by the FCA, and the FCA was endeavouring to look into the liquidity issues.



Q42 **John Mann:** Mr Sharp, do you expect to see fire sales?

Richard Sharp: I certainly think the funds are looking aggressively to manage their portfolios, but the benefit of gating gives them the opportunity to try to maximise value for their investors.

Q43 **Chair:** Sorry, I didn't understand that answer. Are you saying that they did the right thing or the wrong thing?

Richard Sharp: No, I think the question was on fire sales and the underlying assets. The issue is that, clearly, they should be looking to liquidate the assets. The gating provisions give them more flexibility, so they don't have to undertake adversarial sales. The information from the market is that they are out seeking the opportunities to liquidate their portfolio, but it is not at any cost. They are going to try to do it in an orderly fashion.

Q44 **John Mann:** What about our exposure to the Italian bank crisis? How severe is that?

Dr Carney: Let me start with UK exposure to Italy. UK banks' direct exposure to Italian banks is less than 1% of common equity of the UK banks. It is 0.9%. UK bank exposure to the Italian economy today is about 11% of common equity; given that it is the third-largest economy in Europe, it is quite modest. That is well managed.

In terms of the seriousness of the situation in Italy and the Italian banking sector, 18% of the total loan stock is non-performing loans. The provisioning of that is less than 50% of those loans. The economic outlook is modest at this stage, and of course the issues with the banks are reinforcing that. Some form of recapitalisation of some of those institutions is likely to be required. That will be in very short order pretty fully informed by the EBA stress test, the results of which are due, I believe, on the 29th, so by the end of the month. There is a macroeconomic risk, and the Italian authorities are certainly aware of it and are looking through to solutions to that. In terms of UK exposure, as I said at the start—I gave you the numbers—it is modest.

Q45 **John Mann:** So our risk of eurozone contagion is very modest.

Dr Carney: Well, that is a bigger question.

Q46 **Chair:** And that is the more important question. It is not the exposure to Italy that matters; it is the exposure to the eurozone risk—the systemic risk of the eurozone as a whole. Perhaps you would like to address that. It is what happens if something goes wrong in Italy and has contagion to France and the rest of the eurozone. That is what we want to know.

Dr Carney: Well, I was answering the question I was asked first.

Q47 **John Mann:** This was my second question. I look forward to the answer.

Dr Carney: We are building up to the global issue.

Q48 **Chair:** We want to get away for lunch.



Dr Carney: I understand. The challenges in Italy and the Italian banking system are at the acute end of the spectrum in Europe. That is our judgment at this stage. There are some issues in some other southern European countries, but they are not of the same scale. Those economies are not as important. When you go to the core of Europe—France and Germany—in France, for example, the non-performing loans of French banks are between 4% and 4.5% of total loan stock. I gave you the figure for Italy, which is about 18%. The quality of capital of the French banks is much higher.

Q49 **Chair:** How do you feel about the quality of French bank reporting?

Dr Carney: I am fine with the quality of French bank reporting. Some of the issues with continental banks, however—this is a big difference with the UK—is that they have deferred tax assets on their balance sheets. We learned the lesson with RBS not to count those assets. By 2019, they will not be allowed to have those assets on their balance sheet. Those are the European and Basel rules, but for the moment they do have them, and in the case of the Italian banks it accounts for 2% to 2.5% of their underlying equity. That is an asset that will go away with time, so quality of capital is a bit of an issue.

If I can broaden the broader contagion question, one of the concerns that this Committee had in March was that a tighter risk environment and tighter risk aversion would increase spreads, challenge funding conditions and challenge equity prices on the continent, and that would have a feedback loop into economic performance. Italy is a more extreme case of that. We see it mainly in equity; we do not see it in the funding costs, given the support from the ECB. We could see some of that in other continental economies, which has potential to slow the eurozone economy. The question is to what degree.

Q50 **John Mann:** I have one final question going back to the Chairman's original questions on your role and process in what some have described as the political field. I have previously defended your right in that regard; I even clashed with my colleague on that. The shock to the system is of course short-term shock. If there is a referendum in Scotland—regardless of the long-term economic arguments; one could put a case that it would be very beneficial or very bad—there could be a shock to the system if in the next two years there was the break-up of the United Kingdom. That would have a market impact. Do you intend to prepare plans, and advertise or publish those plans, should there be a Scottish referendum within this Parliament—that is, before 2020?

Dr Carney: One of the things we learned from the experience of the Scottish referendum was that it would have been better to put in place extraordinary liquidity facilities, announced well in advance, as opposed to having to announce them in the event of a vote going a certain way. It would not have been, in my judgment, the committee's judgment or the Bank's judgment, a good thing to pop up and all of a sudden announce that extraordinary liquidity was being made available, as opposed to what we did. We were able to say on 24 June—I will continue on Scotland in a



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second—"We have already dealt with this. Banks have already prepositioned. They have got a lot of money, and they can have a lot more if they need to. Everything is fine in this regard." In the last Scottish referendum, however, we would have had to announce something, so we learned a lesson from that. That is the first point. If there ever were an analogous scenario—I am not making any prediction about the specific question—being well out in front matters.

Secondly, on what we saw in terms of the risk to financial stability around the last Scottish referendum, a lot of it addressed the headquarters of major financial institutions, the responsibilities of the home Government for those financial institutions, and whether they had the fiscal capacity to meet those responsibilities. Without prejudice to any political evolution, certainly those types of issue should be addressed well in advance of any decision that would be put before anyone. I'll leave it at that.

- Q51 Wes Streeting:** Good morning. I want to ask questions about household debt and some of the issues around consumer confidence. The GfK measure of consumer confidence announced on Friday that it recorded its sharpest drop in consumer confidence since 1994. Given the inevitable slowdown in consumer spending—indeed, some consumers are stopping spending—does the degree of household indebtedness in this context matter?

Dr Carney: The first thing, as detailed in the report, is that the balance sheets of British households have improved, as I think you are aware, over the course of the last several years. The overall debt levels have come down from north of 160% to about 130% of income. The proportion of highly indebted households has also fallen; this is detailed in the report, but the order of magnitude is that it has gone from just under 3%, post-crisis, to around 1% of households that have debt. Service ratios are above that key threshold of 40%. That is the good news. British households have been paying down debt. They are less vulnerable than they were. Crucially, what matters is the economic environment going forward. It is a product of not how much debt you have and how that is distributed, but of the greater growth in the economy, the level of unemployment and where wages are going. To the extent to which the economy slows, these issues may become more prominent.

- Q52 Wes Streeting:** You referenced the figures for where we are now versus where we were in the run-up to the financial crisis. Do you think that financial instability at present poses less of a potential risk to household finances than in 2008?

Dr Carney: Yes is the short answer. One of the things was to take the opportunity to reinforce a measure—now two years old—of this Committee on mortgage lending. High loan-to-income mortgage lending was starting to really ratchet up; the Committee put in place a portfolio restriction, under which no more than 15% of a bank's portfolio could be above four and a half times income. That was carefully judged. We felt that that created enough room for lending to younger households that would have the prospect of income growth over time. It appropriately balanced the



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risk portfolios of those institutions and prevented a broader slide in underwriting standards. We also introduced minimum interest rate requirements and reinforced some other reforms that had been put in place. That helps. I do think that having that in place for the past few years has helped to maintain the underwriting standards, so that there are fewer vulnerable households. If, over time, the economy is to slow, of course that in and of itself makes it less likely that any slowdown would become more severe.

