HOUSE OF COMMONS

Treasury Committee

Oral evidence: The work of the Prudential Regulation Authority, HC 704.

Tuesday 16 January 2018

Ordered by the House of Commons to be published on 16 January 2018.

Watch the meeting

Members present: Nicky Morgan (Chair); Rushanara Ali; Charlie Elphicke; Stephen Hammond; Stewart Hosie; Mr Alister Jack; John Mann; Catherine McKinnell; Wes Streeting.

Questions 1 - 70

Witnesses

I: Sandra Boss, External Member, Prudential Regulation Committee; Sam Woods, Deputy Governor for Prudential Regulation and Chief Executive Officer, Prudential Regulation Authority; Mark Yallop, External Member, Prudential Regulation Committee.

Written evidence from witnesses:

– [Add names of witnesses and hyperlink to submissions]

Examination of witnesses

Witnesses: Sandra Boss, Sam Woods and Mark Yallop.

Q1 **Chair:** Good morning. I think I am allowed to still say happy new year. It is very nice to see you all for this session on the work of the PRA. For the benefit of those here, but also those who are watching online, it would be helpful if you could introduce yourselves and the roles that you hold.

Sam Woods: I am Sam Woods, Deputy Governor for Prudential Regulation.

Sandra Boss: I am Sandy Boss, an external member of the Prudential Regulation Committee.

Mark Yallop: I am Mark Yallop, an external member of the PRC as well.

Q2 **Chair:** Thank you all very much. As you might imagine, we have quite a broad range of issues to ask you about. It is not going to surprise you if we start with Brexit negotiations with the European Union. I wanted to start with the letter that you put out on 20 December, Sam. On 21 December, the European Insurance and Occupational Pensions Authority put out its opinion on how insurance firms and supervisors should be preparing for Brexit. There is quite a difference between the two approaches.

It is worth saying that the European approach does not allow firms and regulators to proceed on the assumption that there will be a close relationship with the UK and the EU 27 supervisors after Brexit. Indeed, it states that insurers must "not rely in their contingency plans on any arrangement between the European Union and the UK to continue after the withdrawal date". Sam, I think I am right in saying that you sit on the EIOPA board?

Sam Woods: It is in fact David Rule, who works for me, who sits on it. I used to sit on it. We are closely engaged.

Q3 **Chair:** Perhaps you could just talk us through the involvement, as members of the board, with the discussion on the European perspective; how you got to a state where the two approaches seem to be so very different; and what is going to happen if in fact the negotiations go as the Europeans appear to expect rather than as the PRA expects.

Sam Woods: Yes, I am very happy to do that. There is a narrower tension, which I will begin with, and a broader tension. We have been heavily engaged with EIOPA, through David on the committee and I have also spoken on several occasions to Gabriel Bernardino, who chairs that organisation, and will again next month. The narrow point of difference in that opinion is particularly around the contractual continuity issue. On that issue, we see it in exactly the same way as the Committee sees it and as was described in your transitional report. In terms of their diagnosis of the problem, EIOPA see it in the same way.

The difference comes in what we are saying about it and what needs to be done about it. We have been very clear, as has the Committee, that the best solution to that problem is for the Governments to agree something as part of the withdrawal agreement that ensures those contracts are not disrupted in a way that they may otherwise be. I very strongly maintain that view. It is very helpful that the Government on our side have said they would like to do such a thing and, if they cannot agree it, they will do something unilateral. On that point, EIOPA is in a different place. It is being more cautious, I think, about speaking directly into the negotiation and to the politicians around things that it thinks it needs to solve. There could be a whole bunch of reasons for that; I do not find it entirely surprising.

That motivates the narrow difference you pointed to, but I will very briefly point to a broader difference. I alluded to this, but we did not have much time on it, on 20 December. It is a point of tension that will arise between us and our colleagues in the EU 27 as we go into the next phase. This will be even truer in banking than it is in insurance. Our perspective is basically that retail activity, both insurance and banking, should be local, ring-fenced and in subsidiaries; wholesale finance is naturally cross-border and we should find ways to make that work within a suitable regulatory framework. That stems a lot from our history overseeing a major financial centre. Our colleagues do not have that experience to the same degree, and that motivates a mindset that is more local, more ring-fenced and more like what we do for retail, for everything. I think that is going to become a point of tension as we advance through this process.

Q4 **Chair:** How are you pursuing those discussions at various levels, with the Treasury, within the Bank here, with firms based in London, but also with European counterparts? Are you having discussions with European counterparts, and are they feeding what is being discussed back to their own Governments to prepare for negotiations?

Sam Woods: Yes, we are extremely actively engaged. Obviously, I spoke to all of them just before I was here on 20 December to give them a heads-up as to what was coming out, because experience tells me people react better to stuff they know is coming. Actually, there was a very positive reception to that. I am going again to Frankfurt, and I will go to Paris and may also go to Dublin within the next two or three weeks, to talk to them about how we see that.

The reason for that is that, in the end, we need to negotiate with our colleagues MOUs, statements of responsibility, splits of responsibility and things of this kind in order to allow us to deliver the vision that we have put out, which we discussed here last time. Those discussions are very active.

There are other things, like contractual continuity. That is one example where, naturally, because we are here in Britain, we are ahead in our thinking and more focused on these issues. We tend to share that. There is a lot of sympathy and agreement around the substance, but, as I said, we are slightly more out there in terms of speaking publicly to what we think needs to be fixed than our colleagues.

Q5 **Chair:** What message are you getting back from firms? There obviously is a difference in approach. How are firms preparing? Although the PRA has given them perhaps more commercial guidance, are they following the European models that are preparing for a worst-case scenario?

Sam Woods: We will know better by the end of Q1, because the end of Q1 is a significant moment: then, we are 12 months out from the date at which we expect to leave the EU, and at which point hopefully a transition period will begin. If we get to the end of Q1 and a transition period has not been agreed, I think we can expect those activities to go up another gear. They are already in a reasonably high gear.

If on the other hand, as I hope will be the case and seems plausible, we get to the end of Q1 and there has been a clear political agreement, the question will be the extent to which firms feel they can rely on that political agreement. There will be a question for us, which has not yet arisen but I guess will come to the PRC in due course, about what we would say at that point. That will be significant.

Q6 **Chair:** Firms have about 10 weeks effectively, until the end of March, for the Government to arrive at an agreed transition or implementation agreement outcome; otherwise the PRA will have to revisit its assumptions and its approach.

Sam Woods: The approach we put out in December is robust to a number of outcomes. We would not be changing our approach. We would have a decision to take at the end of Q1 if it appeared that a transition was not going to be forthcoming. That really comes to what the contingency planning is. Should I come on to that?

Chair: Yes, please do.

Sam Woods: There are questions of degree in all this. To remind ourselves of the scale of what we are talking about here, we have 271 branches coming in here from all around the world; that is 111 insurance and 160 on the banking side. If we just focus on the banking to bring it to life, of those 160 bank branches, we have 77 coming here from the EEA. For a sense of the scale, across those 160, that is £4 trillion of assets; that is twice GDP. The EEA bit of that is about £1.1 trillion, but they also do a thing called remote booking, which would take it up to about £1.8 trillion. We have GDP, basically, coming in from these EEA branches. There is a lot at stake here and a lot of risk for all of us, which we are trying to manage.

One parameter is the degree of co-operation we get. If we get no co-operation at all, which is not my expectation, ultimately we are not in the business of allowing branches, and firms would have to subsidiarise. There are steps within that. Say we get enough co-operation for us to be happy with smaller ones, but we are feeling a bit iffy about the systemic ones. To give you a sense of that, of the 160 from around the world on the banking side, we think 51 will be north of our £15 billion cut-off if you aggregate branches together, which is the starting point for systemic; maybe half of those would end up actually being systemic. Of those 51, 25 are EEA. We said 23 in December; I have another couple in there now. You might get into a world where you say, "We are good for smaller ones, but for bigger ones either there is subsidiarisation or there are other mitigations that we want to put in place". That is one parameter.

The other very important parameter is transition. If you have transition, you have more time for firms to deal with it. The worst outcome of all is one in which there is no transition and no co-operation. I am sorry for a long answer. That is where the Government's commitment to provide interim permissions will be useful to us. We see that as a deep fallback. We do not want to do that, because we want to be across these firms. If we find ourselves in that place where there is little time, no co-operation and we need to pull the rip cord, that is the one we reach for.

Q7 **Chair:** Ms Boss and Mr Yallop, can I ask you as external members of the board about the discussions that you have had on the board about the various scenarios and outcomes? Perhaps you could tell the Committee about the discussions you have had and what views the external members are taking on this.

***Sandra Boss*:** Certainly. Over the course of the last year, we have probably had five or six very meaty discussions, some with just the PRC and some involving the FPC as well, on a broad range of Brexit-related issues. That spans the branching issue specifically, but also other matters such as contract continuity and the nationalisation of the acquis. In the context of branching, we have really had a history of branching. In 2014, we put out a new branching policy. This is now a rethink of that branching policy in light of our broader understanding of the international environment, but also the EEA-specific issue.

The policy that Sam was describing is part of a consensus decision-making process. Most of the committee members agree—including the externals, although I will not speak for Mark—that taking branching as our primary assumption where possible is consistent with the way that we want to be an open economy and want to be cognisant of the additional costs that are associated with subsidiarisation. We want to have a model, ideally, that would be very much like what we are already doing with many other countries where we have these MOUs. We were quite comfortable that to subsidiarise early would be a disproportionate step, and that is one of our considerations.

Mark Yallop: We have had, as Sandy says, very extensive discussions through 2016 and 2017, building on the original papers on branches versus subsidiaries published back in 2014. My commercial experience suggests to me that, if you want to end up with an open, collaborative, and co-operative relationship with a party that you are negotiating with, the best way to ensure that outcome is to start with an open and collaborative offer in the very early stages of negotiation. As Sandy says, not only is the option of first going down the hard, closed subsidiarisation route an expensive one for the firms themselves, but it also sends the wrong kind of opening message for this discussion with our counterparts in Europe.

