

Treasury Select Committee

Oral evidence: Bank of England Financial Stability Reports, HC 681

Wednesday 20 December 2017

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Members present: Nicky Morgan (Chair); Rushanara Ali; Stephen Hammond; Stewart Hosie; Alison McGovern; Catherine McKinnell; Kit Malthouse; John Mann.

Questions 1–70

Witnesses

I: Dr Mark Carney, Governor, Bank of England; Sam Woods, Deputy Governor for Prudential Regulation, Bank of England and Chief Executive, Prudential Regulation Authority; Richard Sharp, External Member, Financial Policy Committee; Donald Kohn, External Member, Financial Policy Committee.

Examination of Witnesses

Witnesses: Dr Mark Carney, Sam Woods, Richard Sharp and Donald Kohn.

Q1 **Chair:** Good afternoon, gentlemen. Thank you very much indeed for being here. I am sure this is an early Christmas present for you, to appear in front of the Treasury Select Committee. It would be very helpful if you might introduce yourselves for the record.

Donald Kohn: I am Donald Kohn, external member of the Financial Policy Committee.

Dr Carney: I am Mark Carney, Governor.

Sam Woods: I am Sam Woods, Deputy Governor.

Richard Sharp: I am Richard Sharp, external member.

Q2 **Chair:** Lovely. Thank you very much. As I think you know, I may have to leave early, depending on how the session goes, because the Liaison Committee is meeting to quiz the Prime Minister at 3 o'clock. If I leave, John Mann is going to take the Chair.

Perhaps I will start with this lunchtime's publication. Governor, can you take us through what has been published today?

Dr Carney: Yes, thank you, Chair. First, in terms of context, as you know, the UK is the leading international financial centre. I will not go into all the superlatives, but that is a national asset; it is also a global public good. That brings tremendous benefits to the economy: it helps with financing here, hundreds of thousands of jobs, tens of billions of tax revenues, significant exports. But it is also a source of risk to the domestic economy, and today's announcement is about managing that risk. There are elements of the announcement that are about transition; management of risk will come into that.

I wanted to focus particularly on the risk from the banking sector. Foreign banks operating in the UK have about £4 trillion of assets, so that is about two times the value of all the goods and services produced in this country—two times GDP. Upon exiting the European Union, we will need to authorise those banks that currently use the passport to operate in the UK. There are 77 banks under that; there are 160 overall. We have announced today an updating of our approach to authorisations of branches and subsidiaries, for banks, insurance companies and CCPs. I will focus on banks.

We look at two things: what the bank does; and where it is from and our relationship with where it is from. On what the bank does, the question is: how systemic is it? The first question is: does it deal with households and small businesses? Does it have retail deposit-taking activity? There are some specific thresholds. In general, if it does, it will be systemic.



HOUSE OF COMMONS

That will have consequences and it will have to subsidiarise. For reference, out of the 77 from Europe, probably about four banks fall into that category.

The other aspect of being systemic, though, is in this so-called wholesale activity. The question there is: how big is the balance sheet? We have given an indicative threshold of £15 billion. How complex are the activities? How interconnected is the institution to other bits of the UK financial system? Does it provide any critical functions? We use those indications, plus judgment, to determine who is systemic. That is "what it does". If it is systemic, the question is: what is our relationship with the home supervisor? At present, we have very strong co-operative relationships with any bank that operates as a branch here, so an American, Japanese or Canadian bank or a European bank operating under the current arrangements in the EU.

But we all know those arrangements are going to change. We have to take a decision as to what we do from now. We proposed that our presumption will be, consistent with the Government's objectives in negotiating a new partnership, that we will continue to have a form of supervisory co-operation and information sharing with the EU authorities after Brexit, but we retain all our options. If that is not forthcoming, there will be consequences for those institutions. In other words, if we have a systemic institution and we do not have a supervisory co-operation arrangement and other information-sharing provisions, so we are not satisfied there, clearly our responsibility is to protect the safety, soundness and stability of the system, ultimately protecting the citizens of the United Kingdom. We would cause certain actions to happen, most notably subsidiarisation, possibly restrictions on business, additional capital and liquidity, and other factors.

To summarise, the posture we have is consistent with the way we treat US, Canadian, Japanese and other firms. Nothing is going to change for them, because we have these relationships in place and they are not being negotiated to change. We presume co-operation, because that is the objective and that is in the best interests not just of the UK but very much of the EU and the global system. If we do not get it in the fullness of time, it is fairly clear, in what is set out today, what the consequences will be for those institutions.

Q3 Chair: A large number of questions stem from all that, and I think everyone is going to be digesting this for some time to come. First, it sounds to me like, although this is a proposal or a plan, depending on how negotiations go, it could be that it has to change.

Dr Carney: The way I would put it is that it is a proposal, and it is out for consultation, as any change in our supervisory approach must be, until the end of February. People look at cost-benefit and other aspects. I would suggest that, subject to that consultation, the approach would not change, but the application of the approach to EEA firms or EU 27 firms might change, depending on the negotiation. It is an approach that



HOUSE OF COMMONS

works for, again, an Australian bank or a German bank five years from now, but how we apply it and what consequences there are for the Australian or the German bank depend on what that supervisory relationship is and what that institution does here in the UK.

Q4 Chair: It would be helpful for the Committee to hear how you reached this set of proposals. It sounds like it is very much a plan for status quo, so people are not disrupted. Yes, there is obviously a concern about supervisory authorities. Your alternative option would have been to require them to establish subsidiaries, over which the PRA would hold greater regulatory oversight and control. Perhaps you can take the Committee through—I do not know if Mr Woods wants to contribute as well—the decision-making process to get to this stage. It would be helpful to know about the discussions that you have had with the Treasury and other central banks in the EU.

Dr Carney: I will try to address all three of those, and then pass to Mr Woods to supplement. In terms of the approach, as I said at the start, we oversee the world's largest international financial centre. For cross-border flows of capital—foreign capital coming into the UK, being reinvested abroad and vice versa, not the bit of the banking sector that is, quite sensibly, ring-fenced for the domestic market—an integral part of how global financial centres work is for those institutions that meet certain very high standards to be able to do some, although not all, of their activity through a bank branch.

I will give you an example. A large American firm like JP Morgan has both a branch and a subsidiary in London, and certain activities are allowed through the branch; certain activities are managed through the subsidiary. That is how the overall management works. We have a memorandum of understanding with the US authorities; we share information; we have joint supervisory visits. We understand the risks of that entity overall, and therefore we have comfort. In circumstances, though, where we did not have that comfort post Brexit with European institutions, we would require them to subsidarise.

As we sit here today, as I said, there are around £4 trillion of assets here. A substantial proportion of those are of European banks operating in London. We had to take a judgment: do we take a glass-half-empty approach to the negotiations, at a time when there is a prospect of a transition arrangement—I know it is not finalised—and say, "No, you have to subsidarise now, and then unsubsidarise in the future if there is an agreement"? That is a tremendous amount of cost, disruption to the system and disruption to Europe. We are in a position right now where, as a consequence of the system under which we are operating in Europe, we have line of sight to the risks; we have direct conversations with the supervisors; and we can catalyse actions, if necessary, to manage those risks we have.

Our understanding of how the transition or implementation period may work is that that is likely to continue through that period of time. Now is



HOUSE OF COMMONS

not the time that one has to say, glass half empty, “Subsidiarise. We are never going to get a deal.” If it comes to a point, let us say at the pre-Christmas hearing of the TSC a year from now—

Chair: I am sure you are already looking forward to that.

Dr Carney: I am already looking forward to it. I have blocked out my calendar.

If it does not look like we are going to have that—and that would be at the start of a potential transition period—those directions to subsidiarise as a consequence would be there. The point I would make is that it is clearer now, or should be clearer with the release of this today and the subsequent consultation, which firms and which businesses might have to subsidiarise if these negotiations do not go well in the UK. I will show my cards. I do not think that is a good outcome for the system, for Europe or for the UK. However, if we do not have that co-operation, it will be the right outcome for the UK, and we would cause that.

I will be quicker on discussions with other central banks. I have had discussions with my counterparts at all the major central banks in the EU and the ECB, at minimum to let them know that this is the approach we are taking, so they can understand it. Sam can speak to his conversations. Obviously we have had conversations with the Treasury. I will finish on this; I am sure we will get into it. This is one key component of contingency planning for Brexit. It is identified in the report.

Finally, within the Bank of England, there has been intensive work through the PRA. The PRC—the policy committee that sits on top—has discussed this on a number of occasions, as has the FPC, because these are issues of systemic concern. In this financial stability report, this is identified as one of the actions that need to be taken, as we said, by the end of the year. We felt that today was the right day, given that we were meeting.

Sam Woods: I will add two points, very briefly. First, we have an awkwardness here on timing. For logistical reasons, we need to let the firms know where we are on this issue at the moment. As the Governor was just saying, we would need a very good reason to depart from our established way of doing this, which is to be open in a controlled way for wholesale, but, for retail, to be more local and take a stronger grip on that.

The way we have reconciled those things is to provide a planning assumption for firms today, but I have been absolutely clear in my letter to firms today that we are going to keep that position under review as the negotiations progress. Of course, if the negotiations get to a point where it appears that it is not sensible for us to assume a high degree of co-operation, the position will have to move on. That is the position we are putting to the firms, which I think will enable them to get on with



HOUSE OF COMMONS

what they need to get on with, while reserving our position in relation to where the negotiations go.