- Q53 Wes Streeting:** In her questions about the counter-cyclical buffer, Rachel Reeves explored what the possible Bank responses might be to the decision taken in relation to consumer lending by banks. It seems that part of the policy response to reduced levels on the CCB is aimed at maintaining household levels of borrowing and levels of consumer spending. Is that a fair characterisation of the policy intention? And if it is a fair characterisation, is it a responsible policy, when it is likely that the economy is heading into recession?

Dr Carney: I won't comment on the last bit of your question. The forecast is for the MPC. I think we have to look at this issue, which is complex, from the perspective of a combination of policies, including underwriting standards, such as the one I have just referenced—an underwriting standard that we have encouraged and the PRA has put in place for buy to let. The combination reduces risk and reduces the proportion of riskier borrowing. Part and parcel of that is to ensure that for those households who want to buy a house or need to buy a flat, or those businesses that want to expand or start up and have viable ideas, the credit is available.

Yes, in a low interest rate environment and with a well-functioning financial system you are going to have risks to financial stability. We have to be alert to those—we have tried to be alert to those—and we really do need a mixture of policies in order to address them. Perhaps the best way to answer is that it would be extremely unfortunate if the hands of the Monetary Policy Committee were tied because we were unable to address financial stability risks and it could not then take action that was consistent with better economic outcomes in the short term.

- Q54 Wes Streeting:** Your response leads me neatly into the issue of house prices and mortgages. I think that however people voted in the referendum, lots of people are now asking, "What does this mean for me and my family?" I think that mortgages are at the forefront of people's concerns. The short-term Treasury analysis forecasted that house prices would fall between 10% and 18%, and for people like myself who would like to be on the housing ladder, that is not a bad thing, necessarily. But if that were to occur, what levels of negative equity would we see among UK households, and what work has the Bank done to forecast some of those consequences?

Dr Carney: We have done a series of stress tests for much more severe housing outcomes than that. The 2014 stress test had a 35% house price fall—that is not a prediction; it's a stress. 2014 was in the order of a 30% house price fall. In both cases, there was a macroeconomic scenario that



was consistent with a rise in unemployment as well, because one thing that British households do is pay their mortgages unless they absolutely can't, and the reason they can't is invariably connected to joblessness. We have run those stresses, and we have banks capitalise in a way that is consistent with those stresses—capitalised in such a way that they can withstand those stresses and continue to meet whatever credit demand there is in that macroeconomic environment.

I will point out, just to give an order of magnitude, that in the report, on page 18, there is an assessment that looks at what had happened to bank equity prices at the time the report was published. It and imputes how much of a stress is implied if all of it were ascribed to economic outcomes—in other words, if there was a slowdown in the economy and a fall in commercial and residential real estate prices, and then there were various defaults. It works out to about half as big as the stress tests that we had run, which you can see fairly easily in chart 8.2.

- Q55 **Wes Streeting:** It would be good to get a range of views, from across the panel, on some of my next questions about what we might see in the medium term on how mortgage rates will respond to financial instability. The short-term Treasury analysis of Brexit forecast an increase in household borrowing rates by 70 basis points. So far, mortgage rates have fallen post-referendum in line with the falling yields in the bond markets. It would be good to get your views across the panel on how you think mortgage rates will respond in the medium term to financial instability. Sir Jon, do you want to comment on that?

Sir Jon Cunliffe: I think you are seeing two separate effects happening on bank lending spreads. One is the overall fall in the yield curve. At the same time, there has been some increase in their cost of borrowing, and some increase in the cost of equity. When you put the whole thing together, in net terms at the moment, their all-in cost of debt funding has not been affected, but we will have to see how that plays out in the future. To the extent that there is a risk premium, it now goes into UK assets more generally. I think we've probably seen the start of financial markets putting a risk premium on UK assets, simply because of the uncertainty around that, if only that. That will then feed through to bank lending spreads.

Donald Kohn: I think Mr Cunliffe has pointed out the right things. One is what is happening to the base level rates. That is for the Monetary Policy Committee, not the Financial Policy Committee. The other part is the risk premium that might be charged to UK banks because of the perception that they are a little bit riskier, or to UK households because of the perception that lending against residential real estate is a little riskier given the uncertainty about how all of this is going to work out. So there are two effects balancing out.

I think our job as the Financial Policy Committee is to make sure that there is no constriction on the supply of credit amplifying whatever adverse effects come from this shock to the UK economy. That is what we have worked on with the CCyB, with the build-up in capital beforehand—



offsetting, or things working in different directions. We are trying to make sure that whatever adverse consequences there are, they are not amplified by the financial system, and that it is an honest assessment of risks. It is encouraging that despite the very sharp drop in bank equity prices, the risk premiums charged to banks in debt markets have gone up a little, but not very much, and very much less than you might have anticipated from past episodes of very sharp drops in equity prices.

Q56 Wes Streeting: Before I take Mr Sharp's view, why do you think that has been the case?

Donald Kohn: Because of the build-up in capital that happened before. The Bank started in a much stronger position. While equity investors have questions about the extent to which banks will be generating profits in the future in this new environment, they apparently do not have major questions about whether they will actually survive or not. They are confident in their resilience, but less so in their earning power.

Richard Sharp: I do not have too much to add, other than to point out that one feature of the housing market, obviously, is the buy-to-let market. We had a very large cohort come in just before the referendum, which was obviously tax-driven. I would certainly expect that the banks will want to see what regime we are in, in terms of house prices, before they go back to aggressive lending in the buy-to-let market.

I would also point out that some of the consumer market was assisted by the challenger banks, which have also seen sharp share price falls. Those tend to reflect an expectation that they will grow their portfolios significantly more slowly in future. Similarly, I suspect that many of the relatively new institutions will want to look with some patience to see how the market develops before they get back into aggressive lending mode.

Sir Jon Cunliffe: I might be able to add a helpful metric to the point that Mr Kohn made. If you look back at the financial crisis period, or the euro crisis period, for roughly similar falls in bank equity prices, you would have seen their debt spreads go up by more than double. I think Table B.1 on page 19 shows that. What you are seeing now are concerns about banks' profitability and returns, not about their robustness and resilience, which is why the share price can drop, but the creditworthiness and solvency of banks is not in question, and the debt spread does not increase.

Chair: Well, they could always have a look at their remuneration, couldn't they, and trim that back a bit?

Q57 Wes Streeting: Sticking to the issue of the impact on household disposable income and consumption, one of the things that concerns me is that households have not seen an increase in mortgage rates since the financial crisis, and many households will have no experience of an increase in their mortgage rates, because of the conditions that they have enjoyed since they took out their mortgages. Given the number of times that we have returned to the issue of financial awareness and of the lack of financial literacy on the part of consumers, some households



will simply be unaware that their mortgage rates can increase. So I guess there are three dimensions to that challenge. First, in broad terms, how can the Bank communicate to households that their disposable incomes may change in the medium term through no fault of their own? How can the Bank make sure that people are thinking now about planning their finances appropriately? Also, what do you think, with all of this taken together, the impact on household disposable income and consumption will be? Some mortgage owners will tighten spending because their mortgage has become more expensive, but some homeowners—buy-to-let landlords, for example—will presumably pass that cost on to their tenants. What consideration has the Bank given to those impacts taken together—disposable income and consumer spending?

