HOUSE OF COMMONS

Treasury Committee

Oral evidence: Re-appointment of Alex Brazier to the Financial Policy Committee, HC 936

Wednesday 18 April 2018

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Watch the meeting

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

Questions 1-34

Witness

I: Alex Brazier, Executive Director, Financial Stability Strategy and Risk, Bank of England.

Written evidence from witnesses:

– Alex Brazier CV

– Alex Brazier Questionnaire

HOUSE OF COMMONS

Examination of witness

Witness: Alex Brazier.

Q1 **Chair:** Alex, thank you very much indeed for coming in for today's reappointment hearing. Will you introduce yourself for the record and for those watching online?

Alex Brazier: I am Alex Brazier. I am an executive director at the Bank of England and a member of the Financial Policy Committee.

Q2 **Chair:** It is in relation to your appointment to the Financial Policy Committee that you are here today. I want to start with the debate that the FPC had at its March meeting about the countercyclical buffer. The record notes that "the Committee considered the adequacy of a 1% UK" countercyclical capital buffer rate. While the FPC collectively decided to hold the rate, obviously there were arguments presented for the rate to be a little higher. I wonder whether you will tell the Committee your personal position on those debates.

Alex Brazier: The debate, for me, has really had two strands. The first has been about Brexit, and the second has been about the overall risk-taking environment in the UK other than Brexit, which covers a wide range of things.

On the Brexit front, the perspective we have taken is to assess whether even the most extreme versions of Brexit for the macro economy are encompassed within our stress test scenario for the banks. The reason is that the banks have shown themselves to be resilient to that stress test, so if we think Brexit is encompassed, it does not actually warrant additional capital for the banking system beyond that we have already added.

My perspective on that, in line with the record, is that it is very difficult to imagine macroeconomic scenarios for Brexit that are outside our stress test scenario, which itself is tougher than the financial crisis. Remember that it has in it a 4.5% fall in GDP, a rise in unemployment to 9.5% and a rise in interest rates, so it is a very severe stress test. However you look at it, it is very difficult to conceive of Brexit scenarios worse than that, so for me and for many other committee members, Brexit does not warrant additional capital buffers for banks.

That leads to the second group of issues, which are around the overall risk-taking environment. My take is that we have been in a so-called standard risk-taking environment for some time—it took us a long time after the crisis to get back there, but we have been back there for a while now—and now, really for the first time since the crisis, we are seeing some signs of risk taking picking up in a few places. It started out as a so-called pocket of risk in consumer credit. We are now seeing some signs of it in mortgage markets and in corporate lending. None of those signs are major flashing lights, but they are just things to keep an eye on.

My view was that 1% remains adequate, but those are things I want to investigate fairly thoroughly over the coming months and quarters. What is really important for us is that we keep up with these risks as they evolve. The mistake in past regulatory cycles was to think you had written the rulebook for all time. What is new here is that we have not written the rulebook for all time; we have an outcome to deliver, which is a resilient financial system, so we have to keep capital levels up with the risks that the banks are taking.

Q3 **Chair:** I am sure we are going to come on to some of the specific risks. I know the committee wants to proceed by consensus, but from your experience of being on it, can you conceive of countercyclical capital buffer—gosh, that's a tongue twister—decisions being voted on at some point?

Alex Brazier: Yes, for the simple reason that it is a bit more like a monetary policy decision, in that it is a number around which the judgments could be fairly finely balanced. To date, consistent with the Act, we have felt able to form decisions by consensus, although I note that that has been easier at some times than others. Back in 2016, when we raised the countercyclical buffer, there was a debate about precisely how fast and how far. We could get to an environment where people have different judgments and feel the need to call a vote. We have recorded that we are all perfectly happy with that and could even expect that to happen on an instrument like this.

Q4 **Chair:** On forward guidance, the FPC's decisions are scrutinised and taken into account by many people, and the record states that "it might be beneficial to note the probable direction for the…rate," given the risk taking you have talked about and looking at the evolution of risks in coming months, "in considering whether a rise was warranted." What do you think the benefits might be of being a little more explicit about the likely direction? Do you think that firms would take any account of the warnings?

Alex Brazier: To work backwards through that, I think they are taking account of what we say. When I talk to bank executives and chief risk officers, they are very alert to our pronouncements on capital buffers. I am not sure, though, that we ever want to get into the business of giving forward guidance in the sense of strict commitments. However, we can—this is important given the stage we are at with this regime—try to give people as much information about the way we will respond and what we will respond to. The way I think of it is that the ideal outcome is the "look, no hands" version of capital buffer setting, where the banks can effectively internalise everything we are doing, look at what is happening to credit growth and to financial conditions, and figure out themselves, without us even needing to write it in a record, that the likely direction of travel is up or down. But now, while this thing is still relatively new—it is perhaps out of infancy and into adolescence—is the time to do as much as we can to establish the conditions under which it will go up and the conditions under which it may go down.