Secondly, in terms of conversations with counterparts, I have spoken to all my main counterparts who do my job in the main EU 27 jurisdictions, and, crucially, the ECB, which has oversight of the whole eurozone, with the purpose of letting them know that this is what is coming out. They have had some pressure on them around this issue of branching. I think they welcome the basic stance, but they understand that the long-term position here is going to be shaped by the negotiation.

Q5 Kit Malthouse: I wondered about numbers. You said there were 77 banks affected, of which four were immediately systemic and would have to subsidise. You then identified two further categories: those above and below £15 billion. What is the split of the remaining 73?

Dr Carney: As you say, you have four on the retail side. At present, there are 23 branches within that 77 that would get to around or above that £15 billion.

Q6 Kit Malthouse: Does that include the four?

Dr Carney: No, that is on top.

Q7 Kit Malthouse: There are 23 out of the remaining 73, leaving 50.

Dr Carney: Exactly. I will add one other wrinkle to it. Some firms, as they have been thinking about how they would organise in Europe, have been thinking about creating a new subsidiary in Europe and branching back into London. That is a moving target, but there are around 10 of those, which would be on top, within that overall envelope. You are moving towards around half of the institutions that you would need to have a hard look at in terms of the application of this policy.

Q8 Kit Malthouse: Is that a hard look in terms of whether they should subsidise?

Dr Carney: That is correct. In the way I would try to describe it, you look at that first, because what matters is how risky it is. If the answer is, yes, it is risky enough, you would ask what the relationship is with the home state supervisor. Do we have confidence in its regulation? Do we have information flows? Will we have memoranda of understanding? Can we catalyse certain actions to help manage the risk here? Do we even have line of sight of the risk? We cannot go from a position where we have very good institutions operating here and we have good line of sight to, five years from now, having effectively a black box on the continent that is operating back here.

Q9 Kit Malthouse: There are 25 to 30, effectively, that you have to review individually.

Dr Carney: Yes. If I can make one other point, some of those are multiple branches of the same firm.



Q10 **Kit Malthouse:** There are 25 or so. Do you have time to do that?

Dr Carney: That is a good point. It takes, as is outlined in here—and Mr Woods can expand on this—about 12 months for our authorisation process. We are in the process of reallocating a bunch of resources for a large number of potential authorisations. We have been doing work already, because we received an initial round of information, but we have not done anything on this scale. We will benefit tremendously from an implementation period being agreed by the end of the first quarter, if it is. If it is not, that may be an indication of two things: the degree of co-operation that is going to be there; and the timeframe, which would cause a revisiting, I would suggest, of this policy paper.

Q11 **Kit Malthouse:** The drop-dead date, then, is the end of this coming March. You need to know; otherwise, they have to start the—

Dr Carney: In saying that, I am making a judgment about the potential tenor and prospects for the negotiation and for co-operation. We would have to make that judgment. It will not be a secret judgment; it will be made in the context of an overall relationship, where it is heading, where it is likely to head and how we manage the risk. I will say this, though: we know these firms now. We have the relationship now. We know the risk now. We are in a pretty good position to take that risk of having a limited amount of time to have them adjust their business models, if it comes to that. Obviously, we very much hope it does not come to that, because that is not in the UK's, Europe's or the global system's interest. But if it does come to that, we will have enough people to do it and we will look to take that decision in as timely a way as possible.

Sam Woods: Perhaps I can add a bit of colour on the operational challenge that we will have from this. The all-in number of branches coming in across both the banking and insurance sides is 157, from the EU. We then have some firms that are currently using freedom of services to come here without a branch and may wish to continue here once we have exited, which they would need authorisation for. In our estimate, which is another moving target, this might be a couple of hundred authorisations that we have to do, including insurance.

To scale that for you, in the first four years of the PRA's existence, we have authorised 48 new firms, roughly half and half across the two sides of the house. That is a massive step up. We have been preparing for that. We already have 45 staff in place whose only job now is dealing with these issues with firms. Another 40 to 55 of the PRA's staff are working a lot, but not exclusively, on this issue. Then we have a further team of 20 or so who are doing the central co-ordination, bringing in the rules and all that kind of stuff. It is a major challenge. One of the reasons, although it is probably not the most important reason, that we have been consistently, very much in line with the Committee's own recent report, in favour of some form of implementation/transition period is that doing that over three years versus 15 months is evidently less risky.



HOUSE OF COMMONS

Q12 **Kit Malthouse:** Can I ask one last question? On the four you have immediately identified as being systemic, do you have an estimate of the amount of capital they will need to commit to the UK?

Dr Carney: I do not have it to hand. Since the major UK banks comprise instantly 85% of retail, it is a relatively modest proportion. The bigger capital requirements would be because of the wholesale bank footprints.

Q13 **Kit Malthouse:** My next question was going to be about that next class. You could be looking at the tens or hundreds of billions in capital.

Dr Carney: Tens of billions, yes.

Q14 **Kit Malthouse:** While it is an awful lot of money, in banking terms, it is not enormous.

Dr Carney: No.

Kit Malthouse: The fines they often pay run to those amounts.

Dr Carney: It would be material for some of the institutions. It would be material for the system. It would cause firms to adjust what business they do here, what they do elsewhere, what they shut down, and would take capacity out. Candidly, it would not take capacity out for UK businesses and households; it would take capacity out substantially for Europe, but also for the rest of the world.

Q15 **Chair:** We need to move on, but I want to ask you a broader question, which perhaps builds on this. Since we last saw you, Governor, we have had the Budget and the OBR's latest forecast, which at the moment is predicated on not much more information on Brexit, because when it published it did not have an awful lot more on the negotiations, but also on having a smooth and orderly Brexit, which would one assume also includes a smooth and orderly transition for financial services, given the amount of money paid in taxes. You will have seen Michel Barnier's comments this morning about financial services not being part of a free trade agreement. I want to get a general comment on the OBR forecasts, the position on Brexit affecting the economy, if indeed it is, and this issue of negotiations around financial services in the trade talks with the EU.

Dr Carney: As you are aware, probably the most significant element of the OBR forecast is the reduction in its productivity forecast. We—the Bank of England, the MPC—had reduced our productivity forecast; the OBR's is now below ours. Ultimately, that is not an immediate financial stability issue, as you can appreciate, but it is over time in terms of debt burden and the ability to service debt. The smooth and orderly aspect of its forecast, which is consistent with the MPC's—we have a different version of it but a similar assumption—is the central scenario. It is an assumption; it is the most likely scenario.

Of course, the FPC's job is to look at not what is most likely to happen or what we would like to happen, but the tail risk and the worst scenario.



HOUSE OF COMMONS

We look at the exact opposite, which is a disorderly scenario. I am sure we will get into it, but one of the tests against which the stress test should be judged is: are they tough enough to deal with a disorderly scenario for the banks? I am sure we will come back to that.

The third question was around Michel Barnier's comments.

Chair: Yes, the comments on the financial services free trade agreement talks.

Dr Carney: Yes. I have a couple of observations. In my understanding of the process, the negotiating mandate is set by the European Council, not by the European Commission. Obviously the Bank is not involved in these negotiations at all.

I will underscore two aspects of financial services, as it currently stands in the UK. First, the UK financial system, like it or not, is effectively the banker for Europe in the most complicated bits of finance: the wholesale markets, the equity underwriting, the derivatives, the FX trading. There are substantial economies of scale and scope that benefit both sides.

Secondly, we have a system and a set of regulations that have been significantly improved over the course of the last decade, which means that we can operate that system responsibly and reliably. We have a commitment to openness in the system as well. The point I am building to is that, if you are going to have trade in services, financial services is now in a position where you can have free trade in financial services or some form of co-operative arrangement in financial services, because you have very high common standards, high transparency about who implements them and existing modes of supervisory co-operation. All that exists. What you have to do is build a dispute-settlement mechanism on top of that. I do not accept the argument that, just because it has not been done in the past, it cannot be done in the future. We would walk away from progress if that were the approach we took to issues.

Q16 **Catherine McKinnell:** Dr Carney, you mentioned the stress tests, and I wanted to ask about that in a little more detail. The 2017 stress test, as I understand it, was not designed to deal with a disorderly Brexit or to anticipate those outcomes, but it has been looked at in that context. Could you outline how that stress test differs from a Brexit scenario, but particularly from a disorderly Brexit scenario? Are you confident that all those scenarios have been adequately tested?

Dr Carney: First is to recognise how severe the macroeconomic scenario is in the ACS: over a 4.5% fall in UK GDP; unemployment to 9.5%; sterling down by more than a quarter again; interest rates up by four percentage points; house prices down by a third; real estate down by more than that; commercial real estate down by more than that. They are very big hits. On top of all that, there is a stressed hit for misconduct cost to the banks of £40 billion, which is just taking capital away from the



HOUSE OF COMMONS

banks. It is done as a global stress; as you know, it originates in Asia and then cascades through the global economy, which captures those banks that have big international operations. That is why we did it that way. We had in the order of £50 billion of losses in the first two years, so more than what happened in the first two years of the financial crisis.

We have separately, for obvious reasons, been looking at a series of things that can go wrong under a disorderly Brexit: problems with derivatives; reductions in trade because of tariff; loss of trade because of losing product or service authorisations; and loss of confidence in UK assets and, as a consequence of that, interest rates going up and further effects. We have looked those individually as a committee, done the modelling and analysis of that, and then looked at the combination: if you added all those things together, would you end up with more losses on bank balance sheets than we had in the ACS, given the scale of what was lost in the ACS?