Dr Carney: To answer the first part of your question first, in terms of guidance or perspective for households, the measures are reinforcing—in communication terms; we don't have to change them—what this Committee did two years ago, which is to say, "Think about a stressed interest rate. Think about an interest rate being three percentage points higher than today. Think about your ability to service debt if that were to happen." Now, I recognise that in this current low-rate environment that seems relatively unlikely, but it is also a good way to think about a potential shock to income, or disappointment on future income, and about having enough headroom for an individual taking out a mortgage to ensure that when times are a little more difficult the individual can meet that and be comfortable and not concerned about it. So we are reinforcing that. We certainly reinforce it—it is there for the banks, and those are the standards that the banks and building societies have to meet, but for household understanding that may help.

On the second thing, you are asking one of the key macro-forecasting questions, which is one of the key judgments that the MPC is just in the process of making. So it is the right question, but today, unfortunately, is not the right time to answer it. The more fulsome answer will come with an MPC forecast and a hearing like this that follows whenever it does after 4 August.

Donald Kohn: If I could add just one thing, it is that we tested the banking system against a sharp rise in interest rates in our 2014 stress test, to make sure that even if households had problems, the banking system would have enough capital to continue to lend—and it did, under very severe stress, with rising interest rates and sharply falling house prices. So it would not be a good situation for households perhaps, but at least it would not have that amplification for the banking system.

The other point to make is that the most likely scenario—so maybe I shouldn't be saying this, because it is a little MPC-ish—for a rise in interest rates is a strong economy. It is possible to have a rise in interest rates without that, if inflation expectations increase or something, but it does not necessarily have to be all bad news.

Q58 **George Kerevan:** I want to take the questioning in the direction of the bond market and yields. Let me start by being a little counterintuitive.



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Suppose one of the issues with regard to risk lies not in there being too little liquidity but, in fact, in there now being too much. The response to Brexit around the globe has been to loosen fiscal monetary taps. We have around \$12 trillion of debt trading at negative rates and in the UK we have started to experience ultra-low yields. In your collective wisdom, what might be the risks to financial stability that ensue from low yields?

Dr Carney: I will build on a point just made, which is that one of the risks is that you get a snap-back in yields because of changes in growth or inflation expectations, changes in policy and policy uncertainty. A variety of factors could cause a snap-back, and that is certainly one of the risks against which we have to stress our institutions. It is particularly when it becomes conventional wisdom that it is not going to happen that you have to make sure the institutions are prepared—in terms of both capital and risk management—for that “fail event” possibility. We did it in 2014, and there is another round of stress testing this year. This is the type of thing one looks to.

The second point I would make is about understanding, in part, some of the messages behind these extremely low rates. There is a chicken and egg element to it, which is that you can start with central bank policy or you can start with the underlying fundamentals that are driving these rates, including if one takes risk aversion as a fundamental. Central banks are then having to set policy consistent with those fundamentals in order to provide appropriate stimulus. What is unusual about the current environment, and what has been amplified, is that you have extremely low interest rates and very high equity risk premium.

The equity risk premium in the UK has been rising over several years and has gone up quite substantially in the past few weeks. That is consistent—we have done analysis, and there have been speeches and reports and other things around this—with an investor community as a whole that is taking out some insurance for extreme risk events. The insurance is taken out in the bond markets, so the safety of money, even with negative interest rates, is valued as a hedge for a portfolio. There is obviously an extreme element there. I won't make a monetary policy comment about that path, except to note that we believe we have the tools to continue to meet our responsibilities for both monetary and financial stability at the Bank of England.

Q59 **George Kerevan:** Sir Jon, can we pursue this? In what sense does a period of low yields lead to bank instability by undercutting bank income and therefore being one of the drivers of the collapse in bank shares?

Sir Jon Cunliffe: The thing one has to look at in the longer term is whether banks can make a return for their shareholders, whether they are investable, and whether they can accrete capital—whether they can generate profits that they can use internally to generate capital. If you look at whether they can make a margin on their lending when interest rates are very low and how big an issue that is for them, that is one, but only one, of the factors that goes into whether they are investable, whether they can make a profit and whether they can accrete capital.



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It is different for different banks and in different jurisdictions, but certainly if you look at the UK banks prior to the referendum, they were indeed generating quite a return on their domestic lending and on their retail mortgage lending, and some were on their commercial lending. Rates of return were sufficient to generate a return on equity that would have allowed those things to happen. In that period, looking at UK-focused banks, you didn't see that low rates were causing one to have financial stability worries about accreting capital and profitability. Of course, they have not made a profit—some have, but on average UK banks have not been profitable and have not generated the return on equity that shareholders have looked to, but there have been other things that have been to do with that. Some of them have been going through the costs of restructuring, changing their business model, their investment banking activities and conduct costs. The costs of conduct or misconduct, both in the UK and abroad, have made very heavy inroads into their profits. If I look backwards, I think I would say that banks focused on the UK economy were making returns and the like. Going forwards, those are some of the issues that we will have to think about as part of the general economic forecast.

Q60 George Kerevan: Are you therefore implying that the low share valuation of British banks is a legacy issue, rather than being primarily to do with the EU?

Sir Jon Cunliffe: I think that investors are looking—when it comes to conduct, there is uncertainty about how large future conduct costs will be. From memory, I think that British banks have paid out £10 billion a year for the past four years in misconduct fines and the like. I think that investors are looking to know when the end to that will be and what else might be coming down the pipe. The very unfortunate thing about misconduct is that it has gone on for longer than people would have thought with new things being discovered.

I think investors are looking at whether banks can make a profit and what sort of profit they make in a low-interest environment, but they are also looking at whether banks have got a change of business model, saying, "Do you have an investment bank? Does that investment bank have to restructure?" We saw at the turn of the year, when there were concerns about emerging markets, that the share price reflected that, in that banks that were exposed to emerging markets went down more. I think that investors are not just looking at low interest rates. They are looking at an amalgam of possible impacts.

Q61 George Kerevan: But we have to deal with both.

Sir Jon Cunliffe: Banks have to deal with all that, yes.

Q62 George Kerevan: If yields remain ultra-low to negative, that has a—

Sir Jon Cunliffe: It is both the level of yields and the slope of the yield curve.

Q63 George Kerevan: Mr Kohn, care to add anything?



Donald Kohn: I think that what is difficult here is to think about the alternatives. To build on what the Governor said, there are global forces driving down these interest rates. If they were somehow propped up, I am not sure that that would be good for bank profits. In fact, I am pretty sure that it would not be, because if they were propped up above what they needed to be, that would imply a weaker economy, a recession, drops in property prices and so on. The banks, as Sir Jon said, will have to adapt their business models to this world of lower interest rates, with perhaps less investment banking income and so on. You cannot look at the interest rates separately from the economic environment in which they are occurring.

