HOUSE OF LORDS

Select Committee on the European Union

Financial Affairs Sub-Committee

Corrected oral evidence: Brexit and Financial Services in the UK

Wednesday 12 October 2016

10 am

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Members present: Baroness Falkner of Margravine (The Chairman); Lord Butler of Brockwell; Lord Callanan; Lord De Mauley; Lord Desai; Lord Haskins; Earl of Lindsay; Lord Shutt of Greetland; Lord Skidelsky; Lord Woolmer of Leeds

Evidence Session No. 5 Heard in Public Questions 38 - 47

Witness

Sir Jon Cunliffe, Deputy Governor, Financial Stability, Bank of England.

Examination of witness

Sir Jon Cunliffe

Q38 **The Chairman:** Good morning, Sir Jon Cunliffe, Deputy Governor for Financial Stability in the Bank of England. Welcome to our evidence session on Brexit and the impact on financial services.

I need to go through some technical issues, so I will go through the pro forma. You have a list of interests that have been declared by Committee members. This is a formal evidence-taking session of the Committee and a full transcript will be taken. It will be put on the public record in printed form and on the parliamentary website. You will be sent a copy of the transcript, and you will be able to revise it for any minor errors. The session is on the record; it is being broadcast and is available through the parliamentary website.

Sir Jon, I will kick off because we have only an hour with you. Given the moving feast that you and we have seen since 23 June and the impact it has had, I appreciate that you have had a pretty busy time of it, which is why I am particularly pleased you are here. Could you start by telling us, in light of the Prime Minister's speech last week and her road map, what you think the impact of a harder Brexit will be on financial stability? What do you make of the current state of the economy since the referendum?

Sir Jon Cunliffe: I will start by looking at the recent past, because that may give us some pointers towards the future. The referendum result on 24 June was a big surprise to financial markets. We saw very big moves in asset prices. We also saw large volumes; something like six to seven times the normal volume of business in the currency markets went through the Asian currency markets that morning.

Markets did what they are supposed to do. They absorbed the news and the shock, and they changed prices relatively smoothly. Key in financial stability terms, that shock was not transmitted to the rest of the financial system in the way, perhaps, that we saw market shocks and big movements in prices being transmitted during the financial crisis. That speaks a lot to the work that has been done over the last eight years to reinforce the financial system, particularly the banks at the centre of it, but it also speaks to the preparations that firms and central banks made to ensure that liquidity was available.

If I take that incident, the financial system is more robust to shocks from market news and the like. There was great uncertainty about the timing of the negotiations. The timing is now clearer but the process of negotiation and the outcome are quite difficult to predict. One would imagine that, as more news comes to the markets, markets will react. The pointer I take from the referendum event itself is that markets and the financial system are much more robust than they were. That does not rule out market-induced financial stability events as more news comes into the system. We saw last week news about how Brexit might play out. It seems to have affected the currency markets last Thursday. We had a flash crash, where sterling in thin Asian markets lost 6% of its value in a matter of minutes.

We have seen that sort of crash before in US treasuries and German bunds. Some of it is not just to do with news about Brexit coming into sterling price but to do with the way markets are currently configured. It recovered quickly, although the underlying trend for sterling, as we know, was down. I would not rule out, in that sort of financial stability sense as more news comes in, that there is potentially stress in the markets, but I take some comfort from the resilience on the 24th.

If I now look wider than market impacts on financial stability—

The Chairman: Could I interject a supplementary on what you have just said? Given what you said and given that you expect markets to react as more news comes in, are you making preparations for March when the Prime Minister has announced that we will trigger Article 50, and are you speaking across central banks to your counterparts?

Sir Jon Cunliffe: We did extensive contingency planning beforehand. Much of that machinery and many of the preparations we put in practice still remain there to be used if we need them. Yes, of course we are in dialogue with central banks. On the particular incident last Thursday, the Bank for International Settlements markets committee is now going to look at what happened and try to understand it. Yes, the contingency planning is there. We have not dropped it or forgotten about those risks.

Turning to broader financial stability risks around the UK's exit from the European Union and the process of negotiation, I do not know what the end point of the negotiation will be. I do not think it is sensible to comment at the moment that the end point will be this or that. We talk about hard Brexit and the passport, but actually we are talking about a whole spectrum of channels by which financial services in the UK can be exported into the European Union. I am never quite sure what lies behind the labels "hard" and "soft". You really have to dig down to look at the detail.

