HOUSE OF LORDS

Select Committee on Economic Affairs

1st Report of Session 2010–11

Meeting with the Governor of the Bank of England

Report with Evidence

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Select Committee on Economic Affairs

The Economic Affairs Committee is appointed by the House of Lords in each session with orders of reference "to consider economic affairs".

Current Membership

Lord Best
Lord Currie of Marylebone
Lord Forsyth of Drumlean
Baroness Kingsmill
Lord Lawson of Blaby
Lord Levene of Portsoken
Lord Lipsey
Lord Hollick
Lord MacGregor of Pulham Market (Chairman)
Lord Moonie
Lord Shipley*
Lord Smith of Clifton
Lord Tugendhat

* Lord Shipley was not a member of the Committee at the time of the meeting.

Declaration of Interests

Members declared the following relevant interests:
Lord Levene of Portsoken: Chairman, Lloyd's
A full list of Members' interests can be found in the Register of Lords' Interests:
http://www.publications.parliament.uk/pa/ld/ldreg/reg01.htm

Publications

All publications of the Committee are available on the internet at:
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Committee Staff

The current staff of the Committee are Bill Sinton (Clerk), Stephen Seawright (Policy Analyst) and Karen Sumner (Committee Assistant).

Contact Details

All correspondence should be addressed to the Clerk of the Select Committee on Economic Affairs, Committee Office, House of Lords, London, SW1A 0PW.
The telephone number for general enquiries is 020 7219 5358/6968
The Committee's email address is: economicaffairs@parliament.uk

Meeting with the Governor of the Bank of England

1. On 16 November we held an evidence session with the Governor of the Bank of England, Mr Mervyn King, the Deputy Governor for Financial Stability Mr Paul Tucker, and the Chief Economist Mr Spencer Dale. On 23 November Mr Dale wrote to the Chairman providing further information requested by the Committee. The transcript of the evidence session and the supplementary evidence is reproduced here for the information of the House.

Minutes of Evidence

TAKEN BEFORE THE SELECT COMMITTEE ON ECONOMIC AFFAIRS

TUESDAY 16 NOVEMBER 2010

Present		
	Lord MacGregor of Pulham Market (Chairman)	Lord Lawson of Blaby
	Lord Best	Lord Levene of Portsoken
	Lord Currie of Marylebone	Lord Lipsey
	Lord Forsyth of Drumlean	Lord Hollick
	Baroness Kingsmill	Lord Smith of Clifton
		Lord Tugendhat

Examination of Witnesses

Witnesses: Mr Mervyn King, [Governor of the Bank of England], Mr Paul Tucker, [Deputy Governor (Financial Stability), Bank of England], and Mr Spencer Dale, [Executive Director and Chief Economist, Bank of England].

Q1 ***The Chairman:*** Good afternoon and welcome Governor, Mr Tucker and Mr Dale. We are very grateful to you for coming. We always appreciate these sessions and of course now that we are in such a fantastically moving scene it's all the more relevant that you should be here and I think you are here at a very appropriate time. I don't need to go through all the preliminaries because I think you are very much aware of them—about speaking up and so on. I think if we asked everyone to declare their special interests on this session we would be here all afternoon so I am going to assume that anyone who is interested in the interests will read them in the Register. Governor, is there anything you want to say before we go into the questions?

Mr King: Nothing except we seem rather far away from you, but we will try and move closer to you during the session.

The Chairman: I think this is probably to suit the television cameras. I'm not sure.

Lord Tugendhat: Those of us who are hard of hearing would be grateful if you could speak as you just did.

Mr King: I will endeavour to do so, my Lord.

Q2 ***The Chairman:*** Thank you very much. Can I begin with a few questions on inflation—and particularly of course in the light of your letter yesterday to the Chancellor—where you forecast, as you put it in your letter I think, that the inflation rate might rise still further and so on and, inflation is likely to remain above the target for the next year or so. Given that the MPC has forecast an imminent fall in inflation, do you think there is something flawed in the forecasts?

Mr King: No, and I think it's important not to think of forecasts as a point estimate, spot the ball forecast where you're trying to get the precise number. Of course it is a concern to us that inflation is above the target, and has been so for a number of months in the past three years, but I don't think it's difficult to understand why. In fact there are many explanations that one could appeal to for why inflation is currently above target. We've seen significant increases in energy and commodity prices. We saw VAT go up in January of this year; it's due to go up again in January next year. And of course, perhaps most important of all, the effective exchange rate of sterling has, on average, fallen by 25 per cent from the middle of 2007 to the end of 2008 and has been broadly stable since. Now a fall of that magnitude would, in and of itself, add about six percentage points to the price level which, spread across say three years, is roughly two percentage points on the inflation rate. Now, in the medium term we would certainly hope and expect to bring inflation back to, and keep as close as we can, to the target. But I think in the short run the real question is why has it been above target? I don't think it's difficult to understand why and I think, most important of all, if you look back it's important to remember that inflation has been very volatile. It hasn't been high and stable above target, it's been very volatile. So at the beginning of 2008 inflation was around 2 per cent—our target. It went up to 5.2 per cent and came all the way down to 1.1 per cent, then back up to 3.7 per cent, down to 3.1 per cent, today 3.2 per cent. So it has been volatile. We are concerned that inflation has been above target. Our real concern is not the fact that it's been above target as such, where we think there are short-term explanations for it. It is to ensure that inflation expectations looking further ahead remain consistent with the 2 per cent target. As we move into the medium term for longer run, influences on inflation, that will feed through and inflation will come back to the target.