Q64 **George Kerevan:** Let me put it in another context, then. If you go back to the end of the 1990s, when we had the Asian crisis and the dotcom bubble bursting, the response of central banks was to loosen liquidity, and that had an impact on yields. While that was a short-term solution, it did not prove to be a medium-term or long-term solution, because we then ran into the banking crisis of 2008. What I am probing is whether the response of the banking authorities throughout the globe to Brexit is a short-term palliative that makes matters worse in the medium term. Ultimately, it depends on ultra-low to negative yields, and that ultimately will undermine the banking system unless something emerges to change the whole picture.

Dr Carney: May I make a general point that goes to the structure of the Bank of England and the responsibilities of the various committees, including this one? I suggest—you have to hold us to account—that this institution is best placed to deal with that type of situation that you are describing. I entirely agree with Mr Kohn about broader global forces. We have supplied some Bank of England research about what is affecting the overall equilibrium rate of interest and giving a sense of longer-term forces that are putting us in this position.

There is absolutely an issue that we have flagged with respect to monetary policy measures that are taken with the best of intentions that interact with the financial system in ways that, at a minimum, lessen their effectiveness and, in some extreme cases, could be counterproductive. I am not commenting on anything in particular, given the purdah, but the general point is that the FPC meets regularly now, thanks to the changes in the Bank of England Act 2016, which this Committee helped to see through.

The FPC meets regularly with the MPC on issues of mutual interest. One of the issues of topical mutual interest is the interaction between monetary measures and the financial system and the overall impact of that on the economy, not just in the short term, but in the medium and longer term. And that draws on the expertise of the individuals on the committee, and the analytic fire power within the PRA and the financial stability arms of the Bank of England. These are real issues and it has to be well thought through. We cannot give with one hand and take away everything with the other. We need to understand the net impact of our measures.



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- Q65 **George Kerevan:** Looking at that further, last month's UK 30-year gilt sales were showing yields of 2.8%, or something like that, right throughout the 30 years. What does that tell you? What conclusions should we draw about the market's view of British economic growth over that period?

Dr Carney: Well, if you drew an arithmetic conclusion based on the Bank of England meeting its 2% inflation target and there being any term premium between today and the long-term, it would suggest 30 years of stagnation. I would underscore that there is a big element of what is happening in markets which, in my opinion, is a hedging of downside risk. This is an economy which is highly flexible, which has tremendous strengths reinforced by a financial system that can withstand huge shocks. There will be adjustment and growth in this economy without question.

You are asking an arithmetic question: what would conventional analysis tell you in terms of the underlying real performance of the economy from the bond market and I have given you the answer. But I would go to the latter part of my answer, which is I would not take that core signal in terms of the prospects of this economy; they are much better.

- Q66 **George Kerevan:** Okay, so a flattening of the yield curve, which in the past may have indicated something dangerous around the corner, is just something we can ignore?

Dr Carney: From a financial stability perspective, the danger is that the underlying fundamentals will reassert and the recognition in terms of the growth path will be an adjustment of the slope of that yield curve. The question is how smooth or how abrupt is that adjustment going to be and how well prepared is the core of the financial system for that adjustment. We take that very seriously, because we think it is something that will happen at some point. So through our stress testing, through our supervision, we help to ensure that those institutions are prepared.

Donald Kohn: I think we included a bounce-back in the term premium in our 2016 stress tests that are in the banks right now, so at least we will test the resilience of the banking system against this.

- Q67 **Mr Rees-Mogg:** In many ways I was hoping we would come on to the issues that came up during the Brexit campaign later, when we were further from the heat of battle. Because they have come up in the Chairman's questions, I think there are some important things to follow through on. First, Governor, do you think it is important that the Bank of England, like Caesar's wife, should be above suspicion?

Dr Carney: Yes, I do.

- Q68 **Mr Rees-Mogg:** And that it is in the public interest that the Bank of England not only should be independent, but should be seen to be independent?

Dr Carney: Yes, I think it is. I think it is also in the public interest that public authorities respect the independence of the Bank of England, and



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recognise when independent, analytically based objective judgments are made by the committees of the Bank of England.

Q69 **Mr Rees-Mogg:** Would it be fair to say that politicians do seek to influence even independent bodies?

Dr Carney: In my experience, politicians—well, in my experience in independent bodies, casting my mind back to my time at the Bank of Canada, I am not aware of political influence, no.

Q70 **Mr Rees-Mogg:** Going back to the congressional report that has been mentioned, does it surprise you that the Chancellor of the Exchequer sought to influence not the Governor of his own central bank but the Governor of a foreign central bank? George Osborne wrote to Mr Bernanke about “very serious implications for financial and economic stability, particularly in Europe and Asia”. I am a bit surprised that you know that a senior politician seeks to influence the Federal Reserve, but think he wouldn’t try to influence organisations within his own country. It seems unlikely.

Dr Carney: I don’t accept the first point of your statement, which is that I “know” that. I know it because you’re looking at your iPhone; I know it to that extent. I wasn’t party to any of these conversations, and I am not aware of these conversations at first hand.

I go back to my previous testimony. As I also said in my previous testimony, on that specific situation, it is the case—I am aware of this not just in my role as Governor of the Bank of England but as chairman of the Financial Stability Board—that central banking authorities, when there are serious issues of misconduct, consult with their foreign peers to assess the potential financial stability implications of that. That is the case, as you would expect. On the specific situation, questions about the Chancellor’s conversations should be directed to the Chancellor.

Q71 **Mr Rees-Mogg:** The question I was asking was the broader one of whether politicians seek to influence independent bodies. You were saying that broadly they don’t, which I am quite surprised by.

Dr Carney: No, Mr Rees-Mogg. What I said was that in my experience, have there been efforts to influence me in my role as Governor of the Bank of Canada, Governor of the Bank of England or chair of the Financial Stability Board—the three public body roles that I have held or currently hold? No. There have been efforts to inform me in those roles about people’s perspectives and information. That is entirely legitimate. You would expect me to be informed. I am informed by the questioning of this Committee.

Q72 **Mr Rees-Mogg:** I don’t think it is illegitimate for politicians to try to influence you; I think it is illegitimate for you to respond to that pressure. I think the two are separate. One can do one, and you would be right to resist it if it happened.

Dr Carney: I am distinguishing between informing and influencing, yes. Influencing is to have been influenced by.



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Q73 **Mr Rees-Mogg:** I wouldn't read that into it. I would view that as the effort to—I think we are broadly agreeing, but we are squabbling about one word. I think that politicians do try to get their view across, if I can put it that way.

Dr Carney: Inform, yes.

Q74 **Mr Rees-Mogg:** And it is your job to make your own judgments, regardless of this influence.

Dr Carney: Yes. I am perfectly capable of doing that.

Q75 **Mr Rees-Mogg:** That's fine. That is where I wanted to get to. Then there is the question of the lack of appearance of impartiality on the part of the Bank. If we can go back to 21 October 2015—Trafalgar Day, as it happens—the Bank published a paper, "EU membership and the Bank of England". You made it clear that it was "solely concerned with how EU membership affects the Bank's ability to achieve our core objectives of maintaining monetary and financial stability", but then you waxed somewhat lyrical about the benefits of membership of the European Union. You said that "the evidence suggests that UK has successfully harnessed the benefits of openness afforded by its EU membership while avoiding some the drawbacks of reduced flexibility" from which its continental neighbours suffer. To what extent does that relate to the Bank's remit of price and financial stability?