Q5 **Chair:** Before I hand over to Catherine, thank you for the questionnaire that you have filled in. Presumably, part of that—sort of giving a guidance or an indication—is about engaging publicly and talking about it. We will probably cover that this afternoon a bit. I think you say that you have not done as much of that in the first term as you would like, although I was very impressed by the YouTube clips. I haven't watched them, but apparently you are on YouTube. Is that right?

Alex Brazier: If you had watched, you would have doubled the viewings. *[Laughter.]*

Chair: We'll arrange a Committee special. In your experience, what have you found are the best ways of engaging? Where do you get the best questions? That is not just with the banks, but perhaps with business more broadly.

Alex Brazier: Although I say that I have done less of it than I hoped, I have still done an awful lot of getting outside London and reaching the parts we don't normally reach. I have been to town hall events, industrial estates, community halls—I have done more than 40 events in the last three years.

What struck me is that what we have been asked to do is, first, pretty complicated and, secondly, difficult to explain, because the costs of what we do are very apparent now and the benefits are only apparent a long time down the road and may never be apparent, since—hopefully—you don't have the financial crisis that you've avoided.

The only way really to connect with people is to do so as much as you can, as directly as possible. Reports and everything have their place, but actually communicating with people face to face, or on new digital media or local media, have been much more effective in my experience than newspaper interviews or such like, or reports.

I have done 40 of those events in the first term, I will have a programme of events in my second term, as well, and I will also try to expand a bit more into schools, for two reasons. One is that there is a readymade audience there and the second relates to diversity. As you know, and as this Committee has discussed, in economics in particular we have a pipeline problem, and anything I can do to help that—it's a double win when we go to schools.

Q6 **Catherine McKinnell:** It never takes very long in a Committee hearing for us to move on to the subject of Brexit. We now have a political agreement between the UK and the EU on the transition. To what extent has that provided reassurance—succour—from a financial stability point of view?

Alex Brazier: A good deal of reassurance, but let me just give you a couple of extra points on that.

We always knew there would be a gap between any political agreement and it being given legal certainty, but from the very beginning we were clear that not all the actions that need to be taken to avoid any disruption to financial services could be taken in time. So we were very clear about calling for a transition period, and therefore the political agreement is a welcome one for us.

The added bit, though, is that with the Government's commitment to legislate for a temporary permissions regime, we and the regulators have been able to give regulatory underpinning to that transition period, by saying, "You do not need to plan on the basis that everything needs to be done by March 2019. We will assume a transition period. But Parliament is sovereign and if there isn't, at the end of it we will have the temporary permissions regime as a backstop."

That is different to the European position, where—at least as yet—there is no governmental commitment to any sort of backstop, to permit financial services companies to operate temporarily. Regulators there face a difficult choice between giving the transition period some sort of regulatory underpinning, which runs the risk that in the end the transition period doesn't materialise and you have left it too late, or operating as they have been doing and assuming the worst—assume no transition period. That itself is a risky business, because you're asking firms to make rather large adjustments in quite a short time.

The combination here of the backstop permissions regime and the political agreement on transition has been very beneficial to financial stability. It will give people time to take action in an orderly way, and households and businesses here can have the confidence that, whatever happens, they will not see, on this count at least, substantial disruption to financial service provision.

Q7 **Catherine McKinnell:** That possibly answers my next question, which came out of the March meeting and the report that assesses the ongoing risks at "a medium level". Is that a full answer to why those risks are assessed as medium? Is it to do with timing and not having full certainty?

Alex Brazier: We did not provide an overall collective traffic light for the risks; we provided it for a number of issues. I would describe it as being made up of two parts. The first is ensuring that there is no disruption to the flow of new financial services to the UK economy, which is where the transition period and the temporary permissions regime help.

Secondly, there is still a set of other issues that would need to be resolved by the end of any implementation period—whenever that is, March 2019 or the end of 2020—around contract continuity and data sharing. Those things cannot be solved by the private sector alone. They require regulators, sometimes on both sides of the channel, to take action to give reassurance that contracts—existing contracts, particularly in derivatives—can continue and that data can continue to be transferred. Even if you have all the regulatory permissions you need to do something, if you cannot transfer the data to your data centre, there is still an obstacle to providing the service.