We have seen that the answer is no. The scale of losses would be significant, not surprisingly, but they would be encompassed by the ACS, given the severity of the ACS. Remember that the ACS is not just a recession, but £40 billion of misconduct costs as well. The point we tried to make in the report is that, from a disorderly Brexit perspective, our judgment is that the banking system is adequately capitalised to take that hit and continue to meet the demands for credit in the real economy, but that is it. That is effectively what we have said: if you had a disorderly Brexit and you had a global recession, or a Brexit and a big misconduct hit at the same time, with a slowdown in global growth, it is likely that the system would need some more capital.

We have to step back and recognise that we now have a banking system with 16.5% of tier 1 capital. The capital build has been really quite significant. We have done it for a reason, because there are these possibilities. Sitting here today, when we do not yet know for certain that we have a transitional arrangement, and we do not yet know the outcome, I am glad we have done that.

Donald Kohn: It is important that, although the ACS was not built from the ground up as a disorderly Brexit scenario, it contains a number of elements that might occur, tail risk, in a disorderly Brexit. In particular, as the Governor highlighted, the loss of confidence and decline in demand for UK assets would drive up risk spreads and drive down sterling. Certain assets like property prices would go down; the recession that accompanied it would drive down property prices. Although it was not designed that way, it has a lot of those elements. That gave us some comfort that, when we went back and re-engineered Brexit against the losses, we had encompassed a lot of what would happen.

As the Governor noted, if you get that, plus the global recession, plus the misconduct, you might have something bigger. That is why the Financial Policy Committee said that, over the first half of next year, we will have



to see how all those risks evolve to assess whether this 1% CCyB, countercyclical capital buffer, is adequate.

Q17 Catherine McKinnell: Barclays and RBS failed the 2017 tests on the basis of the cut-off date for their capital reserves, but they have obviously since built those up. Are you comfortable with that margin of error, or should the banks be looking to increase their robust resources?

Dr Carney: I am going to ask Mr Woods to speak to that in part, because it goes to what actions were required out of the 2016 tests and what both institutions were supposed to do in 2017.

Sam Woods: Yes. Actions speak louder than words on this. This is the first year that we have not required any of the banks to do anything off the back of the stress test. The reason for that in the case of those two banks is exactly the one you gave: that both of them fell south of something we call the systemic reference point, which is one of the thresholds they are meant to keep north of in the tests. However, the margin by which they fell south was smaller than the amount by which they built their capital since the cut-off date of the tests.

The easiest way to say that is, if we ran the test again today, we think they would pass, whereas last year for those two institutions, RBS had to submit to us a revised capital plan because it was not in a good enough place, and Barclays was in a place where it had preannounced some changes by the time we announced the results of the test. That is quite a significant moment, because it is the first time in all the time I have been working on this stuff that we have done one of these exercises and have not required one of the banks to do something.

Dr Carney: If I may just give one example on that, in those plans post 2016, for example, Barclays was going to divest its stake in South Africa. That was a capital additive action. We knew they were going to do that; they intended to do that; they delivered on it. That is one of the reasons why their capital is up, so it was fair game, if you will, and it would have been too much to require them to raise additional.

Q18 Catherine McKinnell: The test scenario includes, as you mentioned, the misconduct costs and the £40 billion put aside for that. How do you assess that level of risk? Obviously, you have identified that if we had the misconduct, as well as a disorderly Brexit, as well as a global financial downturn, we would be in difficult territory in terms of the stress test. Particularly in relation to the misconduct cost, where do you think we are in terms of the risk factors?

Dr Carney: Let me explain how we do those calculations in general terms. There is an accounting reserve for misconduct. Effectively, you have a very high probability of paying something out. More or less, you have had the judgment; you know the amount you are going to effectively pay; you have a high degree of confidence. The accounting



HOUSE OF COMMONS

reserve will quite often be lower than the reasonable expectation of what a firm will do.

However, we have not put in place a reasonable expectation; we have done a stressed expectation. For the known misconduct issues—PPI being one example here, or issues related to US mortgages from years ago for some of the firms, and US litigation ongoing for them—we have taken from historic precedent and averages, and looked at the stressed worst outcome for those to come up with that £40 billion. That does not take into account if something new is going on.

Q19 Catherine McKinnell: This is what I am getting at. Is there enough being done to prevent banking misconduct?

Dr Carney: There is a lot being done to reduce banking misconduct. I would suggest one of the things that is recognised is that fines of institutions well after the fact, which affect current shareholders and current institutions and not the individuals who perpetrated the acts, should not be the only tool. You have justice here, so it is understandable that they happen, but they should not be the tool to be the deterrent.

There has been quite a dramatic change in the UK by the introduction of the Senior Managers Regime, so that the senior-most individuals in these institutions are individually accountable for the actions. Have they taken action to make sure people on the trading desk know the rules and are trained in understanding them? Are there compliance functions there? I have used that as an example.

I am afraid that in organisations of hundreds of thousands of people, there will instances of misconduct. However, if there is a pattern of misconduct, it is not just those individuals but the senior managers who face consequences. One of the ways to have consequences for them is to have an ability to claw back bonuses. That is one of the advantages of having at-risk compensation as opposed to people being paid upfront in cash: it helps you change some of those incentives and enhance individual accountability.

Q20 John Mann: I am going to bring Mr Sharp into the discussions, if I may, although, Mr Kohn, you may have a view on this as well. Is there unanimity on your approach to consumer credit? Is the FPC's current view that risky consumer credit is a problem at only some banks? Is that fair?

Richard Sharp: You know that at the FPC we do not get into the micro-prudential assessment of individual banks. With the stress tests, we have assessed the risk of loss on consumer credit, and assessed that against an understanding of where the banks themselves are. We have taken quite a critical view of whether they had been in the past taking account of the probability of loss and the amount of loss that they may experience. That is reflected in the 2017 stress test. In addition, in



HOUSE OF COMMONS

respect to the communications that we make, we, as the FPC, have asked that they be undertaken by the PRA to the banks themselves.

We were concerned—and I think you flagged that in a letter, as well, to the Governor—at the pace of the growth of consumer credit in the economy. When we see something growing very quickly like that, that comes up in our indicators: we assess it; we ask ourselves what the risk of loss is and what could be going wrong. We discussed it; we formed a consensus; and we acted.

Q21 John Mann: You are a precise man. That is a reasonable compliment to make. However, this term that you have allowed to go in the report, of consumer credit not being high by historical standards, is not really very accurate, is it? When before 1999 was it as high?

Sam Woods: Perhaps I can say a word on that. Consumer credit—

Q22 John Mann: Let Mr Sharp respond, given his background.

Richard Sharp: I have been in finance but not a consumer lender, I should hasten to say, and I remain in finance, but not on the consumer side. When we look at consumer finance, we get presentations from the different experts within the Bank of England, and they demonstrate to us where we have seen consumer credit high in the past. One of the things that you will have seen was particularly high here was the growth in auto-finance. That was going at record levels. However, when we looked at it in aggregate, we had seen levels where consumer finance had been higher.

Q23 John Mann: The Governor did not see auto-finance as a problem at all in the last meeting.

Dr Carney: I believe, Mr Mann, if you check the record, I said it is not an issue for the banks, and I stand by that. If the residual values of autos put back to the banks fell by 30%, it would be 6 basis points of bank capital. On 1,670 basis points, it is not an issue for the banks.

Q24 John Mann: There is this feeling there that you are perhaps underplaying the problem with the rise in consumer credit. There is use of the word “historical”. Do you think it is accurate, Mr Woods?

Sam Woods: If I can just respond to that and make one other point, that refers to the current level of consumer debt to household income, which is around 15%. That is in line with the average it has been over the last 20 years. It is below the peak it reached of about 20% in 2005. However, we think it pays to pay attention to some of the simple things, and the fact that it has been growing at 10% a year has caused some concern for the Committee as a whole.

The second point to make is around the action that we have taken on that. You asked if it was just a problem at some firms. We applied the same standard of stringency across all the firms, but the impact of that is different across different firms. In one of the annexes of the stress test



HOUSE OF COMMONS

report, we publish what percentage, and also in billions of pounds, we think the individual firms will lose. You will see that varies quite considerably from one bank to another.

- Q25 **John Mann:** I am all for getting the averages, but this use of the word “historic” is inaccurate. It is an inaccurate term. What puzzles me is why you are appearing to slightly play down the risk. Mr Kohn, what are the economic circumstances, in your view, that would make this level of consumer credit a risk to the economy?

Donald Kohn: A risk would occur if the economy turned down for some reason and consumers could not repay their debt. That would come back to the banks. We found in the stress test that some banks seemed to be calculating the capital they needed against consumer credit just fine. However, other banks were not. Some banks seemed to be emphasising the recent good behaviour of consumer credit in this steady expansion and presuming that was going to be good through the cycle.

Our job in the Financial Policy Committee, of course, is to look at the downside risk—what would happen if something bad happened—and ensure that the banking system does not make a bad shock to the economy even worse. It is therefore important that the banks hold enough capital through the bad times and not base their capital just on the good times. Because there were some banks that were okay and some banks that were not, we worked through the PRA buffers to the individual banks that we thought had problems with this.