Dr Carney: Well, the question is the dynamism and the resilience of an economy, and the judgment is whether being part of a broader market, being part of a broader financial system, with the risk-sharing benefits that come from the latter and the productivity and potential growth benefits that come from the former, is net additive or detractive. Does it add or detract from financial stability? The judgment of the report is that it added.

That said—as you are aware, I hope, having read the report—we also flagged that the tighter integration that comes with being a member of the European Union also brings exposure to risks, and the most important risks, and pertinent and immediate risks, from that membership relate to the unfinished business of the eurozone. So there are positives and negatives and then there is also the last aspect detailed in that report, relating to how membership of the European Union influences our ability, and particularly that of this Committee, to promote financial stability, to take action to address issues as they arise.

Q76 **Mr Rees-Mogg:** That is a good long answer, but it doesn't really come to the paean of praise that you gave the European Union in your speech. It is absolutely fine for you to talk about your core objectives, which is what you said you would do, but the quotation I gave you goes much further than that, saying that the net benefits of European Union membership are greater than the drawbacks. That is then becoming your political opinion. That is the difficulty of the Bank moving away—

Dr Carney: It is not a political opinion; it is an economic opinion. It is a judgment—a judgment based on analysis. The very serious issues that you



all, as parliamentarians, with your fellow parliamentarians, will address in the coming years—weeks, months and potentially years—are what aspects of that relationship should be adjusted and which retained—retained, altered, adjusted, ended; however it's done. And one of the considerations you, I am certain, will take into account is the net impact of those changes on the economic and financial stability of the United Kingdom. This relationship clearly is relevant to economic and financial stability; and the judgment, analytically based and objectively given, is that on net it was beneficial. How it is adjusted—could you come up with a new relationship that is more beneficial? Of course, as you know, Mr Rees-Mogg, the report does not look at alternate relationships between the United Kingdom and the other 27 countries. It doesn't do the counterfactual analysis; it does it relative to what had happened before.

Sir Jon Cunliffe: Having been associated a little bit with the report, I would just make a number of points. One is the point the Governor made. The report did not take a counterfactual about what would have happened had the UK never been a member, and it recognised that a number of changes were not to do with the membership of the European Union but happened in the period of membership. Secondly, it did not attempt any counterfactual about what the alternative might be. Thirdly, it looked at the risks through openness and those channels. Fourthly, it looked at the way in which financial regulation had impacted the UK and financial stability, and might in future.

The last point I would make, on the dynamism issue, is that the dynamism of an economy is its ability to grow without generating inflation pressure. So this is not just an issue of financial stability; there is an issue of monetary policy here, which is: to what extent can the supply side of the economy meet demand without generating inflation pressure? I'm in purdah, I'm afraid, as well. *[Interruption.]* I'll just finish the point; it's not very long. One of the things that we will have to look at, from the monetary policy point of view, is the implications of the current position for the supply side of the economy; it's our job.

- Q77 **Mr Rees-Mogg:** I wasn't really focusing on the report; I was focusing on the Governor's speech in launching the report and the pro-EU tone of that. Let me move on to the evidence you gave this Committee on 24 May. You were asked what would happen in terms of interest rates and you said, Governor, that it could result in either a lower or a higher Bank rate. Your steps—admired steps, if I may say so—after 23 June were immediately to loosen monetary policy. Was it ever realistic that monetary policy would be tightened in the event of a Brexit vote? Or was what you said then simply helpful to the position being taken by the Chancellor?

Dr Carney: Recognising—

Mr Rees-Mogg: Recognising that you can't say what is going to happen in three or four years.



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Dr Carney: Exactly. I would draw your attention to the conclusions of the Monetary Policy Committee at its most recent meeting on 16 June, which was consistent with its May meeting. These are nine independent individually accountable people voting, unlike the FPC, which in general forms a consensus, though it could have a vote.

The nine independent voting members of the MPC, every single individual on that committee, said the following: "In such circumstances"—being a vote to leave—"the MPC would face a trade-off between stabilising inflation on the one hand and output and employment on the other. The implications for the direction of monetary policy"—whether it went up or down—"will depend on the relative magnitudes of the demand, supply and exchange rate effects."

That was the judgment of the MPC. The stance of monetary policy, direction of monetary policy—tightening or loosening, up or down—will depend on those relative effects. Each member of the MPC, as it sits down this week, next month, the following month, will have to take an assessment of the relative magnitudes of those effects—demand, supply and exchange rate—and chart in their individual opinion, which will be aggregated up to a collective decision, what are the implications for monetary policy.

If I may say, Mr Rees-Mogg, what I said there was consistent with the entire committee, so I did not mislead this Committee by representing the views of that committee in a way that was inconsistent.

Q78 **Mr Rees-Mogg:** I wouldn't dream of accusing you of misleading, which would be unparliamentary, even in a Committee. The point I was making was that you must have thought at the time that it was very unlikely that the result of the vote to leave the European Union would be a monetary tightening.

Dr Carney: I will appeal to purdah in answering your question. I will welcome that question when we are back after the August inflation report.

Q79 **Mr Rees-Mogg:** I am happy for you to appeal to purdah. I have one final question, which is the one that went most unanswered in our previous discussions on this. Would you do the same in a general election?

Dr Carney: What precisely?

Q80 **Mr Rees-Mogg:** In terms of the overall approach of the Bank of England to an Opposition party's economic policy. The example given in the brief is a good one. If a Government proposed that it would finance Government spending by printing money, would the Bank of England come out and say that that would create an economic risk? Or would it maintain its reluctance to intervene in political affairs?

Dr Carney: First, this was not a general election. It was a single binary and irrevocable decision, as opposed to a general election, which leads to—

Q81 **Mr Rees-Mogg:** It's probably more important than a general election.



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Dr Carney: Secondly, we observed purdah during the official purdah period, with the sole exception, which we flagged to this Committee, that the MPC minutes had to come out during that period. We had a responsibility to release those minutes, though those minutes were consistent with the minutes of the May meeting. It was not new information or a new perspective, if you will, in those minutes. So we observed purdah, and we also observed our statutory responsibilities to identify the most important risk to financial stability.

Q82 Mr Rees-Mogg: In the statutory requirements, the Bank is not required to say anything that would not be in the public interest. We established at the beginning of the conversation that it is in the public interest for the Bank of England not only to be independent but to appear to be independent.

Dr Carney: The assessment of the Financial Policy Committee that issues around the referendum were the biggest domestic risk to financial stability did several things, apart from just meeting our statutory obligations, which should be the alpha and omega of this discussion. It also catalysed action by the PRA, from the supervisory perspective, on open foreign exchange positions—I won't go into detail on that. It catalysed action by the Bank of England in terms of liquidity facilities being put in place. It catalysed actions by private financial institutions to manage risk in the run-up to the referendum. It also catalysed action between the Bank of England and foreign central banks to put in place a series of other contingency measures, which have not proved to be necessary to be used. All of those initiatives, which spring from objective, analytically based analysis, helped to ensure that this system could adjust as smoothly and effectively as possible to put this country in a position to take maximum advantage of the decision of the people of the United Kingdom. We make no apologies for having done our job and helped others to do theirs.