In relation to the financial stability risks, wherever we are going, we clearly want to go there in a smooth and ordered way. To the extent—I do not know what the extent will be—that activities cease to happen in London, cease to happen at all or move to other jurisdictions in Europe or elsewhere and the structure of financial firms has to change, there is great uncertainty about how much that will have to happen. First of all, you want to make sure that control over risk is maintained throughout the process. You want to make sure that contract certainty is maintained and that there is no discontinuity of service, because, suddenly, services that were operating and contracts that had been made could not continue.

The second thing is for supervisors and regulators. Bear in mind that the Bank's primary interest here is financial stability. We want to make sure that we do not lose sight of things, as structures and business models change or activities move or adapt. You want to make sure too that the management of financial firms remains focused on the full spectrum of risk that they face and that they are not distracted by having to deal with transition and changes that are happening. I cannot say now whether the change will be large or small or how it will impact. I have read some of the evidence of your witnesses and there is great uncertainty about it. You want to make sure that it is ordered and planned and that there is time to execute the plans. If you do not, you are increasing vulnerability and you will get hit by other shocks at the same time. That is how I would characterise the financial stability risks. Do you want me to talk about the economy as well?

The Chairman: Briefly, if you would just touch on that.

Sir Jon Cunliffe: I will do it very briefly. The initial indicators after the referendum were that confidence and the like moved a long way down. Some of that came back just before the Bank made its August forecast. There was a depreciation of sterling by that point. We based the August forecast on that. The underlying narrative of that forecast is that uncertainty about the UK's future trading arrangements with the EU and the economic impact of that will weigh on business investment and the large and irreversible decisions that businesses take about hiring and pay. In the course of next year that will communicate to household consumption and the housing market.

The news since then has been a bit stronger than we anticipated, as set out in the minutes of the September MPC. On the underlying contours of the way this will move through the economy, we see nothing to suggest that that is the wrong way to think about it. We will process all the news, including what has happened to sterling in recent days, in our November forecast to try to reach an overall view of where the economy is going.

The Chairman: Lord Skidelsky, is that adequate or do you have a supplementary?

Q39 **Lord Skidelsky:** Sir Jon, you referred to the depreciation of sterling and, in your last few remarks, to the economy. What do you think the connection might be? In other words, what do you think the effect on the macroeconomy will be of the plunge in sterling?

Sir Jon Cunliffe: There is no simple numerical relationship between the exchange rate, economic activity and inflation. One knows the channels. A lower exchange rate increases demand for UK goods and services abroad. It may encourage some import substitution towards domestically produced goods and services. On the other hand, if it raises prices it lowers real income and that affects consumer demand. It may affect investment, because a lot of our investment goods are imported.

The important thing perhaps is why the exchange rate is moving. The underlying cause of the exchange rate moving will affect the path of demand and the path of supply in the economy. One has to put all those things together. If the exchange rate is moving because there is uncertainty about the UK's future trading relationships with its biggest partner, you would expect that to affect demand and supply independently of what is happening to the exchange rate. That is a really long way of saying that I am not going to give you an answer, because I do not have one and because we have a forecast round coming up in November for the Bank that will be a very important forecast round. We will try to process all of this through our models to try to pick up how those effects, which move in different directions, will impact on the path of the economy and the path of inflation.

Lord Desai: Do you take the view that the market has overreacted as far as sterling is concerned, or do you think it is the right response?

Sir Jon Cunliffe: I normally try not to express a view on whether markets are right or wrong with the exchange rate.

Lord Desai: The last time we had a problem regarding the market being right all the time.

Sir Jon Cunliffe: All I would say is that they are processing news about the outcome. I will break my normal vow to say one thing, in the hope that it is helpful. The hardest news for markets to process is political news. Markets find political uncertainty very difficult to estimate, as opposed to economic uncertainty and the like. Clearly the outcome of the UK's exit from the European Union will be the product of political processes here and in other countries. Markets find that kind of news difficult to face because it does not fit inside normal models and the heuristics they use about the economy. That is not to say they have over or underreacted. I think markets will continue to react to news about this because it has an impact on the economy and its prospects.

Q40 **Lord Shutt of Greetland:** Sir Jon, you said earlier that you do not know where the end point is. Can you help us with the starting point? We hear about various possible arrangements, but perhaps a special or bespoke arrangement is right for the United Kingdom. How would that best preserve the United Kingdom's financial sector? What features would you be looking for? Is there anything where, as it were, the EU negotiators will think, "Oh well, that is not bad; we will pitch for that"?