- Q26 **John Mann:** Governor, I have one final question on this. Are there particular groups of consumers much more at risk than others: those, for example, on zero-hour contracts, or those who have not had real wage increases? Are there particular groups—and large groups—where the risk of something going wrong and being overextended is identifiably clearer?

Dr Carney: I will answer that, but let me just start with the overall point. I appreciate the precision of your question, but I do not want to leave a misimpression in terms of our level of concern about household indebtedness. In the end, it is one of our top financial stability risks. Specifically with respect to consumer credit, as Mr Woods and Mr Kohn indicated, that was a key component of the stress test, and it is having consequences for the banks, not on the auto side but on the other side of consumer credit. One of the consequences of the stress test will be additions on an individual level by banks, so there is differentiation by bank, for additional capital to be set aside against consumer credit risk.

Now I will go back to the macro. The overall situation has improved. In general, there are more people in work. Because of the level of interest rates, the overall level of debt burden is much lower than it was in the 1990s. The charts are in the report. In fact, it would take another 150 basis points of interest rate increases for that debt burden to get to that historic debt service ratio average of 2%. The overall story is better. However, some banks have given themselves too much credit for that, if



you will, and have taken too much advantage of it, so there is an adjustment there, both in terms of supervision and capital.

Finally, to your point, which is an important one, in terms of consumer vulnerability, there are without question parts of the working population—importantly, of the working population—that are vulnerable: they have not seen wage increases; they start from an overextended position; and some of their consumption is reliant on the availability of consumer credit. Those issues are important.

Those issues in terms of suitability, as you can appreciate, are principally the responsibility of the FCA as opposed to the FPC. When we look at the system as a whole, we say, “This is growing rapidly. There are some issues around it. How do we target an intervention?” That is what we have done with capital and supervision, in co-ordination with the PRC, to help manage the scale of the risk. However, you are right, as you know, and the vulnerability study of the FCA that came out within the last two months highlights some of the orders of magnitude of the issue.

Chair: Thank you. I am going to ask you to keep your answers more brief, only because otherwise there will be time for me to go off and do the Liaison Committee and come back, with the list that we have got to get through.

Q27 Stewart Hosie: Mr Sharp, in the write-up of the FPC meeting from 5 December, the Treasury representative, Charles Roxburgh, said the Government “were considering all options for mitigating risks to the continuity of outstanding cross-border financial services contracts”. Did he set out any of the Government’s options or plans for mitigation?

Richard Sharp: We, as a committee, discussed the risks associated with cross-border contracts in light of some of the changes that may take place. The committee, as it is structured, benefits fantastically by having the Treasury there, so that you get a joined-up discussion of the issues. Particularly I feel this as an external member.

Q28 Stewart Hosie: Indeed. In that joined-up discussion, did the Treasury representative outline any of the Government’s actions?

Richard Sharp: We did not ask for the details. We wanted to inject the issue there to make sure that we were in a position at some point to receive comfort.

Q29 Stewart Hosie: Did you get that comfort?

Richard Sharp: We got an understanding that there was an issue that the Government were constructively focusing on. That gave me comfort that there was a material issue that would be addressed.

Q30 Stewart Hosie: Today, in the last while, we have got the statement from the Chancellor, which says, “As requested by the Bank and the FCA, the Government will, if necessary, bring forward legislation: which will enable



HOUSE OF COMMONS

EEA firms and funds operating in the UK to obtain a 'temporary permission' to continue their activities in the UK for a limited period after withdrawal; and alongside the temporary permissions regime, the Government will legislate, if necessary, to ensure that contractual obligations, such as insurance contracts, which are not covered by the regime, can continue to be met." Is that the kind of thing you were expecting to hear?

Richard Sharp: Yes, that is what I was expecting to hear.

Dr Carney: You have tabled the right issue. That is the Government's response. That ability to give temporary permissions addresses the 6 million UK citizens or entities that have insurance contracts from EEA firms. It helps with the derivative issue. However, as Government are aware and you are aware, it cannot solve the derivatives issue, because we also need something in parallel from the European side, since the derivative contract is a two-way contract and requires permissions on both sides.

Q31 **Stewart Hosie:** Can I come back to contracts and clearing slightly later? You make the important point that that may well protect 6 million UK insurance policyholders. However, there are also 30 million EU 27 policyholders with contracts in the UK. Given, as you said earlier, that there have been discussions with the other banks, and given that we have got this statement from the UK Treasury today, do you anticipate any difficulty in unilateral legislation within the EU 27 to ensure that this is reciprocal in both directions?

Dr Carney: The incentives for the EU 27 are aligned; it is their citizens who would bear the brunt if the legislation does not pass. We have had conversations with our counterparts over recent months on this issue, and they are well aware of it, but I would leave it to them to announce their own legislative process or response.

Q32 **Stewart Hosie:** Indeed. However, as you say, given that the interests are pretty much aligned, there is no technical reason why they could not legislate in a similar way.

Dr Carney: No, none to my knowledge.

Q33 **Stewart Hosie:** That is helpful. Can I talk about something slightly more sensitive, namely the remarks you made on succession planning at the LSE during the Financial Stability Report press conference? I know it was an off-the-cuff question, but it may have been one that was foreseen. Did you discuss your attitude to succession planning in the LSE with anyone from the FCA or the FPC before giving that answer?

Dr Carney: "Yes" is the short answer, but I will give context. The Bank of England—not the FPC—is the regulator of LCH, the systemically important CCP, and the ultimate parent is the LSE Group. The FCA is the regulator, obviously, of the London Stock Exchange, and the ultimate parent is the LSE Group. I do not think it should come as a surprise that



HOUSE OF COMMONS

the CEO of the FCA and the Governor of the Bank of England were engaged on this issue throughout the period. We were apprised of the original succession plan. We were aware of the issues in terms of the evolution of that succession plan or not. We had multiple conversations with the Board, the independents, the senior management and the CEO.

It was entirely clear to me and the CEO of the FCA that the then CEO of the LSE Group was not going to continue in his role. They had got themselves in a legal position where they could not definitively say that he would not come back to that role, even though he had represented to us on multiple occasions—that is to the Governor of the Bank of England and the CEO of the FCA—that under no circumstances would he return to take up his position as CEO of the LSE.

Q34 **Stewart Hosie:** Is that why you described yourself as “mystified”?

Dr Carney: That is exactly why I was mystified. It was a slightly Kafkaesque situation in that there was a shareholder who wanted the CEO to continue but the CEO had no intention of continuing under any circumstances. That is a quote from multiple meetings with that CEO, directly with me, in the presence of the CEO of the FCA. It was not going to happen. I observed quite rightly in the response to that question the extraordinary contribution of Xavier Rolet to the institution, but also the fact that I could not envision a circumstance in which he would return, because that was based on his own intentions stated multiple times, including stated to me that morning. That undid it, and I received a thank you from the CEO of the LSE.

Q35 **Stewart Hosie:** Let me move on to the final point I want to make. It goes to LCH, as you say owned by the LSE, the world’s largest clearer of interest rate swaps. It is described, as you have just done, as a globally and systemically important part of the financial infrastructure. I know, and you know, that there has been a huge amount of anxiety about the potential loss of clearing business of all sorts post Brexit. Could I ask you to tell us what discussion you may have had, or what pressure you may have been putting on politicians and partner organisations elsewhere, to make sure that those swaps continue to be cleared easily, as they are, and that the business is not lost?

Dr Carney: There has been no pressure, and I do not think my colleagues have said anything in private that we have not said in public. The raw economics around this are pretty compelling. As you know, globally systemic clearing does not just clear in euros and interest rate swaps, but in dollars, yen, Canadian dollars, Aussie dollars, etc. There are huge economies of scope benefit, diversification benefit and scale benefit from that.

If the so-called location policy were put into place, and so the sliver of that overall activity—euro business conducted between two EU 27 institutions—were pulled out, that is 13% of an overall pool. The loss of those diversification and other benefits would have, in our judgment—and



we have pretty good information, because we have received and understand the economics of it—a cost to EU institutions and EU firms somewhere in the order of 1 to 3 basis points on the swaps.

That does not sound like much, but the volume is so large that 1 basis point is €20 billion to €21 billion per annum. On top of that, as the Chair will appreciate, if you take some of the swap business over but have to leave the legacy, there is capital tied up there and you have to recapitalise. That calculation does not even include that. We have observed the economics of this, and we have also tried to explain, most importantly, the type of supervisory co-operation arrangement we would be prepared to have for those jurisdictions vis-à-vis the activities of the entity in their currency. I know for a fact we do have such an arrangement with the Canadians.

- Q36 **Stewart Hosie:** The difference in the cost is described on the two wagon-wheel charts on page 59 of the report. Can I ask about other jurisdictions that are thinking about taking slivers of the business, as you say? Do you think there is a clear enough understanding about the magnitude of the cost that would involve to them, and indeed what it would do to the cost of capital if London remained a major player but was diminished because of this extra financial burden?

Dr Carney: I would think exchanges like this help in terms of getting those understandings out there. It is in the end a cost that would be borne by European pension funds and industrials, and ultimately European households. That is who would bear the cost. There would be a very marginal increase, having taken out that sliver of cost, for everybody else, having lost some of that diversification left in London. However, that would be marginal as opposed to significant.