Q8 **Chair:** There are 30 million EU 27 insurance policyholders who have contracts with UK insurers. I just wondered if you knew, out of the 30 million, how many are expat UK nationals with private pension contracts. If you do not have that information, could you write to us with it?

Sam Woods: I can give you a reasonable answer. What proportion are private pensions? It is probably around 5%, so quite small. The other way round, inbound, there are 6 million. We do not think there is any private pension in there here in the UK. What the intersection is between that 5% and expats I cannot tell you; I do not think we have that data. It will obviously be something smaller than the 5%, so that is a relatively narrow issue. For the 30 million overall, our point is the same as the Committee's, which is that those contracts would not be ruptured by an exit, but they would not be serviceable. That would be an absolute mess, hence the need to fix it.

Q9 **Chair:** That is why I think you would agree with the Governor, who, when he appeared before us, talked about the best way being for the EU 27 to unilaterally do what the British Government have said about honouring or grandfathering the contracts.

Sam Woods: Yes. The neatest thing is if it is part of the withdrawal agreement and is co-ordinated. That is particularly important for the derivatives side. Co-ordinated and unilateral is actually pretty good for the insurance contracts. Common sense suggests to me that that solution will be found. If we get a transition period, it does not solve the problem, but it gives more time to fix it. It also reduces in size firms' self-solving activity, which is moving books of business around.

Q10 **Stewart Hosie:** You were talking about the risks of branches and the cost of subsidiarisation. You said that a political agreement and a transition period would be better. You also spoke then about other mitigation. Are we talking about some kind of supplementary ring-fenced capital somewhere? What technical mitigation do you have in mind to solve that?

Sam Woods: I will outline that for you. I personally would not go the ring-fenced capital route for branches. It is a bit of a nonsense, because you do not have a separate legal entity. At the hardest end, you can restrict business: you can just say, "You cannot sell any more; you can stay here", "You can only do that line of business", or, "You can only meet your business plan". Those are tools that we use in certain situations. We could also put in place governance arrangements. We could say, "Although you do not have a legal entity here, we want someone, and we are going to catch in the senior managers regime who is responsible for X, Y, Z".

We could potentially have arrangements to ring-fence some liquidity that would be held in a separate place. There are things of that kind, and then there is a set of reporting things you can do as well. Those would be the first things that you would reach to. In the end, if you cannot get the level of co-operation that you need, it leaves you in a pretty difficult place.

Q11 **Mr Jack:** Can I ask you about the 2017 stress test? This question is probably to the external members. It was not designed as a test of impact for a Brexit scenario, yet the Financial Policy Committee seems to have repurposed it as such, saying that the stress test is worse than any Brexit scenario. Is this the view of the PRC?

Mark Yallop**:** I am not sure "repurposing" is quite the right word to use. It has looked at the economic impact of the stress test we applied this year, which was, I remind you, the most severe that we have run so far in the sequence of annual stress tests. You may recall a 4.7% reduction in GDP, another 1.8 million added to the unemployment roster across the country, inflation rising to 5% and bank rate up to 4%. It was a very, very severe economic disturbance for the UK.

It then recognised that it is impossible to forecast what a disruptive Brexit outlook really looks like, because there are so many variables here. Any particular single forecast runs the risk of looking rather foolish in three months' time or six months' time, let alone two years' time. You can create some scenarios rather than establishing, as we would with the stress test, a formal single forecast against which you test the economic outcome. The parameters that it used for those projections were things like changes in tariff, financial or non-tariff barriers, authorisations to sell goods, disruption to financial services and so on.

Q12 **Mr Jack:** You do not think there is a bespoke Brexit scenario stress test in that case, because the situation is changing.

Mark Yallop**:** There are too many unknown variables at the moment to create a single stress test. You can, as the FPC did, look at all these economic variables and the economic disruption that they would cause, and then compare the outcome of that work with what had happened in the annual cyclical stress test. We have seen the analysis that it conducted and the output of that analysis, and it is indeed the case that there is not a set of disruptive Brexit assumptions that produces a worse outcome than we saw in the 2017 stress test for the banks.

Q13 **Mr Jack:** You are confident it is robust enough.

Mark Yallop**:** It appears to be at the moment, yes.

Sandra Boss**:** It is important to remember what the annual cyclical scenario stress testing process entails. This is a very extensive analytic effort on the part of the banks. They dedicate tremendous resources each year. They run one fixed scenario through all their models all over the world in order to come up with a predictive number, which is used by the FPC and the PRC to set capital requirements. We would run the risk, if we set a predictive stress test, of exposing the industry to an enormous amount of analysis, only then at the conclusion to run the risk that that Brexit scenario would be not quite right. Hence it makes much more sense for us to ensure that our test is robust, as this one clearly is, but not to try to micromanage the exact terms of a Brexit scenario.

Q14 **Mr Jack:** The banks currently hold more capital than the regulatory requirements, so they can accommodate changes to the PRA capital buffers following the stress test. They do not have any need to build up any more capital at the moment; that is how the numbers are reading. Do you think that they will add more capital anyway, to maintain the voluntary excess of the stress buffers, and, if they do, would that impact on lending in any way?

Sam Woods: There is a static and a dynamic version of that question. The static question is: will banks always run with a buffer above our requirements? Yes, they will, because if you were running a bank you would not want to be sitting one basis point above what we were requiring you to hold, constantly ringing us up and saying you might dip in. How much headroom do they run with? It varies a bit; perhaps 1% of CET1 is a rough yardstick.

That headroom has been bigger in recent years for two reasons. One is that our requirements have been evolving, and that has made banks cautious in thinking, "Let us have a bit more room". As Mr Yallop said a moment ago, we have been working the severity of our stress testing up to the right sort of level, which we think it is now at. All these requirements from Basel have also been phasing in. This is a way for you to think about it: if a bank gets ahead of these capital requirements, it will gradually start tracking up and will end up with a buffer perhaps in the sort of range I was just suggesting.

On the dynamic question of whether the test will have made them move their capital position, and whether that will have an effect on lending, the simple answer is no. The big picture point there is that, since the Bank of England has been doing this, and in all the years I have been involved in it, this is the first time we have not had to require any of the banks to change their capital position off the back of the test. That is quite a significant moment.

Q15 **Mr Jack:** Is the stress test itself, rather than the countercyclical PRA buffers, really the marginal tool of financial stability policy?

Sam Woods: It is in effect, because of the way the capital requirements are set up. That is without getting into all the glorious detail of the capital stack, which is probably rather more complicated than it should be, to be honest. The marginal piece is something called the PRA buffer, which the PRC sets. That is not informed mechanically, but it is informed by the stress test. That is where you would go. The countercyclical is informed also by the stress test. The big difference with the countercyclical and some of the minimum requirements is that they are controlled by the FPC. The idea of that requirement, which is moving to 1%, is that, as we go into a stress, the FPC would release it and that would cushion any contraction of lending.

Q16 **Stephen Hammond:** Good morning. Thank you all very much for coming. I have read carefully your letter to the Chairman of 3 January, and I wanted to come back on a number of issues that are contained in it and your response to our Solvency II inquiry. At the outset, can I welcome annexe 1? In large part, it is a helpful response to our report. In the letter, you say that there is a lot of common ground about aspects of Solvency II that do not work well, and that there is a degree of overspecification in the directive. Obviously, annexe 1 sets out some of your responses to that overspecification.

There are three points that lead from that. First, it seems there is still a degree of difference between you and the industry on the amount of improvement that you have so far taken and that is available to you. There is also an issue of where you have exercised national discretion, and I wonder if you could lay that out to the Committee, and whether you intend to review further the opportunities for national discretion.

Sam Woods: Thanks for your comments. I genuinely think there is a high degree of agreement between us, the Committee and the industry about the stuff that is not working well in Solvency II. The Committee's inquiry was very well timed and has in effect given greater pace and urgency to the remediation we are putting in place. We are midstream. We had put out two consultation papers before I wrote to the Chair. We put out another one last week on reporting.

On the question about discretion and points of difference with the industry, the two are connected. The best way, perhaps, to illustrate the discretion point is in the context of reporting; it could apply anywhere, but this will give you a sense of the scale of it: 80% to 90% of the reporting package under Solvency II is harmonised. We make no bones about it: the amount of reporting we are getting under Solvency II is four to five times higher than what we used to have, and we did not used to think we had way too little. It has brought in a lot more reporting.

The remaining 10% to 20% is stuff that we have required through what we call national-specific templates. This is for things like stuff to do with Lloyd's that is very specific to the UK and no one else needs it, or with-profits funds, which is essentially a UK issue. When you look at those two things together, and then the scope we have to reduce the 80% to 90%, which is limited by market share, we have a national discretion of 20% to 30% of what we are talking about. The package we put out last week basically uses half of that. You could argue, and the industry probably would, that we should go even further than that. We have tried to focus on the most important things. Of those 13 national-specific templates, we are making changes to eight where we think we can row back a bit.

A more important part—and I know you and the Committee have been very focused on this point—is the requirements for smaller firms. We are putting in place these quarterly waivers and will use them to the maximum extent, particularly for the 220 out of 280 firms that are smaller. That is just to calibrate for you in one example where we are using the discretion we have. We are kind of going halfway; that is a reasonable balance.

On the points of difference with the industry, as I say, there are a lot more points of commonality than difference. There will always be some points of difference. If I am not giving too long an answer, perhaps I could pick out two or three to give you a sense of it. First, the industry says, "You are gold-plating the Solvency II accountability requirements because you have imposed the senior managers regime". That is true; we are not required to do that under Solvency II, but we think it is worth doing. It is something from which I do not think we should back off.

The second thing is model drift, which is a little more technical but important. One of the problems with Solvency II is that you sign off the model and then that sets the capital requirement for the firm. The history of financial crises tells us that is a risky arrangement, so we have some basic measures we want to track. We say, "Are the capital requirements drifting down through time?" We should do that.