Sir Jon Cunliffe: I can make a couple of important contextual points for the Bank. One is that our primary responsibility is financial stability, not the business of the UK financial sector. That is an important consideration. It is a consideration for government, but the primary objective for us is to maintain financial stability. We have a secondary objective, which is to support the Government's overall economic objectives. We tend to look at it more through that lens. That said, changes in the structure of financial services in the UK and the way things are done, et cetera, affect not just the economic picture but financial stability. We take a pretty strong interest in that area but we come to it from that lens.

I go back to what I said at the beginning when the Chairman asked me about hard Brexit, the single market and the passport. The single market in financial services—the so-called passport—is, as you have already seen from your examination of other witnesses, a complex web of permissions in different pieces of EU legislation, often operating in different ways for different parts of the financial sector, that allow relatively frictionless trade in financial services to happen cross-border. Trade in financial services happened before the passport and before the single market. It is not a question of tariffs, but it decreased the friction cost. The way that is used is different in different parts of the financial sector, and it is different in different financial firms.

The financial services industry is not really organised around the passport. You cannot say, "Well, there is this part of the financial services industry that uses the passport". Your word was "preserve". One would want to ensure that it could continue, and this part does not. Retail financial services in the UK are not very much affected by the single market and financial services. It is around the wholesale services market-based finance that you see the biggest impacts.

The Prime Minister has talked about a bespoke deal. To me that means that if we are not a member of the single market—you cannot be a member of the single market unless you are a member of the European Union or of the EEA, you share European Union law with the other members and are subject to the enforcement of the ECJ, et cetera—the current way in which that relatively frictionless interaction happens will not continue. That does not mean that that relatively frictionless activity cannot continue. You just have to find different ways of arranging it. You cannot arrange it as a European Union member subject to European Union law.

To me, a bespoke arrangement is about understanding how those permissions are used and which parts of the financial services industry use them most. That is not easy, because they have never really thought about this. They have never had to measure it. You only measure what is important, and measuring how you were using the passport in complicated transaction chains was never really very relevant to the financial services industry. It would have to work out how they are used, where they are used and which are the most important, and what the alternatives are.

Some of the alternatives involve doing things in a different way through different legally incorporated entities registered in the European Union. What are the extra costs of that? If you do the business that way—business used to be done that way, so we can go back—what is the extra cost and who pays that cost? Investment banking in the European Union is not making stellar returns at the moment, and in some cases it may be that a business does not move; it just stops because there is less depth of financial services available.

That is what bespoke means. Bespoke means trying to understand those interactions and then saying, "All right, are there different ways in which that relatively frictionless activity can be continued, or continued to some extent?" Unfortunately with this, you really have to get into the detail of how things operate at the moment, how they would need to change and what the cost of that is before you can answer that question. I am sorry, that is a very long and probably confusing answer.

The Chairman: Lord Butler, did you want to pick up any of those points?

Q41 **Lord Butler of Brockwell:** May we pursue that a little? Figures were published by the Treasury Committee in the House of Commons showing that 5,500 UK-registered firms depend on passports to do business in the EU. On the other side, 8,000 European companies rely on passports to offer services in Britain. One would think that this is a very important issue for them. It is an important issue on both sides. Do you therefore see the possibility that passports as such will continue, or some equivalent of passports? Is there scope for an early financial deal?

Sir Jon Cunliffe: Andrew Bailey's letter to the Committee set that out.

Lord Butler of Brockwell: That is right.

Sir Jon Cunliffe: It also shows that there are something like 350,000 passports, of which virtually all—more than 300,000—are outbound from the UK and the minority are inbound. It is quite difficult to go from the number of passports and firms to the amount of what I would call economic activity. In some areas like insurance, where passports are used, they are very cheap and easy to get. Passports are used for relatively small volumes of business such as selling travel insurance cross-border.

The scale of the activity that happens through the passporting channels is pretty appreciable. You really have to get at this from the private sector end and ask firms, "Which of your business lines, which of the transaction chains and which of the bundles of services you operate use some or all of the passporting permissions?" There is now starting to be some private sector analysis of this. The Oliver Wyman report, which came out a couple of weeks ago, suggested that £50 billion or £60 billion of revenues were associated with European Union business in the UK, and that something like £18 billion to £20 billion would be at risk if there were no passports. It added ancillary services to get to the number, which I think was about £35 billion or something. It had a range.

That is an appreciable amount of revenue. You can translate that into GVA, which Oliver Wyman did and came to something just above 1% of GVA associated with business between the UK and European Union financial services that would be affected if they were using the passport. I looked through it. The calculations are still quite difficult. Getting underneath it is pretty hard.