Q3 ***The Chairman:*** Would you like to define more precisely what you think the medium term is? In your opening remarks you referred to commodity price inflation. Of course, imports have been rising faster than exports. How concerned are you that inflation could be imported from abroad and hence be less controllable by domestic monetary policy?
Mr King: Those two questions are intimately linked. If there are movements in imported costs, or indeed in some cases domestic costs from a change in the rate of value added tax, it may be very costly to try to offset that in the short run. If inflation expectations are well above target and de-anchored then it may be necessary to adopt difficult and painful policies to bring those inflation expectations down. That was the challenge we faced at various points in the past. At present that isn't the case and I think that if you look to imported costs you can certainly see that over the last six months. Since the summer, oil prices are up 15 per cent, metals prices up 25 per cent, food prices up 35 per cent. These are big shocks which will have an effect on the price level. Now looking further ahead, say two years to three years ahead—which is what I meant by the medium term, to answer your question—then I think other factors come into play. People have different ways of thinking about it but I think if you look at any of them it's consistent with inflation being well under control. So if you look at what's happening to broad money growth, that was rising at 10 per cent a year for much of the past decade, now it's rising at 1 per cent or 2 per cent a year—negative in the United States and the euro area until recently. If you look at money wage growth, it's running around two percentage points a year, well below the level we think would normally be consistent with meeting the inflation target. It's very hard to know how much spare capacity there is in the economy but that there is spare capacity I don't think is a particularly controversial statement. If you look at medium-term inflation expectations, as I said, they are still at levels which, over quite a long period, generated an average inflation rate of 2 per cent for much of the period from 1992 until 2007. So there can be no certainty. A lot will depend on what happens over the next couple of years, but I think a reasonable view and judgment about the medium term factors driving inflation would say that they're all pointing in the same direction, which is inflation consistent with target.

Q4 ***The Chairman:*** Given though that your projection for inflation for at least the next year is likely to remain above the target, and given the fact that there has been an underestimate of inflation, is it appropriate for the bank rates to continue at 0.5 per cent?
Mr King: The Committee has taken that view. There is enormous uncertainty; we don't have a crystal ball and I would not recommend that you put faith in people who pretend to have a crystal ball. It's a question of a balance of risks. One of the upside risks that we've pinpointed for a long time now is the risk that if inflation persists above target people's confidence in it staying or coming back to target will be diminished, inflation expectations will rise and the difficulty of keeping inflation low will go up. That risk has to be balanced against the amount of spare capacity and the downward pressure on inflation that we see. I think the reason why the Committee has not voted to raise interest rates significantly is that if we had, in order to offset the excess of inflation over the target in the past year or so, we would have had to raise interest rates substantially, deliberately to ensure a much slower growth rate of demand and spending, creating even more unemployment—it's already gone up from 5.5 per cent to around 8 per cent—and quite deliberately slowing the economy even faster. If we had done that, at a time when the indicators of inflation—whether they be money growth, wage growth, spare capacity or inflation expectations—were not pointing to the need to do that in the medium term, I think it would have been potentially damaging to people's confidence in our ability to look through some of these short-term shocks and stick to a steady course to bring inflation back to target in the medium term.

Q5 ***Lord Lipsey:*** Another thing which, in the words of your own inflation report, is highly uncertain is the growth prospects. It would be a very brave man who entirely ruled out a double-dip recession, although I understand that's not your central forecast. What puzzles me is if we were to get into double-dip recession territory, we have fiscal policy constraint, interest rates as near damn it at zero and a large programme of quantitative easing already in place. What other instruments are available to the authorities to try and get us out of it again?
Mr King: I don't think it's very different from normal. I would like to think that normally the central bank would have set interest rates where they thought they should be. We could do further quantitative easing if that turns out to be necessary—further asset purchases. We see that as a normal instrument of monetary policy. It has a long pedigree in the past. What is unusual is not the nature of the instrument but the circumstances in which we are deploying it. Twenty or 25 years ago there was a lot of discussion about overfunding and underfunding. That's exactly the same instrument as asset purchases. So I don't think this is a particularly unusual instrument. The question is, is it the right thing to do? That's a different question. But that is an instrument that could be deployed if necessary. In

terms of fiscal policy, the automatic stabilisers are quite powerful in this country with high marginal tax rates. They will come into effect and we have an annual budget before Parliament. There's no constitutional ban on whatever happens in terms of economic policy. So, as I said not so long ago, what's slightly strange about this debate to me is that whereas in some countries like the United States it may be difficult to get Congress to agree on the appropriate policy measures, we have far more freedom of manoeuvre for those charged with policy to make changes as and when seems appropriate. It wasn't a plan B that we were short of—there are lots of plan Bs—it was having a plan A and putting that in place seemed to me the most important thing.

Q6 ***Lord Lipsey:*** Although you may think this is an appropriate fiscal policy on the best assumptions we have as to the future at the moment, you wouldn't rule out some relaxation in the present programme for the reduction of the deficit were the economy to grow more slowly than we all hope.
Mr King: The automatic stabilisers will bring that about. I don't think anyone is saying that the automatic stabilisers will always and everywhere be completely overridden, they won't. The question was, on the assumption that the economy would grow along the central path envisaged by the Office for Budget Responsibility, what would be a sensible fiscal path of reduction along that central path for growth? Around that, if the economy grows faster than expected, maybe the deficit will come down quicker than expected. If the economy grows more slowly then it may come down more slowly. But that will be the natural application of the automatic stabilisers and it's wholly consistent with having a credible medium-term path.

Q7 ***Lord Lipsey:*** So sorry to interrupt. You also refer to Parliament, which has seen some voluntary change in fiscal policy brought about by Parliament itself.
Mr King: If Parliament wants to do that—
Lord Lipsey: Do you mean if Parliament wants to increase public spending, in the circumstances as I'm saying, that is something it could do?
Mr King: Absolutely, there is no constraint on it and I don't understand why anyone thinks it's particularly novel that you should have to announce in advance that you could take measures as and when necessary. Of course Parliament can do that at any point.

Q8 ***Lord Forsyth of Drumlean:*** Just returning to the points about the inflation expectations and notwithstanding the limitations of your crystal ball, with the benefit of hindsight do you think that the fears that were expressed about the dangers of deflation have proved to be exaggerated?
Mr King: Without specifying what those fears were it's quite hard to know but I think that after the collapse of the banking system in October 2008 we saw not only a very sharp contraction in output but a contraction of world trade even faster than that which occurred in the 1930s. That was a deeply worrying time because there was a collapse of confidence—orders and output—around the world. It wasn't just confined to those countries that had been affected by the banking crisis. In those circumstances I think that immediate and strong policy action was undoubtedly called for and I don't think we regret having done that. So I think that was appropriate and it's very hard to know what would have happened had that policy response not taken place. But I think there would have been serious concerns about the state of the real economy and indeed the outlook for inflation at that point.