Q8 **Catherine McKinnell:** Do you think that the measures that are needed to address all those risks will be implemented in time? To what extent can you predict a successful outcome?

Alex Brazier: On the UK side, a combination of the regulators and the Government have put in place most of the things that are needed, but not everything is done yet. I would highlight the derivative contract continuity issue, which affects £26 trillion notional value of outstanding derivatives—that is a quarter of the derivatives of people here, which are held by institutions here. Ensuring the ongoing continuity of those contracts will take concerted action on both sides. That is what we said in the March report and we stand by that. But I have every confidence that that is what will happen by the end.

Q9 **Catherine McKinnell:** To what extent are you able to engage with our EU counterparts and those on the other side who are responsible for making sure that happens smoothly?

Alex Brazier: Very able. As I think the Governor told you in December, the incentives are aligned here, and we are in touch with our European counterparts. I spoke to my counterpart at the ECB earlier this week. They share our analysis of these issues and they are examining them closely as well.

Q10 **Catherine McKinnell:** Do they share the same level of concern?

Alex Brazier: As the Governor said to you in December, I think I should leave it to them to announce anything they might do on that front, but I know that they share our analysis of the issue and they are examining it as much as we are.

Q11 **Catherine McKinnell:** Okay. One final question: in the written evidence that you provided, you say that, following the EU referendum, "the FPC was able to release capital buffers…the market expectation of a downturn did not, as so often in the past, become self-fulfilling". Are you arguing that it was FPC action that prevented a major downturn or recession following the referendum?

Alex Brazier: No; it is not as specific as that, but I think our ability to take action was a positive factor. The point I am trying to make is that we have built up all this resilience in the banking system—they have three times as much capital as they had before the financial crisis; they are able to withstand these severe stress tests—but what value does that have? That is the one occasion where we have seen it have value. Other financial market prices were pricing in something pretty severe for the economy, but that did not materialise. That is good, but that is what they were pricing in. Confidence in banks was absolutely assured—funding costs for banks did not rise; credit supply did not tighten—so the success of the regime was not in avoiding a downturn, but in ensuring that credit conditions did not tighten. On so many occasions like that in the past, pessimistic expectations about the economy have become self-fulfilling to some extent, because credit conditions tighten. That did not happen this time. That is a reminder, as the memory of the crisis fades, of the value of what we have done. Some people still think we have done too much—some people think we have done too little—but it proved its value at that one moment.

Q12 **Stephen Hammond:** Good afternoon. Thank you for coming. In your written evidence, you said you "see no serious pressure today" for a lighter touch regulatory system. Could you say what indicators you would use if you saw that pressure coming through? Also, what has led you to that judgment?

Alex Brazier: My point in the questionnaire is simply that there is always some level of grumbling from the regulated sector about the stringency of regulation. To some extent, that is absolutely inevitable because the purpose of regulation is to make people do things that they would not necessarily do in their own private interest. So, to the extent that it is working, there should be some level of grumbling. The level of grumbling is definitely not an indicator of pressure for light-touch regulation.

I would throw it back the other way. The indicator of how serious the pressure for light-touch regulation is is the level of support in Parliament for the objective we have been given, and that objective is to maintain a resilient financial system at all times. I do not worry about grumbling from the regulated sector at all. I would worry if a constituency arose in Parliament or elsewhere in public that thought that memories of the crisis had faded, that it really was not that valuable to have a resilient financial system, and that we needed to go for competitiveness or growth and actually store up trouble for the future. The indicator I would use is one about parliamentary pressure for light-touch regulation, rather than industry pressure for such regulation.

Q13 **Stephen Hammond:** I do not think anyone will argue about the need to maintain a resilient financial system, but do you think that in certain parts of the financial system, in the aftermath of the crisis, the initial regulation that was put in place was inappropriate and therefore needs review?

Alex Brazier: I think, and I listed in the questionnaire a couple of examples, there is a list of things where, in a huge post-crisis reform programme, it was almost inevitable that when you took stock and looked at it, you would think, "Okay, we should have done x or y a bit differently." What is important is that we actually do that: we look at it, we take stock and we make the changes. There is no shame in that. It does not mean it was wrong; it just means you are constantly improving.

The objective of the FPC—I only gave you half of it—is to maintain a resilient financial system. There is another half, which is, "but not at the expense of the long-term growth rate of the economy". So if there are things we can do to regulation to refine it and improve it that actually contribute to growth, but do not diminish the resilience of the financial system, we have a duty to take them. I list—something that you are all very familiar with—the risk margin in everybody's favourite insurance regulation, solvency II, and refinements to the leverage ratio for banks. Those are just two examples where the post-crisis reform programme could be refined and it would be positive for growth and industry without compromising on resilience standards.