You then have to ask how much of that could continue. My point was simply that the passport as it exists, which is firms incorporated in the European Union, subject to European law and subject to the ECJ, et cetera, cannot exist unless one is in the EEA. You can replicate those permissions in different ways, either with some sort of umbrella agreement or sector by sector. It is a painstaking process, and maybe it is the converse of the painstaking process that we see firms go through of working out how they use the passport, but one could certainly replicate that. There is nothing to stop that happening. That would be part of a much bigger negotiation with the European Union.

If your question is, "Is there an interest on both sides in doing that for the 8,000 plus European firms that have passports into the UK?" I think I would say that the UK—let us call it London for shorthand but it goes much wider than London—has a pretty unique and complex financial ecosystem with very deep and liquid capital markets. That lowers the cost of capital and financial services for the real economy in the UK and in the rest of the world that uses it, particularly the European Union. If one fragments that ecosystem, and puts up barriers and increases costs, for example by banks having to hold more capital because they have to hold it in different locations, and if certain things that happen in a fairly frictionless way actually happen with constrictions and constraint, that is going to put up the cost of finance and financial services more generally on both sides of the channel.

Lord Butler of Brockwell: We have had some evidence that one of the strengths of London—let us continue to call it London—is that the ecosystem is so complex that it is really difficult to replace elsewhere in Europe. The only place where it could be replaced is in New York. Do you think that constitutes a reason why it is in the EU's interests to disrupt that ecosystem only to the minimum extent?

Sir Jon Cunliffe: In the economic and financial stability terms I talked about a bit earlier, yes. There are broader political issues around the negotiation of exit on both sides and I am abstract from all of that. Economic geography is not my specialism; predicting tipping points in agglomerations, when they move and when they do not move, is hugely difficult. For me, it is pretty unlikely that what we call London—I make the point, because a lot of financial services and infrastructure is not in London but elsewhere in the country, but let us call it London because that is what seems to be happening in the broader discourse—will be replicated in the foreseeable future in one place in the European Union. It takes an awful lot of time and human capital. It is based around the interaction of financial services and other services. A great deal of the business is not to do with the European Union; in fact, only a minority of the business is to do with the European Union. The idea that this ecosystem is transplanted somewhere else into Europe in the foreseeable future is highly unlikely to me; over time, I do not know.

Could it be transplanted to New York? Of course, it already exists in New York. There is a large and complex ecosystem in New York, so could some of the things that now happen in London transfer to New York if they could no longer happen here? We are talking not just about economies of scale and scope but about how information is used by different players. In these complex financial transaction chains, even though one firm has a transaction chain, I have seen work suggesting that more than a quarter of the value of that chain comes from other financial firms that participate in those transactions in some way. About a quarter comes from non-financial firms such as lawyers, accountants, et cetera, who are also necessary to make that complex financial transaction work. You need all those things to be not just close to each other but able to interact with each other quickly and seamlessly. You cannot just take all of that and move it somewhere else. It exists in New York. Those economies of scale, scope, information-sharing and ancillary services are there, so some of it, yes, could certainly go there.

The Chairman: That brings me to Lord Callanan, and after that Lord Haskins on transitional arrangements.

Q42 **Lord Callanan:** One particularly important part of the ecosystem in London is of course euro clearing. There has been a lot of speculation about the risk or otherwise of London remaining the centre of euro clearing when we are no longer part of the EU. Do you think that is at serious risk of relocating?

Sir Jon Cunliffe: I have spent much of my career on this subject, so can I be forgiven a slightly long and technical answer, if that is okay? First of all, there is a political angle. It is unusual to see Heads of State or Government talking about where clearing services are located or whatever. The issue of euro clearing clearly has political weight and significance and that may determine the outcome. I cannot really comment on how that goes into the overall, much broader negotiation between the UK and the European Union about the terms of the exit and what it looks like.

I will dodge the political question, if I can put it that way, and just turn to the technical. By clearing, we are not talking about paper clearing but essentially about central counterparties clearing derivative contracts. I will make a number of technical points that go to what this business is. Following the financial crisis, the G20 pushed very hard to put derivatives contracts into central clearing, to have them centrally cleared. That means that the margin you provide against changes in value is provided centrally, and regulators can look at the models that generate how much margin the different counterparties have to put up in advance for movements in the prices that can happen. It is transparent, and you avoid what happened in the financial crisis. Financial instruments move very quickly and counterparties start requiring more margin from other counterparties. That was a real accelerator in the crisis that drove firms' margin call and drove them into distress.

