HOUSE OF LORDS

Select Committee on the European Union

Financial Affairs Sub-Committee

Oral evidence: Financial regulation and supervision following Brexit

Wednesday 1 November 2017

10.15 am

Watch the meeting

Members present: Baroness Falkner of Margravine (The Chairman); Lord Bruce of Bennachie; Lord Butler of Brockwell; Lord De Mauley; Lord Desai; Lord Fraser of Corriegarth; Lord Haskins; Baroness Liddell of Coatdyke; The Earl of Lindsay; Baroness Neville-Rolfe; Lord Skidelsky; Lord Woolmer of Leeds.

Evidence Session No. 5 Heard in Public Questions 64 - 78

Witnesses

I: Sir Jon Cunliffe, Deputy Governor for Financial Stability, Bank of England; Sam Woods, Deputy Governor for Prudential Regulation and Chief Executive Officer of the Prudential Regulation Authority (PRA).

Examination of witnesses

Jon Cunliffe and Sam Woods.

Q64 **The Chairman:** Good morning, Sir Jon Cunliffe and Mr Sam Woods. Welcome to our inquiry on financial regulation and supervision following Brexit. First, can I apologise that you are so far away? Apparently, it was impossible to rejig the Committee after a rather large evidence session yesterday in sufficient time for this meeting, but we will hopefully be able to communicate properly and hear each other.

In welcoming you, I need to make some opening remarks. 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. This will be put on the public record in printed form, and will be on the parliamentary website. You will be sent a copy of the transcript, and you will be able to revise it in terms of any minor errors. The session is on the record; it is being webcast live, and will be subsequently accessible via the parliamentary website. Before we begin, would either of you like to make any opening remarks?

Sir Jon Cunliffe: No, we can go straight into the questions.

The Chairman: Thank you very much. We have had a lot of media attention in the last 24 hours on what the BBC reports are your views that Brexit could cost 75,000 finance jobs. This applies to both of you, but to you, Mr Woods, of course, in terms of the contingency planning that you have required businesses to submit to you; I think it was July when they submitted those. What are your concerns regarding that scenario? Could you tell us, or is this an accurate report?

Sam Woods: Perhaps I could start with that. The first thing to say is that the 65,000 to 75,000 is not a Bank of England number; it is an Oliver Wyman number. How Oliver Wyman came up with that number is that they looked at the scenario that they considered the most extreme, where the UK defaults to WTO status, what portion of revenues of the UK financial services sector might fall away. They thought, crudely, that 40% to 50% of the EU 27 revenues, which are £40 billion out of £200 billion, might fall away. That got them to a £20 billion revenue number, if you like, and a 10% reduction in revenues. They then associated with that a 30,000 to 35,000 reduction in financial services jobs here in the UK, and added to that the ecosystem effect—so ancillary jobs and things of that kind—hence they got to 65,000 to 75,000.

Now, as I say, that is not a Bank of England number. We have not specifically endorsed that report. However, I would say that in terms of a long-term possibility, among one of many scenarios, I regard that as within the plausible range of scenarios. There is, though, a further, very important point, which is the distinction between that, which is one of a wide range of scenarios that could occur in the longer term, and—to come directly to the other part of your question, Chair—the short-term effect, and what we are learning from those contingency plans that have just come in from firms.

In that context, looking across all the plans that we have had from banks and insurance companies, I would say that it is a moving feast, and we will not know until we get there, but you could reasonably think of a day-1 movement of perhaps 10,000. I would be surprised if it ends up being more than that for banks and insurance companies, and to put that in context, that is less than 1% of UK financial services jobs. It is around 2% of UK bank and insurance jobs, or 2% to 3% of the City, if you chose to use that different denominator, so that is clearly a much lower number. It is not an insignificant number, but it is much lower.

The big question is not really where we are going to get to on day 1, although that is very important; it is which path we end up being set on for the longer term, and that depends, at least in my opinion, quite fundamentally on what kind of deal is struck.

The Chairman: Two points of clarification: first, this is the Oliver Wyman report of 2016 that you are referring to.

Sam Woods: That is right.

The Chairman: Yes, we are familiar with that. The other point is whether the day-1 scenario that you have mentioned here would be if there were no deal, or whether this would be the scenario in any event, irrespective of what happened.

Sam Woods: There is a bit in here about the definition of no deal. We have asked firms to show us what they would do in order to preserve the safety and soundness of their business in the event that, at the end of March 2019, there is no successor to passporting as it currently exists between the UK and the EU 27, and there is no transition period. The plans they have put to us are what they intend to do to stay safe and sound in that context.

I would say—and we will perhaps come on to this in later questions—that when we look at the totality of their plans, there are within their plans some cross-cutting issues, most obviously existing contract continuity and data. When we look at those, it is not entirely convincing that firms will be able to self-solve them. There is no deal as in "passporting falls away", and no deal as in "none of those very important plumbing and infrastructure points are fixed". One is considerably more severe than the other.

Lord Butler of Brockwell: Just a point of clarification: you have referred to day 1. What about pre day 1? What is your estimate of the risk of people implementing precautionary plans in the near future?

Sam Woods: It is a sliding scale through time. I expect that, for most institutions that are doing significant activity in terms of establishing a stronger or new EU 27 base, those plans will start to be operationalised from the first quarter. Some steps have already been taken: some institutions have reserved school places, taken lets on office buildings and things of that kind, but that will really start in earnest at the beginning of next year.

It is partly for that reason that our mode of operation in the PRA part of the Bank may also need to change a bit around the new year. We need, of course, to engage not only with what we are talking about now, which is firms we currently supervise that need to restructure outwards in order to accommodate the change, but with the very significant number of firms who are coming in and think about how we enable them to navigate the change.

Q65 **The Chairman:** Thank you. To both of you—I want to broaden this out—we have taken quite a lot of evidence to date in this inquiry about a standstill or transition period, and what some people refer to as an adaptation or implementation period. You probably understand what we mean by that; the Government call it implementation, but I am using the more technical phrases that have been given to us. What would this kind of period need to encompass, and do you recognise the need for two separate periods?

Sir Jon Cunliffe: If I could just make one point on the previous answer that I think is worth bringing out a bit: firms are doing what you would expect them to do. They are saying, "Until I know what happens, I will assume no European authorisations other than WTO, and no transition", and that is necessary for the management of stability risk as a whole. What will happen after that day is very difficult for them to know, but if they have operations now in the EU and operations in the UK, where they had all those operations together in the UK, and in the light of changing business models anyway, I think they will all revise or review their business models after Brexit to see where they can make the right return on equity and how to structure it.

I know the EU regulators have said that they will countenance some arrangements with activity on the continent and in Ireland, and firms retaining capability in the UK, but they will want to think about that afterwards. This day-2 number or whatever is quite difficult to know. What is clear is that if there is no deal—if it is WTO, and firms cannot see the future—they will review, and they tell us that their position for day 1 is essentially to get themselves to the point where they can operate across the point of Brexit. I say that because of your question.

Transition, implementation and standstill are terms that mean different things I think. Two things are key for us, from a financial stability point of view. One is that firms have the ability to make a transition to wherever they need to go, in good time and in an orderly way. The risks around the point of Brexit are risks of breaks in continuity of service—people depending on contracts or hedging protection et cetera that can no longer be performed because of the change of Brexit. It is important that firms can make an orderly transition, and that takes time. We know that normally, when we ask banks to make transitions, or insurance companies, they are given up to 16 years, in some cases, to do that. These are big machines that have to make that transition, so point 1 is that there needs to be time to make the changes that are necessary for the end point.

It follows from that that point 2 is that you do not want firms to make changes twice, which is what the Chancellor has said, so they need to have some idea of the end point they are moving to. There are a lot of political decisions about how you incorporate that in transition, standstill, or implementation, and those really are not for the Bank of England. There are different ways you can structure this. What is important for us is that firms know where they are going, where they have to go to, and they have the time to get there in an orderly way, and if there are any problems that firms cannot solve for themselves—Sam mentioned some elements around contract continuity or data—answers are provided for those.