Q14 **Stephen Hammond:** You are obviously aware that in the US there is some change to regulation. There are two major things. One is to take some smaller institutions out of "systemic", but more important is to look at some element of the ratios, which would be a slight weakening in comparison to international standards.

Alex Brazier: It is very important to note where they start from. The US starts well above the agreed international minima. On the capital and stress testing front where they have made proposals to change their regime, when you look at those proposals, many of which have come out in the last week, they are moving almost identically to our regime. They are moving towards the way we do stress testing, the way we set bank capital and the levels of bank capital that we are looking for, which itself is north of the agreed international minima, but they have come in towards us. It has not been a softening of US regulations either relative to agreed international standards or yet relative to us.

Q15 **Stewart Hosie:** On Fintech, do you think developments such as open banking are going to be a net positive for banks, in that that will help reduce costs, or a net negative, in that it could challenge their current business models?

Alex Brazier: I think there are two aspects to Fintech. You listed open banking. I think that is a definite positive for consumers, but it is probably a negative for some of the incumbent banks. Let me give you an example. The incumbent banks currently earn probably about £1 billion a year from being able to pay slightly lower deposit rates than other banks. If open banking and the ability to access all your banking services through one front end encourages people to shop around and compare rates, then that should be competed away.

On the retail side it will challenge some business models, and in the very long run you can imagine more competition for things like SME lending. You have seen what has happened with Ant Financial in China and Amazon in America using the data they have on payments to construct more accurate credit ratings for small businesses and being able to lend more to small businesses. For those reasons, it will become more challenging on the retail side.

The area where Fintech offers promise in reducing costs for incumbents in the immediate future is around wholesale banking. That is probably one of the most productive applications of distributed ledger and blockchain technology, as opposed to crypto-currencies, which I am sure we might come on to later. It is effectively using that technology to try to strip out the duplication you get from having brokers, clearers, exchanges, settlement and custodian by having common databases that everybody can access. That offers a real opportunity for efficiency gain, and when we did the exploratory stress test last year, the banks were fairly convincing on the ability to use that sort of technology in the medium term to reduce costs on wholesale banking. But the area where they will unambiguously face more competition is on the retail side.

Q16 **Stewart Hosie:** That is helpful. As financial services generally develop and innovate, more activity may move out of areas regulated by the PRA toward areas where there is either no regulation or regulation by the FCA. Are you content that the FCA, for example, has enough expertise in financial stability to aid the FPC in your work? At present, how would you categorise your relationship and that of your team with the FCA?

Alex Brazier: In short, very good. It has built, certainly over the three years that I have been doing this job. If you think about the FPC's life, the first few years were very much about the banking system, building resilience and introducing stress testing. The last few years, consistent with the way the financial system has shifted toward market-based finance and Fintech and other issues, have meant that we have become much more closely engaged with the FCA. As you know, the chief executive of the FCA is a member of the FPC and a former deputy governor of the Bank. That is not unhelpful when it comes to building those relationships.

We have worked with the FCA on a wide range of issues about finance beyond banks: on investment funds, derivatives, Fintech, most recently on crypto-currencies and on leverage in non-banks, which is ongoing. Those tend to work very well. We put together joint teams across the two institutions and they come and present their work to the FPC. I am very pleased with the way the relationship with the FCA is developing.

The issue for the future, just to finish the point if I may, is the one you said: at some point we may have different objectives. It may be that our objective means the FCA doing something that its objective does not say. It may not be inconsistent with its objective, but an example could be that the front end—the service providers for open banking—could over time, if this takes off, become very important in the operational stability of financial services overall. We would need to ensure that the levels and standards of resilience the FCA was applying kept up with their importance in the financial system, in the same way that we do with the PRA for banks. Our relationship with them may get slightly more intrusive, but progress so far has been very good.

Q17 **Stewart Hosie:** That leads me to the example you gave of Amazon effectively getting into SME lending, and other tech organisations filling bits of that space. How should the FPC view the prospect of that sort of competition coming from what is clearly the non-banking sector? How would you assess whether it was a good or bad thing in financial stability terms? How would you measure it? When you are answering that, put your mind to the FCA-type role as well. When would that be big enough to be a consumer risk that could morph into a systemic risk? I don't know the answer to that, but I do know how big Amazon are.