The other example, which is quite topical given what is going on in the construction sector, is around pensions. The ABI quite rightly points out that Solvency II does not require us to get insurance companies to capitalise their own pensions, but we think we should do that. There will be some points like that where it is not unhealthy for us to have a bit of difference, but we should focus on the other stuff where Solvency II needs to be fixed.

Q17 **Stephen Hammond:** We are delighted to hear that and I have to say we are looking forward to your fuller report in March, which I hope will detail some of those in greater depth. There are several other areas. One of the challenges at the moment is the need for the UK to save more as a country; savings ratios are low. The financial services industry therefore needs to develop long-term saving products.

It is quite clear from the evidence we receive that the introduction of the risk margin and some of the rigidities of the matching adjustment are reinforcing the trend for life insurers to exit that long-term savings market. Yet, in your evidence, I notice you said you thought that these enhanced strong incentives. Therefore, I wonder if you could say why you think there is a difference between the two positions, and comment on whether you think Solvency II is therefore undermining the industry's ability to meet what the customers need.

Sam Woods: The two elements—the risk margin and the matching adjustment—are quite different. For people who are not following the detail of this, the risk margin is an extra margin of error that can be helpful if the firm gets into difficulty. It is an extra liability. We did not have anything like that in our old regime. Our view is that the calculation in Solvency II for that thing is simply wrong. As a result, it is much too sensitive to risk-free rates and it is very big at the moment. We have around 50 billion quid of insurance liabilities tied up in that, which is about 2% of insurance company assets. That may not sound like much, but the capital requirement is only 5%, so it is a big, big number.

Our concern around that is not the capital requirement per se, or the effective capital requirement, because that is covered by this thing called transitionals; it is about what is happening with new business, to go exactly to your point. The way that insurance companies have solved this problem is by shipping out longevity offshore. They are allowed to do that, but we do not think it is a sensible arrangement, so we want to fix that. We will be minded to take that forward, particularly as we have not got to where we wanted to in Europe on it.

The matching adjustment is a slightly different beast. We have always had something like that in our regime, and this is something that does encourage insurance companies to invest long term and match assets with liabilities. It is a very big benefit; it is about £59 billion-worth of benefit. Again, to calibrate that for you, for the firms that are using it, the difference between having it and not having it is the difference between being at 155% of their capital requirement and 65% of their capital requirement.

It is a very large benefit. The problem with it is that the version we used to have was a bit more flexible and we could use our judgment around it. The new version is actually pretty generous, but this is an example of overspecification. The way it is specified is leading us to have to jump through various hoops to get to the sensible outcome. That is pretty unhelpful.

Q18 **Stephen Hammond:** On 25 October, you published CP21/17. Would your response be that you accept there are legal requirements on the matching adjustment, but the industry should use that document as the UK regulators' interpretation of where there is flexibility within the prescription?

Sam Woods: Yes. What we were trying to do in that document, which I think we have done successfully, although it is rather technically expressed in the actual document, is to think of it as being a bit of a grey zone. You can imagine, if you are running an insurance company, given the size of the benefit you get from this matching adjustment, you do not want to get near to the fence where you might lose it, because that would have a pretty big effect on your capital position.

There are some things, like assets in a construction phase and assets with a repayment option, where it is not completely clear if it is allowed. We have been very clear about how that is allowed. The other way to understand it is that Solvency II says things like, if there is a breach of matching adjustment, it has to be rectified in two months or you lose the benefit. Firms say, "What happens if we discover the breach three months after it occurred?" We said we would be sensible about this and it would be two months from when you detect it. Of course, you have to try to detect it; you cannot just close your eyes to it. That is trying to minimise this grey zone, so people go up to where they are meant to go rather than stopping 10 metres inside.

Q19 **Stephen Hammond:** I know I only have 10 minutes. I have two last questions. I could go on for quite a lot longer, which I would find fascinating but I am not sure about others. I notice that there is a recent opinion by EIOPA on dynamic volatility adjustment. Will you be tackling that in your March letter to us? Could we ask that you do? There are clearly some new opportunities there for you.

Sam Woods: Yes, I will. I will bring it to you for my discussion with the Committee next month.

Q20 **Stephen Hammond:** Finally, as a general question—perhaps this is one where the external members would like to comment as well, please—if you look at the regulatory requirement that was available under ICAS, the introduction of Solvency II and the overspecification we talked about, there is a general view that little actual additional protection has been put in place. Do you think that Solvency II has been worthwhile, given the costs it has created for the industry, for you, I am bound to say, and indeed for consumers? Perhaps the external members would like to start on that, to give Mr Woods a rest.

***Sandra Boss*:** It has been a tremendous investment for the industry. We know that there is £2.6 billion of initial cost, and an estimate of £200 million per year of running cost. There is no question that that cost exists. The prudential standard that we observe is similar to what we had previously. The biggest advantage that we get, frankly, from Solvency II is more harmonisation of standards around Europe. Solvency I was minimum harmonising, and at that time the UK was quite a good step ahead in terms of its prudential requirements. Now we find there is much more of a level playing field with other European institutions, which is a benefit to our insurers, as they are competing across the continent.

Q21 **Stephen Hammond:** Your contention is that people have levelled up to us.

***Sandra Boss*:** An argument can be made on that front. Certainly there is more commonality.

***Mark Yallop*:** The cost of implementation was significant financially and in terms of the time taken to implement. I have less sympathy for critics of the ongoing running costs of Solvency II, because it is a very small proportion of the margins of insurers. Solvency II introduces a number of completely new concepts, like the requirement for gone-concern capital for insurers, which was previously assumed to be able to run off, per the UK experience in some famous cases in the past. It has created, as Sandy said, a step up in requirements.

We could consider, in some hypothetical new world where we have more flexibility, how much of that we want to retain. But there is a cost to diverging from a global trend towards more harmonised regulation for insurers. The EIOPA and IAIS work that we were talking about earlier on is practical evidence that others are converging towards more common standards. There is regulatory and economic benefit in being in with the pack there rather than an outlier, which would need to be weighed in the balance against those freedoms that you could envisage.

***Sandra Boss*:** I should have declared earlier that I have an interest in insurance, because I am on the board of a Bermuda insurance company. I raise that now because it should be on the record, but also because it is relevant to what Mark has just said. When I look at the Bermuda standard, prudentially, they are considered to be fully compliant with Solvency II. Previously, if we go back five or 10 years, Bermuda had much more relaxed standards than the UK. Now, when we look at the transition that it has made to being a fully compliant Solvency II regime, it makes for a much more level playing field. That is of benefit, and I have noticed some real changes in the Bermuda regime in the course of just the last 18 months, even after it was declared fully compliant.

Sam Woods: Could I add a tiny factoid to illustrate the point that Mr Yallop made about the ongoing cost? The ongoing cost is around £200 million per year, which is obviously a significant number. To put that in perspective, the average motor policy in this country is £440; that is 35p. That is obviously not a small thing; there are a lot of motor policies. But everything we are talking about here—and this is mainly the reporting cost—is within that context. That gives a sense of scale.

Q22 **John Mann:** Do the banks fully understand the risks of the increase in consumer credit?

Sam Woods: We have been working to make them appreciate those risks more fully. Basically, that has come down to two things. First, we think they have been placing a bit too much reliance on recent benign conditions in terms of what can go wrong. In the stress test, we topped up capital requirements by £10 billion, basically to offset for that. Secondly, we have been looking at the processes within the banks and how well this stuff is looked at. We are a bit concerned that the information coming up to the boards of the relevant institutions is not sufficiently granular or clear to allow the boards to have a really good sight of what is going on and make changes in risk appetite. On that topic, my colleague James Proudman will write to the banks, probably tomorrow, to highlight that point to them.

Q23 **John Mann:** Is that a question of competence or of wilful neglect?

Sam Woods: I certainly do not think it is wilful neglect. In some aspects, there may be questions of competence. You are also seeing, which perhaps is unsurprising, that we as the regulator—both the PRC and in this case the FPC—are taking a more cautious view than some of the institutions. Having said that, there are early signs that some of the heat is coming out of that market.

One way to illustrate that is that there are things called 0% balance transfers, which some of you may have used, and the maximum term has been marching outwards for four or five years to 43 months; it has now for the first time tacked back to 39 months. That, and what we see in the credit conditions survey, are very early signs that some of the heat may be coming out, but I would not want to put too much weight on that.

Q24 **John Mann:** When will consumer credit and household debt become a systemic risk?

***Sandra Boss*:** If you look at the peak, household debt was 147%. It is 134% now, so it is lower than it was, but it is up from 126%. This is the GDP measure, isn't it?

Sam Woods: No, it is the income measure.

***Sandra Boss*:** The low was 126% of disposable income. Now we are back up to 134%. Affordability is not right now the biggest concern; 73% of that is mortgage debt, and there is a lot of evidence that people are able to service their mortgages. But we are cognisant at the Bank of the risks of increases in balance levels. We are also cognisant of the risk of rate increases.

We know that 15% of individual households report in surveys that they are struggling with servicing their debt. That might not be a prudential concern, but it is a concern if we look at our remit letter; one of the things we care about is consumer outcomes. If there are individual households struggling, that is a primary concern for the FCA, and we are mindful of it as we exercise our prudential powers.

Q25 **John Mann:** I am trying to ascertain, in your judgment, what the tipping point would be that would make it a prudential risk.

***Sandra Boss*:** It is a creeping case as opposed to an individual tipping point.

Q26 **John Mann:** Obviously, but I am trying to get a general sense of what you think of that. Is it something that is never going to happen, from everything you can see at the moment?

***Sandra Boss*:** We know that, in the stress tests we have done, we have imposed an extremely high level of stress: 4.7% GDP drop; 9.5% unemployment; we take £50 billion of credit losses in the UK. The banks, prudentially, can withstand that, so it would be somewhere beyond that.