It could be a number of things. If there is just more time, but no clarity as to what the end point is, then firms will, of necessity, assume what they are assuming now: the worst case. That may enable them to slow their preparations down, because they will have more time, but they will not be able to aim for any other point than WTO and no permissions, because they will not know. Transition is useful in giving more time in any event, but to satisfy that "only adjust once" criterion, you need to have some idea of where you are going to.

The Chairman: That brings me neatly on to another definitional problem that we have encountered in taking evidence. You have talked about needing to know what the destination is. Some of our witnesses have told us that they want a transition agreement to be legally binding—something along the lines of a MoU deposited at the UN. Others have indicated that a communiqué at the end of a European Council would be sufficient. Where does your thinking lie in that regard?

Sir Jon Cunliffe: This is about the risks that firms are prepared and able to take, and the risks that we are prepared to countenance them taking. It is not a binary point; this moves through time. Firms, in the end, will need legal certainty around things like contract continuity, or "I am providing services to a client on 28 March 2019. Will I be able to provide those services on the 29th?" In the end, they need certainty. The point at which that certainty arrives, and how that affects their planning, will be different for different firms.

As to how that certainty can be enshrined, the Brexit Secretary said yesterday that the obvious place to put that is in the withdrawal, or separation, agreement. That has force of treaty between the UK and the European Union. That is where you would normally put it. If you do not put it there, my guess is—I am not a lawyer—that there are other ways in which you could give it certainty, and certainly that separation/withdrawal agreement will not be agreed and ratified by the European Parliament, and I assume in the UK, until quite late in the process. If firms know that this issue is going to be addressed, how it is going to be addressed, and there is a legal vehicle to take it forward, then my view is that it would give them much of the certainty they need.

The Chairman: Sir Jon, I am just about to come to the timing of it, but do you think the announcement of a transition itself is sufficient if it is declaratory—in other words, in a communiqué? Let us say some are asking for end of year; in fact, most are asking for end of year—the next European Council in December—and others, perhaps, are asking for the end of quarter 1. Mr Davis yesterday, in his evidence session, referred to the end of quarter 1, rather than this soon, but would that need to be legally binding?

Sir Jon Cunliffe: I do not see any way that the European Council could make a legally binding commitment until it either has a treaty between the UK as a non-EU member and the EU, or some other legal means. However, firms are going through a necessary planning process now for the default option, because they have no information on something else. If they have a strong political commitment that there will be something else, my guess is that they will not suddenly pick up all their plans and shred them, but they will be able to pursue those plans such that, as they get more certainty, they will be able to take their foot off the pedal a bit. In the end, they will need to depend on a legal structure being agreed between the two.

The Chairman: Can I just finally press you a bit on timing, from where you both sit? We have been hearing from our interlocutors that a transition period is a diminishing asset, and the later that it is announced, the less value it has. What do you think would be the appropriate timeframe, in optimal terms, for the UK and the EU to announce this?

Sam Woods: I would say, perhaps obviously enough, the sooner the better. I agree with the view that has been offered by the Chancellor and a few others that this is a wasting asset; it is worth less through time. However, that does not mean that its value would suddenly plummet to zero at one particular point in the calendar. If the transition period was not agreed soon but was on offer much later in the process, it would still have some value but less than it has now.

To be more specific on your timing point, if you think about it operationally, we, as the supervisor, have a macro version of what the firms have. We have to think about how, if there is an exit at the end of March 2019 that does not allow some of this business to continue, we deal with that. A major part of that, for us, is the inbounds. We have 160 branches here—about 75 banks and 85 insurance companies—from the EEA, and we need to think about how we can authorise those institutions.

Typically, we think of an authorisation process for a firm as taking us 12 to 18 months. That is the normal timeframe. We are now within, if you like, the first of those 18 months. We are in a prep phase with firms. I think, if we get to around the new year and there has not been a clear political announcement from both sides on a transition, for purely operational reasons we will need to get going on all that work. I think you will find that, in that respect, the firms are generally in the same place. As Jon says, I think both we and the firms would attach some weight to something that was not legally binding but that was clear, and where there was a clear signal as to what the route to legal binding-ness—if that is a word—would be.

The Chairman: Sir Jon, do you have anything to add to that?

Sir Jon Cunliffe: This is different for all firms. I distinguish a little between economic activity and financial stability, but the longer you leave a commitment to a transition and a commitment to a path to enshrining that, as Sam says, in some sort of legal agreement, the more firms will have to do. A lot of them have made their preparation; they have chosen their option, they have decided where they want to go, but they have not yet invested in all the permissions and the people. They have taken options on offices, but the longer you leave that, the harder it is to put it into reverse for the firms, in terms of their activity. From a financial stability point of view, you cannot wait, as Sam says, to take the action you need to take to ensure that if the transition is not there, the risk can be managed.

Lord Haskins: On the authorisation side, you have talked about other EU banks getting authorisation here. What about our banks, or banks here, getting authorisation there? There are 27 different countries. Will that be done on a single basis through the EU?

Sam Woods: No. We have been heavily engaged on that already, because obviously those banks and insurance companies that are affected have been going to our colleagues in those other jurisdictions, and I would say that it is mainly BaFin and the SSM—in Frankfurt and Bonn, respectively—the CBoI in Ireland, ACPR in France, and one or two other smaller countries. There has been quite a lot of engagement already between the firms and those regulators about what it would take to be authorised, and indeed some authorisation applications have been submitted to our fellow regulators.

There is also engagement ongoing, which is quite intensive, between us and our fellow regulators about how we manage those restructurings as they occur, given our usually shared objective of safety and soundness. All those things are happening now. I think that is consistent with these things getting operationalised in a harder sense, starting in Q1. The submission of an application for authorisation, for instance, is not of itself an irrevocable step, but when I say it is a sliding scale, we are already sliding in the scale.

Q66 **Lord De Mauley:** You have started to address this, both of you, but what measures need to be taken, and what can the Bank do, to ensure continuity of cross-border and other contracts? Are there differences in terms of measures between sectors of the industry, for example between futures contracts and insurance contracts?

Sam Woods: Maybe I can start with our understanding of the issue, just briefly, and then come on to the mitigations. There is an issue around, mainly, derivatives on the banking side, and then insurance claims on the insurance side. For derivatives contracts, our advice is that if the UK simply tumbled out of the EU, that of itself would not invalidate the existing derivatives contracts that are across the border. To give you a sense of the scale of that, we think there is around £20 trillion gross notional of contracts across the border. We think that is around a fifth of the derivatives contracts that UK banks have. The ECB has done analysis of what portion is the other way; it thinks it may be a similar number for EU firms. We think it might be slightly higher, but, anyway, it is a very big number.

The issue is not an immediate rupture of the contracts. The issue is that, to varying degrees in each of the jurisdictions, and, interestingly enough, UK law is at the stricter end in this regard, normal life-cycle events in the course of a derivative—something like the client wanting to exercise an option, roll over an open position or things of that kind—are themselves regulated activities. If the firm does not have a permission for the entity the contract is with, it is illegal for it to perform that act.

Just to give you an example from this country, the way FSMA works is that if you perform an act for which you are meant to have an authorisation and you do not, you can go to jail for up to two years, or have an unlimited fine. Now, boards may have some appetite for legal risk, but I do not think many are going to have that kind of appetite; at least, I rather hope they do not have the appetite for that kind of legal risk, and I am in fact very confident that they do not. The problem is that these contracts will become steadily more inoperable in practical terms after the exit. That is the derivatives side.

On the insurance side, it is slightly more straightforward, again to varying degrees in different jurisdictions, and with slight subtleties around place of risk and place of activity—all sorts of things of that kind. The bottom line is that paying an insurance claim tends to be a regulated activity where the same constraint applies. If the UK exits the EU and you have a customer who, say, has bought a policy from a UK insurance company but is in the EU 27 and wants to claim, it may well then be illegal for the company to pay that claim. That is the problem.