I was at the Pittsburgh G20 when we decided to do that. It is the right thing, but it requires concentration of the central clearing of derivatives contracts, because that is where you get the benefits and that is where you can net risk. That is where a firm that has some contracts with a plus direction and some with a minus direction with different counterparties can put them into central clearing and only has to take the margin cost of the net rather than the gross positions. That is a huge reduction in the margin that they would otherwise have to post; if you like, it is the insurance they have to pay against moves in prices, if they can take their pluses and minuses and net them off and just pay the net as an insurance into the central counterparty.

This is multicurrency infrastructure. If you are talking about interest rate derivatives, you want to be able to put into clearing—into the central counterparty—dollar-denominated, euro-denominated, sterling and yen, and get the netting benefits of that. By doing that, you reduce the cost because you can take the pluses on your dollar-denominated interest rate stocks and the minuses on your yen-denominated ones. It all goes in and it comes together.

When I hear the argument that derivative contracts have to be cleared in the jurisdiction of the currency at issue, so that if it is a euro contract it has to be cleared in the euro area, and if we extrapolate from that that dollar contracts have to be cleared in the US, sterling here and yen in Japan, et cetera—some jurisdictions take that view—you make multicurrency infrastructure impossible. If you do that, you make the cost of clearing much higher. To me, clearing from a financial stability point of view through central counterparties is a really important reform since the crisis.

If you look at some of the clearing that happens in the UK, 25% or 30% of the instruments in that will be euro-denominated, but they are clearing against dollar-denominated and all the rest. I can understand the politics around this from previous existences, but what we are talking about technically is multicurrency infrastructure and, in this case, the benefits that netting and compression of margins bring. If we fragment the clearing systems—this goes back to Lord Butler's point—the cost will go up across the system.

I have one last point on clearing and then I will stop. The fact that it is multicurrency infrastructure means that many jurisdictions will have financial firms that are dependent on it. You have to ensure that they have line of sight into the regulation and supervision of that infrastructure and influence over it. It is efficient to have large multicurrency machinery. We have it for payments: SWIFT, for example, located in Belgium. We have it in securities, depositories. We have it in CLS, which does foreign currency settlement. Lots of the pipes in the global system are multicurrency, but they are in one location. That means that there have to be arrangements through colleges and elsewhere to ensure that other jurisdictions whose firms use the infrastructure have some line of sight and have some confidence. If they do not have confidence that it is being run well and is secure, they are within their rights to say, "Well, I don't want my firms to use this infrastructure because it is a bit precarious and if it falls over that is a problem for me". There is a quid pro quo, if you like, on the way in which you supervise and regulate these things with the fact that they are multicurrency. If we are talking about going to a world in which you have to clear in the jurisdiction of issue, the costs are going to go up in a pretty big way.

The Chairman: In plain English, I think you are saying that it is unlikely that relocation of eurozone trading will go back to the eurozone, if it is a rational decision rather than a political one.

Sir Jon Cunliffe: I am grateful for the rider. I think the system works well at the moment, in terms of how it is developing. We are putting more contracts through central clearing now, not fewer, because that is the impulse from the G20. More is coming into the system and at the moment it works well. The supervisory arrangements work. There can be other reasons for moving it. I am not going to make a prediction, unlike my erstwhile colleague at the Bank of England, about what is going to happen, but it is important to understand what we are talking about.

Q43 **Lord Haskins:** I want to come back to the issue of financial stability and uncertainty. The banks have said to us several times that on the one hand they want uncertainty to be cleared up as quickly as possible. On the other hand, they have said that this a very complicated business and is going to take several years to sort out. There is a contradiction in terms on that.

It seems to me that there are two aspects to the uncertainty: first, the uncertainty leading up to a deal being completed, and, secondly, the uncertainty of, as inevitably there will be, transitional periods thereafter. We are going to have some degree of uncertainty for several years to come. You said at one point that uncertainty created by politicians making slightly rash judgments in public is something that markets find difficult to deal with. The reality is that, between now and when the negotiations are complete, the politicians are going to say lots and lots of things in public. The Bank will scarcely be able to keep quiet if some of those statements are clearly going to stimulate uncertainty. That is the first thing. How is the Bank going to respond to that? The second point is that there are politicians who have told us, "Let's bash on very quickly and get the thing dealt with. It will all be simple. We can go to the WTO or whatever it is, and everything will be resolved and the uncertainty will go". What would your view be on that?