Q83 Mr Rees-Mogg: Did the Bank of England consider whether it was in the public interest to risk its reputation for impartiality?

Dr Carney: The Bank of England, and the Financial Policy Committee, is well aware of its statutory responsibilities and is perfectly capable of discharging those. It did so in a professional, objective and analytically based manner.

Q84 Mr Rees-Mogg: Did it consider this risk?

Dr Carney: Mr Rees-Mogg, I think that the question, to be honest—

Mr Rees-Mogg: This is my final question. Did it consider that risk?

Dr Carney: I think that those who cast it into question should consider their motivations and their judgments.

Q85 Chair: The Brexiteers are divided about this. Jacob has concluded that your position, Governor, is untenable. Boris Johnson is saying that you are doing a superb job. If I were to go around the House of Commons, I would find a wide spectrum of views. There is a spectrum of views on this Committee as well.



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The first conclusion I invite you to draw from all of this is that once the Bank of England had been given statutory responsibility for financial stability, it was inevitable that sooner or later, the Bank would be drawn into areas of what are considered political controversy, because the responsibilities that you are now seeking to exercise or fulfil are ones that have hitherto rested solely or virtually solely with the Chancellor of the Exchequer. Therefore, there may be more to come, and this may not be an exceptional event.

That brings me to one question in this area. I am surprised—why are you not pointing out that this responsibility is new, in your replies? With respect to differentiating between how the Bank might behave in an election and how it has behaved in previous elections—a point made in the earlier set of exchanges with Jacob—why have you not observed that there has only been one general election in which you have held that responsibility? That, too, is untested territory. The very question you were asked is something we cannot possibly know the answer to.

Dr Carney: My answer at the start referenced how things had changed. Granted, I did not go into detail about things that had changed, including the statutory independence of the Bank and its committees. But things have changed, and they have changed for a reason—ignoring risks did not work out that well in the past. In terms of the experience with this new model—the 2012 model, updated in 2016—

Q86 **Chair:** Which is unique for a major central bank.

Dr Carney: Which is unique—we do have experience of one general election campaign, which I thought would have been evident in our previous exchanges, Mr Rees-Mogg. That was a campaign where there was a wide range of policies and a wide range of potential outcomes. As I think people recognise—certainly it has been my entire lifetime experience—exactly which policies are implemented at which pace over the life of a Parliament is often quite different from the order in which they are written down in the manifesto, whereas with a single binary decision about in/out, that is not the case. That is different. It is unique.

Q87 **Chair:** You have gone back to the earlier reply that you gave some weeks ago.

Dr Carney: I am merging the two, if I may.

Q88 **Chair:** The second conclusion that I want you to comment on is this. It seems to me that if the FPC or you had remained silent about these risks prior to Brexit, you would have been criticised for not fulfilling your statutory duty. Furthermore, given the market volatility and turbulence since the 23rd, that criticism would by now have been extremely severe. Perhaps I will ask Jon Cunliffe to comment on that, since he has a good deal of political experience.

Sir Jon Cunliffe: Maybe I could pick up on what Mr Sharp said, and maybe also answer Mr Rees-Mogg's question about whether one considered the reputation. I speak as a member of the FPC—I am accountable as a member of the FPC. It weighed very heavily with me that



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one could see that asset prices were moving in relation to the referendum. We could see how, when the odds moved, sterling moved and other things moved. It certainly weighed with me that were the referendum result to be a vote to leave and were there to be instability and large movements in financial markets and we had not identified that, I would have worried about the reputation of the FPC and its ability to do its job.

I know the Act. I know that I could have concluded that it was in the public interest not to have said anything, but then we would have been in a position where in my mind, financial market participants and maybe the broader public might have lost confidence in the ability of the Bank of England to give an accurate picture, so when we gave a picture now that we thought the financial sector was robust, that would also be called into question and we would look as if something was surprising us when in fact we had thought about it and taken action.

I did weigh those things in my mind, and looking at the Act and the duty, I certainly felt that I would be in a difficult position as a member of that committee had this happened, markets moved and people said, "You were put there to do that job"—I went through the financial crisis and I can remember what it felt like to be behind the curve—"and you didn't do it." Yes, that did weigh on my mind.

Dr Carney: I will supplement that very briefly. If you have not identified the risks, you do not have credibility when you assert resilience. That is the bottom line. I was a central bank governor through the 2008 financial crisis. You have to come straight with people about where the risks are and then have a clear plan to address them. You cannot govern by assertion. You cannot wish things away. That perpetuates a financial crisis and reinforces it. So, I came to exactly the same conclusion as Jon.

Q89 **Chair:** Picking up your point about perpetuation of a crisis, do you think this is a short-term risk or a longer-term risk now that we have had the event?

Dr Carney: No, the financial stability risks have been more immediate. We then shift into economic risks and opportunities, which will very much be determined by the decisions of Parliament.

Q90 **Chair:** So this is a short-term financial stability issue.

Dr Carney: Yes. I would say that we remain vigilant as a committee around the issues related to this.

Q91 **Chair:** Not a long-term financial stability issue.

Dr Carney: Well, long-term issues—it goes back to this issue of stagnation. We were talking earlier about Italian banks. Longer-term, the underlying performance of the economy is one of the key determinants of financial stability, and the decisions—again—that Parliament will take in coming years will be hugely important in determining that trajectory. Our job is to make sure the financial system functions well and to help with the adjustments that are consistent with those decisions.



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Q92 **Chair:** And to that extent, it is the job of the FPC to make judgments about political decisions that might have a bearing on financial stability.

Dr Carney: It is certainly to inform those, yes.

Q93 **Helen Goodman:** I am sorry I was not here for the first hour, but you will all know there is quite a lot going on at the moment. I thought that Jacob was going to ask you some questions about sterling, but he has not, so I will ask you a couple of questions about sterling before I come on to some questions about the current account. The fall in sterling since 24 June has taken us back to—at one point—a 30-year low. I know we bounced up a bit again this morning. The falls have not been as sharp as when we left the ERM in 1992. Do you think that the impact on the economy of these falls is more severe or less severe than that occurrence?

Dr Carney: Well, I'm going to appeal to MPC purdah a bit on the ultimate impact on the economy, but I will answer as best I can. With the '92 year-end experience, part of the issue around that was an overvalued currency.

Helen Goodman: I remember.

Dr Carney: It was overvalued in an arrangement for a reason that ultimately didn't succeed, so that the movement in the currency initially was correcting an overvaluation; it may have had an overshoot. It took a number of months to find its bottom, as you will recall.

The issue here, well flagged up front, has been the adjustment in the level of the currency, consistent with the underlying adjustment in the economy. There will be a new trading relationship—economic relationship—with Europe; that is a change to the terms of trade. It will take a period of time for the economy to adjust to that. This is a flexible, robust economy with a good financial system. It can adjust, but the exchange rate move can help with that adjustment. It can help with the relative importance of the traded sector versus the domestic or so-called non-tradeable sector. Also, the adjustment in the level of the currency will be a product of investor perceptions of risk and risk premium that develop, or not, on UK assets. As the FPC and the other arms of the Bank of England, we want to make sure that none of those risks are financially related.