What are the potential solutions? In decreasing order of effectiveness/desirability, by far the best fix for these is if something can be included in the withdrawal agreement, or a separations issue agreement of some kind—a bilateral agreement to fix these things in a symmetrical way on both sides. There is precedent for this sort of thing. The most obvious one—Jon might even have been involved in it—was with the introduction of the euro. The same question arose: "Does the introduction of the euro disrupt large numbers of existing contracts?" The answer to that was, "It may do, unless someone does something", so a clause was inserted in the euro regulation that dealt with that problem. That would be by far the best fix; that would give certainty, and would effectively deal with the issue.

The next step down is whether the UK and the EU 27 could respectively, either in a loose agreement or entirely separately but informally co-ordinated, take unilateral actions to deal with that problem. That, again, might be effective. It strikes me as more likely to be messy and more likely to end up with slight disparities that people find difficult to manage.

Then, third best—and, in my view, very unlikely to be satisfactorily effective—is self-solving by firms. If you will forgive me such a long answer, in brief the first option is for firms to move those contracts. They can use a part VII court process to do that. They can set up a thing called a societas Europaea and move that across a border. Many firms are planning to do some of those things. Looking across the totality of the derivatives side and insurance side, I do not believe that we can be confident that that can be credibly and completely done for all firms and all clients by April 2019. That is one self-solve. We will definitely see bits of that, but it will be highly incomplete. Really, that is the main option that they have.

The other way they could do it is to get their clients to agree to re-paper. Again, some of that will happen, because with derivatives, if you have an EU 27 company that is transacting with a UK bank, they may wish to move their existing contracts to the new EU entity that they are contracting for new business for netting benefits. Bits of that will happen, but I just do not believe that all these contracts with all customers can be re-papered in the timeframe that we are talking about.

Sir Jon Cunliffe: The £20 trillion is for uncleared derivatives. These are derivatives between banks and end users that do not have to go through clearing houses. The effort, since the global financial crisis, has been to put more of this activity through clearing houses, because it gives you better risk management, and there is probably about £70 trillion of these contracts sitting in clearing houses and the like. Some will run off before Brexit, but a large majority will stay. I assume there will be some questions on clearing houses later on, but they face a number of issues about permissions and authorisations, and they also face this life-cycle performance issue.

Q67 **Lord Bruce of Bennachie:** Just a development from that: when we started this debate, both in the run-up to and after the referendum, there seemed to be an assumption that some form of passporting would continue. That now seems to be receding over the horizon, so my first question is whether you agree that that is the case. Also, what are the implications of that relatively simple operation, as opposed to what you have just described, which is highly complicated, for financial stability, both here and possibly contagion within the EU, which nevertheless could have repercussions for us?

Sir Jon Cunliffe: I do not think the Bank of England ever assumed that passporting would continue.

Lord Bruce of Bennachie: I did not say the Bank would.

Sir Jon Cunliffe: There are a range of views on Brexit, and the outcomes of Brexit and the like. There are some areas in the EU legislation that provide for third countries to be equivalent and treated in a certain way, and the Governor said quite early on that that probably would not work for a relationship as deep and as complex. They are quite specific, in specific pieces of legislation, but for the main banking services, there is no equivalence. There is only the passport, and our assumption was that once we left, a whole range of possibilities, from nothing to everything, was possible. As to where the City or industry opinion is now on passporting, it is difficult for me to say. I do not hear much about it nowadays.

Lord Bruce of Bennachie: My point is that, given that is not going to happen and therefore there is going to be a whole load of complicated, individual discussions and agreements and so forth, how does that impact on regulation and financial stability, if it is more complicated, therefore, to administer than the current system?

Sir Jon Cunliffe: The first point is that it does not have to result in lots of separate agreements. I cannot comment, because it would not be very valuable, on what the end state is, but you can see end states in which the passport might continue, or something like the passport might continue, or in which there is regulatory and supervisory equivalence between the UK and the EU that allows the current level of financial services trade to continue afterwards. I do not think that is ruled out of the negotiations, but there is a possibility that it is much more of a sector-by-sector, or firm-by-firm, approach. We cannot know which of those will happen.

Lord Bruce of Bennachie: Can it be more asymmetric? We have agreements now where we are rather more relaxed about people trading here than the other way around. First, can we continue that, or even be more generous; how would the Bank view that? Secondly, does it matter if there is a difference?

Sir Jon Cunliffe: I would distinguish two things. There is a negotiation that will have to happen, a trade negotiation or some other negotiation, where the Government may want to decide on symmetry or non-symmetry for negotiating reasons. It is a government decision to decide, in the end, how open we want to be relative to how open the other side is, and that is not for the Bank.

What is important for us is financial stability. We are responsible for financial stability for probably the largest international financial centre in the world. It is 10 times GDP, and openness—and openness in financial services—can be and often is a good thing. It is more efficient, and it enables you to manage risk better. You get more liquid pools of capital; you get diversification benefits. However, you have to be sure, when you are open to financial services from abroad, that those financial services are either coming from well-regulated, well-supervised jurisdictions with whom you have good, co-operative relationships, or, if they do not, that you can ensure that the activities that happen in the UK are managed in a certain way. Sam may want to say something on retail and wholesale here as well.

However, for the Bank, whatever arrangements the Government decide for incoming financial services afterwards, from a financial stability objective—which is admittedly much narrower than the range of objectives the Government have—we need to ensure that incoming financial services either come from jurisdictions with good standards and supervisory co-operation, where the risk can be managed. We have a lot of US entities in the UK, so that is not an impossible task. Alternatively, if we think the risk cannot be managed in that way, the way those services operate here has to be protected from risk. That would be our consideration.

The Government, I think, will have to take a view on what they want to allow in, but from a financial stability point of view, our point would be that it has to be from well-regulated jurisdictions and there has to be strong and deep supervisory co-operation. Alternatively, we have to manage those services in the UK in a different way to ensure they are carrying, if you like, protection here, and we can manage what they do here at the same time.

Sam Woods: I wonder if I could just add one very brief point. You mentioned complexity; it is pretty likely that if passporting falls away for significant sections of cross-border business, which is typically wholesale, we will end up with more complicated structures of firms, because of the interconnections that there will be between business they are doing in the EU 27 and business they are doing here in London.

I think you were suggesting that the path without passporting is likely to lead to greater complexity in some ways. I think that is a correct observation. The only caveat I would add is that that is really true for wholesale business, both banking and insurance, but that is already pretty complicated. It is just taking it to another degree; that, in and of itself, is undesirable, but it is not as though we start from a place where that is all wonderfully simple and clean, and it is moving to a very complicated thing. It is more a question of degree.

Lord Bruce of Bennachie: Lord Haskins asked a question before about bilateral country-to-country, as opposed to EU-wide, agreements. If it is going to be that complicated, is that, from your point of view, a better way forward? The rhetoric says, "This gives us an opportunity to be even more global than we are". Is not having an EU-wide agreement but still being able to negotiate with individual member states about access, and maybe asymmetrically so, something that the Bank would find concerning, or something that they would regard as a market development?

Sir Jon Cunliffe: At the moment, it is a complicated picture. Some things are negotiated nationally; some would happen at the level of the euro, if I can put it that way. If a bank wants to establish a subsidiary in a euro country above a certain limit, then that subsidiary would be supervised in Europe not by the national authorities of France or Ireland but by the Single Supervisory Mechanism that exists for the banking union. Some of those decisions are at the banking union level for euro-area countries. If you want to establish a subsidiary in a non-euro-area country, it is national, and there are some areas where the establishment of services is not dealt with at a national level—CCPs and infrastructure, for example. That is all authorised at the European level anyway, so it is a bit of a patchwork at the moment.

I do not think of this in terms of a better opportunity or a worse opportunity. From a systemic point of view, I want the interlocutor on the other side to be part of a high-quality regime that we can have confidence in, and be prepared to co-operate with us and operate with us to ensure financial stability. We do that at the moment with national regulators for some things, with the SSM for other things, and with ESMA et cetera for a few things, but the key is not which level. It is that whoever is sitting on the other side of the table is part of a well-regulated, high-quality jurisdiction, and there are proper and effective supervisory arrangements.