- Q37 **Rushanara Ali:** Can I just start by making a declaration of interest? I have known Mr Sharp before joining this Committee, and he has been a donor to a charity for young people that I chair. My first question is for Mr Woods. The ECB has criticised the Brexit-related relocation plans of the UK banks, especially the extensive sourcing of risk-management capabilities and governance structures from outside the EU. You have seen these plans, too. Are these criticisms legitimate?

Sam Woods: Let me make two comments in response. First, it is in the nature of the supervisor to criticise. If you ask me what I think about the 400 plans that I saw and what is going to happen at this end, I also have a number of complaints about those and there were a number of deficiencies. You need to factor that in to what you are reading.

The second point is that it is absolutely clear that in almost any version of how this plays out, in the first wave of restructuring there are going to be very strong interconnections between EU entities and UK entities. That is not true for all banks, but it is true for most, and it also true for most significant insurers. That does present a supervisory challenge for both us and the ECB in making sure that we have between us a decent view of



that. It is one of the reasons that in our document today we have got a section that talks about all this, saying, "This is how we approach it." The one advantage we have in that particular issue is, because we regulate a financial centre, we already oversee a number of quite complicated structures. It is probably less of a leap for us than it may be for those of our colleagues across the water who do not yet do business of that kind.

Q38 Rushanara Ali: Obviously, we hope that the situation will feel less confrontational, if you like. However, I wanted to pick up on a point that the Chancellor made, where he criticised EU colleagues for advancing "protectionist agendas ... disguised as arguments about regulatory competence, financial stability, and supervisory oversight". Is the ECB's policy on banks' relocation plans an example of that protectionist agenda, and does today's announcement, given the approach the UK is taking towards EU banks, mean that sort of rhetoric is going to soften? Are we going to have a more co-operative relationship with a view to having the reciprocal arrangement that my colleague mentioned earlier?

Sam Woods: I will say a word, but perhaps the Governor wants to add something more. I think I heard the Chancellor make that particular comment; it was in the context of what is happening on CCPs and a desire to onshore all that into the EU 27. In the banking space, I would say that at a working level we have an extremely good and co-operative relationship with our colleagues in the rest of the EU 27. However, Brexit is throwing up a point of tension, which will probably build rather than subside, about our view of the global financial system.

Because of our long history hosting a global financial centre, we naturally approach wholesale as more open. We have all our structures for dealing with that, which is what today's publication is about. Our colleagues do not have that same background, so there is a stronger mind-set to apply the kind of logic that we apply to retail to wholesale. That is likely to be a source of tension through time between us and our colleagues. It will be navigable but it will be tricky.

Dr Carney: I agree with that. You characterised it well, in that our approach is one that aligns with openness—responsible openness, if you will—because it is based on a very high degree of regulatory standards and close supervisory co-operation. We would hope that it is reciprocated. If it is not, there would be consequences, because we cannot be in a position where there are significant activities of foreign firms here and we do not really know what is going on back home. That is clearly not taking our responsibilities to the British people. This is the way international financial systems work. By setting this out, we would like to develop it further.

Q39 Rushanara Ali: Turning to the issue of financial sector job losses, there have been various estimates, ranging from the 75,000 set out in October this year down to 4,600 by April 2019. Please say a bit more about your sense of whether you think those are accurate, given the quote from the Chief Executive of Morgan Stanley, who said, "The story has always been



three to five years out, not what does it do to the City the morning after Brexit ... If people judge it by the numbers that move [immediately] afterwards, they will miss the point.” Do you agree with that point?

Dr Carney: I agree with that entirely. It is the point I was going to make. Your two questions are linked. If, in the short term, there is an ability to maintain very deep interconnections and back-to-back risk into London, and therefore risk management, the people who do risk management and the people who do the audits, accounts and services around it are in London, the initial job losses are much less. If, over time, that is pulled into the continent, the losses are much greater. Part of where these numbers will jump around is whether you take the quote you had in your earlier question about a supervisory approach as mattering at the point of Brexit or as a desired end state in five or seven years. That all links back to how much co-operation you have as part of the system. It is all interlinked.

I would focus more, as the Chief Executive you cited, on medium-term numbers being the most relevant. The short term can bounce around. Ideally with the transition arrangement, there will be a limited amount of this, but there is likely to be a degree of expediency because we are dealing with hundreds of firms that potentially have to reorganise and not everybody will be as well set up as the best-in-class firms. Therefore, decisions will have to be made in the interests of the system.

Rushanara Ali: Would anyone else like to come in?

Sam Woods: No, that covers it well. The 75,000 is an Oliver Wyman number and they do that top-down, starting from financial services revenues. That is one of many paths in the five- to seven-year bucket. It is clearly not a day-one thing.

Q40 **Stephen Hammond:** Gentlemen, good afternoon. In the speech that Michel Barnier made back in November, as opposed to the one made this week, he spoke about the fact that the UK would not be allowed to cherry-pick in financial services. He also said that regulatory change would not be allowed to threaten the financial stability of the European Union. I have obviously listened very carefully to what the Governor and Mr Woods have said, but in light of this statement have Mr Sharp and Mr Kohn, as external members of the committee, convinced themselves that today’s announcement does not threaten stability in the UK and that we are likely to see reciprocal action from the EU?

Donald Kohn: I cannot speak to reciprocal action from the EU but we certainly discussed the content of today’s announcement in the Financial Policy Committee, and I thought the key elements were to protect the financial stability of the UK, which is our job, by making sure that people branching in and institutions branching in were held to a very high regulatory standards—at least as high as the international standards. Secondly, we must ensure that Mr Woods and his colleagues in the PRA have very good visibility into the risk they might be taking at home and



are able to judge how their risk-taking in the UK relates to the rest of the organisation—the very close co-operation the Governor and Mr Woods have been emphasising.

Thirdly, something that has not been mentioned so much is resolvability. We need to be sure that, if a globally active institution or institution active on both sides of the channel or ocean gets into trouble despite the high regulation and the good supervisory insight—because bad things can still happen—it can be resolved in an orderly way. That includes resolving the pieces in the United Kingdom without threatening the financial stability of the United Kingdom. Those are all part of our discussions, and the criteria set out today were consistent with what the Financial Policy Committee had discussed and made very good sense to me.

Richard Sharp: I would only add that the announcement today provided for and anticipated all reaction functions in a constructive way, which is why it was appropriate to make the announcement today. I certainly take a lot of comfort from the active engagement by the Governor and Deputy Governors with their counterparts in multinational organisations. As a realist, if you look at Basel or FSB and shared interest, and this is a critical issue in cross-border global financial institutions being well supervised, I am both hopeful and optimistic.

Q41 **Stephen Hammond:** You will be aware Mr Bailey was before the Committee at the end of October. We spoke in some depth about the competitiveness mandate, or not, and elements of competitiveness alongside financial stability. He said if the UK wants to be competitive in international markets, it will be based on firms that compete strongly. He was rejecting the idea and basically said that competitiveness can only come from competition and there should not be a mandate on the regulator, effectively. Is that a view you agree with?

Dr Carney: I do, in general, subscribe to that. Stiff competition is what drives innovation and ultimately drives productivity and competitiveness. Frequently the terms are unfortunately used almost interchangeably, as there is a very big difference. One leads to the other and also leads to better consumer outcomes. As a financial stability authority, you have to make sure you have the right mechanisms to deal with those who fall by the wayside in competition. That goes to Mr Kohn's point on resolution being an absolutely essential component of that. We are much more focused on that. It also goes to what Mr Hosie was asking about CCPs and market infrastructure, so having infrastructure that can withstand it. That goes to the core of it. That is the first point.

The second point is that, without question, financial stability is integral to the long-term competitiveness and productivity of the United Kingdom. We are looking to maintain the elements of that in an open system.

The last point relates to regulation. I am going to speak from an international perspective. This is not a UK-EU 27 negotiating point; this



is an FSB overall regulatory point. We have been through 10 years of fixing the fault lines of the financial crisis. We have put in place a host of new regulatory measures, most of which are extremely well judged, with many of them influenced by colleagues around the table and behind me, at the Bank of England. The fact is that with so many new rules in place, there is some duplication, inconsistency, overlap and underlap.

Now the big job, which will ultimately affect the competitiveness or productivity—which is a better way to put it—of the financial services sector, is to make adjustments to those rules on an international level so that we achieve the same level of resilience in a more effective way. We are currently looking at issues around the leverage ratio, the central clearing of derivatives and the incentives for investment in infrastructure and the regulatory impact on investment in infrastructure at an FSB level, which will cascade down to the UK.

Q42 Stephen Hammond: I take the point that over the last 10 years global regulatory systems have converged, but there is some evidence at the moment that not just the UK and the EU but the EU and US are starting to see some divergence in regulatory systems. I wanted to be clear on how you fit them in. You are aware that competitiveness is a code word for over-regulation in some people's language. How do you fit all that together?

Dr Carney: There are two points. First, the changes to regulation, actual and contemplated, in the US are moving more towards how regulation is applied in the UK as opposed to a dramatic deregulation of the US system. I will draw attention particularly to the way they have been conducting stress tests versus the way the Bank of England has. The movement is more towards a Bank of England-type approach. It will not totally match it but it is probably, in the end, a more efficient approach. Secondly, there are some add-ons unique to the US that are potentially being removed: additional leverage ratio, the Volker rule and certain definitions in that, which we do not have. We think we have the right balance there. I would not say that we are seeing in the US an undercutting of the standards in the United Kingdom.