I will appeal to Sir Jon's description of the banking sector—I think you were here for that. Whereas the equity prices have moved because of concerns about returns and, to some extent, related to the economic environment, the cost of their funding really hasn't moved. It has moved up a bit, but effectively it hasn't moved. That suggests that the financial risks are not there. The bigger risks—or uncertainties or opportunities, pick your word; we are on a Financial Policy Committee so we tend to speak in terms of risk—relate to the understandable uncertainty at present about the nature of the future relationship with Europe and the rest of the world, and the process by which to get there and the ultimate outcomes of those discussions. The exchange rate is helping in this circumstance.



Q94 **Helen Goodman:** Thank you. Mr Kohn, do you want to add anything?

Donald Kohn: The experience of, really, the last couple of decades is that the responses of economies to changes in exchange rates, in terms of imports and exports, have tended to be somewhat more damped, I think. Partly that is because of the complexity of supply chains— so it is not just produced in the UK, or in the EU. They are very complex. So it takes a while to adjust the supply chains to have effects on imports and exports in terms of volumes. That response, as I think we have certainly seen in the US and the UK, has also been damped relative to earlier.

I would say in the current circumstances that I would anticipate—I may be venturing on to grounds I shouldn't be on—even more damped responses, because of the uncertainty about the ultimate relationship between the UK and the EU. This is something the Governor picked up in his speech about uncertainty the other day. If you are going to make a major decision about constructing a factory, or building an office building to house your headquarters in the UK, I think before you did that, even though it might be less expensive now, you would want to make sure you knew what the terms of trading between yourself and the rest were.

So I do think the uncertainty, as the Governor said, enhances the option value of waiting, given this uncertainty; so I wouldn't particularly anticipate much near-term effect on the volume of imports and exports, at least until things got sorted out.

Q95 **Helen Goodman:** But depending on how the negotiations go, we might see some adjustments down the track.

Donald Kohn: Yes.

Q96 **Helen Goodman:** Mr Sharp, do you want to say anything?

Richard Sharp: First of all, I think we can take some comfort from the efficient working of foreign exchange markets during this period, which is very important. They did act as a very effective conduit for absorbing the shock. Secondly, if you decompose the exchange rate adjustments, you will see that we have obviously had a profound move against US dollars, but on an exchange rated basis we can take some comfort from the fact we are where we were in roughly 2013 or so. So some of the trading relationships are not going to be so radically affected as ones by the US. With respect to the monetary policy implications, that is for the Governor and the MPC to consider.

Helen Goodman: Sir Jon Cunliffe, you looked as if you were bursting to say something.

Sir Jon Cunliffe: It was a mistake if I did; I do not have a huge amount to add to that.

Q97 **Helen Goodman:** Mr Kohn, you talked about the change in the structure of the economy over the last 20 years. Obviously one big change has been the increase in the size of the financial sector. Do you think the currency fluctuations will be dampened or amplified by the fact that we



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now have a larger financial sector than previously?

Donald Kohn: I think our job on the Financial Policy Committee is to try to make sure as best we can that we guard against the financial sector amplifying these shocks. So I think that, with regard to the banking system, the build-up in capital and the release of a small amount of capital by the Financial Policy Committee is an attempt to make sure that the financial sector—at least the banking sector—does not make the adjustments larger than they need to be to adjust to the underlying change in the real economy.

We have also monitored very closely what is going on in financial markets. We have been concerned about liquidity in those markets. It is a difficult problem to deal with, but I think we have tried to flag for Parliament, for the public and for the financial system that some decline in market liquidity has a potential for having gaps and overshooting and market prices. So hopefully by being very transparent about our assessment of risk, we have helped people to protect themselves against some of these risks. I think our job, exactly as you put it, is to make sure that the financial sector does not amplify the risk. We have tried to act to validate that.

Helen Goodman: Thank you.

Sir Jon Cunliffe: To make up for my earlier reticence, I would like to emphasise that point. The markets were positioned with 85% probability of remain when the polls closed. At about three o'clock in the morning they had switched to an 85% probability of leave. Six to seven times the normal volume went through the foreign exchange markets in that period. It was a big adjustment. The prices changed, but the markets functioned, prices were made and the price discovery mechanism continued. I think that has been true of equity markets and, to a lesser extent, bond markets, because there the volumes have been smaller.

It goes back to Ms Reeves's questions. I think the role of the FPC is to make sure that the financial system: a, does not amplify and make things much worse; and b, actually acts as a shock absorber and enables adjustment to take place. Pre-crisis, it operated as an amplifier and made things much worse. I hope now we are in a position where those nodes at the centre that transmitted and amplified the stress have been reinforced. I think you can see that in the way the financial markets functioned, and I hope we will see that in the way the banking system responds. It is not the job of the FPC to deal with demand. Demand management is not the FPC's responsibility. It is its responsibility to try to make the system help the adjustment rather than hinder it.

Dr Carney: I entirely associate myself with that. Again, having the core of our system flat, going into this extreme volatility event—the largest in sterling markets—helped those markets function in the short term and then puts us in a position to reinforce publicly the resilience of that system. We then turn from markets to the banking system, and the real



economy through the banking system, and our banks being in a position to do their jobs, and they are very much in that position.

If we hadn't catalysed a change, apart from the risk assessment of the FPC through the PRA supervision and the actions of the institutions, I think it is pretty likely that at least one or two of those institutions would have been caught on the 85% probability going into the shift and we would be having a different conversation today.

Q98 Helen Goodman: Okay, let me move on to the issues around the current account. At the beginning of the financial stability report, you identified this as the first of the risks that the referendum could increase, because it is so large at the moment. But, Governor, you said in your Q and A afterwards that "the movements in sterling could be beneficial for the current account." Could you just explain those two apparently contradictory statements?

Dr Carney: It depends how you define beneficial. Movements in sterling such as the appreciation that we have seen should on the whole improve the current account balance—make it smaller. Mr Kohn rightly pointed out that the so-called trade elasticities have fallen over time and there is reason to think they might be a little lower, but in general we would expect more exports than otherwise and fewer imports, and that improves the trade balance.

The other thing that will improve—and this goes to the link to the financial system as a whole—is that the UK has very large foreign assets and very large foreign liabilities. The balance sheet is enormous, having been built up over centuries. Most of those liabilities are in sterling and most of the assets are in foreign currency. When sterling depreciates we get improvement in our balance sheet position. We have had that happen and it leads to an improvement, all else being equal, to the net income account of the current account. So we get two benefits: the trade account and the net investment income improvement.

The movement, all else being equal—and all else is never equal—in the currency since the referendum, were it to stay roughly at these levels, would broad-brush bring about a one-third improvement in the current account; make it that much smaller. That is the beneficial aspect of the adjustment.

The issue around the current account relates to its financing. What happens to the nature of the financing flows because of the changed economic outlook in the UK and the uncertainty around that? Do they become shorter term? Is there a higher risk premium for a period of time? What is the knock-on effect on the economy of the change of financing flows? This is the less positive aspect of the current account adjustment.