One of the issues in Europe when you do that is, because of the way in which competencies or powers—effectively, authorities—are divided up between the different levels, you often have to deal with a multiplicity of players on the European side. The Single Resolution Board, which we would have to deal with if we had to deal with the resolution of an institution that operated in the euro-area and in the UK, has quite a complicated wiring diagram between the member states, the ECB, the Council, the Commission, et cetera. Our interest is in ensuring that that interlocutor works and can work effectively with us. I am slightly agnostic about whether it is at the national or the European level; I just want to know that it works.

Q68 **The Chairman:** Just a very quick point: the *Financial Times* yesterday channelled some concerns about the increase in back-to-back lending transactions. Would mutual access agreements be a preferred option from a regulatory perspective to deal with the risk inherent in back-to-back arrangements?

Sam Woods: The first thing to say about back-to-back arrangements is that it is normal for wholesale banks to pass around risks within different bits of themselves across borders; indeed, it is inherent in how those businesses are arranged, and that is the reason why, from a resolution point of view, typically those wholesale and trading banks are a single point of entry. People do not make the assumption that you would be able to break the thing up in a hurry during a resolution, whereas for retail business, that is more typically local, and indeed, as you are aware, we are ring-fencing our own banks in that respect. It is normal for banks.

Although the phrase "back-to-back" is not used for insurance companies, they do exactly the same thing, which is to reinsure within themselves. Back-to-back arises where you have separate legal entities. Crudely, people are talking about a trade done with an EU 27 counterpart by the EU 27 unit of a trading bank. It would then hold the counterparty credit risk for that in the EU entity, and it would enact a parallel trade for the market risk—ship it into the London entity or, indeed, into the New York entity or somewhere else.

Those arrangements can be complex, and that is something we worry about. We always want to make sure that the booking arrangements within firms are sufficiently clear, and that here in the UK we have a senior manager whom we can hold accountable for making sure they know what is going on. We are used to that; we can manage that sort of business. It is difficult, but we do it.

The *FT* has thrown at me a number of pieces on this, speculating about what the perspective of our counterparts in the EU 27 might be on that. It is fairly clear from, for instance, statements that have been made by Sabine Lautenschläger at the ECB, from a Q&A that the ECB has put out, and from what the EBA, which is the authority that we all sit on, has published that there is an understanding and an appetite from EU 27 regulators to have firms doing a certain amount of that activity. However, it goes back to something that Jon said at the very beginning: the question is where that will go longer term. I think everyone can see that in the first wave of this, there will be quite a lot of that, and we will need to manage it, but the question is whether that is a steady state or whether it evolves differently through time.

Q69 **Baroness Liddell of Coatdyke:** I wanted to broaden out slightly away from financial stability exclusively in the financial services sector and look at some of the more macro issues. Let me stress that I am talking about post day 1; I am not talking about the short term. The Financial Policy Committee made a statement on 25 September where a number of concerns about the other threats to UK financial stability were laid out, everything from indebtedness to geopolitical tension and so on. You know it better than I do.

How can the Bank, post day 1, mitigate the impact of Brexit in relation to these macro risks? What is the scale of impact on the macro risks after day 1, and what tools are you thinking of in the medium to longer term to mitigate that risk?

Sir Jon Cunliffe: The *Financial Stability Report* in September set out, as it always does, the risks, and they are not all about Brexit: risks around snapback—a sharp change in valuations of financial assets because of changed perceptions of, say, US interest-rate policy—or the growth of debt in China, or, as I think we mentioned, geopolitical concerns. There is a range of those.

We have no control over what happens in the politics elsewhere of other countries, but we mitigate those by ensuring that the financial system could take a shock arising from that area. That is where the annual stress test that we do is hugely important, and this year's stress test has a very big shock on global GDP from China. Remember, the stress test is not what we expect will happen; it is a tail event—it is an extreme scenario—but one that could happen, so it has a recession in China, for example, and it also has shocks to banks' trading activities, including through currency movements.

We may also look to see that banks and the financial system are protected against particular areas where that risk might come. We have been doing work, for example, on liquidity in financial markets to ensure that liquidity is there if you have a sharp correction. However, generally, it is about looking at the UK financial system and making sure that people have properly provided for, and could withstand, those risks—not without taking losses, but withstand those risks without falling over, and withstand those risks in being able to continue to lend to the UK economy.

We also characterise the risks around Brexit, and the ways that we are trying to mitigate them are as Sam said. We are working actively with the firms to ensure they have plans and those plans do not generate financial stability risks, and where there are cross-cutting issues, such as contracts, trying to surface those and get those dealt with.

However, there is also the question: if Brexit proves to be an economic shock to the UK—I am not saying it will be—can the financial system take that economic shock, and are there things within the UK financial system and economy that might amplify that shock? For example, if you have a high level of household indebtedness and households are highly leveraged—they have debt to income of about 135% now in the UK, which is lower than the crisis, but is high by UK historical and international standards—would that act as an amplifier in a stress scenario? The stress may start with Brexit, it may come from Brexit, but could it be amplified by other things?

In the same way, we have a large current account. The ONS have just redefined it at 4.4%. To what extent could that amplify stress? Could some of the vulnerabilities that we have in the UK more generally be triggered by a stress in Brexit? There, the work of the FPC is about trying to ensure that those vulnerabilities are provided for, again, by making sure the system is resilient to a shock, taking into account the vulnerabilities that we have.

The stress test that we have this year is not a Brexit stress test, but it is pretty severe. It has a 4.7% drop in UK GDP, a 33% drop in house prices, and a 40% drop in commercial property prices; I think unemployment goes up to nearly 10%, and the Bank raises interest rates by 3.7%. Previous stress tests have also been pretty severe, so this is not extraordinarily severe for this year. However, without knowing where those things come from, plus dropping world GDP by 2.4%, China going to -1.4%, and lots of other things as well, we put the financial sector—the big, key banks—through that, including their trading books and trading risk, to say, "Are you resilient to those things happening?"

Not that we expect those things to happen; it is the tail event and we want them to be able to withstand the losses and continue providing financial services to the UK economy. The lesson of the crisis is that it is the credit crunch, when they de-lever and stop providing services, that makes a bad thing much worse. We have tried to incorporate all those things in the stress test.

Q70 **Lord Haskins:** We have spent a lot of time in this building over the last 10 years looking at regulation post 2008, and the procedure has been basically to integrate more the regulations and markets across the EU, and to improve the quality of supervision. That is what we have been trying to do.

There is a danger, with what is happening now with Brexit, that there is going to be a fragmentation of that process and that the integration process will be affected to an extent by this. The question is whether this is going to make supervision of the markets a more complicated and difficult issue, given it was already quite complicated and difficult before we started.

Sam Woods: The issue is quite different for banks and insurance companies, compared with financial market infrastructure, including central counterparties. I will answer in relation to the first, and pass to Jon on the second.

If we just take banks—and you can read this across to insurance companies to some extent—fragmentation in retail is a different proposition from fragmentation in wholesale. Retail banking, in my view, is naturally local, and that, indeed, is the whole logic of the ring-fencing that we are currently applying to our own major banks. It is also the underlying logic, although we apply it proportionately, to our third-country regime in relation to banks, where we say, "If you want to do significant retail activity"—which we define crudely as north of £100 million of transactional retail deposits—"you have to do that in a subsidiary, and not in a branch".

The world is largely arranged in that way already. It is going more in that direction. That is entirely sensible, not least because if you do not arrange the world in that way in peacetime, in wartime everyone wants to arrange it that way and it is extremely messy. I am more concerned about the drift, exactly as you describe it, in relation to wholesale finance, and in particular in relation to wholesale banking.

This is not only a Brexit thing; the US has brought in this FPO regime, which requires wholesale banking, at least to some degree, to be contained geographically within the US. There is currently a proposal being put forward in Europe, which we think is not a good idea, which is really a response to that and has the same logic. Brexit, of course, potentially adds to that, if we find that we cannot agree suitably co-operative arrangements on regulation and supervision, and I do think that that would be a step backwards.