***Mark Yallop*:** This is a good news, bad news story. The good news is that 10 years have gone by and we have massively increased the amount of capital in the banking system. It is genuinely hard, if you are an economist looking at this problem, to find a set of circumstances in which there is a macroprudential problem for the UK banking industry. That is only one half of the story here. Much more likely, before a macroprudential financial stability, safety and soundness type of judgment became a problem, you would reach a different issue: a question of social justice and the impact of impoverished households who are facing really severe problems of indebtedness, worklessness, family breakdown, addiction and so forth.

That problem would become a much more pressing issue for the country than whether we needed another £1 billion, £2 billion, £5 billion or even £10 billion of capital in the banking system. One has to think about these two aspects to the problem. The social justice one is a bigger, more pressing issue than whether the firms are financially stable enough to ride through a consumer credit crisis.

Q27 **John Mann:** I am trying to put words in your mouth, because I am trying to paraphrase you; I am not trying to twist what you are saying. You are saying, in terms of what this Committee and Parliament should be thinking about, that the big problem looming, which could happen and we ought to be putting our attention to, is one of social justice.

***Mark Yallop*:** I am biased, because I have spent five years sitting on the board of the Centre for Social Justice, which I am sure you are aware of. I have an interest in the work that it has been doing and some relatively superficial knowledge of the analyses that it has done. I am obviously swayed by that, but I think it is a more pressing aspect of the problem to look at than whether the banks are adequately capitalised to cope with a downturn.

Q28 **John Mann:** I suspect none of us wants to be caught out by another financial crisis that emerges from nowhere, in a sense, however big or less big that is. If Mr Yallop is right and there is a danger of a growing social justice crisis emerging as a consequence of the way that household debt and consumer credit is going, again, I would not want to be—I suspect we would not want to be—caught out by that suddenly emerging and a significant section of the community being impacted, even if that could be shown to be, for the entire economy, not a major or critical prudential risk. Would that seem reasonable to you, Mr Woods?

Sam Woods: The Committee and all of you will have a far wider interest in this topic than we will have from a safety and soundness perspective.

We are on it from a safety and soundness perspective. We have acted fairly harshly in terms of remediating the safety angle. But there are issues that have a macroprudential angle for us about how highly indebted households respond in a stress.

As we go into a downturn, we know that households with a debt servicing ratio of something above 40% tend to haul back in their spending much more than other households, and that makes a recession much worse. It is entirely common sense, when you think about why people might do that. It is the case that we track what proportion of the population has a DSR north of 40%, and that has crept up from one low number to another low number; I think it is now up to about 1.4%. It is lower than it has been in the past, but we watch that. We are not alarmed by it, but we have been a bit concerned, and this is the reason we have been saying a lot about this.

Q29 **Wes Streeting:** I have a couple of quick follow-ups on the same topic. Mr Woods, you have just talked about the PRA's clear remit in this area. Can I ask the non-execs a question, thinking about your wider experience? There is a great amount of anxiety about household debt, particularly unsecured lending, especially for the reasons that Mr Yallop mentioned in terms of the social consequences of irresponsible lending. The challenge we have is that we ask Treasury Ministers about household debt and they point the finger at the FPC. We ask the FPC what the problem is and it says, "Do not worry; the PRA is dealing with it". Who owns the problem that Mr Yallop describes?

***Sandra Boss*:** One group that has not been mentioned is the FCA, and it has been doing quite a lot, for example with payday lending. There are a lot of consumer finance activities that do not happen in PRA-regulated firms. This is a classic case where we really need to join up on this and be mindful that this whole discussion we are having is beyond our technical remit; it is something to have regard for when doing our normal job. We would be very happy to see the FCA continue with the kinds of steps it has been taking around its regulated institutions. The payday lending changes happened probably a couple of years ago, but they are still filtering through. That collectively can be of use to the industry. You are right that we should not be pointing at each other. It is something that we need to work with our colleagues on.

***Mark Yallop*:** I do not think it is abrogating our responsibilities at the PRA or even at the Bank to say that we are a relatively minor actor in this story, which is a very troubling one. As Sandy says, the problem is lack of joined-up thinking across multiple actors who need to be brought to bear on the problem. It is a problem of lack of financial education. It is a problem of how best we use the opportunities afforded by big data and analytic tools: to use people's defaults on utility bills as a way of predicting potential problems in household financing in the future. How can we use fintech and the opportunities there? There are many arms of government, the FCA and private sector bodies that need to be brought to bear on this. The reason why this persists is the difficulty of getting all those actors into one place with a common mission and purpose.

Q30 **Wes Streeting:** You anticipated my follow-up question on that point. What is the mechanism? You are effectively saying that the mechanism is not there, but we need a way to bring people together to talk about how, collectively, to both identify the scale of a problem and then take appropriate action.

***Mark Yallop*:** The DWP has done a lot of good work, but it does not control all the resources. The Treasury has some other resources here. Actually, you really need to get Andy Cook, the chief executive of the Centre for Social Justice, in here and quiz him. He is used to coming to many other Select Committees, but I bet he has never appeared in front of you. It might be interesting.

Q31 **Wes Streeting:** He will be really grateful for the plug when he gets the invitation and has to spend days preparing.

***Mark Yallop*:** It is an opportunity for him.

Q32 **Wes Streeting:** Finally, on consumer credit, quite rightly, for the reasons you describe, Mr Yallop, we are focusing on people who are most disadvantaged by inappropriate or irresponsible lending. There is a flip side, of course, which is the possibility of tighter stress testing of consumer credit lending and increasing PRA capital buffers having an impact on the ability of households to borrow at affordable rates of interest.

To what degree should we be concerned about that side of the coin? Are we going to get lots of constituents writing to us and complaining because they are not able to borrow or take out products that would be totally appropriate? Perhaps they are taking out products, but they think they are needlessly more expensive because of policy levers that we have encouraged you to pull.

Sam Woods: You may get such letters to some degree. I would not expect you to get that many. There is notably a trade-off between wanting a banking system to be safe and sound and the terms on which credit is available. If you look at the bigger picture on this, I would point you to the fact that, on the mortgage side of things, there is a ferocious price war going on. In fact, the spread between the relevant wholesale funding cost indicator and what banks are lending out on, say, a 70% LTV mortgage for a two-year fixed is the lowest it has been since the crisis at only 70 basis points.

Credit is relatively cheap in the mortgage space. It is also cheap in unsecured. You can get a £10k loan unsecured at about 3.7%. That is not a lot for something that has no security against it. That is one of the things we have been looking at, because those interest payments are in a sense the first line of defence for losses that will arise. That is one of the reasons we have added a bit more capital. I do not think that it is something you should worry about. You may get a bit of that. It may be that at the margin there is someone who would have switched their credit card if they got 43 months with zero interest but will not if they get 39 months, but I do not think that should bother you.

Chair: Mr Cook is a former constituent of mine, so I shall pass on your recommendation. As you know, more seriously, we are doing an inquiry into household income looking at all this. It is a very good suggestion. You mentioned fintech, and we are going to cover that.

Q33 **Stewart Hosie:** The Governor told the Committee in December that the biggest disruption to the banking market arising from fintech is likely to come from the unregulated sector. How can the PRA manage the risks posed by firms that do not fall within its regulatory remit?

Sam Woods: This is obviously an extremely timely question, because open banking and PSD2 both went live on Saturday. It is a significant moment in the development of this area. The generic answer to your question is that we have the ability to designate firms outside our perimeter to come within the PRC's remit. So far, we have used that for around nine firms, not the kind of firms you are thinking about here. We have used it for broker dealers; you might think that we had brought in investment banks that would not otherwise come into our remit. There is a mechanism for that, and the FPC regularly reviews the regulated perimeter to ask exactly that question.

In the context of fintech, the question is, as we get this set of organisations around the perimeter of the banking sector offering people new ways of entering their bank and multiple banks, how we manage the risks around that. First, quite importantly, the FCA will be the regulator of most of those entities, and possibly all of them in the first instance. We have to look at it in a balanced way. On the one hand, this stuff should be great for consumers. Any of us who are using even the most basic form of these mobile apps know that this is a better way to interact with our bank than the way we used to have to do it. It should also drive more competition through time.

There are then risks to us. Some are more obvious: will deposits become more flighty? This is a "bank run from your armchair" type of risk. This is perhaps directly to your point: if things go wrong at one of these third-party providers and if it is relatively thinly capitalised, will customers expect to be made good by their bank? That could be a potentially significant risk. Is there a higher risk of cyber? That is an open question; that may or may not be the case.

The fourth is a longer-term one and may be the biggest: will these entities succeed to the degree that they disintermediate banks and banks no longer deal with their customers directly? Anyone who has been to China lately and seen how Alipay works over there will have seen that that can happen to a big degree. That will happen, if it happens, because consumers want it to happen, but we should be alive to the risks.

Q34 **Stewart Hosie:** That is a detailed answer. Let me ask a specific question. As fintech becomes more prominent, these intermediaries are there and the different routes to access exist, could there be a systemic risk? Does your ability to designate them within your regulatory framework mitigate that kind of risk?

Sam Woods: It is unlikely to become a systemic risk in the near term. If we feel it is becoming so, that is what the regulatory perimeter discussion at the FPC is all about. Most are probably thinking of the narrow fintech companies, but there is a much bigger question over some of the big tech companies as they edge into this space. To date, they have been extremely careful, to the extent they are doing it at all, to do it in such a way that does not bring them into our world. I suspect they will try to maintain that position, but it is something we have to keep an eye on.

Q35 **Stewart Hosie:** Many or all of these entities, as you said, are FCA-regulated. You can bring them in. It is a small number so far. You mentioned the FPC. I know we have had previous discussions at other hearings about this. How does the linkage with what the PRA identifies and communicates to the FPC in its macroprudential systemic risk role work? Is there enough understanding of the risks of fintech as it grows and spirals in an unregulated space?