Sir Jon Cunliffe: First of all, I do not think I said that markets had difficulty in processing uncertainty to do with rash words or rash decisions. My point was a much more general one, which is that markets have difficulty predicting politics because it does not fit into economic models, and you cannot use the past as a guide to the future. It is a general point. Political uncertainty is the most difficult thing for markets to calibrate. I was not making any comment about political statements. There will be a lot of political noise around this negotiation because it is, in the end, a political negotiation and that is what happens. Markets will have to deal with that.

To go to your last point, we will do our assessment. The FPC has said that it is assessing and we will find out more as the process goes along. It is assessing financial stability implications and we will use our normal publications—the financial stability report and the like—to report on that. As far as the economic impacts are concerned, we will use the inflation report to report on those. We did that before the referendum, and we will continue to give our forecasts for parts of the economy and our assessment of financial stability. We will give that through the statutory products that we are responsible for producing.

On the question that the private sector would like certainty, this is very complex, and it comes more broadly to the question of transition. This is a very difficult part of the negotiation and you can arrange it in different ways. You normally do the transitionals for trade deals at the end, but then of course trade deals normally increase access. I do not know what the result of the negotiation will be, but to the extent that it decreases access or changes the way that people do things, it is possible that they will need more advance warning of what is going to happen, or what will happen in the transition, than when you are increasing trade access.

Politically, there are different ways to say this can be done. There has been lots of comment on it. My point was a broader and perhaps more unhelpful one. No matter how it is arranged, we just want a smooth and orderly progression from where we are to where we are going, wherever that is. That is to do with ensuring that firms are able to plan and to execute those plans. I can think of lots of different ways it could be done, but they are political choices. I do not think the Bank would want to comment on this.

Lord Haskins: The difficulty is that events can sometimes be ahead of things. We have already had evidence that businesses in the City, and indeed non-City businesses in manufacturing, are taking their own steps to make up their minds about it—Nissan, for example—and they will not wait three years to get certainty. They want financial certainty as much as anybody else. The danger is that they will make the decisions before it is clear long term what the position is going to be.

Sir Jon Cunliffe: I think that is right. It is true for financial firms as well. They have a duty to their shareholders and a duty to their customers and clients. In the end, they exist to serve the real economy, and that is who their customers and clients are. To the extent that they are providing services, they have to try to make sure that there is no discontinuity and they do not have breaks in services. We will be trying to ensure that they have plans to do things smoothly. If they do not know the outcome, they may have to prepare for different outcomes to be able to deal with them.

If your point is that that may lead them so far down the track of preparing for alternatives that they may then have no choice, and that if they reach the tipping point they may have to go ahead even if they do not know, then yes, that is quite possible. My point was more about the stability and order of the process; it is important that they have time to plan and to execute. You might not be able to do some things very quickly: for example, novate contracts in financial services. The experience is that that takes time. Those considerations have to be built into the arrangements. As to how you do it, there are lots of different ways, as we read in the newspapers. Those are political choices.

The Chairman: Lord Shutt wanted to come in briefly and then we need to move on.

Q44 **Lord Shutt of Greetland:** I hope this is helpful. There was a news item yesterday, which I do not fully understand, concerning a little London issue about a bridge over the river. I raise this because there seems to be some doubt about exposure to expenditure. A civil servant is marking the card of a Minister and saying, "There are certain dangers here and I really do put this in big print".

We have the issue of the trigger of Article 50. You have been talking this morning about difficulties, uncertainties and passporting. Is there any sense in which the Bank of England would mark the card of Ministers and say, "Look, you are not ready to pull triggers because there is more work to be done"?

Sir Jon Cunliffe: I have been an accounting officer. As an accounting officer you have a responsibility, if you think something is outside the rules, to ask for an instruction. I am pleased to say that I never had to do that. I have had colleagues who had to do that. That is part of the system within the Civil Service.

The Bank has statutory objectives around monetary and financial stability to try to use the instruments that Parliament has given us to deliver those two things and to comment on the path for the economy and why monetary policy is as it is, how we see it developing and, as I said earlier, the risk to financial stability. We do not have an accounting officer responsibility to mark the card of Ministers—to use your phrase. We have a responsibility to say how we see those things evolving, and to say it publicly. We are required to produce public assessments of those things. Before the referendum that is what we tried to do, and we will continue to try to do it.