The reason for that is that, going back to my earlier answer, it is going to increase complexity for us all. It is also going to increase costs for the entities. Both of those are things that you can deal with, but I do not see what the commensurate benefit is on the other side. That would be a net negative, and that is why we think that continued market access, twinned with appropriate supervisory and regulatory co-operation for certain parts of financial services, would be a good thing, but I will pass to Jon for the central counterparties.

Sir Jon Cunliffe: The Bank said in its report in 2015 that, in general, EU regulation and legislation has implemented international standards in a high-quality way. There have been some things that we have not necessarily agreed with, and when you are having an agreement for what was then 28 countries, it can be more cumbersome et cetera. However, when you look at the international standards where they exist and how the EU has implemented them, it has been high quality. The FPC said, I think, in August 2016 that the UK needs regulation and supervision at least as good as international standards, just because of the risk we are carrying with a financial sector 10 times GDP.

One hopes that international standard-setting that lies at the heart of bank prudential rules and market infrastructure rules—not for insurance—continues, and that both sides continue to implement it in a high-quality way. However, clearly, the more fragmentation there is in the rule-making, the more fragmentation there is in the supervision, and the harder it necessarily becomes. There is a lot of EU legislation in areas where there are not international standards, particularly in the market finance area—so legislation on hedge funds and the like. First, we must ensure that we maintain international standards that are implemented well in all countries. It is very important to the UK, particularly given our openness.

On the standards for financial market infrastructure, again, we are implementing international standards, but the EU has gone quite a long way with EMIR. If we fragment that business, but still try to keep it cross-border, then the supervision of it becomes very difficult. To put it another way, if fragmentation means that you not only put the business in one country and supervise it in that country but it has no cross-border aspect either, then supervision is easier, because you are just dealing with national firms. However, if you are trying to maintain the benefits of cross-border activity—economic and financial stability—through diversification and deep markets, and you layer on that fragmentation by ring-fencing activity in certain jurisdictions, you do make the situation much more difficult.

Lord Haskins: I assume that the ECJ has no relevance to any of this.

Sir Jon Cunliffe: In what sense?

Lord Haskins: In the sense of arbitration.

Sir Jon Cunliffe: At the moment, if there were a dispute in the EU as to what the legislation meant, or whether a national authority had fulfilled its obligations under EU legislation, it would go to the ECJ, and the ECJ would make a binding recommendation. However, in terms of jurisdictions outside the EU, no, I do not think it would.

Lord Haskins: It is not a problem for us because of the Government's view on the ECJ.

Sir Jon Cunliffe: What would be the problem? I apologise.

Lord Haskins: The problem of the process: taking a dispute to the ECJ, and the United Kingdom Government saying, "No, we are not happy with that".

Sir Jon Cunliffe: I would not use the word "problem". If I have understood the question correctly, I would go back to my earlier answer. We have a lot of US banks operating here; we have Swiss banks operating here. They are very large operations. We have a supervisory relationship that is deep and comprehensive with the US authorities, and there are lots of them.

That enables us to say with confidence that we are prepared to have those entities operate here without ensuring that they are completely ring-fenced here in what they do, and when it comes to resolution, as Sam said, it is not sensible to treat them as separate parts. We would not be able to go to the ECJ in future, one assumes, for dispute resolution, so that would put us in the same position as we are with our American counterparts. Therefore, we have to have both high-quality regulation and the comprehensive supervisory co-operation. That is, if you like, what replaces that framework.

Q71 **Lord Desai:** I just wanted to pursue something on the fragmentation. There are two ways of looking at this. One is that the markets should be perfectly co-ordinated and interconnected. The other is that they could be fragmented. It is possible to argue that in a perfectly co-ordinated market, a shock from one side to the rest would go very quickly, whereas in a fragmented market, you could break the circuit. Intellectually, at least, there are arguments both ways—a fragmented market might actually be healthy.

Sir Jon Cunliffe: The Bank's report on the EU's impact on the Bank's objectives in September 2015 went exactly through that, and that is why I was saying openness is a way of diversifying risk, spreading risk, and just having a deeper market. However, it also clearly enables risk to come into your system and enables risk to move through the system, which is why, if you are going to be open, you have to be able to depend on the regulation and the supervisory co-operation with the other side. It is essential, and the benefits of openness depend on international standards, high-quality regulation and supervision.

Sam Woods: You have exactly that same proposition, if you like, writ small for individual financial services companies. Evidently, if you are a highly international bank or insurance company with a big exposure to China, you are exposed to that risk. At the same time, you may be less exposed than a purely concentrated UK player if we have a downturn in the UK. There is a trade-off between those things, and as regulators it is not our job to tell firms what shape they should be. It is to assess, given the shape they have, what they need to be safe and sound. As Jon said in an earlier response, the heart of that for banks is our stress-testing regime. The heart of it for insurance companies is, in fact, a stress test, which is how we set the capital requirement for them, but it happens to be a specific test to each company, rather than a cross-cutting test.

Q72 **Lord Skidelsky:** Mr Woods, in your recent speech of 4 October, I think, on geo-finance, you concluded that the Bank struggles "to see an outcome in which banks and insurers do not get harder to supervise and harder to resolve for all involved", and you said that we will have to see whether we are successful. Could you just spell that out a bit, in terms of the fragmentation versus the concentration of regulation?

Sam Woods: I am really thinking there about the ways in which the shapes of banks and insurance companies are going to evolve through this process. On most plausible paths, the structures that we are going to end up with post Brexit—if I look across the 400-plus plans that we have had from affected firms—will be more complicated than those we have today.

The easiest example of that is to think about the example we were talking about earlier, where you have a bank that is currently here, using passporting today to sell across borders, but has everything here in London. In the new world, it would have to have a bit of this going on in an EU 27 entity, and then the two things would be interconnected with each other, and probably also with the home country, if it is, for instance, an American, Swiss or Japanese bank.

I may be wrong, but most of the paths that I can see I think are going to lead to that world, where it is harder for the firms to manage, it is harder for us to oversee, and it is more difficult to resolve. However, I again introduce the caveat that I gave earlier, which is that it is not as though today's structures of, for instance, international trading banks are the exemplars of simplicity. This is already quite a complicated thing, and it is going to get a bit more complicated.

Q73 **Lord Butler of Brockwell:** We have been talking about co-operation between the regulatory authorities. Can we pursue the institutional aspects of that for a moment? I imagine you would not go so far as expecting there to be a joint supervisory body, but what might cement co-operation? Would it require a formal agreement of some sort, do you think, between the UK and the EU regulatory bodies?

Sam Woods: It may be worth describing, very briefly, what we do today with the EU 27 and what we do today with the US, because there are two quite different models that are out there and operating as we sit here. Within the EU, there is a quite highly developed institutional and regulatory architecture around this business of supervisory co-operation, and the best example of that is this thing called the JRAD process, which is the Joint Risk Assessment and Decision.

That is a process in which, by law, a college is constituted that comprises the group supervisor of, say, a bank—it is also true for insurance companies—the supervisor of any subsidiary of any size, and the supervisor of any significant branch, but not of other branches. That is the college. That college meets, and it makes decisions. The decisions are taken by the group supervisor and the supervisor of the subsidiaries, but not by the branch supervisor, and those decisions include setting the capital requirements for the entities involved, setting the liquidity requirements, and those sorts of things. There is a structure of that kind that we work with today, and that works fine.

We have a different model with third countries, and I give the US as an example, where we agree an MoU, and the MoU does two things. One is that it allows the data to flow back and forth, but secondly it has a split of responsibilities: "Here is what you are doing, and here is what we are doing". That is a lighter machinery. With the right level of trust and co-operation on the other side, though, that is also an effective machinery.

To come more directly to your question, in a future world in which continued preferential market access arrangements were agreed for certain parts of financial services between the UK and the EU 27, it is quite natural that some counterpart of that would be some kind of successor to what we have today, but it could not be exactly what we have today, because, for instance, if there is a dispute it goes up into an entirely European structure, the ESAs.