I will make a general point. We have to start all these discussions around the competitiveness of the City with the fact that we have a financial system in the UK that is 10 times GDP. No other major economy has anything of that order of magnitude. The US banking is less than one times GDP; we have a financial system of 10 times GDP. We had a near-death financial crisis 10 years ago in this country. We cannot be in a position where we run big risks with that again. That is why the Committee has been very clear that, in its judgment, after leaving the European Union, we remain committed to standards as least as high as now, which substantially exceed the international minimum standard. In our judgment, that is the best thing for the overall competitiveness of the UK economy.



Richard Sharp: In terms of the financial institutions, we now have, post crisis, a shared interest with the boards of the institutions to have well-run organisations in the interest of their shareholders. Shareholders lost out as a result of poor risk-management practices. Competitiveness does not necessarily mean laxness. It means high-quality, sophisticated people—that Mr Woods has the capacity to employ and retain intelligent, capable people who, as regulators, engage constructively and in a high-touch manner with the institutions involved rather than, say, box-ticking or an ignorant way in the extreme. It is not an issue of laxness; it is an issue of sophistication. I certainly saw that in the meeting of chief risk officers. Although through the stress test we have imposed costs on those institutions to change their modelling capabilities and undertake a very rigorous and expensive exercise to conform to it, that has ultimately been for the benefit of the institutions involved. There is a shared interest in that approach.

Q43 **Stephen Hammond:** Absolutely. I do not think anyone would suggest that laxness was anything other than to be pushed out of the system. It is a question of appropriateness, and at what level that appropriateness strikes. The FPC has a competitive recommendation from the Government. If that were an objective, would that in any way change the way you work?

Donald Kohn: I do not think so. It is critical for a competitive system to be a resilient system. People will not be placing funds here: they will not be doing business here if they think there is a risk their funds will not be returned and they are not engaged in a system that can stand up to stresses. That is our job. In terms of competition inside the system, I do not think anything we have done has impaired that ability to compete. Our first job is financial stability. Our second job, subordinate to that, is to support growth and the Government's policies. When we do cost-benefit analyses, we look at the effect on growth in the United Kingdom. I do not think there is anything inconsistent with what we are doing on either competition or competitiveness.

Dr Carney: I would be wary of changing the statutory objectives of the FPC and elevating "competitiveness", which is a slippery concept, to co-equal with financial stability. Take a hard look at the FSA. I remember the FSA and it had a competitiveness objective, and you knew they had a competitiveness objective if you met with them. The consequence of that is part of what we have been digging ourselves out, to be blunt. In the first five years after that change, memories will still be there, but what about 10 or 15 years down the road? It is very dangerous to elevate competitiveness with financial stability.

There are lots of other ways to get it. You can push the FPC and push the Bank to make sure it is being as efficient as possible in achieving levels of resilience, but with a system that is 10 times the size of GDP, the people of the United Kingdom deserve some authority that is looking to make sure the system as a whole is resilient.



Q44 **Alison McGovern:** I am going to move on to fintech. Governor, in April you made a speech saying that competition from fintech could reduce customer loyalty and that would have consequences for our banks, and that our prudential standards and resolution regimes would need to be sufficiently robust to these risks. What did you mean by that?

Dr Carney: Yes. Those comments were in tandem with one of the other stress tests that we did over the course of the past year, which we reported out last month: the so-called exploratory scenario. It was an exploratory scenario, not a stress test, but it was to look, among other things, at the potential impacts of fintech. To be clear, the potential issue, which could be as part of the consequence of PSD2, open banking and those arrangements coming in place at the start of next year, is that the interface between a traditional bank and the customer is an API, a tech-fin company, or some other entity that has the customer loyalty. That would then increase competition within the sector by moving deposits for the best rates, finding the best rates through algorithms or other mechanisms. I can think of the companies; I am not going to endorse them.

To be absolutely clear, the point we make is that could well be a system that is much better for the consumer: they get more choice, finer pricing and more availability. That is great. Our job is to make sure that a bank that has moved from having brand loyalty—stickiness—to becoming basically a utility, a white-label product underneath this fintech company, is sufficiently resilient for the volatility they may get in funding or business opportunities and have thought that through. That is part of the question we asked of the banks as part of this exploratory scenario.

To be honest, we felt, and this is detailed in the stress-test report, that banks might not in every case have adequately taken into account this competitive threat. One of the indicators was they felt their cost of acquisition of customers would go down and the churn would go down. However, there are good reasons to think that, in a successful fintech and open-banking world, both of those are going to go up or there is going to be a relatively limited number of people who retain the front-end to the customer, ultimately to the benefit of the customer, and everybody else has to adjust accordingly. That is what I meant and that is part of what we have tested.

Q45 **Alison McGovern:** Do you feel you have a responsibility to consumers? I know your statutory responsibilities are quite clear but, in this scenario, do you feel the Bank is trying to achieve a good deal for consumers?

Dr Carney: In this case, we come at it from financial stability, but we want to make sure that, if that is the way the system evolves, the system is robust for that—in other words, the underlying institutions can handle higher volatility in their funding, have planned for it and are supportive of this system. Mr Woods can speak to this, but we have also streamlined and revamped our new bank authorisation unit. There is a high number of institutions coming through. We work with the FCA in their sandbox.



HOUSE OF COMMONS

We are trialling a number of these things. This system really does have a potential to be more competitive and resilient. We are not protecting the banks. We are trying to look to make sure the banks would be robust enough for a system that could have a lot more competition.

Sam Woods: We do, of course, have a secondary competition objective for the PRA. That has led us to do things, including the things just described by the Governor. Of those 48 authorisations we were talking about in the Brexit context, 23 are new banks, of which four are digital banks. I will not name them. That leads us to encourage that kind of activity. We are trying to balance that against some of the risks.

Q46 **Alison McGovern:** Looking at it from the banks' point of view for a second, the Basel Committee on Banking Supervision has estimated that 60% of retail banking profits are at risk. Do you have any comment on the UK banking sector and where you think they are?

Dr Carney: Yes, a substantial proportion is potentially at risk, absent a competitive response. The question is: what is the digital offering of the bank? How are they expanding? It goes to a client service question. Every institution thinks they are going to have a great digital offering and they are going to be the winners in this. We will see, but "at risk" is fair.

Sam Woods: The banks have put into us, in this thing we call the biennial exploratory scenario, that they thought they would be able to survive a world in which it was low for long and you have a heavy competitive pressure from the fintechs. We thought, in the end, that was not a completely convincing response for a number of reasons, not least what they thought they could do with their costs in such a situation and what they thought would happen to their cost of equity. We think there is probably more risk there than the banks are willing to acknowledge in what they have put into us. That is all about the numbers, profitability and capital levels. None of that leads us to think there would be a major financial stability issue coming out of that; it is more that the shape of what we have would change.

The second point is to come back to what the Governor mentioned about banks getting disintermediated by the front end. If you go to China, the massive extent to which that has happened is very striking. That is very real.

Q47 **Alison McGovern:** One of the previous challenges that regulation of the sector experienced was a skills mismatch. How confident are you that you have the right skill level of people to deal with new technological development?

Sam Woods: The truth is that it is very challenging. The area in which it is most challenging is not the one we have just been talking about; it is what we call operational resilience, including cyber. The UK financial system is under heavy attack, like many other parts of the system. We have had to trigger the thing we call our Authorities' Response



Framework six times in the last year for cyberattacks that were big enough that we had to trigger that. However, there has been a very helpful development within the last year. There is now a part of GCHQ called the National Cyber Security Centre, which is a significant unit. This is what they do for a living. We have now brought that unit into our response framework and put them in charge when we have a live incident. I was up there two weeks ago meeting the team. We have a smallish team, which has the capacity to deal with it as a regulator, but we need to leverage ourselves through entities like that, because some of this is about activity we would never have the first line of sight into.

Q48 Alison McGovern: Do you think there are signs that open banking is making a difference to the fundamentals of the way banking works? Are people going to move? Is this going to be the thing that unlocks competitiveness or is it still some way off in the future?

Dr Carney: I would not say that I feel we are on the cusp of that revolution, but the building blocks are being put in place and this can move fairly quickly. The biggest disruption is going to come from outside the regulated sector. The most obvious entrants have not yet, at least to my view, put an offering on that will take a substantial proportion of the business. It is pretty close to being there for the taking, I would suggest.

Sam Woods: It is still early days. Switching rates for current accounts are currently down, so it is still on the floor. I remember looking at this in 2011 as part of the Vickers review and we made a number of recommendations. The switching service has helped a bit. Funnily enough, it has been extremely helpful in the context of ring-fencing where we are moving all the sort codes around—an unforeseen synergy between the different parts of that committee's recommendations.

Dr Carney: Both of those were your ideas.

Sam Woods: They were not exclusively my ideas, but, yes, it is still early days.

Q49 Alison McGovern: Are there any further comments? Dr Carney, you have previously answered questions from this Committee on the gender pay gap. While this session has been ongoing, the owner of the Clydesdale and Yorkshire Bank has emailed us to say that their hourly gender pay gap is 37% between men and women. Do you have any comments for your colleagues in the financial services sector?

Dr Carney: I have not seen that and I should not comment on a specific firm. As this Committee will be aware, gender pay gaps in financial services are high relative to other industries. It requires a multi-pronged approach to change over a period of time. There is the Women in Finance series of initiatives under the Gadhia review, which was launched at the Bank and to which we subscribe. We and a number of private financial institutions are putting that in place. Those types of initiatives will make a difference if they are deliberately followed through. Gender-



pay-gap reporting helps focus the minds of the senior-most management and their shareholders on whether there is progress or not.