Q45 **Earl of Lindsay:** I want to ask you about the EU equivalence regime as it is currently designed. Is it something that the UK negotiations should seek to achieve for the United Kingdom, and therefore for financial services in the United Kingdom, or is it something that we should be striving to avoid? Is it something that would bring sufficient benefit by allowing companies from the UK to plan for the future, or might it actually stifle innovation and competitiveness and be subject to the sort of vulnerability of decisions relating to equivalence that are essentially political decisions?

Sir Jon Cunliffe: I will not give advice to the negotiators, if only because one of the most irritating things when you are a negotiator is to have your predecessors give you advice. It is not the job of the Bank to do that.

Generally, the principle of equivalence is much more within the European Union. One of the lessons of the financial crisis is that, if we want globalised financial services, we all have to have confidence in each other's regulatory and supervisory machinery. That is where international standards come in. We should also recognise the equivalence of our regulatory and supervisory structures. It is more about recognising the equivalence of the outcome than the equivalence of the input. We may do things in a different way. The US does prudential capital for banks in a very different way from the UK and the EU, but they are both equivalent in that they are implementing a Basel international standard. Equivalence is a broader concept.

More generally in trade and financial services, irrespective of the EU issues, people are starting to think about how we build regimes that can recognise each other's equivalence. There is some talk about that in the Trade in Services Agreement. In TTIP there has been some talk too, but not in financial services, about how we get to more mutual recognition of equivalence in our regulatory and supervisory structures. Equivalence is a general thing. It is a good thing if we can do it properly, because it will allow more trade and interaction in financial services while assuring people that it happens within a robust framework, so that you can depend on the other guy.

The EU equivalence regimes are relatively new. They came in the Barnier wave—the second wave of financial services legislation—and are quite different in the way they operate from other things in the single market. I have certainly been involved in one equivalence decision, which is the recent agreement between the EU and the US—the CFTC—on clearing houses. It is useful for the EU to have regimes that recognise third countries and that allow for that trade to continue. I thought that before the referendum, and I think that now. It is useful for the UK to have regimes that recognise equivalence. The general principle of this is useful: the ability to have a globalised financial sector and to be confident that it is robust and is serving the real economy.

As for the specific EU regimes, we do not have much experience of them yet. Equivalence is a decision of the Commission. Conceivably it could be politicised, and we know that equivalence can be reversed. Of course, if you have a global system in which you try to ensure that cross-border activity happens under an umbrella where you are confident in the other jurisdictions' regulatory and supervisory structures, you need to make sure that if you diverge at some point you have a way of dealing with that, and either no longer have the access or settle the divergence in some way. The EU will have to do that.

I think they are useful regimes, globally as well as in the European Union. They do not cover many areas, as you know, in financial services. There is no equivalence regime in banking, for example. The equivalence regime in insurance is not really about access. They are not there to cover all the things the single market covers. It is a useful concept that could be developed further globally and within the EU. If a financial firm is covered by one of those agreements, could it depend now on the fact that there will be an equivalence agreement between the UK, when it is not a member, and the EU, and plan on that basis? All of that will be part of the negotiation. My answer is that, to the extent that you can depend on the outcome of the negotiation, you can depend on that. My more general point is that the world generally is going to have to think more about how we develop those regimes because they are a necessary part of a globalised financial sector.

The Chairman: And we remain of course with membership of Basel, the Financial Stability Board and all the other bodies that also regulate those areas.

Sir Jon Cunliffe: They do not regulate, but they—

The Chairman: They set the standards.

Sir Jon Cunliffe: They set the standards and, to my mind, the only way equivalence regimes can work generally—

The Chairman: Is through them.

Sir Jon Cunliffe: —is if there are global standards. If we have all agreed a standard, you can assess that the standard is met, although your legislation may look very different, because different countries have different structures. Equivalence regimes then become easier to do. Even without this question, there is some underlying move in that direction, but it is very difficult. As a regulator and supervisor from a UK perspective, as Lord Butler observed, the passport works both ways. We are responsible for financial stability of possibly the largest international financial centre that there is. We want to ensure that firms that do business here either come under our regulation and supervision and that we will take responsibility, or are being regulated and supervised by equivalent jurisdictions. It is important both ways.

Q46 **Lord De Mauley:** Sir Jon, what are the prospects for the UK continuing to have influence on financial regulation in the EU, and indeed internationally, once the path to exit has been decided?