Any successor to that regime could contain the same substance in terms of what we do together and how we agree stuff, but would need a different overarching architecture, and such an agreement would be most naturally captured in the financial services chapter of a free trade agreement. It is quite striking to me, looking at the submissions that have come to the Committee, that that also seems to be what most of the people who have submitted to the Committee are arguing for. There are different flavours to it, but it is broadly in that space.

Lord Butler of Brockwell: It would be part of an FTA, but not just a memorandum of understanding.

Sam Woods: If you are going to agree market access arrangements, that needs to be part of something that is not just an MoU between regulators, because it is not within our gift to give that. If you agree such a thing, and one obvious way to do that would be in an FTA, then a logical counterpart of that is supervisory co-operation of the sort that I just described. To me, it is more natural that you would just capture the whole arrangement in an FTA. Might there be a version where the market access bit is captured there, and the rest is captured between regulators? I suppose that is possible.

Lord Butler of Brockwell: Are there any dangers in that? Would you then be drawn into support for a European entity that got into trouble?

Sam Woods: I will pass to Jon with his resolution hat on in a moment, but I would say that the answer to that is no, with one caveat, which is that evidently where we allow firms to trade across the border, we are running some risk in terms of having that entity doing business within our shores.

That is why we have to have a strong degree of confidence and trust in what is happening back in the home regulator such that that risk is within tolerable bounds, and that is very important for wholesale business, because the whole thing is bound up together and you cannot just do your bit of it. It is also important for retail business, but for retail you can do more yourself to mitigate and control the risk of the thing that you have than you can for wholesale.

Sir Jon Cunliffe: I will just say a word about the resolution side, which is about what you do in death, not what you do in life, but it goes to what you will tolerate in life. There are now international standards that have been developed on resolution, and not just the degree of protection that firms need to carry that can be accessed once they have failed, rather than beforehand, so they could be wound down safely and the like without having to go into insolvency, as Lehman's had to in the crisis, and how they should be structured and the like.

That is a key thing in considering, "Do I allow this firm to operate in the UK?", and if it is a wholesale financial sector firm, then making it a subsidiary gets you so far but, as Sam said, these firms are so integrated in what they do that in the end many of them have to be resolved as a single entity—a single point of entry. Do I have confidence that the home authorities have a resolution framework that can allow this firm to be resolved? Secondly—and this is part of the international standard—will there be enough loss absorbency and resolution attributed to my part of the firm, the firm in my jurisdiction, to ensure that if things go wrong in this jurisdiction, it can be dealt with without the host having to put in financial support? I think that is where the question started.

The international community's answer to this resolution issue of cross-border wholesale banks has been to set out a framework and to ensure loss absorbency—i.e., debt that can be bailed in—and some of that being attributed, in a contractually enforceable way, to the branch or the subsidiary to ensure that happens. There is another model for that, which says that in life, you treat it as a collection of separate firms, in which case each one of those has to be resolved separately and armoured to deal with resolution.

One of the tests for whether we allow branches or subsidiaries in the UK at the moment is whether we have confidence in the resolution framework of the other side. In the EU at the moment—and maybe this goes back to Lord Haskins's point—I do not have to worry about the rules, because we are all subject to the same law and the like, and the UK regime for resolution is effectively implementing the EU directive. After we leave, then in the same way as for the US or the Swiss, we will have to have confidence in the resolution arrangements for the EU side. However, it is resolution, in the end, that is supposed to protect you from your taxpayers having to bail out either a national institution or an overseas institution that has systemic operations in the UK.

The Chairman: Staying with banks' role in international standards-setting, I wanted to bring in Lord Skidelsky.

Lord Skidelsky: Where are we in our list?

The Chairman: I think you were going to deal with question 9, Lord Skidelsky—banks' position. We are going across, because Mr Woods introduced the international, US framework. I thought that you had agreed that.

Q74 **Lord Skidelsky:** Yes. I wanted just to go on pursuing this point about international standards. You have a much more complex system than you used to. In the early 1930s, Keynes wrote, quite famously, "Let finance, above all, be national". Well, you have absolutely the reverse of that; it has gone the other way, and what is more, you have—especially in the wholesale market—an explosion of derivative instruments, trillions and trillions of them.

There are two questions that arise. First, to what extent can the Bank of England lead, or guide, the setting of international standards and, secondly, are there any international standards available that can prevent, or even seriously mitigate, another crisis like the one we had in 2007-2008? One is really asking two questions: one is about regulatory autonomy, and to what extent, in order to maintain financial stability, the Bank of England has to have regulatory autonomy. The second is whether regulatory autonomy is possible in the world we live in. Sorry—they are two separate questions.

Sir Jon Cunliffe: I will start at the high level that you started at, Lord Skidelsky, and come down to the detail. If you believe that a global financial sector or global capital market, properly governed and managed, is both an economic benefit and can enable you to diversify and manage risk better, then you do not start from "let finance be international" but there are benefits here that you want to keep. If you believe a world in which finance is completely fragmented and national would be a worse world, then the question is: "What are the conditions under that, properly managed and governed?" That is where international standards are key.

The international standard-setting process existed for banks before the crisis. It now exists in a much deeper, more powerful way for banks, and for other areas of the financial sector: financial market infrastructure and the like. This whole idea of international financial stability is really what is at the heart of the Financial Stability Board, which tries to pull it together and push global standards.

Could global standards have prevented the crisis? There are different views on the reasons for the crisis, but one of them was the undercapitalisation of banks. Sub-prime losses of $360 billion turned into $2.7 trillion-worth of losses for the financial system, in part because those losses knocked banks over, and once you start knocking banks over, you get credit drying up, and that knocks small banks over. The Basel III standards, which are being completed and I hope will be completed soon, have much higher levels of capital—real capital, not tax receipts and other things that were there before. That should make banks much more resilient and able to take a much higher level of losses without those knock-on effects.

In the same way, derivative contracts were not cleared through central counterparties in the main, and there was a huge web of contracts between bilateral players that a) nobody understood, because they were not transparent, and b) were not being margined; i.e., collateral was not being provided against them for shifts in value until, suddenly, the crisis came, and then players started to demand margin from each other, which, again, accelerated the crisis. I could give other examples.

The international standards have made a very substantial contribution to reinforcing the system against those sorts of risks. You can ask whether you would have had the sub-prime lending in the first place, but if you had had those sorts of losses, would it have translated into a global financial crisis? Under current standards, no; I do not think it would have done.

The Chairman: We are becoming slightly diverted. I want to press on this area whether you think the Bank will still continue to have leadership in international standard-setting.

Sir Jon Cunliffe: I apologise, Chairman. You have started me off on my special subject; I apologise.

The Chairman: For which we would love a dissertation—at another time.

Sir Jon Cunliffe: I have spent many years of my life in this; I have to believe in it. On what the Bank is doing, it goes back to the fact that we are not national in finance in the UK; we are very international, and we are 10 times GDP on this. Much of this is being an international financial centre. We need those standards; we need the strongest international governance relationships.

The Bank has always invested an awful lot over the years not just in the individual committees that do the rules et cetera—and we intend to continue doing that—but in what I call thought leadership. The Bank has spent a lot of its intellectual capacity on thinking about these international financial regulatory and supervisory issues, and the macro-financial, and trying to give intellectual leadership to some of those debates. My predecessor certainly did a huge amount of this. Other people in the Bank have done this.

Brexit will change this only to the extent that we will not be able to give, or try to give, thought leadership and detailed influence on rule-making within the European Union, because I assume we will not be in the European Union. However, we will still, a fortiori, want to influence the global debate to try to ensure that these things are evidence-based and properly managed. We have a base for that. I hope it is not being overoptimistic to think that the Bank has a strong international reputation, and we intend to continue that and continue to invest in that.

Lord Skidelsky: Will Brexit give us opportunities that we do not have at the moment to strengthen our regulatory autonomy?

The Chairman: Very briefly, Mr Woods.

Sam Woods: Very briefly, we are overwhelmingly focused at the moment on delivering an orderly transition—all the things that we have been talking about in this hearing. This is a number-1 priority for us. We do not see very high returns to investing heavily, at this point, in the question of how the regime might be shaped after that point, basically because it fundamentally depends on the nature of the deal.