Alex Brazier: The two are kind of related. As you say, I will try to think about the second one while doing the first—multi-tasking. How would we measure it? In the same way that we have done for the banking system, which is to ask, "On the one hand, what is the contribution of this to the growth of the economy? Therefore, if we restrained it, how costly would that be?" versus, "In a downturn, would it create more disruption?" In a sense, you have apples and pears, but you are trying to weigh them together. That is what we have done with the resilience level for banks and the appropriate level of capital. We would do that again. That is what we do on everything, including crypto-currencies, and what we would do in this case if it came to it. It is about the contribution, if you like, to economic growth, taking account of its long-run impact against, effectively, the downside risk it brings. That is what you are trying to weight it against. Like an insurance policy, you are trying to weigh together the benefit in the bad times against the cost in the good times.

The FCA's role normally kicks in well before our role in an issue like this. If these tech companies become more important in SME lending, conduct issues and consumer protection issues bite a long time before systemic risk issues do. To give an example, smaller banks in the UK are typically not systemic. They account for about 20% of the stock of lending, but as a group they now account for about half the flow of lending to households and businesses, so their importance to households and businesses is growing. These technology companies are a million miles away from that as it stands, so this is effectively a forward look and a "What if?", but it would need to go a long way—well beyond a consumer protection issue—before it became a systemic issue.

Q18 **Stewart Hosie:** So even in aggregate, you think we are a substantial way from that?

Alex Brazier: Yes.

Q19 **Stewart Hosie:** And therefore a substantial way from having to worry about tier 1 capital or leveraging rules or liquidity cover for those companies?

Alex Brazier: Oh yes, and I would note that the business model of these players, although they are lending to small businesses in some way, is not currently like a bank. Their funding structure is very different, so you wouldn't be able to, as you hinted at, lift the banking rules and apply them to a different thing. You would need a bespoke set of regulations.

Q20 **Stewart Hosie:** I think that is the argument that the insurance companies made, and that, in a sense, is what happened, but that is for another day.

Alex Brazier: I'm pleased to hear that.

Chair: With something closer to home, and probably of immediate interest, I call Charlie.

Q21 **Charlie Elphicke:** Despite Brexit, the economy seems to be growing, employment seems to be at a four-decade high and consumers are willing to take on more risk. They are optimistic about the future—so much so that, you say, mortgage risk taking is showing signs of increasing. Loan-to-income ratios are bunching up against the 4.5:1 threshold, especially outside London. Loan-to-value ratios have increased. Would you agree that consumers seem to be increasingly confident about the future, and does the bunching at the ratio make you question whether the right threshold is in place for the FPC to recommend?

Alex Brazier: There are two questions there. On the first, I wouldn't actually translate it into consumer confidence, because what seems to be happening on the lending side is that lending standards—at the margin—have loosened a little. It doesn't look like it has been households demanding more credit on the basis of an optimistic or excessively optimistic view. It looks like it is lenders expanding the supply of credit.

When you look at household credit overall, it is not growing at a particularly rapid rate. Under the surface, what has happened is that a very sharp slowdown in the buy-to-let market has masked this pick up in lending to owner-occupier mortgage holders.

As you say, we have had the bunching up against our 4.5:1 threshold. It used to be that around 12% of new loans were in the 4:1 to 4.5:1 loan-to-income range. It is now above 18%, so nearly one in five loans are just below our threshold. My own view is that that shows the threshold to be working. It is a guard rail we put in place. It is working. Things have come up against it. Without it, we may have seen much more risk taking.

I do not necessarily want to recalibrate those rails, because when we put them in, we assessed what the point was at which households typically got into trouble with mortgage payments and needed to cut back very sharply on their expenditure more generally. That point was important, because lots of households above that level of debt actually makes the whole economy a more volatile place. It is an intuitive result: people with big debt-servicing costs need to rein in sharply on everything else. More debt means deeper recessions. I am pretty confident that that analysis still stands.

However, the question is not so much about households but lenders, and whether they are actually taking account of the fact that, even though they are still within our thresholds, they are taking a bit more risk. There is therefore a bit more of a risk of loss in a downturn. Are their capital levels keeping up with that? Our stress tests try to do that annually, but given what we have seen happen, it is now worth a slightly more regular check-up of these things, to ensure that the capital levels they have are keeping up with the risks they are taking.

Q22 **Charlie Elphicke:** Is another way of looking at it that because of Brexit, the Bank of England flooded the system with money, lenders have a whole load of cash in their pockets that they are trying to shovel out the door, and they are then pushing it on to consumers?

Alex Brazier: No. Do you want me to elaborate on that?

Charlie Elphicke: Yes please.