Q9 ***Lord Lawson of Blaby:*** If I may just, before moving on, ask something arising from what you have just said; you've talked about inflation, you've talked about the real economy and of course the bank's remit is exclusively a remit about the rate of inflation.
Mr King: Absolutely.
Lord Lawson of Blaby: You have on this occasion just now, on a number of previous occasions before this Committee and on other occasions outside this building, been very hard—I think correctly—on the importance of inflationary expectations in conducting an effective anti-inflationary policy. I'm sure you are right that at the present time the inflationary expectations probably are not too bad but don't you feel—and I think maybe this is implicit in your letter to the Chancellor—that we are on rather thin ice and that there is a real danger that inflationary expectations might take off? There may be those in the financial markets, cynics, who feel that somehow you're prepared to be soft on inflation because with our huge growing indebtedness this is the time-honoured way of reducing the real burden of Government debt, so don't you feel perhaps that it is important to disabuse people of that and to prevent the inflationary expectations from taking off rather than waiting until the ice cracks and then you have to act after the event?
Mr King: It's always very difficult to judge how thin or thick the ice is. We have a difficult balancing act because if the ice turns out to be somewhat thicker than perhaps some of your comments suggest then we will find ourselves in a position two years from now where we will have seriously undershot the inflation outlook. Let me make it absolutely clear—and I am grateful to have the opportunity of doing it—that we are focused entirely on the outlook for inflation. We are conscious of the fact that it's rather difficult for us to influence inflation over the next 12 months. The

short run effects are going to come through and only very drastic policy action to try to offset them might have a chance of influencing that, but at the cost of making the inflation outlook, two to three years ahead, a rather perverse one. So we have to balance the risk on the upside to inflation expectations moving up against the risk on the downside as we see things at present. There are significant risks of inflation undershooting the target; these things have to be balanced. I accept that there is no unique answer to that question of where you strike the balance. Different people can take different views and one of the strengths of the MPC is that it's a forum in which those different views can be discussed and debated and played out. But I think at present the Committee would feel that given what is happening to broad money growth, given what is happening in the labour market, given what is happening to the amount of spare capacity in the economy, all of those things make us feel that in the medium term inflation will come down. But it is a very important part of our framework that we have to go out and persuade people of the argument and convince them that there are good reasons why inflation is above target in the short term and that given the stance of policy that we're pursuing we'll bring it down. I certainly think it would be a disaster to try to think you can solve the debt problem by allowing inflation to go up. We have a very large deficit at present and if financial markets were to believe that we were prepared to allow inflation to rise in order to somehow try and reduce the burden of the debt, that would very quickly be reflected in long-term interest rates and the cost of funding would go up, undermining our attempt to stimulate the economy to ensure an adequate amount of growth in order to keep inflation close to that 2 per cent target in the medium term, and we would certainly lose all credibility. So I think we are firmly committed to our inflation target but in order to meet it we have this difficult balancing act where, as you rightly say, on the upside the major risk is on inflation expectations; that's where the ice is thin. It's also thin, sadly, on the other side where, given the amount of spare capacity and the other medium-term indicators I have described, there is also a risk that inflation could fall below the target and that will be just as damaging.

Lord Lawson of Blaby: I am slightly surprised that you think there is an equal risk of inflation falling below the target but you are much better placed than I am to make these judgments.

Mr King: I meant three years ahead—not now but looking two to three years ahead.

Q10 ***Lord Lawson of Blaby:*** That's beyond my capacity. But anyhow, if I may move on to something else, we have later today—this evening—a meeting of the 16 members of the eurozone to discuss this latest turn in the continuing eurozone crisis. Very happily, we are not part of that but of course we are not unaffected by what happens, so can you say what, in your judgement, would be the right response of the eurozone members at their meeting this evening and can you also let us have your wider reflections on the lessons of what has been happening in the eurozone?

Mr King: Given where the crisis is focused at present I hesitate to say I wouldn't start from here, but I think that's what I would say and of course, as you rightly pointed out, fortunately we are not starting in that position ourselves. There are some very delicate discussions going on in Europe at present as we speak and I don't think it's helpful for me to comment in public about what the outcome of those negotiations and discussions should be. I think it is very important that we do what we can to support our partners in Europe to find a solution which will see their way through this. The UK economy is going through a very difficult rebalancing that will take possibly five years or more. A very important ingredient of that, from our point of view, is a healthy economic expansion in the euro area so that we can take advantage of the lower real exchange rate which will offset the downward drag on demand from fiscal consolidation. So I think it's in our interest to try to ensure a successful euro area in terms of economic growth. I think what they should do is something that they are discussing and any comments that we want to feed in—and we are feeding in comments—at this stage, should be done privately. The general lesson I think is a very old lesson. It was a lesson which was discussed very openly by those before 1999 who were considering going into monetary union and a view of many economists in Germany, including several who later participated in the operation of a euro area, was that monetary union was very difficult to make work without fiscal union. I think that is a very strong lesson which has been demonstrated, on more than one occasion now, in the past decade. That observation does not help to find one's way out of the present difficulties but I think it's something that needs to be borne in mind when framing the ultimate direction in which the euro area will go; that it is very difficult to have one without the other.

Q11 ***Lord Lawson of Blaby:*** Thank you. On this issue lastly—it's a very small, a very minor technical question, as it were and perhaps you or your colleagues have the figures—how substantial are the holdings of Irish sovereign debt in the British banking system and is this a concern at all?

Mr King: The direct holdings of Irish sovereign debt are not especially large but the holdings of securities issued by Irish banks are bigger and of course there are wider exposures to assets comprising loans to the Irish economy more generally. So I think the overall exposure to the Irish economy is by no means trivial.

It's something which is relevant to concern about financial stability in the UK, but it's focused more generally on the Irish economy, than the Irish banking system, and only to a relatively small extent direct exposures to Irish sovereign debt.

Q12 ***Lord Forsyth of Drumlean:*** There seems to have been an unusual degree of disagreement amongst MPC members on monetary policy of late as to whether it should be, more or less, expansionary. I think there's a three-way split although perhaps two splinters in the split. Could you explain to us what the issues are behind this?