Sam Woods: As a purely practical matter, within the Bank, where we have a topic that we are working on and is likely to be of interest to both the PRC and FPC, basically they are given the same analysis. Sometimes there will be joint meetings and sometimes things will be discussed separately. Consumer credit is a good example to illustrate the point. Both committees were interested for the reasons given and asked, "Do we use the FPC's tools or the PRA's tools?" There was a decision that it was better to use the PRA's tools for various reasons. That is a decision for the PRC. That architecture can sometimes be cumbersome for staff to work; we have quite a complicated set-up in the Bank, with the court and then the three decision-making committees. There is of course a risk of overlap, but that is better than what we used to have, which was a yawning underlap.

Q36 **Stewart Hosie:** No, I agree. The Governor told the Committee in December that banks may not have adequately taken account of the competitive threat posed by fintech. Do the externals think the PRA has a role to play in ensuring the banks are alive to the competition risks from fintech?

***Sandra Boss*:** The opportunity that we have used most recently on this is the biennial exploratory stress testing scenario. It is important to note that that specifically looked at an intense competitive situation in which the major banks that we regulate—the FPC and the PRC look at this together—were exposed to intense competition largely from fintech. We asked them to define their response: what new business model changes; what cost adjustments; what pricing adjustments?

In that context, on the one hand, we found that we were quite happy with the first order response. It was the first time we had done something like this. But one of the pieces of feedback that came from both committees was that banks could do more to think about extreme scenarios where they more challenged by fintech.

Sam mentioned open banking and PSD2. Both of those create unknown uncertainties in terms of fintech. We have told the institutions that we will, in the supervisory dialogue, continue to discuss with them the issue of fintech and how it is affecting their business models. Some banks are more alive to this than others.

Q37 **Stewart Hosie:** I have just a final question on that. Changing bank accounts, even with all the publicity, support and encouragement, is a minority sport; almost nobody does it. If fintech really kicks off and you can sit in your armchair and do it, is there any background concern that the stickiness of bank deposits might become very unstuck? People might change their bank account like they change their television channel. Is there a risk to the underlying stability for bank deposits if people can quite literally sit on their phone or tablet and change bank account almost for fun?

Sam Woods: That would be a good problem to have. There is a risk but, like all these sorts of risks, it can be mitigated by the tools that we have. To give you two examples, we have requirements for the liquidity we require banks to hold, so the most obvious response would be: "There is an observable change. Can we amend those in the same way?" The banks might respond commercially by saying, "Deposits are shifting around more than they used to. Therefore, we need more fixed-term deposits. We will have to pay up for that with a better deal for consumers". There are ways of dealing with it, but that is one of the risks that we are alive to.

***Mark Yallop*:** First of all, I should declare an interest, because I sit on the board of a US fintech company and I am an investor in a number of start-up fintech businesses in this part of the world. The corollary to everything we have just been talking about in relation to competition, the threats to the banks and the difficulties that might create for the PRA is the fact that, if you look at the quantum of investment going into fintech, a very significant part of it is going into businesses that are not directly competing with and trying to disrupt existing business models of banks, but are trying to facilitate and create efficiencies for the incumbent firms.

If you talk to senior bank management, you will find that they are very apprised of the opportunities to cut costs, improve the efficiency of their existing operations and make themselves leaner and more efficient through using fintech. They have some material difficulties in making that work in practice on a day-to-day basis, but their desire is to do more of that. Fintech is an opportunity for the existing firms as well as a threat for them. It is just worth bearing that balance in mind.

Q38 **Chair:** On regulation, some of the large incumbent banks are said to rely on rather outdated IT. I just wondered how you regulate and investigate IT preparedness and vulnerability to cyberattacks, but also things like the changes to data protection, which are costing not just regulated financial services firms but many of us millions of pounds to prepare for. Perhaps you could just talk us through how that works.

Sam Woods: This is a huge issue for us. There is the very specific thing of the incoming GDPR, which is what you were referring to. I am sure that Parliament as an institution is dealing with it, as are we as the Bank of England, but we are also making sure firms are going to be there by the time of implementation in May. The much bigger picture is what we call this area of operational resilience. If you think about the way our regulation is set up, we have a very elaborate way of saying how much capital and liquidity banks and insurance companies need. We have lots of governance for all that.

We also have a set of regulations around operational resilience. Part of that is about making sure that institutions have capital to deal with problems if they go wrong. Part of it is about when firms are outsourcing, and we have some arrangements that look at whether that is done in a correct way, including—and this is relevant again to the case in the papers over the last couple of days—how much continuity there would be if the firm went bust in terms of its outsourcing arrangements.

We have all those things, but the truth is that they need to develop much further, partly in response to cyber. The system is under constant attack and, as I mentioned last time I was here, we had to trigger our authorities' response framework six times last year on this topic. The other entity that I mentioned last time I was here is the part of GCHQ called the National Cyber Security Centre. I must say that has been a very helpful development for us, because this is what it does day in, day out. It has a big unit; it is very expert in it; and it can deal with all the hostile actor stuff, some of which is not easy for us to get into directly. We have plugged it into our world, into that framework, and we have put it in charge. This is an area of development where we want to make more progress. By the same token, it is quite challenging and some of it is quite novel.

Q39 **Chair:** Given the news in the last couple of days, have you had any conversations with the banks about their vulnerability to the collapse of Carillion? The figure in one of the media reports I saw last night was around £2 billion. Is that taken account of in scenarios under stress tests?

Sam Woods: It is taken account of, but of course I also check. I check with both the banks and the insurance companies. This is a bit of a low blow, but this asset data that the insurance companies complain about having to give us I used on Friday to find out what the exposures are to Carillion. That is the sort of thing we use it for. Those direct exposures are entirely manageable across all the institutions. There is then the question of whether there will be a wider, indirect issue with all the suppliers, and that is more difficult for us to get a handle on; I am not massively worried about it.

The other bit of it is what we just talked about, operational continuity, so we have been asking institutions, "Quite aside from your financial exposure, are you going to be able to open your doors on Monday?", which is the financial services version of the problem that the Government are having to deal with. So far, that has been okay; there have been a few issues, but nothing too serious.

Q40 **Catherine McKinnell:** The PRA's competition objective is secondary to its primary objective of safety and soundness, and it is limited only to facilitating competition rather than promoting it. But in the *Annual Competition Report 2017* it refers to a staff working paper that concludes, "The historical concern for safety and soundness when pursuing competition is misplaced, hence the PRA can be proactive in seeking to facilitate competition". I would be interested to know your views on that, whether you agree with that conclusion and where you might see safety and soundness as not compatible with a competition objective.

Sam Woods: I agree with that conclusion and that paper was written by the two Pauls, Paul Fisher and Paul Grout; Paul is in charge of competition for us in the PRA. The most elegant enunciation of that argument, although that is a very good paper, is not that. There is a one-sider in the interim report that the Independent Commission on Banking did back in 2010, which was written by John Vickers. John Vickers is uniquely placed to talk about the relationship between competition and financial stability. That one-sider basically says, "Here are some arguments that say that competition can be bad for financial stability. Here are some arguments that say the opposite. The sensible conclusion is that there is no fixed relationship between these two things and it will vary from one topic to another and through time". I have not seen anything in the six years since John Vickers wrote that to lead me to a different view and the paper you refer to is consistent.

Properly managed, these things can be mutually supportive. Let me give you one example. We have finally managed to get agreement in Basel to this thing called "finalising Basel III", and the bit of that that is relevant to this discussion is a longstanding complaint from smaller firms that do not use models to model their capital requirements for mortgages: that they end up with a higher requirement as a result. We have agreed, as part of that deal, to bring the requirement for low LTV mortgages, as in sub-70%, down from 35% to 20%. The reason that is relevant is that it is very useful from a competition perspective, and that is why we were keen in pushing for it. But it is also good for safety and soundness because, if you have a system of the sort where there is a bit of a slant, it naturally encourages smaller firms to go into higher-risk lending, which is not helpful. These things, I think, can work together well.

Mark Yallop: Speaking as an ex-practitioner, I would be very nervous about any moves to position the competition objective as pari passu with the other objectives. We all know the problems pre the crisis and the fact that that was the case then was one of the problems at that time, so I am very happy with the positioning of the secondary objective. There is plenty of evidence, which at some point we can go into, if you want to, that competition is taken pretty seriously by the executive. Every single paper we receive at the Prudential Regulation Committee has an analysis of the extent to which it impinges on our secondary competition objective.

Look at the track record of numbers of firms. We have authorised 35 banks since the PRA has been in existence. Only 62 challenger banks have been authorised in the world and 35 of them have happened in this country. That is just one little statistic for you.

Q41 **Catherine McKinnell:** You have already touched on this in some of your responses, but the 2017 stress test included a biennial exploratory scenario in which established banks were exposed to greater competition, including from fintech, in a low-interest-rate environment. The banks thought that they could cope with your scenario, but you identified three risks to that. Do you have concerns about the profitability and viability of banks if competition for retail banking improves? Do you think there is any conflict here between your objectives of stability and competition?

Sam Woods: As Ms Boss said before, there are a number of areas where we were a bit sceptical about the rather sanguine view that the banks appeared to be taking. Basically, could the disruption be worse; could they fail to get costs down in the way they imagined; and could their cost of capital not fall in the way that they think it would? On each of those, you can make a reasonable argument.

Having said that, what I took from the test was that it is not really a financial stability worry for us. This was low for long plus disruptive fintech, and it is plausible to take from the test that the banks could survive it and we would not have a banking resilience type of problem, but they would just be in worse shape and with more challenged business models than today. It is reasonable to take that from the test.

To the point of a tension between the two, for what it is worth, I agree with Mr Yallop that the secondary objective works quite well. It means that, when we are pursuing safety and soundness, we have to do it in a way that is most friendly to competition, and that is a useful constraint to have upon us. I would be very cautious about having them at a parallel level. Part of that is because, when we pursue the main objectives, sometimes that in itself is the most important thing for competition.