Alex Brazier: You may be referring to the term funding scheme, which was launched in the aftermath of the referendum, when Bank rate was cut. Recall the purpose of that scheme. It was to ensure that lending rates could be cut—the cut in Bank rate could be passed through to lending rates, even though there was limited space for banks to cut deposit rates. It was completely successful in achieving that. There was £127 billion borrowed in the scheme. Its effect on bank's net interest margins was sufficient—in fact, just right—to allow them to cut lending rates by 25 basis points. It was about passing through a monetary policy measure. When you look at the correlations between use of the scheme and lending growth, you see that it has not actually tended to be the driver of credit growth.

What it has done, and this is a positive effect, is somewhat to pre-empt open banking. It has done that by taking away some of the incumbents' deposit advantage, which I talked to Mr Hosie about, and allowing smaller banks to compete on more even terms.

That then leads to the question: what happens when this scheme ends? We now have four years in which banks can square their funding positions gradually. Over time, smaller banks will need to pay back their borrowing from the term funding scheme by getting the deposits that are now with some of the bigger banks. Open banking should help with that. The timing is very good. I would hope to see more competitions for deposits allowing smaller banks to get that funding more easily as the scheme winds down. However, I do not think for a minute that it has been the major contributor to the risk taking that we have seen.

What seems to be the major contributor is a general perception that after the period you described of low unemployment, low interest rates and now rising incomes, arrears rates on all these types of credit have been very low. There is a danger, as we saw in consumer credit, that lenders perceive that to be that the lending is lower-risk, when actually it is just fortuitous economic circumstances that they have been the beneficiaries of. It is very important that they only reflect true reductions in underlying risk rather than the beneficiaries of, as you describe it, the very good macro environment.

Q23 **Charlie Elphicke:** Let us explore that a bit more. You say in your own written evidence that you, "Probably started out furthest from the average committee position on the importance of the pocket of risk that was developing in consumer credit." How would you describe your position, and what was concerning you in particular?

Alex Brazier: It is easier to say what was concerning me in particular and then work backwards. What was concerning me was that the rapid growth we were seeing, 10%-plus, was a signal that lenders were thinking that this lending was lower-risk than it had been and, maybe, than it was. The signals were not just the growth rate, but the fact that the cost of credit was coming down relative to Bank rate, things like balance transfer periods were being extended, and some other underwriting standards were being loosened at the margin. At the same time, risk rates on capital—the amount of this lending that they were funding with their own capital—was falling. All of that stacks up to a picture of thinking that risks are lower, when actually, because it is expanding so quickly, the risks are going in the opposite direction.

That was my worry. We did this health check via the stress test. It confirmed that view. As a result, we used the stress test to ask banks to hold about £10 billion more capital against their consumer credit books to reflect the risks they were running in the event of a future economic downturn. For me, because my worry was about the resilience of the banks, that was a great solution.

Although I don't think they were, some people could have been concerned that this was a macroeconomic risk. I thought that as a committee we fairly quickly achieved consensus around the view that, to the extent this posed a risk to the economy, it was only because it would pose a risk to the lenders. After all, even at these rapid growth rates, the flow of consumer credit is only about 1.4% of household spending. It is not a direct macroeconomic issue; it is about the resilience of lenders.

Q24 **Charlie Elphicke:** Finally, consumer credit has been expanding. We are seeing mortgage finance expanding. Interest rates are very, very low. What happens if that changes? The trend is going to be that interest rates will increase over time. Is there an issue that the consumer household sector is over-indebted and that that could cause challenges and difficulties in the months and years to come?

Alex Brazier: I would temper that view, for the reason that we have been active in macroprudential policy while interest rates have been low. On consumer credit, actually, changes in Bank rate are not the major determinant of credit. The spreads are so wide that changes in Bank rate are a very small proportion of the servicing cost. It is mortgages where this potentially really bites. But because we have put into place measures to limit loan-to-income ratios with the FCA—that was a good example of co-operation with the FCA—to put in place affordability testing of borrowers, to check they can afford the mortgage repayments even if mortgage interests rates go to around 7%, which is switching to the reversion rate and that rate going up by 3%, we should not see large swathes of the household sector getting into distress because interest rates have gone up.

In a way, we have constrained the growth of mortgage lending in a low interest rate environment. Today, about 1.4% of households have a debt servicing ratio above 40% of their income. Even if interest rates jumped suddenly to 2% overnight, that number would be 1.9%. That is the average of the past. So even if interest rates jumped up very suddenly, it is not that we would have a large proportion of highly indebted or struggling households.