Mr King: Yes, I don't think it's very surprising that, in these circumstances, there should be a difference of view about the precise calibration of the monetary policy response. We have been through what I believe to be the world's biggest financial crisis. We have seen a fiscal deficit here of over 10 per cent of GDP; a programme has now put in place to deal with that. But inevitably there must be some uncertainty about the response of households and consumption to that over the next few years. We have seen a 25 per cent fall in the effective exchange rate, which is very large. There is plenty of scope for disagreement about the precise numerical impact of how that feeds through to inflation. There have also been very large increases in commodity and energy prices and so on. Given all those different shocks to the economy, particularly to the outlook for inflation, I do not find it surprising that, on the one hand, there is agreement across the Committee about the big picture. We had a large shock to the economy; a good deal of spare capacity; a rebalancing is needed; there do seem to be signs of export demand picking up; and we have a fiscal consolidation coming down the road. I think that big picture everyone agrees with. The question is, what is the precise quantitative impact of all this on the outlook for inflation? There are some differences on the Committee, you are absolutely right. I don't think, given the scale of the shocks that we are confronting, it is particularly surprising or very large, but there are those differences and we explain them in the Report. When the minutes come out tomorrow, then you will see the distribution of views on the Committee.

Q13 ***Lord Best:*** Has quantitative easing led to the banks lending more to companies and to individuals, as was hoped? And, if it hasn't, is it at least in part because of the way that you have used QE, which is different from the way that the US Fed has used that opportunity?

Mr King: No, I don't think so. First of all, the objective of asset purchases, as we prefer to call them, was not to increase bank lending directly. It was, put very simply, first of all to increase the amount of broad money in the economy by buying government assets, a neutral form of purchase by the central bank to put that broad money out there in the economy. And then those who had sold the assets to us, with these much larger holdings of money, would then themselves choose which private sector assets to buy. They could have bought gilts or corporate bonds or corporate equity, or a wide range of private sector assets. The choice was theirs, not ours; I think that is a better way of doing it. As I said before, this is not a particularly unusual or novel way of doing monetary policy. There is a long pedigree in the historical description of monetary policy. But of course, as with any policy move, not just asset purchases, but including interest rate movements, it is very hard to know what the counterfactual is: what would have happened had we not done this? I think that there is certainly evidence that large companies have been able to finance themselves more easily by issuing corporate bonds and equity. That has been a fairly successful route by which big companies have been able to go around the banking system. It has been much harder for small and medium-sized enterprises, although to the extent that large companies have been able to finance themselves through the market, that has released money that might otherwise not have been available for lending to small businesses. I think it is interesting that now that the Federal Reserve has decided to engage in further asset purchases, it has decided not to buy private sector assets but to follow the route that we have followed from the beginning, which is a more normal monetary policy response.

Q14 ***Lord Currie of Marylebone:*** You touched earlier on both monetary and fiscal policy, but there have been reports in the press that there were concerns, possibly even amongst your own staff at the Bank of England, that your endorsement of the Government Spending Review oversteps the line separating monetary and fiscal policy. How do you respond to that?

Mr King: I don't take that very seriously, to be honest. I would be concerned if people felt that I or the Bank was behaving politically. I don't believe we are. We are facing the largest fiscal deficit in our peacetime history. I think the surprising thing would be if the central bank had no view that this was a matter of concern. We do believe it is a matter of concern. Of course, in terms of the Bank, I am sure everyone has their own view about the right path. They do on monetary policy; it would be surprising if they didn't on fiscal policy. But everyone accepts that what we have put in our Inflation Report is the view of the majority of the Committee, and I have never commented on anything beyond the overall level of the deficit. I did not endorse the spending review, I did not comment on the balance between spending and taxes as the best way to deal with a fiscal deficit, let alone comment on the individual measures. I have never commented on any other aspect of fiscal policy, other than the concern about the size of the deficit and the need, for monetary policy purposes, to have in place a truly credible, medium-term path—not inflexible, but credible—for reducing the deficit over a horizon which is credible to markets, that is a horizon over which an elected Government can claim to have sway, namely, the length of the Parliament.

Q15 ***Lord Hollick:*** Governor, I would like to ask you about the proposed new financial regulatory regime. What are the responsibilities of the bank under that new regime? What do you think are the most important issues to be tackled, and are you satisfied that the governance arrangement with the Bank of England and its skills are adequate to the task?
Mr King: Three questions: you may have to remind me of the third as we go through it. This is a big change for the Bank. It means expanding our responsibilities beyond monetary policy to include two new areas. The Financial Policy Committee is responsible for macro-prudential supervision, and Paul Tucker will be leading the work on that. The other new area is micro-prudential supervision, where the prudential part of the Financial Services Authority will come to the Bank and we shall take responsibility for it. The big challenges, I think, are twofold. First, in the macro-prudential area—that is the Financial Policy Committee—that committee will be set up fairly shortly and its task in the next two years, before the statutory framework comes into play, will be to advise the Government on what instruments of policy the Financial Policy Committee should exercise. Should it, for example, be able to change capital requirements and the buffers of capital held by banks counter-cyclically? Should it be able to influence parameters to deal with loan value ratios in the housing market or commercial property market? There are a range of instruments that people might think would be appropriate to macro-prudential policy, and the first and most important task of the Committee will be to make recommendations to the Government as to what those instruments should be so, when the legislation takes effect, those specific powers will be delegated to the Financial Policy Committee, who will then exercise them. So that is the first challenge in that area of macro-prudential. The second, I think, is to try to bring about a different style and culture of micro-prudential supervision. I think everyone understands that the purpose of micro-prudential supervision is not in the area of regulation to do with consumer protection or enforcement—that will go to the new CPMA, Consumer Protection and Markets Authority—it is to do with the concerns about the system as a whole, the systemic risks. It is done by supervising individual institutions, but with a view to trying to look at systemic risks. I think that one of the lessons from this crisis around the world is that numbers of regulators and focus on too much detail is counterproductive. Take the bank, for example, where some of the most serious problems occurred: Citibank. The Federal Reserve had many dozens of regulators working inside the building. They were not visiting from time to time, they were inside the building. It didn't help. I think the cultural change we have to bring about is to ensure that the big questions, the big judgements about the risks on the balance sheet, are discussed between a cadre of committed, professional and experienced supervisors, who see their calling as being in the area of supervision and who are not afraid to look in the whites of the eyes of bank chief executives and say, "I think you need more capital" or, "I think your leverage ratio is too high". But not to get bogged down with detail, which so much of regulation has done, and which has proved costly to the industry without offering any protection to taxpayers. It is easier to say than to do, I quite accept that. This is a big task over a long period, but that is going to be the major challenge in that area. Governance, third, wasn't it? There are two aspects to this. People will be rightly concerned that the bank will seem to be a very powerful institution. We are concerned about it. This is not something that we asked to do. I think it was natural for a central bank to take on the macro-prudential responsibilities, but we would have been perfectly content for someone else to do the micro-prudential. We did not lobby or ask for this expansion in our responsibilities and role, but it has been given to us, and I understand why. We have to make sure that the governance is very effective. The principle behind it is accountability. We have to be accountable to you, to Parliament, Government and the public, but I draw a very clear distinction between being accountable to Parliament and the public on the one hand, and being accountable to the industry on the other. We cannot regulate effectively if we are meant to be accountable to the industry. We can consult, we will listen, we will talk, but we can't ultimately be accountable to the industry, we have to be accountable to you. In that context, I would say the question of power can be slightly exaggerated. We have a good example of this. In the three areas I mentioned, monetary policy, financial policy, micro-prudential supervision, there will be committees or boards taking decisions. It won't be me; it will be a committee doing it. On those boards or committees, in each case there will be outside people, away from the Bank, very much as Lord Lawson set up with the Board of Banking Supervision. There will be