Sir Jon Cunliffe: Once exit has happened, we will not have influence from inside on the making of EU legislation. I certainly hope the EU will continue to be a big proponent and supporter of global international standards. I think it will, because the European Union supports international rules-based systems. It is important to the European economy that it is open, and you need international standards for that. But we will not be inside the Council working groups or the negotiations as to how those international standards are put into EU law. To that extent, we will necessarily lose influence, because if you are not an EU member, you cannot be inside the machinery that makes EU law.

This goes back before the crisis, but it intensified afterwards. We have tried in the UK, and in the Bank in particular, to exert an influence on international standards. We have tried to do that because we are an international financial centre and they matter hugely to us. I think the UK has played a part, particularly post-crisis, in the way those standards have developed. I hope and assume, and will devote considerable effort to ensuring, that we continue to do that in the international system. To the extent that we are able to do that, it will influence what the EU does and how the EU sets its own standards.

Of course, good ideas are good ideas whether you are in or out of the EU. To the extent that we are able to show that we have analysis, good evidence-based approaches to dealing with financial service regulation and practical ideas, I think we will continue to have influence. The financial sector changes and adapts so quickly that there will be more regulation, because it will change. We have much of the machinery and investment in human capital in international standard-setting. If anything, we will redouble those efforts. I think we will continue to have a relationship with the EU on financial services, which is another channel, so I expect we will have influence there. The influence that one used to have sitting inside the Council working group or chamber, or inside the parliamentary committee on a piece of legislation, no, of course one will not have that. That is because we will not be a member.

Lord De Mauley: That is, as it were, two years from March, but in the intervening two years how do you see our influence? We are hearing rumours that it is—

Sir Jon Cunliffe: The formal and underlying position is that we are a member until the day we are not. We have a voice and we have a vote. Certainly when the Bank is participating in discussions now on legislation and the like, we are making the points that we would otherwise have made.

Lord De Mauley: And the doors are open?

Sir Jon Cunliffe: My point earlier is that, if you have good ideas which are evidence-based, the doors are always open, in or out. If we are talking about things that are likely to happen after we have left, it is unavoidable that people will pay less attention unless it is a point that is relevant to others. That is entirely natural. If we now know when we are going to leave and we are talking about something that will not affect us, clearly the points we make get read in that light. When we make points, we have to be aware that some of the legislation and the like will not apply to us. We have to make the points recognising that. At the moment, we are not withdrawing from the process. No one has done this before so it is pure conjecture, but as you get closer and closer to the point of exit, the number of things that you are talking about that will not apply to you will increase and the influence over those things will diminish.

Q47 **Lord Woolmer of Leeds:** In the event that the UK exits the European Union, what are the areas where the Bank of England would welcome greater regulatory discretion and control over financial firms? Some witnesses have said that it will be important to maintain regulations that parallel those within the European Union. Others have said that there will be real, meaningful discretion in the future that we will want to use. What are the areas that would be helpful?

Sir Jon Cunliffe: The future will bring new ideas, but looking at the existing stock of regulation, as we did when the Bank produced its report about this time last year on the way in which being a member of the European Union affected our objectives, we came to the conclusion that EU regulation on financial services had in the main been high quality and had implemented international standards—I cannot remember the exact words. I keep coming back to the international standards point because that is the touchstone. We listed a few areas where we thought it had not happened, but the judgment in the main was that the EU legislation had been high quality and robust, which is what we need for the UK, given the task we have of financial stability for what we have just called London. It has enabled us to fulfil our function.

We did not think about it then in the context of how you would change things now, but it follows from that assessment that on the existing stock there are things you might change. As to the overall thrust of the regulation, the way it operates and what it is trying to achieve—take prudential standards for banks and the implementation of Basel III—we would not change that. That will develop over time, and it may develop in the UK in a different way. Inherent in that European legislation were compromises, because it had to apply to all member states. When we look anew at the future we may say, "Well, we no longer need to make that compromise because the structure of our industry needs regulation of a certain sort".

In the main, the judgment was that that regulation was robust and high quality. The FPC in its recent record made it clear that regardless of being in or out of the European Union we will need high-quality regulation and supervision in the UK that implements international standards, or goes further. One of the areas you might also think about is that a lot of the European legislation was maximum harmonisation, which meant that you could not do less but you could not do more, nor do different things. Where there are good cases for flexibilities that address the UK and things we might do in a different way—where there is a good case to change something—we would look at it, and the Government would look at it and be prepared to change it. The overall picture on the stock is the assessment we reached last year, and it has not changed.

The Chairman: Thank you, Sir Jon. That concludes today's first public evidence session. The Committee will adjourn for a few moments while we bring in the second panel. Thank you so much; it was a very fruitful discussion.