Q25 **Rushanara Ali:** Good afternoon. I have some questions about the risks from the world economy. How concerned should we be about the risks that might arise from the Chinese build-up of debt?

Alex Brazier: We have listed this among our top risks—it is certainly among my top risks—for the following reason. China has seen one of the most rapid build-ups in private sector debt in history. We have a chart in the financial stability report that compares it to previous pre-financial crisis episodes—it looks very similar. Chinese private debt-to-GDP is around 210%. Ours is at around 150%. The pace of run-up has been extremely rapid. But there are reasons to temper that just a little, in that the Chinese situation is one in which the state has lots of fiscal space and large currency reserves to defend its fixed exchange rate.

It is not that history must repeat itself in any way, but it is a worry, for two reasons. First, our banking system has direct exposures to China, Hong Kong and other emerging markets of a bit more than 10% of its exposures. The other is that a sharp slowdown in China would spill over the global economy in the UK directly. That is why we put into our stress test what one bank executive once described to me as an "unsporting" fall in Chinese GDP of 2%. That is extreme, but because of these risks, we wanted to do it. The vulnerability is there.

The banks are therefore able to withstand those direct risks and they are able to withstand the likely spillovers to the UK if it happens. I am not saying in any way that it will happen; it is a vulnerability in the global economy. The IMF has called it out a number of times. Our job is not to pretend that it is not there, but to make sure that people could deal with it if it happened.

Q26 **Rushanara Ali:** Is there anything else that the FPC should be doing, or is what you have adequate?

Alex Brazier: On that front, the Bank and I have worked with the Chinese authorities. They are going through a transition. They recently set up as a committee of the state council—something that looks very like a macroprudential committee. We stand ready to help them with that, because it will be a key part of managing the transition.

Rushanara Ali: Presumably it is very different kind of culture.

Alex Brazier: Very different. In the same way I would not lift and shift banking regulation to Fintechs, I would not lift and shift UK macroprudential regulation to China. Nevertheless, we have some experience of this and we can share that and help them. That would be a contribution we could make. In the meantime, our approach has to be to acknowledge this and make sure that our own financial system is resilient to it.

Q27 **Rushanara Ali:** Do you feel that all the steps we are taking would protect us should it spill over into a situation here?

Alex Brazier: To be clear, it would spill over to the UK economy. There is nothing we can do about that. What we can do is make sure that the financial system is sufficiently resilient that it would not make matters even worse.

Q28 **Rushanara Ali:** What should we expect if, as you say, it would spill over—

Alex Brazier: This is a depressing conversation.

Q29 **Rushanara Ali:** What do you anticipate to be the areas of concern? What would be your assessment when this happens, if it happens?

Alex Brazier: Oh, I see. First of all, I would expect two or three things to happen. I would expect a direct effect on UK economic activity. China is a trading partner, after all. I would expect an indirect effect on UK activity through the emerging markets, the US and other economies that we are exposed to. I would also expect a direct effect on banks' exposures and through financial markets.

We saw some wobbles in August 2015, when there were some questions in markets about China's commitment to the precise level of its exchange rate peg. If those were amplified, you could quite imagine a tightening of market financial conditions in global markets.

Those are all the things we plugged into our stress test and all the things we have tested the UK banking system against.

Q30 **Rushanara Ali:** Finally, you note that, "Global debt markets are priced for perfection. At current prices, there is very little compensation to investors for interest rate and credit risk." Are market participants blind to the risks that they might be running?

Alex Brazier: That is an interesting question. I doubt that they are blind to this. Far be it for me to give investment advice. It is a risk hidden in plain sight. I made a speech in January in which I showed that the compensation that investors were earning on sterling corporate bonds, when you adjust for the credit rating and the quality of those bonds, is basically zero. That is unprecedented. The reason for using the phrase "priced for perfection" is that it rests on both confidence in the interest rate path—a high degree of confidence—and confidence in corporate credit. That may be right, but it does not sound like a central view.

I think there is such a risk. This is why we said in our statement in March that the principal risks were in debt markets—in financial markets. What is important for us is to make sure that, given those risks, we do not grow a vulnerability of a corporate sector that is reliant on those valuations to finance its debt.

In the UK recently, unlike in the US, we have not seen a sharp run-up in corporate credit overall. We have seen some tentative signs of risk-taking, which we talked about earlier, that need examining because, as the US shows, this is the sort of environment in which you can see corporate credit levels rise. In this circumstance, that would be an issue for us. We are not there, but we have to keep an eye on it.