outsiders on that board playing a full role. If you take monetary policy, I think we have quite a good track record of demonstrating that it is not just one person, it is not just the executive of the Bank that take the decisions. In monetary policy I have been in a minority on the Committee three times as Governor. I think we have a good track record of showing that we can work together with people from outside, accepting the collective voice as determining the outcome, and that we are quite prepared to be in a minority where that seems to be the view of the majority. I think we have proved that, and we also have, on top of those three committees with outsiders, the Court of the Bank, which, given the reforms that were made to court in the last year or two, has become extremely effective. I can tell you, from our point of view, there is a very effective oversight role played by the Court of the Bank. It is a smaller, more powerful court, with people devoting a lot of time to it. We are highly accountable to that body, and they are responsible for the overall governance of the bank, the budget, the strategy and the remuneration of the staff in the bank.

Q16 ***Baroness Kingsmill:*** I just wanted you to amplify your response a little. I wondered if you could just tell me how many additional members of staff your increased responsibilities are going to require you to take on. Does this mean there is going to be a very significant increase in your budgetary requirements?

Mr King: Far and away the dominant change, of course, is the creation of the new Prudential Regulation Authority as a separate subsidiary of the Bank of England, which will mean quite a large number of people—I hope not too many, and I hope that we can demonstrate that in this area numbers are not a virtue, that we can make do with fewer rather than more. Many of those people will transfer from the FSA to the subsidiary of the bank, the PRA, when the legislation takes effect. That will be far and away the biggest change to the size of the Bank. In the other areas, we have new responsibilities for oversight of the payment system—the settlement system—that will require a small number of additional people, and we have the new Financial Policy Committee that will require some people to service that. I hope these will not be large additions. We have a very good track record at the Bank, of almost continuously reducing the staff numbers over a long period. We have reached a period of stability now; our budget has been well under control for a long period; we have had, on average over the past 10 years, increases of nominal spending of no more than 2 per cent a year, and I like to think that that budgetary discipline will be carried forward to the future. I can assure you Court will insist that it is. But where there is an increase in responsibilities I am sure that you will want us to carry out those responsibilities properly and to have the resources to do that.

Q17 ***Lord Tugendhat:*** Governor, you have spoken very clearly about changes or innovations which follow the macro-prudential responsibility. Nonetheless, could I put this question to you: although the MPC is, I think, widely regarded as a very successful constitutional innovation, and although the debates and the way in which it reaches decisions are widely followed within the political community and the economic community, the exercise of monetary policy is very much identified now with the Governor of the Bank of England. It is very much focused on the personality of the Governor, and I wonder whether you would agree that once you assume these new regulatory responsibilities, again, the focus of regulation, notwithstanding what you have just said, in the popular press and in parliamentary questions and that sort of thing, will focus very much on the Governor. I was going to say if things go wrong, but in the case of regulation it would be very surprising if there are not problems at some point down the road, and we look back over the problems which existed when the Bank of England was responsible for these things. I wonder whether the problems of regulation won't contaminate the reputation you have deservedly built up over the conduct of monetary policy, that if there are problems on regulation, parliamentarians and the media will find that this diminishes your reputation in the area which is, at the moment, your principal expertise.

Mr King: I certainly share those concerns. That concern was one of the most important reasons why many of us supported supervision leaving the Bank and going to a separate agency. The lesson I would draw from the experience since then is that trying to put both prudential and consumer protection into the same agency is not a good idea and it is better to separate them. One of the lessons I draw from the experience of the crisis, however, is that despite a period of 10 years or more when we were not in any way involved with banking supervision or regulation, when it could not have been clearer that the Government had separated it and was proud of the separation and was trumpeting that fact, nevertheless, when there was a financial crisis, our reputation suffered when there was a problem in the banking sector as if we had been involved in banking regulation. I suppose my reaction to that was, "If we are going to have our reputation affected by the way it is done, we might as well be involved in it". So we did not escape the contamination problem by not being responsible for banking supervision. More importantly, in general, I deeply regret the fact, if it is true—I am not sure how far it is—that monetary policy is identified with the Governor. I deeply regret that, because one of the main purposes of building up the Monetary Policy Committee was to explain to people—and I think the business community is solidly behind this—when we say to the business community, "Look, it is a balance of risks, what we do about monetary policy, there is no simple right or wrong answer, we are not going to pretend there is". What we have is nine people, each of whom is qualified to make that judgement, each of whom has a vote. It is not a bad way of making decisions, to rely on where the majority lies amongst that group. I think that gives confidence to the business community that all the arguments they might wish to see debated in the decision on interest rates, genuinely are put on the table, discussed and debated, and the arguments set out in public. That decision-making process is therefore critically dependent on the Governor being only one of the nine. The chairman is perhaps to some extent the spokesman of the Committee, but only one of the nine. I very much hope that monetary policy will not be personalised. The whole brunt of what we have been trying to achieve, and I think much of what my opposite number Ben Bernanke has been trying to achieve in the United States, has also been devoted in that direction. What has made life more difficult, I think, in recent years, is the context of a financial crisis, particularly one that was so severe, in which the events and playing out of the financial crisis were in the newspapers and on television every day for two or three years. It is perhaps inevitable that, for a time at least, it looks as if it is focused on the personality of one individual, but it is absolutely vital we get away from that.