The best example is on the insurance side, and I tried to sketch this in my letter to the Chair. The problem you have with insurance is, because it is rather difficult to look into insurance companies, particularly if you are just a normal policyholder, a ruthless and unscrupulous person could come in and set up an undercapitalised, under-reserved insurance company, beat everyone else in the market and then leave policyholders out of pocket. There have been numerous examples of that coming from certain other jurisdictions. When we are pursuing safety and soundness, we are also sometimes doing something pretty useful for competition.

Q42 **Catherine McKinnell:** Looking at the potential increase in competition ahead, we have already touched upon fintech. Are we likely to see less profitability in banks as a result of that competition? Is that desirable or a natural consequence? On the flipside, the banks have said that they would reduce their operating costs in order to meet some of the competition scenarios that have been tested. Have they not already made the efficiency cuts that would be required, or is it a technological issue: we are managing to make greater efficiency as a result of the increase in technology, which is also creating the competition that is squeezing profits? It would be interesting to hear how you see that panning out going forward.

Mark Yallop: Banks, in general, desperately need to cut their costs, because very few banks in the world make a return equal to their cost of capital. This is a lamentable state of affairs and it is the main reason why bank equity prices are trading at the depressed levels they are, in most cases, with some notable exceptions, not giving them entity valuations that are even equal to their book values. They have a really pressing problem of efficiency and cost that needs to be addressed. You are quite right to say that fintech—and, to the earlier point that the Chair made, as well as overhauling legacy and very expensive and inefficient technology systems more generally—is a critical part of that.

When they address that efficiency problem and they are making healthy returns, these competitive questions that you allude to will become more pressing for them. But I would suggest the first problem they need to address is this issue of book value versus what they trade at in the market and the fundamental driver of that, which is the return on equity as opposed to cost of equity.

Q43 **Catherine McKinnell:** I guess the big challenge for you is to ensure stability and safety while all that change, efficiency and competition is increasing.

I have one final question. The PRA has said that it has authorised 50 new UK banks since 2013 and 10 branches or subsidiaries of overseas banks. It is likely that you will need to authorise more overseas banks in the years after Brexit. Is this something that you are planning for? Do you have the resources required to authorise them at the same rate as UK banks?

Sam Woods: The latest numbers are the ones that Mr Yallop gave as what we have done, but it is the same order of magnitude. To compare that to what we might have to do in the course of Brexit, maybe it is going to be 200 authorisations. That number is moving around, but it could be something of that order. That is a very large task for us. We have been staffing up, so we already have 45 staff who are only dealing with that business, another 45 to 55 who are spending a lot of their time on that issue and then we have our central Brexit unit of around 20. To put those numbers in context, the total PRA staffing is 1,374, so it is about 10% of our staff.

Having to do all that for the timeframe of the end of March 2019 will be extremely challenging for us. We would like to be able to do so. Interim permission could be a useful fallback. On the other hand, doing it over a three-year period, including a transition, is a big bit of work, but that just strikes me as much more doable. It is not the most important reason, but it is one reason why a transition period would be very desirable.

Sandra Boss: One observation that makes an external member comfortable with the ability of the PRA to handle this is that, if we look at the Solvency II implementation and the structural reform implementation, which were similar in terms of the demands on resources and the number of people dedicated, the PRA has been able to go through those two transitions with competent project management and things not falling through the cracks thus far, knock on wood. That helps us have confidence that, if Sam needs to do a very rapid implementation of the new branch policy, as is the current expectation, the PRA would be able to do it.

Q44 **Charlie Elphicke:** Mr Woods, the person in the street feels very strongly that the banks behaved irresponsibly in the run up to the 2008 crisis. They feel that they paid to bail out the banks, that no one has said sorry and they are concerned that they want to reopen the casino and set up roulette wheels once again. Is that a concern you share?

Sam Woods: The first half, yes; the second half, less so. On the first half, absolutely, people are right to feel outraged about what went wrong before the crisis. Frankly, a significant motivation for me being in this line of work is to try to avoid us being in that position again. The amount of taxpayer funding involved, as you say, was pretty extraordinary, so people are right to be very angry about that. We have made a lot of progress in the 10 years since. Where I slightly differ from you is on the characterisation of the utility and the casino. We are ring-fencing retail banks. We are doing that because we think ring-fenced banks do a particularly sensitive sort of activity, which we should be able to manage, to some degree, separately and put extra protection around, which we will do with something called a systemic risk buffer.

The argument for it has never really been that retail banking is nice and safe and investment banking is very risky. The reason that has not been the argument is that the facts do not support it. If you look at the history of banks and what has gone wrong, you see that investment banking is a little more likely to go pop than either universal banking or retail banking, but all have a reasonable probability of default. You can list numerous examples: Ulster Bank, Northern Rock. The logic has never been there, so I do not think we should be hostile to the idea of investment banking. Indeed, we host a huge amount of it here in the UK, but it is sensible for it to be separate, to some degree, and treated in a different way.

Q45 **Charlie Elphicke:** Is ring-fencing just a chimera? Is it just an entirely pointless exercise?

Sam Woods: No, I do not think so at all, and I have devoted a huge amount of energy to landing it.

Q46 **Charlie Elphicke:** It sounded like you were saying they are all very risky and it does not really make much difference, in your previous answer.

Sam Woods: It is the essential flipside of our decision if we want to host a giant financial centre. To ask you the question, if you host a giant financial centre, do you want your domestic banking system to be entirely freely comingled with all that global trading activity? That is a bad system. That is the system we have. We do, however, want our banks, if they want to, to be able to play in a global financial centre and some of them are making a choice to do so. If they want to do so, we do not want them doing it with retail deposits funding their activity, and that is the split that we are bringing in.

Q47 **Charlie Elphicke:** If you are going to stop them setting up casinos again, you have a double game here. You have the international side and the domestic. Let us take Basel III. Just before Christmas, the output floor was lower than was expected; mortgages are treated as lower risk than they are regarded in our market; the whole thing does not come in until 2027; they have 10 years to do what on earth they like. Frankly, is international regulation really working and is it providing the safeguards that we ought to have?

Sam Woods: That is a very good question. First, for context, this is the final edit of Basel III, if you like. For the first version of Basel III, we were massively yanking capital requirements, so we are making the banks hold three times more than they held before the crisis. If you look at liquidity, the relationship between how many liquid assets they hold and how much short-term funding they have—this is to help with this if this runs away—has flipped since before the crisis. They used to have much more of this and less liquidity; it is now the other way round. We have made enormous changes. Perhaps the best way to capture that is that UK banks were 40 to 50 times levered going into the crisis; now they are about 20 times levered. That is still 20 times levered, so we are choosing to operate a highly levered financial system, including the banking sector, but not at the ludicrously high levels they reached before the crisis.

If you then come to the Basel III finalisation, this is more of a tidy-up designed to avoid egregious modelling going on. It has been extremely difficult to get that agreed, not because of our position—we have been trying to get the thing agreed for months—but because of a pretty severe difference of view across the Atlantic between some of the continental

European countries and the US. In the end, compromise was reached on the output floor of 72.5%; it could have been 75% or 70% and landed in the middle—surprise, surprise—with a long implementation period. We thought it was best just to get the deal done and it has been helpful in removing uncertainty. In terms of scale, the changes we are making now are not like the ones we have been making over the last decade.

Q48 **Charlie Elphicke:** In that case, are you going to say to this Committee that you will be vigorous in applying the domestic override to make sure that what happens in the UK has proper prudential regulation?

Sam Woods: I will, and the most important bit of that is this thing I referred to called the systemic risk buffer, which is a thing we have chosen to add to ring-fenced banks and we absolutely will apply that.

Q49 **Charlie Elphicke:** Okay, let us talk about systemic risk buffers. You will remember that Sir John Vickers's report back in 2011 said that there should be a 3% systemic risk buffer and it seems, amazingly, that it was agreed to be as low as 1%. How is that justified?

Sam Woods: There is a very lively debate around the right level of capital for banks. Frankly, I find it helpful that we have John Vickers on one side of us and some of the banks on the other. All these assessments come down to a calculation that involves asking: what is the probability and severity of future financial crises? How much is that reduced by having a high level of capital in the banking system? That is the benefit. The cost is: what is the reduction in the growth of the economy due to a higher cost of lending from having higher capital requirements? You compare those two things.

Anybody can see that there is a strong degree of crystal ball gazing in such a calculation and that is what leads people to have wildly differing views. Those differences of views will persist for a very long time after we are all out of here, I would guess. Personally, I am comfortable with where we are coming in. Why is that? To go back to the work that John Vickers led and that I was also involved in, as it happens, basically the recommendation there was 10% CET1, 20% total capital. Where we are coming in, the banking system is running at 14.5% CET1; our total capital requirements, including bail-in debt, are around 30%, so I feel perfectly happy with where we are getting to in relation to the recommendations of that committee.

Q50 **Charlie Elphicke:** That is not what Sir John Vickers says, is it? He says he is very disappointed the regulator took the view the system had enough capital. I put it to you that you are meant to be the bouncer of the casino, not the croupier. You headed up the secretariat for Sir John Vickers' commission. What has changed your view since?

Sam Woods: I have absolutely no desire to be a croupier. I can assure you that I have done quite a bit to strengthen the banking system over the last decade and will continue to hold it there. It is basically the difference between looking at the whole thing and looking at individual bits. I have the greatest respect for Sir John and his very well informed view of these matters. He is pointing to one specific part of the stack, which is the SRB, where he correctly points out that the calibration we ended up adopting was different from the one that ICB had. However, if you look at the all-in capital requirements, everything, all the CET1 and all the total capital, it is my fairly well informed view that we are going to be north of the recommendations of that committee.

Q51 **Charlie Elphicke:** I would like to commend your speech last year, in fairness, on the punchbowl, particularly the regulatory arbitrage games that are played, and urge you to be vigilant, particularly on the SPVs. Are you going to consider bringing in some kind of regulatory penalty for banks that behave in that way, or making sure that there is a rebalancing mechanism to stop, discourage or counteract that kind of behaviour, so it is a waste of time and money doing it?