The one thing that I would add, though—briefly, in line with the Chair's guidance—is that there is a debate that is going on in America, and within Europe, which is about proportionality very specifically in relation to small firms. There is a question as to whether the practice we have had historically, to some extent, in the US and more so in Europe of applying all the weight of everything to the smallest firms is sensible. At a point after we left the EU, we would want to continue to consider that question, which will also be being considered by the EU 27.

The one final comment I would make on that is that debate, as it is going on in the US and currently in the EU, is not, or should not be, in my view, about weaker standards for smaller companies. It is just a question of whether the full weight of the complexity, all the regulation, needs to apply to the very smallest companies, as well as the biggest ones.

Q75 **The Earl of Lindsay:** I want to go back to central counterparties, which, Sir Jon, you made reference to in your answer to Lord Haskins, and just ask you to set out your views on proposals in respect of future supervision and the possibility of changes to their location. Perhaps you might want to go on and say how involved you are in negotiations around the EMIR proposal that the Commission is working on, and what your views are, in general, about joint and collaborative supervision.

Sir Jon Cunliffe: Maybe I will just put this in context, because it is important to the answer. CCPs have become a politically charged subject, and there may also be trade or industrial policy reasons for some of the changes. I will just comment on the financial stability aspect here.

From a financial stability point of view, as we just talked about, all cross-border financial activity exposes firms in one jurisdiction to risks from firms in another jurisdiction, and in essence CCPs are no different. In fact, some of the £20 trillion of uncleared derivatives that Sam mentioned at the start of this are not going through CCPs. Before the crisis, those relationships happened between banks, so it is not as if there is some financial stability risk about CCPs that is different in kind from general financial stability risk.

Two points need to be made there. One, this is not an issue of currency. If your bank is exposed to a bank in another jurisdiction, if you are a European bank and you are exposed to a bank in the US in dollars, then that can give you a financial stability concern as much as euros, yen or sterling. Financial stability risk, to me, is about how institutions in one jurisdiction are exposed to another.

The second point I would make is that CCPs, in order to shrink risk and make it easier to net off risk, concentrate risk. You have CCPs in one jurisdiction that a number of jurisdictions depend upon, so it is much more of a multilateral relationship than an individual bilateral relationship between two banks. When you have a number of jurisdictions that depend on a critical piece of infrastructure, then from a supervisory and regulatory point of view, you need to have some arrangements that allow all those jurisdictions to have some sight of what is going on, to be consulted, to co-ordinate action and the like, because it is a critical piece of infrastructure that matters to a lot of jurisdictions. This is not just about CCPs: on payments, for example, the SWIFT messaging service matters to everybody, and we saw from the Bank of Bangladesh incident how that can transmit.

What I see in the European proposals, which have a number of different models and a tiering of different models for different sorts of CCPs, is recognition of this need to reflect the multilateral nature of CCPs, and recognition that you need to defer to the home supervisor but there have to be some arrangements between them. Even if we were not going through Brexit, we would have to develop the way we supervise and regulate these critical pieces of international infrastructure, simply because of this co-ordination issue.

Is the Bank prepared to think about extending and developing the models we have for supervision of this key infrastructure, bearing in mind that the underlying risk is the same as any other financial stability risk? Yes. We had started to do it before Brexit. The Bank of England set up colleges for its CCPs. There were colleges in Europe under the European legislation; we set them up globally and invited other jurisdictions to come. We did that voluntarily, precisely for this. There are ways you can do that.

However, managing that financial stability risk does not require the CCP to be located in a certain place if it carries a certain amount of the business in the currency of that jurisdiction. Currency risk, to me, is not part of this financial stability risk, but it may be relevant for monetary policy reasons—the transmission mechanism et cetera.

The second point I would make goes back a little to Lord Butler’s question. You need co-operation and consultation, and you may need to specify those things quite closely. We have an agreement with the CFTC in the US on London Clearing House and ICE-EU, which has joint supervision and deference to the UK supervision through what is called substituted compliance. However, you have to make sure that you do not wind up with multiple hands on the steering wheel and multiple feet on the brake, if I can put it that way. This has to be practical, it has to work, and it has to reflect the balance of risks between the jurisdictions.

The Earl of Lindsay: Are the proposals that ESMA assume greater powers of supervision of their countries an example of intelligent joint supervision, or is that an example of too many hands on the steering wheel?

Sir Jon Cunliffe: The proposal for this to be done by ESMA rather than, as at present, BaFin or the national jurisdictions is intra-EU business, to take this up to the EU level. The proposals to have a location policy are not addressing the financial stability risk I talked about. Inside some of the other proposals in the Commission's draft regulation about joint supervision, or whatever, are the elements that we would, in any event, want to work with, and some of the elements that we have with the US. In its current form, there are certainly difficulties with the proposal as it stands.

The Earl of Lindsay: Going back to the location policy, we have had evidence from other witnesses that suggested that either induced or, indeed, forced relocation is straight fragmentation, which therefore automatically leads to greater risks in terms of loss of stability, as well as an economic cost, and is absolutely in contravention of what the G20 nations signed up to. Therefore, any, shall we say, president of a G20 nation who is indulging in induced relocation is, as it were, at odds with undertakings that the G20 itself made about, as it were, achieving stability through concentration.

Sir Jon Cunliffe: If you reduce the netting opportunities by fragmenting the CCPs—so the ability to net risk et cetera—and you carve out by currency, so you reduce the ability to net between currencies, then you do increase the overall risk in the system, and you certainly increase the cost. You probably do it more for the people you are pulling back, your own firms, than you do for the rest, because the overall pool is still pretty large, but it would increase risks.

The Chairman: Thank you. Talking about hands on steering wheels, Lord Fraser.

Q76 **Lord Fraser of Corriegarth:** You have been talking about how the Bank of England is a leader in international regulations. It has been brought to the attention of the Committee that many of the senior members of the Bank are due to retire in the next two years.

The Chairman: It is on your website.

Lord Fraser of Corriegarth: I could read out the names, if you like, but I am sure you know them better than I do. Is continuity of senior staff, in the context of Brexit, a concern for the Bank?

Sir Jon Cunliffe: The first thing I would say is that a number of members of the Bank's senior team are coming to the end of their terms. Whether they will retire or not is a much broader question, and I would have to consult a number of people not in this room.

More seriously, this question of continuity in the Bank's leadership—not just at deputy governor level or governor level but more generally—is a very important issue in the Bank, and not just to do with Brexit. We regularly review succession planning and we have succession plans. That is, in the end, reviewed by the Court of the Bank of England, which looks across the whole of the Bank to ensure that we have plans in place to enable orderly succession. It is something that I know the chairman of the Court takes extremely seriously.

Of course, appointment of governors and deputy governors is not for the Court; it is for the Treasury, but having worked in the Treasury on some of those issues, I am pretty confident that they have those things in mind. Ensuring continuity is an issue for us at all times, anyway, and we have machinery within the Bank—and I think there is machinery in government—for thinking about those issues.

Sam Woods: I would add only, just to give you a bit more colour, that in my opinion we have a very strong cadre at the level below me and Jon, which is the executive directors in the Bank. That is a very stable team; many of them have been fairly recently appointed. We have low turnover, so that gives me some confidence in the question you raise.

The Chairman: Are you confident of retention of overall staffing resources?

Sam Woods: Our turnover rate across the Bank is running at about 7% or 8% at the moment. That is fine; I probably would not want it to be a lot lower. It could be a little higher. That is okay for now. Brexit, of course, does present a very significant additional burden for the Bank, as it does for all sorts of other institutions, both private and public, and the way we are dealing with that is that we are absorbing a very significant amount of that. On the PRA side of the Bank, because the PRA is funded slightly differently from the rest of the Bank, we have gone out for a small additional levy to enable us, basically, to do the work on nationalising the acquis; supporting the Government's work, which obviously will come through Parliament in terms of the EU withdrawal Bill. In the normal way that we do with such regulatory projects, if you can call it that, we have levied a small fee for that activity.