I will give a few examples. First, just under half of commercial real estate transactions investment had been foreign-funded prior to the referendum. We had seen in the run-up to the vote a very sharp fall in those transactions—they have basically been cut in half over the first half of this



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year. In surveys and direct conversations, 80%-plus of individuals active in those markets identified risks around the referendum as the reason for those adjustments.

So we are seeing an adjustment: less foreign investment in UK commercial real estate and less activity in that area, all things being equal. That is less positive ultimately. In the economy it is part of an adjustment process: it will move, it will restart, it will help, but at the moment there is an adjustment going on.

Secondly, we have seen a modest increase in risk premia. Corporate bond spreads and bank spreads have gone up a bit, even though all-in funding costs have gone down. The equity risk premium on UK equity markets—UK-focused equities—has gone up notably. That risk premium costs more because the cost of capital is adjusted, all else being equal, and that has an effect on economic activity.

That brings us pretty close to demand management and policy responses, including policy responses of other committees' work, so that is where I will stop.

Q99 Helen Goodman: Okay, that is reasonable enough. But are there any things that you think the FPC can do to address the financial stability risks of the current account, beyond the measures you took to get through the transition?

Dr Carney: The measures to get through the transition included the measures to have bank balance sheets and risk management in a position to withstand the adjustment. Earlier Mr Kohn referenced the 2014 stress test. That stress test had at its heart a very sharp current account adjustment: so a so-called sudden stop in foreign inflows, a big movement in the exchange rate, which itself necessitated a rise in interest rates—the type of issue we were discussing earlier. We went through that process with all the major banks and the largest building society to ensure that they could handle not just the economic adjustment, but the movement in yield curves, exchange rates and asset prices. That is a very important way of mitigating some of the risks around the current account. That is in recent memory, in recent risk management. It is in current capitalisation and liquidity of those institutions.

Sir Jon Cunliffe: I will make a very commonplace point. We put this in our financial stability report in 2014 and again in 2015: that one of the things that supports the current account—or capital account, if you look at the other side of it—is the strength of the UK's institutions and the institutional framework. Having dealt with capital account crises in other countries, I think that institutional robustness and people's ability to understand the reaction function of the institutions—what they will do—is extremely important. One of the things we can do is carry on trying to meet our objectives and doing that transparently.

Q100 Helen Goodman: And we have had a significant reduction in political uncertainty in the last 24 hours, haven't we?



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Sir Jon Cunliffe: I was talking about the Bank of England. But if you look at where there have been current account crises in other countries, you will see that the strength of the reputation of the institutions and the institutional framework—the macroeconomic and macro-financial framework—has been important.

Dr Carney: On the back of that, two things: openness—if you are going to have a big current account deficit, openness to the world and to investment is pretty important—and then institutional credibility. If your current account is under scrutiny, again, the responsibility of committees such as the FPC or institutions such as the Bank of England to give clear and objective assessments of the circumstances and the risks around the circumstances is paramount. Having lived through a quarter of a century of other, analogous situations, I think that it is when institutions try to bluff their way through risk, or try to assert their way through situations—no. You have to be clear about the risk, the plan to deal with the risk, the challenges and of course the opportunities. But the idea that it can be swept under the carpet—that is exactly the wrong thing to do.

Q101 **Helen Goodman:** I wonder whether the prospectus you are putting forward now isn't a tiny bit Pollyanna-ish, because the fact is that we have a very large current account. We have had a significant drop in sterling and the underlying problem is that, because of uncertainty and—probably a worse thing—our trade relations with our largest trading partners, we are going to have less foreign direct investment. That is the truth of the matter.

Dr Carney: It is certainly possible that, as Mr Kohn was saying, for a period of time there might be less foreign direct investment than there otherwise would be, until degrees of uncertainty are gradually reduced, but there will still be foreign direct investment. A lot of foreign direct investment is actually reinvestment of profits that are made in-country, so one would expect that to continue. The changes in the price of UK assets because of the exchange rate adjustment of course makes those assets more attractive. That can bring foreign direct and other forms of investment. We are not seeing a sharp increase—we are seeing increases, but not sharp increases—in risk premia in the UK, which suggests current moves in.

The last point I will make, and we saw a bit of this in the first quarter of this year—I referenced earlier the substantial foreign assets of the United Kingdom; UK institutions and individuals—is that there was a big increase in the financing of the current account in the first quarter, as measured through the repatriation of some of those foreign assets. That is another way the current account can be financed. Remember, we are bridging from the current situation to those new relationships, so the question is how to best finance that bridging. That holds for the current account as well as it does for a fiscal deficit and for other policies.

Q102 **Chair:** I would be interested to hear Mr Sharp's views on FDI before we finish.



Richard Sharp: As the Governor said, as an open economy with a lot of global investment opportunities for institutional investors, we compete for capital. We compete for capital on a number of dimensions. One, which Sir Jon alluded to, is clearly the tremendous institutional protection we have here, including the rule of the law and political stability, notwithstanding what is going on now. The other dimension is obviously the return and the risk premium reflects the level of uncertainty. As Mr Kohn alluded to, one thing that is certainly going to have an adverse effect is a long period of uncertainty, simply because institutional investors want to be able to calculate risk in relation to the risk premium. That being said, the UK is still a very attractive haven and I think flows will continue.

Q103 **Chair:** There are two issues: the volatility caused by the uncertainty and the underlying assessment of the long-term trends in FDI. What is your view on the latter?

Richard Sharp: The underlying trend? I think the underlying trend will remain positive, but that depends upon the supply side within the economy, which creates opportunities for investors to catch a positive return. That moves straight into the political dimension and the political response to whether the consequence of Brexit, with respect to the political strategy as well as the negotiation, is to make the UK thoroughly competitive. You only have to look at France right now, for example, and see their immediate reaction to try to create a competitive environment for financial services, to know that we are going to face more competition as a more open economy. The political response to that on the supply side will also determine the consequences.

Q104 **Chair:** I want to pin down what you mean by it “will remain positive”. What will remain positive: the future level of FDI in relation to its current level; or will it just be north of line—that is, we will be net recipients of FDI?

Richard Sharp: For example, we have seen a lot of FDI coming into commercial real estate. That clearly led to a phenomenally overheated market, so that in itself was already seeing a decline before the referendum. We have seen other investments, for example Chinese sovereign wealth fund investments in UK infrastructure, as a long-term basis.

Q105 **Chair:** I am asking you whether the Brexit effect on FDI is positive compared with business as usual prior to Brexit, in your view?

Richard Sharp: I think, in the short run, it is negative.

Q106 **Chair:** In the long run?

Richard Sharp: In the short to medium term, I would expect it to be negative as long as uncertainty arises. The long run will depend upon the political actions that are taken in the meantime.

Chair: I have found this a very interesting session; I think quite a number of us have. We have had to cover some very difficult subjects that go right to the heart of whether Parliament took the right decision to make the



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Bank of England independent 20 years ago and what the ramifications of that are, particularly with its reinforcement with the financial stability responsibility. Thank you very much for coming to give evidence. I am sure we will take some of this further and we will be digging into monetary policy when you are out of MPC purdah.