Sam Woods: My colleagues may want to come in on this too. That is something that we are very much aware of. The way I think about it is that we have been yanking all the requirements over the last decade, getting to the new system, and the banks have been rushing along to catch up with all that. As we go into a more steady-state mode, the pressures for the financial industry to try to find the cracks in that system—this is true in insurance and in banking—will grow. I gave that speech because I was concerned about a number of things that I had seen. It would be naive to think that you will never have some of that pressure in the line of business that we are in. There will be some of it and we need to lean against it, which we do in two ways.

First, there is the detailed game of cat and mouse around some of this stuff. I have mentioned this thing about 35-day deposits, where we have to look at something and ask,” Does that have substance or not?” A lot of that goes on, but that is a very incomplete solution. The more important part of it, for me, is how we use the senior managers’ regime. Under that, there are conduct rules where, if you are a senior manager, you have to act with integrity, due skill and care and you have to be open and transparent with the regulators; there are others, too.

What I was saying in that speech is that, if you are running one of those firms, either as an executive or if you are a non-executive particularly captured by the SMR, which is a subset, you need to be asking yourself not only whether this looks technically okay and is within the strict limit of the rules, but also whether it is the right thing to do. We have to progress it at that level as well as at the other level.

Sandra Boss: It is impossible for us to see everything, and the FCA has a broader and deeper conduct remit, but the SMR is having an impact. It is quite interesting. When I talk to colleagues in the industry, the UK SMR-captured individuals I speak to from time to time will observe that they do not do certain business, which they could technically do, that would make them money. When they compare and contrast their decisions on some of these issues with those of other institutions in other jurisdictions, they find that the UK has moved quite far under the senior managers regime towards this more disciplined thought about the holistic impact of product choices than some other jurisdictions. It is quite remarkable to see how much the UK has moved in the direction that is intended by the senior managers regime.

Mark Yallop: I chair the Fixed Income, Currencies and Commodities Markets Standards Board, which was set up after the Fair and Effective Markets Review. If you are interested, another day, I would be delighted to come and talk to you about what we are doing there. The essence of what that body, which is a private sector industry body, is attempting is to address this problem of regulatory arbitrage. The way I characterise it is that good regulation and a solid legal basis are essential prerequisites for orderly markets and good behaviour, but they are not enough. They are necessary but not sufficient conditions.

The problem boils down to the fact that regulation and law tend to tell you what you can do, what you cannot do and what the penalties for doing bad stuff are, but they do not tell you how to do the things that you want to do in your day-to-day business. That is why LIBOR manipulation, foreign exchange manipulation and some of these other abhorrent practices have sprung up. The way you address that is not generally through more hard-letter law, but through governance, conduct and standards. That is one of the reasons why, in the PRA, we place such heavy emphasis on management and governance as indicators that we watch closely of how firms are performing.

Q52 **Charlie Elphicke:** Therefore, it is important that people should look at Mr Woods' eyebrows as much as the hard-letter rule-making.

Mark Yallop: Yes, the twitching behind the glasses.

Q53 **Charlie Elphicke:** Can I turn to the flipside, which is the competitiveness of London as a financial centre? On one hand, one wants regulation to protect the banking system. On the other hand, one wants London to remain competitive and pre-eminent across the globe. What is your approach to that? How does the current reference to competitiveness in the recommendations from the Chancellor affect the work of the PRC? Can you give any examples where you have influenced decisions?

Sam Woods: Yes. You correctly state that the way it arises formally in our activities is as a "have regard" in the context of the Chancellor's letter. It would be a surprise to me if that was not a perennial feature of the Chancellor's letter to the PRC and it is taken into account for that reason. We have done a number of things that speak directly to that. The best example is on the insurance side and, again, I mentioned this in my letter to the Chair, but this is strongly motivated by that.

We have worked very closely with the Treasury and HMRC to create a thing called an ISPV: an insurance special purpose vehicle. The purpose of that thing is to allow to happen here in London something called a cat bond, where if an investor does not want to take a punt on the bond markets, but wants to take a punt on hurricanes instead, they can do so through such a protected cell vehicle. Bermuda had that; we did not have that. We have put some effort into that. In fact, we authorised our first one in December, just after going live. We do not really have a safety and soundness reason to do that. That is done partly under our competition remit and partly under competitiveness. There are examples of that kind where we are engaged.

I know there is a debate, which is in the IRSG report and is always going around, on whether it would be a good thing if the PRA had a competitiveness objective. In the end, Parliament sets our objectives and we would take what we were given. However, personally, I am very cautious about that and it goes back to all the remarks you were just making. If we are sat there with such an objective, the risk of dilution of focus and the risk of weaker regulation when we have a financial sector 10 times GDP is significant, so I would tend to steer away from that.

Stephen Hammond: I have two very quick points. First, anyone who wants to hear about Mr Yallop's activities as chairman of the markets standards board can come to the breakfast next week for the APPG on Wholesale Financial Markets and Services.

Chair: That is a very good advert.

Q54 **Stephen Hammond:** Thank you. Secondly, Mr Woods, in your answer to Charlie a moment ago, you rightly recognised that the ring-fencing has economic costs. Could you state what you think the economic costs have been in terms of percentage of GDP? Have you done any estimate of that? I know the Bank was doing some work.

Sam Woods: The implementation cost, funnily enough, is quite similar to Solvency II: somewhere just south of £3 billion or that order of magnitude, so quite significant. The ongoing cost is higher in terms of the private cost, £2.5 billion or so, but a large majority of that arises precisely from the extra capital requirement that we were just talking about.

Q55 **Stephen Hammond:** I was particularly interested that you accepted the point that there is a cost to GDP.

Sam Woods: It is a net positive, because we think we are bringing in the capital requirements in a place where that trade-off between reduced severity and probability of future crises and a higher cost of lending is positive. We think we are within that space. Some people could argue that we are one side of that or the other, and that is what the debate is about.

Q56 **Stephen Hammond:** Is that the view of the Bank?

Sam Woods: Yes.

Q57 **Chair:** I just wanted to ask a more general question about the work of the PRC and ask all three of you about transparency around the work of the PRC; how you are going to communicate decisions that are made, or how you do; and perhaps ask the external members about how, when you give speeches or interviews, you put forward your views. This is a conversation we have had with members of the MPC and the FPC as well.

Sandra Boss: In general, the PRA has an objective of being transparent in a couple of ways. Clearly, all our policies are under consultation, so there are dozens and dozens, if not 100, consultations a year with industry dialogue. Executives give extensive on-the-record speeches on policy matters. Interestingly, the primary form of communication that we have, from a supervisory perspective, is one-on-one dialogue with individually supervised firms; that is obviously an executive communication. We also have our annual report where the overall work of the PRC is published. We spend time with the Treasury Select Committee, particularly Sam, but that is another form of transparency.

Chair: It is always an enjoyable experience, I am sure.

Sam Woods: It is always very enjoyable.

Sandra Boss: On the subject of how individual external members might participate in the transparency, the general policy is that, if we are to give on-the-record speeches, it is unusual and it would need to be approved. The reason for that is the risk of a cacophony of voices on policy matters, given that we have both FPC and executives on the record. The preference is that we would participate in two ways. First, we interact with the industry on roundtables and off-the-record speeches.

Secondly, we have a lot of engagement with the industry, for example non-executive conferences. There is one done for large banks and large insurance companies, another for the mid-sized banks, where we actively engage with the community and the industry, hear their views and facilitate discussions. Socially, we meet with people in the industry on a regular basis. That is noted; we will do notes for the record. There is quite a lot of informal interaction, even though we are not doing a lot of speaking.

Mark Yallop: I would endorse everything Sandy has just said. It is fine that Sam is the spokesman for the PRC as far as public pronouncements on prudential regulatory policy are concerned. As a matter of record, I speak quite frequently, in my role as chair of the FMSB, and we publish all those speeches on our website, so anybody who has a boring evening and cannot get to sleep at night is welcome to read those. In that context, I talk about my views on the relationship between formal regulation and informal standards, governance and the topics that we were alluding to earlier on. There is an overlap with the interests of the PRA, but it is always made very clear in what capacity I am speaking and I think it is helpful that we do that.

Sam Woods: I agree with what my colleagues have said. The cost-benefit around this is quite different between the FPC and the PRC, because we are doing a lot of firm-specific stuff; there is a lot of rule-making, which all becomes public anyway; and straightforward communication is a more important part of the macroprudential toolkit than the micro one. Again, back to consumer credit, the FPC said a lot about it; we raised the capital requirement and we did the underwriting standards, and that works.

Q58 **Rushanara Ali:** Good morning. I am going back to Brexit and financial services. Michel Barnier said it was unavoidable that British banks and financial firms would lose passporting rights if we left the single market and that there is not a single trade agreement that is open to financial services; it does not exist. He pointed to the EU's existing equivalence rules as the means by which any access for UK firms to EU markets will be achieved. What do you make of his remarks, and are they consistent with what you are hearing from your counterparts in the EU 27?

Sam Woods: It is for the Government to negotiate this deal, but we have an interest and some views. I saw those remarks when they were made and I have also seen some other remarks, which seem to give a slightly different line. If that is the line, I would have a different view on it. My perspective is that it is both desirable and entirely technically feasible to devise something that is not one of the two extremes that Mr Barnier described. You have one extreme of staying in the single market as a rule-taker in order to have continued passporting; at the other extreme it all falls away. It is perfectly possible to have something in the middle and I could sketch that for you briefly, if that would be interesting.

Rushanara Ali: Yes, please.

Sam Woods: As to the elements of such an arrangement, first, I do not think you need continued passporting for all financial services. For instance, retail banking is naturally local; we do not think it should be happening across borders, and the same for life insurance and various things. This is really relevant for a subset of financial services activity: think MiFID-type investment banking activity, central counterparties, asset manager delegation and maybe one or two others; there is a question about wholesale insurance. You could define a narrower subset of financial services activities where this is particularly important.