The other piece of it will be the major bit of staffing we have to do to accommodate this large number of applications that we expect for authorisation, back to the beginning of this hearing. We are already staffing up. We have, I think, about two-thirds of the staff that we need to do that, and I think we will be okay, but inevitably, even if we staff up, the reality of it is that that issue—and all these connected issues we have been talking about in this meeting—will be taking up a significant amount of senior management bandwidth, and that is not really something that we can plug in with extra resource. We just have to absorb that.

The Chairman: I wanted to ask whether you have a bit of extra time to give up. We have nearly come to the end, but we do have one or two other things we wanted to touch on. Either we can do that now, if you have a little extra time, or we would need to write to you.

Sir Jon Cunliffe: We are at your disposal.

The Chairman: Thank you.

Q77 **Baroness Neville-Rolfe:** Sir Jon, you talked about thought leadership in supervision. Obviously, Britain is very entrepreneurial, and the City has encouraged innovation in financial services, of which we can be rightly proud.

Can you talk a bit about the opportunities and the risks for innovation, and for FinTech in particular? You spoke of the passport probably going, and 50% of Innovate Finance members benefit from passporting. You talked about data protection. We are a little worried about the loss of funds from the European Investment Fund for venture capital and FinTech, and then things like financial planning—so the payment services directive that is coming in. It would be good to understand your thinking on this important and developing sector of the financial services industry.

Sir Jon Cunliffe: May I say two things, quite high-level, on FinTech? On FinTech, there is an awful lot to say on it; you might want to say something as well. By the way, I did not say that the passport is probably going; I just said that there is a range of possibilities, and I do not hear as much about it in the financial sector as I heard before, but that is a different issue.

On the question of FinTech, and how we approach it from just a broad financial stability point of view, FinTech has the ability to enhance financial stability. You can think of ways that it can create, again, diversification through more players, which is useful. It can create resilience—better and faster ways of doing things—and just bringing new players in can be valuable in a financial stability sense. An example is that in the revamp the Bank is doing of the central payments system, the real-time gross settlement system, we want to allow more players to be able to connect to it and to have fewer players connect to it through other players, because when you have people connecting to the central system through other players, you create risk, whereas directly, you reduce risk in that sense. There are potential benefits.

There are also potential financial stability risks around this, not just risks in new players and new ways of doing things but the risk that you have old risk in new forms but you do not see it so clearly because it is in a different format. Of course, the existing financial sector is using financial technology developments very heavily as well, so this is not just about new players.

The Financial Stability Board did a pretty comprehensive report on this, published, I think, just before the summer, which came to the conclusion that at a level of financial stability—so this is not about investment protection or the safety and soundness of individual firms—at the moment, the risks of FinTech are being addressed. They singled out risks around third-party providers and cyber, which needed continued monitoring and attention.

A lot of the FinTech new developments have not reached the level of financial stability yet, but we have to be pretty vigilant, because these things can just grow and take off very fast, and you have to be able to ask whether, at a system level, it is a good thing, a bad thing, or an old thing. It is not a better mousetrap; it is the old mousetrap, but it is in a different form, and therefore should it have the same regulation?

Sam Woods: I will try to add just a little. We have to pay particular attention to this on the PRA side of the Bank, because we have a secondary objective to facilitate effective competition, and obviously FinTech is highly relevant to that.

A little-known fact is that, in the first four years of the PRA's operation, we have authorised 30 new banks, which is probably more than most people would think. Not all, but a significant subset, are what you would think of as FinTech players. They are obviously in the very early stages of their lives, and we will see how well they go, but the important thing for us has been that the regulatory perimeter should not present a barrier to new firms just because they are new and different. It should present a barrier if they are a problem in safety and soundness terms, but not otherwise.

FinTech, in my opinion, seems to be alive and well. Also in my opinion, I do not see that Brexit is a fundamental threat to the success of that emerging industry. I may be wrong, but that is how it looks. You mentioned PSD II. The arrival of PSD II and of open banking, which are happening more or less at the same time, are potentially a major step forward in this regard.

As Jon says, there are risks to us in all these opening-ups. The most obvious one would be whether somehow the greater openness of core banking platforms through to other forms of new intermediaries somehow weakens defences against cyber. There is no evidence to say that that will be the case, but it is an obvious concern to have. The second risk is, as people start to interact with the financial system, and particularly with their deposit accounts, in different ways, will liquidity slosh around the system in a different way, and should we be worried about that? Those are things that we are looking at, but the opportunity, of course, is to allow consumers to interact in a much more effective and efficient way with their banks and their insurers. It is pretty obvious to anyone who has been to China recently, and seen the extent to which banks have been disintermediated by one of the FinTech players over there, that could be a very big change.

The other thing I would say is that the biggest opportunity in FinTech may not be around these sorts of things. It may, in fact, be in the financial crime area, because if you think of an area where banks have had to make massive investments in order to bring their systems, their controls and their processes up to date, and an area that is characterised by very high-volume scanning and data analysis, that is, in fact, one such area. It is possible that we may see major developments in that space.

Baroness Neville-Rolfe: That sounds like an opportunity. Taking all that together, do you think our competitive position in this area of FinTech and innovation is going to continue to compare well with other member states, and obviously Singapore and, as you mentioned, China? Can you just talk a bit about that?

Sam Woods: Yes, I believe it will. Now, a lot of the source of that is stuff that is happening outside of the regulatory perimeter, and we would not claim to be a major reason for that, but it is important that both we and the FCA have an appropriate awareness of what is going on, and an appropriate degree of openness to allowing this activity to come within the regulatory perimeter. I know that Andrew is coming here from the FCA. They have set up their sandbox; that has been a very useful and good initiative. We ourselves have done all this work on barriers to entry for new banks, which has also been useful.

It is striking to me that when we talk about those things, internationally and within the EU, we are typically a little further ahead than some others, but our philosophical approach is perhaps a bit different. We have a little more appetite for risk than some of our counterparts in some of those other countries.

Q78 **Lord Butler of Brockwell:** You will understand why a former Cabinet Secretary should ask you about the co-ordination of the preparations for Brexit, but are you satisfied that the Bank, the FCA, the Treasury and DExEU are all on the same page in making your preparations, and is the position of the Government giving you sufficient leadership and guidance in that?

Sir Jon Cunliffe: To answer that question maybe bottom-up, we have very close links with the Treasury, which is our natural interlocutor in government on Brexit issues. We meet with them pretty frequently. A lot of the work that is going on, for example on nationalising the acquis or preparing for transition, has the authorities and the Treasury working pretty closely together. We are also engaged with DExEU and the Department for International Trade a little, just on broader questions. We have different responsibilities from other authorities in government. A lot of this we do internally, and we have to think about that, and the FPC and MPC have formal statutory responsibilities for which they are accountable, but there is, of course, a Treasury member on the FPC who sees all the financial stability work that we do.

In terms of where we are, and whether we are getting clear enough steers and the like, I would only say that we are all policy-making under conditions of uncertainty, of necessity in these issues. Even if the Government told us, “This is what the outcome will be”, you could not be confident of that, because it depends on a negotiation and there are lots of players. This is an example, and maybe quite a strong example, of policy-making in conditions of uncertainty. However, we have pretty good links into Whitehall to discuss how you do that and what we are doing. There is very close contact, of course, between the Governor and the Chancellor, and between the Governor and other parts of government.

Lord Butler of Brockwell: Unless I misheard, I do not think you mentioned the FCA.

Sir Jon Cunliffe: I said "the UK authorities". I meant the Bank and the FCA.

Lord Butler of Brockwell: Very good. Thank you.

The Chairman: Thank you. On that note, I should say that we have had a very fruitful session. It was a slightly longer session than we envisaged, but thank you for giving us your time and sharing your thoughts with us. You will be able to read our report in the new year, but in the meantime, we wish you well.

Sir Jon Cunliffe: Thank you.

Sam Woods: Thank you very much.

The Chairman: This concludes today's public evidence. The Committee will now meet in private. Thank you, Sir Jon. Thank you, Mr Woods.