Q18 ***Lord Tugendhat:*** As I said at the outset of my question, the MPC is widely regarded as a successful innovation and I think its discussions and debates and its differences are widely followed. Nonetheless, if you look at the position regarding the Bank of England and the MPC, if you look at the position in the old days of the president of the Bundesbank and the Bundesbank Council, if you look at the situation with the Fed in America, the nature of politics and the nature of media coverage is that, notwithstanding all that you say, the focus falls on the individual who is at the pinnacle and at the front.

Mr King: Up to a point. I think the Bundesbank is an interesting example, because I think that the German people had confidence in the institution and not the individual. What was most important was that their confidence in the Bundesbank did not change at all when there was a transfer from one person to the next. The most important thing at the Bank of England, therefore, is to ensure that when there is a change of Governor, it is seen as continuity, that there is confidence in the institution, and that weight is not put entirely on the individual. This is the issue that has been relevant in the United States; it is the institution that people should have confidence in. It is like all good football teams, they change one or two players each year; after 10 years it is a completely different set of players but it is the same team institution. We have to do that, we have to make small changes each year so when people do move on it is not a threat to the credibility of the institution, because the trust that people place in it is in the institution, not in any one individual.

Lord Tugendhat: I hope you will be more successful than the England football team.

Mr King: I was not referring to the England football team.

The Chairman: We must move on now to a different aspect of regulation.

Q19 ***Lord Levene of Portsoken:*** As I want to ask you a question about insurance, I would just like to highlight my interest as chairman of Lloyd's. The Government's concentration on the new regulatory architecture focuses almost exclusively on bank regulation with only a passing reference to insurance, even though London has the world's largest insurance market, which is a major contributor to the economy. Insurance is a very different business model from banks and this should be recognised within the regulatory structure. Is there enough focus within the bank and the Treasury on how insurance should be regulated? Given the different business models and the importance of the insurance sector, do you agree that some members of the Financial Policy Committee and the board of the PRA should be drawn from people with an insurance background?

Mr King: There are two or three questions again in that. On the first, let me assure you that we think that insurance is not only extremely important, but is different from banking. Both, from the prudential point of view, will come under the Bank's PRA but they are different. Indeed, in some ways I would say that one of the sad aspects of the crisis is that at least one large insurance company inadvertently strayed into banking, and many banks did not understand some of the principles of insurance. I think you can argue that some of the risks that banks took were of the form where they invested in assets which were generating very modest returns for a large number of years, which they then levered up against significantly to turn into high rates of return on equity, and did not prepare for the ultimate year when things went bad. It doesn't take anybody in the insurance industry to understand that if you declare as profits the premiums that you receive on a policy, you are going to find yourself in deep difficulty if you paid it out as compensation and dividends, when the inevitable event occurs. You can't predict when it will occur, but when it does, it is costly. They are very different types of institutions with different risks and we will have to take that fully into account. I accept that the Bank of England, at present, has neither the experience nor the resources to supervise insurance prudential regulation. It is two years away, roughly, before this will come into effect. We will inherit from the FSA, I am sure, a very strong team. As any manager, we will try to strengthen our team. We are always looking to do that and we will try to do that. But I assure you that we will understand, and we know already, that the issues that will arise in prudential regulation of banking are different from the ones that will arise from the prudential supervision of insurance companies. In terms of the committees, this is a matter for the Treasury. I think they will obviously understand these issues, and I am sure there is a very strong case for having somebody involved, certainly on the board of the PRA. But I think the question of who serves on those committees must be a matter for the Treasury.

Q20 ***Lord Smith of Clifton:*** Governor, may we return to the international context? Are the proposed Basel 3 arrangements likely to prove adequate to the task and, if not, what else is required?
Mr King: Perhaps I could answer that in two parts. I will take the first myself, and perhaps I can ask Paul Tucker to take the second. A lot hinges on what you mean by the task to which Basel 3 is meant to be up to. There is no doubt that it is a big improvement on where we were, be that Basel 1 or Basel 2. It will involve more equity capital being used in banks and, in particular, it will change the definition of capital so that there will be more truly loss-bearing capital available for banks to absorb losses before they get to the point where they may find it difficult to continue. But it will not solve the question of will there be financial crises, because the scale of leverage, the scale of capital requirements is very unlikely, in my view, to guarantee that banks will always be able to find funding along the terms which they have become used to, in the event of a loss of confidence in the banking system. The levels of leverage are simply too high for that. Basel does not go into the heart of that problem, but it is a big improvement, and I think that the debate is far from closed. There are uncertainties on both sides; there is a long transition period now, which I think is highly appropriate; there is a debate going on about large, systemically important institutions—Paul can say a word about that in a minute. That debate is ongoing; it has not been resolved yet. Many of these features do not take effect yet. For example, we put a lot of weight on leverage and liquidity. Fancy risk weights are one thing but leverage and liquidity, liquidity particularly, is very important in dealing with a crisis. We must ensure the banks have adequate liquidity. They have run it down very significantly. It has been built up in the last year or so after the crisis hit, but ensuring that it stays at high levels is important. There will be a monitoring period—a period of observation, it is called—for several years while the Basel Committee will watch and see what happens. But we haven't got to the point—and we're not going to get to the point—where decisions on this will be made for a number of years. So there's plenty of scope for this to be unwound, to some extent, with sufficient lobbying, and I hope that doesn't happen. On the other side, I think there are plenty of opportunities now for debating—and Paul is deeply involved in this—the sort of combination of capital requirements, resolution procedures, which are relevant to dealing with the very largest institutions. Perhaps I can ask Paul to take that second part.
Mr Tucker: There is a lot else in the works. On Friday the leaders in Seoul endorsed one big step forward on this, which has two parts. The first is that the largest and most complex institutions in the world are going to be required to have a capital buffer of some kind over and above what Basel 3 requires of normal banks. It might be equity, it might be convertible debt of certain kinds, but there is agreement across all the countries that this will happen and there is a work programme with milestones to deliver that over the next year or so. The second element of that is that, as has become horrendously apparent over the past few years, when the biggest and largest firms get into trouble, democracies face an appalling choice: put capital into them, put taxpayers' money into them, or experience mayhem. We need to get to a position where these large global institutions can be reconstructed, laid to rest, revived in some way, without taxpayer solvency support. This will require changes in laws in a number of countries, and there is emerging agreement to do that, both globally and within the European Union. It will require the removal of obstacles, to cross-border co-operation. There are questions of sovereignty here, where do we want to be on a spectrum between multilateral binding treaties on the one hand, and unilateral isolation on the other hand? Where the leaders have reached on that is removing some of the obstacles to co-operation. And there has to be serious, top-down planning between the authorities and the firms to ensure that even if we put the right legislation in place—or if you and your opposite numbers around the world put the right legislation in place—firms are not so complex that it still obstructs their effective resolution. That work, which has some momentum behind it, will continue over the next year or so. There are other things as well, one of which I would like to mention. Something that is regularly commented on is to the effect that if we make progress in this country or internationally in making our core banking system safer by increasing the requirements on it, won't financial activity just move outside of the regulated