You could then agree a set of arrangements to manage outcomes-based equivalence, so you say, "We are trying to do the same thing. We do not have to do it in exactly the same way, line by line". It is easiest where you have a strong international standard, so we could all agree we are trying to be Basel-compliant and then we could agree we go about that in slightly different ways, but that is the yardstick. You have independent measures of that; the IMF goes and says, "Are people compliant?"; the Basel Committee itself does, and so does the FSB.

You could devise mechanisms of that kind. Alongside that, you need to have some sort of architecture to manage that process and you would need some kind of arbitration. What I am saying is something like that would be better than either of those two extremes as described. It is also consistent with what the Prime Minister said in Florence. Although technically this is challenging, in my view it is entirely doable.

Q59 **Rushanara Ali:** You do not see, as he does, that it would require the EU to relinquish regulatory autonomy, which would undermine financial stability. You disagree with that.

Sam Woods: I think you can devise a system that does not have that effect, because such a system would not be one in which either party is dictating to the other their rules, but it is a system in which you say, "You can continue to access my market in that particular way as long as we agree that we are outcomes-equivalent. If it looks like you are racing to the bottom, I reserve the right to withdraw that".

Q60 **Rushanara Ali:** From what you are suggesting, there is a practical way forward. Is it the politics, and the general rules around membership and avoiding a cherry-picking approach, that is driving what he is saying versus what is possible, in your view?

Sam Woods: Honestly, I do not know. I say it is technically doable. Whether it can be agreed as part of a deal I do not know any better than you.

Sandra Boss: My views are consistent with Sam's. That is what we would like, but again it is not in our power to give it.

Q61 **Chair:** What messages do you get from your counterparts in discussions you are having, informal or formal? I asked right at the start about the discussions you were having particularly in relation to the announcements in December. More generally, you are absolutely right to say it is not just a question of what the UK wants; it is a question of what the EU 27 want and what the Commission is negotiating. Are you hearing on the ground that your contemporaries would be in the market for something like this and it is a question of trying to get the politicians in the right place?

Sam Woods: No, I am not hearing that; nor am I hearing the opposite. The discussion between the regulators so far has all been about live stuff that is happening in front of us: as firm X is restructuring in way Y, can we both live with that? What do you need on your side? What do we need on our side? That is almost all of what we are doing, because that is, frankly, the most urgent thing, but also because under our current mandates we can address that.

There has been an understandable caution, both from us and even more so from the other side, of getting into discussion about the end state relationship, because that is what the political negotiation is about. We have been quite forthcoming about what we think could be done and will support the Government in that, but the Government will then have to decide what they do. I would say that degree of caution is higher on their side.

Where we are going to get into a middle space is around the stuff that follows from our 20 December announcement, which is: are our colleagues prepared to agree splits of responsibilities, which means that firms can continue branching? That certainly gets you into something that is part of the future, but it is not as big as the question that Ms Ali asked a moment ago.

Mark Yallop: As everybody knows, this is a negotiation. This is the same Mr Barnier who said in a speech at the end of November, if I recall correctly, that the EU might well judge some UK rules as being equivalent to European rules, and he looked forward to the EU putting on the table its most ambitious free trade agreement, beyond anything that had already been envisaged. One can read too much into the minute day-to-day twists and turns of who says what.

The other thing it is worth reminding ourselves of is that we have never been in a more advantageous position of regulatory convergence, collaboration, co-operation and openness in our history than we are right now, because of what has happened in the last 10 years. Overseas regulators are not as open in their dealings with me as they are with you, Sam, but there are a lot of people in the agencies in Europe who appreciate the quality of the relationship we have at the moment and would be very disappointed if they were not able to work, in future, on the same basis. They need their politicians and the negotiations to be conducted in a way that allows that outcome, but the starting point among the regulators here and the regulators in the EU 27 is as advantageous as it could possibly be.

Q62 **Rushanara Ali:** It is the politics that is holding back the regulators from going beyond where you are at the moment. You have obviously made progress in terms of what you have done with respect to the transition deal. In the coming months, do you see much more progress in getting to what you mentioned, Sam, around the potential for some sort of passporting-equivalent process? It seems to me that it is chicken and egg: you wait for the political negotiations to take place, but in the meantime, if the preparation is not done and if you do not have the go-ahead, it is all very well saying it is possible, but it is not going to happen.

Sam Woods: We are basically doing three things. We call it "nationalising the acquis", so bringing 10,000 pages of rules here is an enormous project of itself. Then we are advising the Government and giving views on what we think would be a sensible outcome, ways in which it could be achieved and things that they could put on the table. The Government then have to decide what they think of that and what they want to put on the table. Then we have all our activity with the firms.

Q63 **Rushanara Ali:** On the EU 27 side, are you confident that you will get further than a neutral position, much like what you describe at the moment?

Sam Woods: In this third bucket, given what we put out in December, we now have a basis for a good set of discussions. I would hope to make reasonable progress there and am cautiously optimistic about that. The urgent priority for us all is the transition, because that would allow a more sensible timeframe in which to sort out the rest of this.

As to the wider picture, in terms of the end state, we have a job to advise, but the Government are balancing this against all sorts of other things. The same is true of the Governments on the other side. We need to know roughly where the boundary is in terms of what is the regulators' responsibility to deliver and what is part of the wider negotiation. It may be a bit fuzzy at the margins, but it is reasonably clear where that line is.

Q64 **Rushanara Ali:** It is an area of major economic activity, not just for us but for the others, and in terms of the number of people affected. I speak as the constituency MP representing the borough that covers Canary Wharf, so I have a particular interest, of course. Prioritising it seems, to me, important.

Sam Woods: I agree with that and we are doing an enormous amount of work on it. Where we got to in December was quite a helpful step forward and it has had a bigger effect on the mood, as far as I can divine, than I had perhaps expected, so we are in a reasonably good place now. To be honest, a lot depends on getting this transition agreed.

Q65 **Rushanara Ali:** I have a couple of final questions. Given the mood music from the EU and the absence of clarity for the Government about the future relationship, despite what you have said, is it not the case that most banks expect a substantial loss of EU market access and that their principal hope is for transitional arrangements that will buy them the time to restructure their business in a way that ultimately reflects that outcome, albeit that there have been some positive developments?

Sam Woods: It is true that both the banks and the insurance companies are tending to make cautious planning assumptions, and that is perfectly sensible. They are, therefore, thinking about what it is that allows them to stay in business if all of this stuff falls away. I would not want to discourage them from thinking about that; nor do we want that activity to go at a higher and a faster pace than is necessary. This is why the transition is particularly important, because, if a transition is not agreed, firms naturally will start to progress things at a higher pace.

Having said all that, and to your point about Canary Wharf, there is quite a big distance here between what might happen on day one in jobs terms, which is not my primary concern but is obviously of interest, and what the future paths might be. There are a number of estimates flying around the place, but, if you think of what a day one jobs move might be, we have said it could be up to 10,000 financial services jobs out of the

1.1 million that there are in this country. While that is not insignificant, it is not huge.

Q66 **Rushanara Ali:** Then you have the Mayor of London's report.

Sam Woods: Then there is the question of, longer term, how the financial system is going to reshape itself and that could be heavily influenced by what kind of deal is agreed. That is one of the reasons that that is the top priority.

Q67 **Rushanara Ali:** I have one final question, which is about the length of time it would take to get the kind of deal that allows for either passporting or the equivalent of passporting that you mentioned. How long would it take? Is the transition period of two years right or could it take up to four years?

Sam Woods: The truth is I do not have a reliable estimate, but it seems more plausible to agree such a thing over three years from a standing start now than over one year. That seems more plausible to me, but it will be a question of detail. Perhaps broad outlines can be agreed and then you need to fatten them out a bit more. Mr Yallop made a very important point. We are fortunate in starting this discussion in a unique position of having completely aligned rules and strongly aligned supervision. That is a good place to start from. In our view, it can be done and it can be done in the timeframes that are being talked about.

Q68 **Rushanara Ali:** Even with EU member states being in a different position from where we are, given the dominance we have of financial services in the UK and the expertise that you referred to earlier on in your evidence, you are all confident that it can happen within the next three years versus five years or four years.

Sam Woods: It is hazardous, because we are talking about developing something that has not been done before, starting from a unique position. It strikes me as plausible that a detailed free trade agreement covering the sorts of things I was just talking about—financial services—could be agreed within a three-year period from now.

Q69 **Charlie Elphicke:** Let us assume that there is no deal on financial services at all. Let us also assume that the European Union, albeit that it will mean higher cost of capital for European corporates and consumers, decides that it really wants to take an anti-competitive position on London to the maximum possible extent. In practical terms, is there not an issue that financial services know no borders, with conduits, warehousing and the many routes that one can take to get finance through via alternative jurisdictions or by simply listing quoted bonds and methods like that? Are you bullish that, in that circumstance, London would still be able to carry on?

Sam Woods: It would be very unfortunate if that is where the negotiation ends up, because that would have a number of negative effects, one of which is the one you describe, and the other, which we have said quite a lot about, is the potential effect on the cost of finance to EU 27 corporates and, perhaps to a lesser extent, individuals. I hope we do not get there. You make an absolutely valid point that there are a number of ways in which firms can access these markets. When we are talking about passporting and loss of access, this is the loss of a particularly advantageous way of being able to cross that border. But there are other ways, the main one of which is you just establish a subsidiary on the other side from the one you happened to start on. There are also branches, of course, and that is why our policy is relevant.

To illustrate that, we have a lot of business going back and forth between us and the US, where there is no passporting arrangement. Our sincere hope is that something can be agreed of the sort that I have just described, because we see no reason to step back from that, from an economic and financial stability point of view. If it cannot be, there are other ways in which firms will manage this, but there will be some downside.

Q70 **Charlie Elphicke:** If Mr Barnier raises this point, we should be robust in our response and say, "You will only hurt yourself and you will not prevent London from being an extremely successful financial centre for many years to come".

Sam Woods: I do not want to put words in your mouth.

Chair: Yes, do not cut across Charlie's negotiating position. Thank you all very much indeed for your evidence this morning. It has been very much appreciated, and thank you for your time.