Q31 **Wes Streeting:** I want to ask a few questions about the status of financial stability in the Bank, if I may. In his written response, Martin Taylor noted that, "The Bank of England is full of very bright people with—sometimes—surprisingly strong views, who positively relish discussing ideas. I may be imagining this, but it feels as though the whole financial stability area…has become increasingly attractive to ambitious and creative young people in the Bank." My question following that is—

Alex Brazier: How much did I pay Martin to write that? *[Laughter.]*

Chair: You can tell us that too!

Alex Brazier: The going rate is not expensive.

Wes Streeting: I am just curious as to your own view about whether financial stability has risen in stature in the Bank and what you think is driving that.

Alex Brazier: I certainly think it has done, relative to before the financial crisis. That is a well-known issue. Actually, the big thing that has changed is having a statutory responsibility. Before the financial crisis, it was a bit like saying to people—at one stage I was a bright young thing, but I think that time has passed—that they had a choice between working in an area that had a clear statutory responsibility, "Hit the inflation target. You're an independent committee; you can support it," which is all very exciting, and financial stability, where you could do some analysis. Now, financial stability is on an equal footing, with a clear statutory objective, accountability for it and a realisation among everyone, inside and out, that this is important—see, for example, the financial crisis. That has been the main driver of the big shift over time.

The other thing that has happened is that now that we have come out of the post-crisis period and returned to a more normal risk-taking environment, the questions have started to become even more interesting because it is not just about catching up and correcting all the things that were obviously wrong in the financial crisis; it is about meeting the challenges of being agile and keeping up with the thing as it evolves from now. There is no playbook for that. That is a great way to attract ambitious, interested people, because they are not following instructions.

As I say in response to one of the other questions, unfortunately for us we are world leaders in this. I do not say that in an arrogant way; it just is the case. There isn't really anyone we can follow on this, partly because Parliament gave us a world-leading objective that nobody else has really followed. We can learn from others, but it does mean that we are operating in a somewhat greenfield, or at least brownfield, site and there is room to build the regime out. That is a great way to attract the best people to work on it.

Q32 **Wes Streeting:** Has the level of interest been affected at all by Brexit in that context? Is that motivating more people to work in this area? Or fewer people? Or has there been no impact at all?

Alex Brazier: I wouldn't say no impact at all, but actually the Brexit issues cross the whole spectrum of the Bank's work. We have put together all sorts of cross-Bank teams on Brexit issues. I wouldn't say it has been a draw to financial stability. It has made the work we do in some ways more immediate, dealing with issues such as those we spoke about earlier on transition, but I don't think it has been a net draw for any individual part of the Bank. It has been a cross-Bank issue.

Q33 **Wes Streeting:** I am conscious of time and have just a couple of final things. First, the MPC benefits enormously from a great deal of academic input and critique in its decision making. On the Financial Stability Board, I wondered if you feel there is a sufficient level of engagement with academic thinking or reasoned critique from outside the Bank, and whether that is an area where things can improve.

Alex Brazier: I think it can be improved, but I think there is a fair amount of it already—in fact, a surprising amount of it. It was sort of nascent until the FPC was established and then it came to the fore. I am regularly being criticised by some academics, which is helpful and constructive, even though it may not seem so at the time. We have been engaging quite heavily with academics on what I described as the brownfield site of macroprudential policy. Lots of the thinking that had gone on on this had gone on in universities rather than in policy making groups, if you like. Part of the challenge for us has been drawing on as much of that academic expertise as we possibly can. So we have a few special advisers who come in every now and then to support the teams in their work, to get outside perspectives and expertise. I have been trying quite heavily to draw on as wide a view of outside expertise as we possibly can. Some of these people haven't been engaged with policy making, because there wasn't really the overlap, and haven't been putting themselves forward, so we have been doing a lot of outreach among a wide range of universities to try to engage people and to do joint research projects as well.

Q34 **Wes Streeting:** Finally, you mentioned in your evidence that new financial stability indicators are a priority. I wondered when we can expect to see them.

Alex Brazier: The last question is always the hardest, isn't it? I think over the course of this year. We are working in the coming months with the IMF on some work they have put out—I think probably today—on this thing called "GDP at risk", which is about developing indicators, not of the central outlook for GDP, but of the downside risks to GDP. We are doing that work in parallel with them. I would hope that by the end of year we will have made fairly serious progress on that. Whether we have by that point a list of indicators that we are all agreed on is another matter, but the staff work will progress through the course of this year.

Chair: Mr Brazier, thank you very much for your time this afternoon. We have a couple more people to scrutinise this afternoon, but then we will be publishing our report. Thank you.