perimeter, the so-called shadow banking system? It is undeniable that regulatory arbitrage is a way of life out there, and it would be naïve to pretend that it isn't going to be a potent force, as indeed be will utterly benign evolution of the financial system. And that is on the radar of the international authorities, and there will be work on that this coming year. Domestically, the Government's plans for the new Bank of England system of regulation involve saying to the Financial Policy Committee, "You, FPC, must go to the Government and make recommendations when and how you think the perimeter of prudential supervision and regulation should be altered, because you're no longer regulating and supervising the right things". So there's more and more, and I won't go on, but I think there's no single stream of work that is going to be enough on its own. And so far, the encouraging thing is that the joined-up momentum internationally behind reform is intact, which isn't terribly surprising, given the persistently high levels of unemployment through the Western world.

Q21 ***Lord Smith of Clifton:*** Thank you for that. Could I ask you a related question: what would happen to London, the City of London, as an international financial centre, if we were minded to move towards a breakup of the banks?
Mr King: London is a very important financial centre. I think it will remain so. It's very important that it does remain so. Of course, as Lord Levene reminded us earlier, London as a financial centre is more than just banking. Banking is more than just investment banking, and indeed investment banking is more than just some of the activities that created some of the difficulties. But it is not going to be possible to stay as a leading international banking centre if the structure of those banks poses a serious threat to the UK taxpayer every now and then, and it is very, very important for the United Kingdom to ensure that we can create a banking system in this country which doesn't have the "too important to fail" problem, which doesn't pose a threat to our taxpayers. Then, and only then, in my view, will it be possible to do what we ought to be able to do, which is to continue and prosper as a major international financial centre. We have seen in other countries, be it Iceland, be it Ireland, be it in Switzerland, the dangers of trying to have a banking system that is very large relative to a country's GDP without having an answer to the "too important to fail" problem. It's been devastating in those cases, and at least Switzerland managed to put in place a new and quite significantly changed regime for the capital requirements of their two very large banks, but in the case of the other two countries, it's too late. It's very important that we deal with this problem before the next crisis occurs.

Q22 ***Baroness Kingsmill:*** Governor, I wondered if we could take a little closer look at one of the proposals published by the Basel Committee in July, and that is the counter-cyclical capital buffer. There seems to be some dispute amongst observers as to how effective this is in addressing pro-cyclicality in financial regulations, and I wondered what your view was about this.
Mr King: This will be an issue which the new Financial Policy Committee will have to deal with and to come up with an answer on, so it's not for me to say what the answer should be. I think that in the discussions we've had in Basel, at the international level there has been support for the concept of a counter-cyclical buffer. One of the objectives of the new European Systemic Risk Board—which will start its work in earnest in the new year—is to consider and perhaps make recommendations to Europe as a whole about whether or not such counter-cyclical movements in capital budgets should be made. It's very much going to be on the radar of our new Financial Policy Committee. It's not the only aspect of counter-cyclical behaviour in the financial sector, so dealing with this question is a necessary but not sufficient answer. There are certain aspects of accounting, provisioning, where you can argue that the implementation led to cyclical behaviour, pro-cyclical behaviour. So this is something that people have been very concerned about, and of course all of this was raised well before Basel 2 was put in place. Many academics—indeed, the Bank of England itself—in the discussions in Basel raised a question about the danger of having a pro-cyclical regime. You now know there are dangers, and I think everyone's agreed internationally we should do something about it. What I would say is that at the European level, what is very important is that one European body, in drafting legislation, does not put an arbitrary limit on the way in which this counter-cyclical buffer can move over the cycle in a way which will impede another European body, like the European Systemic Risk Board—or indeed, national supervisors—from implementing what they believe to be an appropriate judgement. That would be very odd, and I do think that in some of the discussions at European level we will need to watch very carefully for attempts under the guise of maximum harmonisation to take away from national supervisors the very discretion which people now believe to be an important component of effective supervision.

Q23 ***Baroness Kingsmill:*** Yes. That was going to be my supplementary—what in your view the role of the local supervisors should be, and in particular, the mechanisms for increasing capital requirements. Do you consider them to be satisfactory?

Mr King: I think national supervisors must have discretion to change capital requirements, both in a counter-cyclical sense and in terms of the so-called 'Pillar 2' judgements. That is where individual institutions are causing particular concerns, perhaps because they are especially interconnected with the rest of the banking and payment system. Basel was there initially with the important objective to ensure a level playing field about the minimum capital requirements, but there was no suggestion at that point that national supervisors should be constrained in the exercise of their discretion to impose larger capital requirements if that was felt necessary to take into account concerns about systemic risk within their own financial sector.

Q24 ***Baroness Kingsmill:*** Do you think there's any risk of a certain degree of competitiveness arising as between national supervisors wanting their particular financial centre to—

Mr King: A very real risk. I think that was one of the objectives of Basel in the very first place, to overcome that. I think that was a successful move. I can't claim to be particularly encouraged by what I see of the discussions that I've been—I was going to say "privileged", perhaps that is not quite the right word—committed to take part in. Many of these have been conducted, I'm afraid, from the spirit of, "Well, what's good for our banking system?" not, "What's good for the stability of the system as a whole?" and I regret that. But I think that the major financial centres are only too aware of the importance of having a well-regulated system. Not stifling activity by an excessively detailed form of regulation, which seems to me counter-productive to all concerned, but a system that properly assesses the risks, and indeed, in some ways, a system of regulation where people have confidence that the regulatory framework has identified systemic risks and will take action to deal with it gives you perhaps a comparative advantage. So it doesn't always work all in the same direction, but we're in very close contact with our colleagues in the major financial centres, and Paul's described much of the international work that he's involved in. All of us involved in the Basel process are conscious of the need to make sure that we do not allow ourselves to get in a position where there is this competitive flight towards badly regulated sectors.