Chair: Apologies. I am going to leave you now in the capable hands of Mr Mann. I wish you all a very happy Christmas and I shall go and repeat this with the Prime Minister.

Q50 John Mann: There you see, Governor and gentlemen, the embodiment of what happens if you have a woman in charge of an important financial institution: pragmatism, flexibility and not wasting your time or the staff time by holding the Committee over for a couple of hours. It is a refreshing change. I am sure you can help percolate that message to others you deal with. We have three more areas of questioning in this session. By coincidence, I am taking the first one on Bitcoin. Who is going to regulate it and, if nobody regulates it, is that going to be a problem for you?

Dr Carney: At present, we do not view it as a financial stability issue. It has increased significantly in value but is not connected to the core of the financial system in general. It is not levered. Its orders of magnitude are that it is half the market cap of Apple. If you add Bitcoin in with some of the other major cryptocurrencies, it is in that order of magnitude. It is significant, but it is more like an equity-type risk that is spread fairly widely around the world. We do not see it as a financial stability issue.

If I can broaden it slightly, there are certainly issues around suitability in the securities area, so from a conduct perspective around so-called ICOs, initial coin offerings, which are just an end around public listing rules and initial public offering rules, in my opinion and the opinion of many other conduct regulators such as the FCA. On the issues there, the tightening up of rules around so-called ICOs is necessary. You have the extremes of bans that have been put in place, for example, in China. I will stop here but raise the issue, in case you want to pursue it, of the underlying technology, which, as others have observed, is of a fair bit of interest. We are working with it at the Bank of England.

At this stage, we think the most interesting applications that would be beneficial for financial stability and efficiency relate to the application of distributed ledger to wholesale settlement activities, but the technology is still a way off from being ready for that. We are on the case. I will raise one other point, which is that I think there will be discussions among international regulatory fora around these issues, given the scale of growth that has been there, and around the potential role of central bank digital currencies in the future.

Q51 John Mann: That debate is breaking out a bit already. On this question of regulating Bitcoin and other cryptocurrencies, we all understand the point that at this stage it is not an issue in terms of financial stability in your remit. Where will the thought process and policy approach originate from to determine how best to regulate and who should regulate? Is it



HOUSE OF COMMONS

something you could ever contemplate would come under your ambit at the Bank?

Dr Carney: Not the regulation of Bitcoin. The regulation of specifically those currencies, specifically if they are used for fundraising purposes, are conduct-related issues. Conduct regulators would look at that. That said, the discussion of central bank digital currencies or their connection with the application of distributed ledger technology, which is not necessary but can facilitate those currencies, will accelerate. We have been a part of those discussions already. The Bank of England will obviously be part of that. I suspect, Mr Mann, that at the FSB G20 there will be discussions of these issues, if not just to put them in their proper context.

I will make one point on Bitcoin, if I may, to link the two. The interesting or the remarkable thing, which is perhaps a better way to put it, with Bitcoin, as we have all seen the value adjustment, is that it has an underlying but not proprietary technology. Owning that asset does not give you an option on the application of the technology. Ultimately, the interesting thing for the system, which would have financial stability implications, is the application of derivations of distributed ledger technology, which a bunch of other people are working on. Owning this over here does not give you anything over there.

Q52 **John Mann:** What of some of the potential applications? For example, Bitcoin and the technology itself would appear to lend itself to property transactions. It would appear to me that would potentially be inevitable and a big improvement in how property transactions are carried out. What resource, what effort and how much of a lead are you taking as the Bank in this or in risk aversion?

Dr Carney: On the contrary, we have had a fintech accelerator for the last several years. We have done a number of trials. We have done trials with distributed ledger technology. We are a public sector participant in some of the private consortia that are looking at the application of the underlying technology, particularly the wholesale. I have participated in discussions with the major central banks on this issue, not Bitcoin but the technology and applications. I did that last month and will again next month. We have a dedicated fintech unit which leverages off the resources across the institution including the PRA. We are pretty active in it but we are also disciplined.

As you know, if we are going to apply something to the core of the system, it is going to need a five-sigma quality rating. We are not going to apply something that works some of the time but does not work other times, is incredibly energy intensive and settles in days as opposed to nanoseconds. That is not the expectation or the requirements of the core of the system.

Q53 **John Mann:** Your Australian counterpart made a clearly very nervous comment about the adverse implications for financial stability of central



HOUSE OF COMMONS

banks issuing a digital currency, but your Chief Cashier, Victoria Cleland, said this “will create some fascinating opportunities”. What are the opportunities and what kind of timescale should we be anticipating? Mr Kohn, you might have a commentary on this as well.

Donald Kohn: I will defer to the Governor. He knows what is going on inside the Bank much better than I do and is much more informed than I am.

Dr Carney: The point that Governor Lowe of Australia made around financial stability is partly an extreme version of what we were talking to Ms McGovern about on fintech. If you have a retail central bank digital currency, in other words a currency that allows any of us and everyone across the country to have an account at the Bank of England, as well as having an account with other banks, you create a situation where you can have an instantaneous run. As soon as there is any concern, people can switch into their account at the Bank of England. That is the first financial stability issue and one that Mr Lowe is talking about. The second thing is that you create a system where all of a sudden the Bank of England potentially has huge amounts of deposits and we are deciding where to allocate those deposits across the economy, to government debt, to corporate debt, which I would suggest is a Gosplan-type system that might not be good. Of the many talents of the Bank of England, I do not think credit allocation for the entire economy would be a good idea.

There are some fundamental problems if you push the retail design all the way down, unless you restrict the amount people can have. Then the question is what benefit you are giving to people in having access to central banks’ balance sheet. Is there a better payment architecture you could build off that or could property transactions be more instantaneous once you have done it? I do not want to be definitive, because there is a lot of research and work being done on this, but what I have seen thus far suggests to me at least that you get those benefits by stopping at a level much higher than the retail level. You do not end up with those financial stability risks—you actually get financial stability benefits—and you save huge amounts in terms of computational-energy-intensity transactional challenges.

However, what I say on this topic today will be outdated six months from now because things are moving very rapidly. I cannot give you a precise timeline of when it would be an application, but I can tell you that we have consistently dedicated resources to this. It is an area of active interest. Even though it is not cryptocurrency based, the exploratory scenario shows the way the Bank is thinking about how the system can reshape because of fintech.

John Mann: We are very interested. I am sure we will come back to this in future sessions.

Richard Sharp: I think what was behind Ms McGovern’s questions is that there are significant uncaptured efficiencies available for consumers right



HOUSE OF COMMONS

across the financial system, which technology has yet to capture. For some people, myself included, it has been disappointingly slow in respect of many of the utility functions. That includes payments as well as asset managements. The opacity of the system has worked against consumer interests. What has been going on now with Bitcoin, with the 600 billion market cap, is going to create a greed-based capitalist response, akin to a gold rush, notwithstanding volatility, which will stimulate further efforts to create efficiencies in the whole fintech area. Whilst many of us can be agog at the volatility, there is something constructive that is going to come out of it, which will be a shot of adrenaline for the whole fintech sector.

- Q54 **Stephen Hammond:** Not only the size but how a current account deficit is financed is self-evidently important in terms of risk. If I read your chart A.19, the reversal of how capital flows have financed current accounts since 2015, clearly it has been financed by foreign investors in the UK. Three points come from that, Governor. The first is: do you think that has been because there is a confidence in UK growth prospects? Is it, to use your phrase, the kindness of strangers? If you were to see a sharp reversal of that trend, akin to the period prior to 2015, what implications does that have for domestic credit conditions?

Dr Carney: The question is very on point because, in part, some of that reversal is what happens in the stress test. The risk premia effects and some of the knock-on balance sheet losses of the banks in the stress test are caused through this channel of a reversal risk premia in order to maintain some level of flow-in on, by that point, higher yielding UK assets but, as a consequence, losses to the institution. One of the big elements of those flows has been into real estate, as you aware, as detailed elsewhere in the report. In London commercial real estate, of the order of three-quarters of transaction flow is now foreign, largely Asian, money. A substantial proportion of residential in the capital is that as well. Those transactions are signs of confidence. It is a bit concentrated in certain sectors and from certain sources.

I can generalise the point: at a lower sterling exchange rate, with solid institutions, there are lots of reasons to continue to see the flow. If we reverse the form of financing, and it is going to be very hard to tell this in real time given the data, and it becomes a sale of UK assets abroad in order to finance, that would be a concern, but I think we will see it in risk premia as well as the change in flow. That would be the best indicator of what is happening. There is also the 2012 to 2015 shrinking of bank balance sheets, which was a big element of that foreign financing at the time.

- Q55 **Stephen Hammond:** In terms of the risk premia, there has been some diversion when UK risk premia has gone up. Presumably your explanation covers that.

Dr Carney: Yes.



Q56 Stephen Hammond: The second point, again to your point about where the concentration of inflows has been, there has obviously been a huge increase in wealth in China. You have a lot of those inflows into commercial property coming from the Chinese. It is true, is it not, that you have seen a credit expansion in China at a rate faster than in the US pre-2007? If you look at some of the other examples of economies that have seen that rapid-rate credit expansion, it usually comes before a fairly nasty domestic financial crisis. The implication could be that we should expect to see some form of financial contraction in China, which would have an impact on the inflows into the UK.

Dr Carney: Again, you have put your finger on it. The genesis of the stress test is exactly that: a sharp adjustment in China flows through Asia and causes the risk premium to move, a pullback of capital flows through the current account, and losses on the banks both in their Chinese exposure but also domestically. As we highlighted in the chapter of foreign indebtedness, as Members know, this has been a concern of ours for number of years. The pace of debt growth and the overall level of indebtedness in China, and the quality of some of that indebtedness, all points to a significant restructuring of some of that debt over time.

Normally in those circumstances, at a minimum you have an adjustment of growth of the order of three or four percentage points lower for a period of time as the work-out process goes. China has tremendous strengths and resources. They are well seized of these issues, and the Chancellor and I were in Beijing on the weekend and had some discussions on these issues with Chinese authorities. They have taken steps and will take more to help the transition.

We recognise it is a major risk. The Chinese authorities recognise it is a risk. Other people see it as such. That was why we ran the stress test that we did. It will have an impact on the UK if there is a sharp adjustment, because we have a very open economy. We have also done our best to make sure the system is resilient to that type of risk, so it does not have an outsize impact on the UK.

Q57 Kit Malthouse: I find myself, when I look at these stress tests, wondering what we have come to when dishonesty is a systemic risk in the industry. In terms of the calculation you make about misconduct amounts, have you discounted it now because of the senior manager regime or is it still at the same kind of level it was before? Will we get to a point where it does not form part of the stress test?

Sam Woods: The short answer to your first question—whether we have discounted for the introduction of the accountability regime—is no. That is because we are naturally cautious in terms of how we do these tests.

Q58 Kit Malthouse: You are assuming it will not work.

Sam Woods: No, because it is a stressed outcome, it is done bottom up. The way that number is constructed is we look at the forward run on PPI, taking account of the time path. Yes, we also look at the backstory,



HOUSE OF COMMONS

which is £67 billion of provisions, 2011 to 2016, of which £35 billion is PPI. You can just look at that.

Q59 **Kit Malthouse:** This might be for sins of the father and mother.

Dr Carney: This is entirely sins that have been committed. Punishment is waiting for identified sin. The question is what the punishment is going to be.

Q60 **Kit Malthouse:** You do not necessarily know what the sin is yet.

Dr Carney: You have this stressed amount for PPI, US mortgage infractions, FX and a series of things that are in the public domain and working their way through the restitution process. This is the stressed amount for that. What is not in here is an estimate of what else could there be that is wrong.

Q61 **Kit Malthouse:** It is the Rumsfeld question: we do not know what we do not know.

Dr Carney: For the things about which we know, we do not think it is reasonable or likely at all that they will end up paying any more than £40 billion. In fact, it is more likely they will pay less. There is some room for other bad things that could be going on.

I want to go to your core point, which is this is systemic, as you say. It is a sad commentary that misconduct is systemic. That is why a few years ago we pushed to change the way compensation is done to have more pullback, to have the senior managers regime put in place and to have the industry define some of the lines in, for example, the conduct in fixed income markets, so that we could link that to the senior management regime so you could get to bad behaviour before it rose to a level of market abuse, which is a higher standard. You get a bigger cultural change through individual accountability.

Q62 **Kit Malthouse:** Over the next 10 years, we should see it reducing.

Dr Carney: I would certainly hope so.

Q63 **Kit Malthouse:** Unless they become more ingenious at it.

Dr Carney: There is the pace of reduction, but there will also be the individual consequences of misconduct within institutions, including for senior managers who did not have the misconduct themselves but oversaw it. At a minimum, compensation consequences for them will be much more frequent.

Sam Woods: It would be surprising if the level of capital we are currently requiring banks to hold against this kind of stuff turned out to be anything near steady state. A lot of this stuff has come in off the back of the financial crisis. The best examples of that are the US issues, which are very specific. Banks are wading through them, and when they get done, they come out of the capital requirement.



HOUSE OF COMMONS

Q64 **Kit Malthouse:** You think all the flat rocks have been lifted and it should start to tail off over the next five to 10 years.

Sam Woods: Certainly.

Q65 **Kit Malthouse:** On the capital allocation issue you have announced today, we have been receiving various statements during the meeting. The question arose in my mind about non-reciprocation. If the EU decides not to reciprocate, there is a requirement pretty much for all financial services organisations to start to allocate capital twice, effectively, or remove it from London to the EU. Mr Sharp, you have a background in this area. Do you think there is a risk that these large global organisations, instead of saying, "We are going to allocate capital into the EU," will say, "Actually, maybe we should think twice about that altogether and allocate that capital where it would see more growth"? The equation is not the UK or the EU. It is the UK or somewhere else.

Richard Sharp: The global organisations have significant continental EU 27 presence. The ones that I am aware of are expanding as a result. You only have to look at the Frankfurt real estate market. They spend a lot of time on capital efficiency. At the same time, the collective regulators are working also at global resolution issues, which also ensures there is not competition for capital in the event of massive difficulty. The nature of the market that operates in the UK and the adjacencies create significant profit opportunities, and the capacity to capture employees and services for financial services obviously gives London a tremendous competitive advantage in terms of the profitability of institutions based here. However, there is no doubt that, as a result of the growth that will take place in some of the centres on the continent, there will be more profit opportunities occurring there as well. I would not expect them to pull back from the EU at all, if that is your impression.

Q66 **Kit Malthouse:** If you were a large organisation, like your former employer Goldman Sachs, you might say that my alternative is not necessarily London or Frankfurt; it could be London or Singapore or Hong Kong.

Richard Sharp: They have been looking at that for 15 years. That was an issue 15 to 20 years ago. They are now there. They have to be globally present at key centres. Obviously Asia represents significant opportunities. When it comes to the profitability and capital allocation, there have been times when capital has been tight, and we have seen that in the amount of capital allocated to trading markets. We looked at, for example, issues associated with the gilt market: whether there was enough capital in there etc. The large global banks have sufficient capital to address the needs but they will be ruthless in terms of profitability. A fixed income market like this year will also cause them to reign back.

Q67 **Kit Malthouse:** That is the point. This looks like a very sensible measure to me. If there is not reciprocation, i.e. they are removing one pillar, is there a net capital flight from UK/Europe as a whole that says,



"We will just head to Asia, because we growth three times what we can expect here. Europe is a mature market that is ex-growth; we are all competing for the same private equity companies." Do you know what I mean? There is nothing exciting happening here.

Dr Carney: I would put it in the positive for London, which is that it would reinforce a distinction between an international global financial centre and a local financial centre, even if the local is relatively big. If you have to be local and ring-fenced to be in the local, as Mr Sharp just said, Europe is big market—there will be profit opportunities and lots happening—but that is different than having a footprint you can go anywhere from. To bring it back to our responsibilities, we will allow people to do that if we have the right relationship and they rise to our standards, which a number of jurisdictions do. We know how to operate that system and we will continue to do so.

Q68 **Kit Malthouse:** On that, an added complication to the whole landscape over the next two or three years is ring-fencing, and we keep being told that progress is being made towards the deadline in January. How are we getting on?

Sam Woods: That links to the wider discussion, because ring-fencing retail activity is the other side of the coin of having a big financial centre because it is what enables you to do the two things at once. That programme is well on track. The deadline is 1 January 2019. I am expecting that we will be largely done within four to six months from now. To give you a sense of where the programme is at, the sort code migrations has been a major thing. That is three-quarters done. There is another quarter to go. The court process is the heart of it, which is a part 7 process tailored for this purpose. Where that process is at is that three of the five banks have had the first hearing, which is called the directions hearing. The other two are going to have them shortly. The final hearing is the sanctions hearing. The first of those will be at the end of February. Assuming the court process works out—and we are in very close touch with the courts about this—the firms will then operationalise the change in the months following that. We briefly upped the risk factor on our programme following the referendum vote, because we were concerned about complications that might arise about doing these two things at same time, but we have now put it back to the rating it was on before.

Q69 **Kit Malthouse:** Is the volume you are having to deal with affected by your announcement today?

Sam Woods: On ring-fencing, no, not at all. It is the case that the court may face a very large number of part 7 transfers from the insurance companies. We have been in discussions with the court about whether it has the capacity to deal with that. That strain is one of the reasons, again, why it would be beneficial to have more time.

Q70 **Kit Malthouse:** Once it is all done, which sounds like it will be in June,



HOUSE OF COMMONS

you are effectively going to have two entities—ring-fenced and un-ring-fenced—to regulate. Are you in ship shape to do that?

Sam Woods: We are in a good place. We are going to have to apply all of the requirements at the level of the ring-fenced bank but we will also reshape the supervision teams. Within the supervision teams, there will be a bit that does the ring-fenced bank. Then of course we will look across the ring-fenced banks and do thematic reviews. It is a massive re-engineering of the banking sector but, touch wood, at this stage it is in pretty good shape.

John Mann: Governor, I will not abuse my position by asking you what next year will bring, other than the certainty that you and your colleagues will be very welcome at this Committee again. We look forward to it. Can I take the opportunity on behalf of the Chair and all the Committee to wish you a very happy Christmas? We trust you will get some quality time within the festive period. We extend that to all those present today, all those watching, and not least the staff and advisory team that we have, who have worked diligently, indeed brilliantly, throughout the year and will need this festive break to recover. We look forward to seeing you again in the new year. Enjoy the break. Until then, thank you for coming this afternoon.