Q25 ***Lord Lawson of Blaby:*** May I ask one or two questions in this area, the first arising out of a remark that you made, Governor, when you mentioned the Board of Banking Supervision, which I set up under the 1987 Banking Act, and which was subsequently first weakened and then abolished by the previous Government? This was a rather more powerful body, a more substantial body, than the committees that you refer to which you have within the bank, excellent job they may do. There's no silver bullet in this area, obviously. You have to operate across a wide range, but do you think within that wide range there is a case for going back to having something like the Board of Banking Supervision, maybe something better, but something along those lines? The second question or second point is I congratulate you, if I may, on your speech you made in New York on, I think it was, 25 October, which didn't seem to me to get sufficient attention in this country. It was a very wide-ranging and very hard-hitting speech about the banking systems that we are lumbered with in the West, and although you were quite diffident in what you were proposing, you were pointing out the flaws very clearly. It seemed to me that you did feel that possibly some kind of structural reform—you didn't specify what—would have a place in our banking system. I'd like you to comment on that. I agree with that, I think it's right, but I'd like to hear what you think. It seemed to me to arise from this, that there is a real danger of putting too much weight on the regulatory/supervisory system, that the discipline for the banking system needs to be a mixture of market discipline and the regulatory supervisory discipline, and there's a great danger of trying to put too much weight on the regulatory and supervisory. This links up with Mr Tucker's reference to the danger of migration to the shadow banking system, where the disciplines are market disciplines, basically. The interesting experience we had is that what was thought to be one of the most vulnerable parts of the so-called shadow banking system, namely the hedge funds, caused much less problem than the banks, which were meant to be much more highly regulated. So if everything is clear, maybe the danger of this migration to the shadow banking system is not all that great, given the fact anyway that the more complicated, more all-embracing the system of supervision and regulation is, the more it will be gamed, as we saw from Basel 2, and therefore the less effective it will be.

Mr King: There are three points. Let me try and take them in turn and remember them. The first one is I would hope that the board of the Prudential Regulatory Authority would look very like or behave very like the Board of Banking Supervision. It will have outsiders on it. It will have people without conflicts of interest, but I hope with a great deal of experience of banking and its supervision in practice, rather like the people that were put on the Board of Banking Supervision, and they will be involved in the major judgements. Now, for me, the success of the board of PRA is that when it meets, typically it has three big questions on the agenda, and only a small number, and it doesn't have an agenda of 57 different items of which number 32 is, "Do we approve or not approve the particular risk model number 97 used by insurance company X?" That focus on detail strikes me as inappropriate and you'll miss completely the big risks if you're swamped by that amount of detail. So I hope the board of the PRA will be rather like the best features of the Board of Banking Supervision. The second point, remind me again, was the lecture I gave in New York?

Lord Lawson of Blaby: Yes, in New York.

Mr King: Yes. Well, I think that lecture should speak for itself. As you rightly said, what I tried to do was to analyse what I thought was wrong with the present system and I quite consciously stayed away from what I think is the right answer. I don't think there's any silver bullet, but I certainly don't think we should be content with the present system, and I think it is worth contemplating a wide range of reforms to see if we can't improve it. There is a body, of course, the Independent Banking Commission, doing exactly that, and because they've been set up, I think it is better to allow them now to produce their report, to present it to you, defend their conclusions. I'm happy to comment on it once it's come out, but what I don't want to do is to come out with my blueprint before they've reported. I think we should give them a chance to report, but I think the speech speaks for itself. I'd be happy if people read it, and I think they can draw their own conclusions. On the third, I think you touch on a very important point, because much of the reaction amongst media and the public to what has happened in the financial crisis is that they feel they didn't understand what was happening and perhaps the supervisors didn't quite understand what was happening. Therefore the answer was, in some sense, to be all over them, to monitor every single detail. Now, this, at one level, is a degree of madness, because to do it properly, you'll need one regulator for every employee in the financial services sector, and that makes absolutely no sense. What is much more important is a fleetness of foot in the micro-prudential supervision, to try to work out where the big risks are. I think that does go back to having senior, experienced people who can have a feel for whether a bank is doing something sensible or not. They will need a certain amount of detail to support them, but once the entire process gets subverted into focus on detail, the people running it are lost, overwhelmed by the problem of managing the process. So it is very important to avoid that. And I think the other aspect of fleetness of foot in the macro-prudential area is to ask questions about where activities might be risky or not. Now, you gave a good example about hedge funds, where we could rely there on market discipline, because there was no expectation at all that they would be bailed out. The result is they were simply unable to obtain leverage on the same scale as our major banks. The biggest leverage was in the major banks. But there are other aspects of the development of the financial system: money market funds in the United States were one, which developed as a means of funding the banking system without going through the regulatory hoops, and there I think the great skill of the Financial Policy Committee is going to be to say, "Here's a development which, if it carries on, could pose a threat, because it links directly to the banking system. What should we do about it? Should we consider bringing that into the net of regulation; should we not?" Those questions need to be discussed, but all of this is a million miles away from saying, "Here's a long list of all the financial institutions you can think of. Let's regulate every single one of them in massive detail" because it simply won't work. It's a suicidal mission to set out with this attempt to believe that whatever goes on, you can stop it. You can't. You have to work out which aspect of the financial system it's most important that we protect—the payment system, retail deposits, perhaps the financing of small and medium-sized businesses, are the most important. But work it out, what it is you need to protect under all the circumstances and, as far as possible, ensure that that is robust with respect to various shocks that occur. That principle is, I think, the most important one in the design of regulation.

Mr Tucker: Could I add two things to that, just on the shadow banking system? You're obviously right that the hedge fund sector didn't need to get bailed out and was subject to market discipline. As the Governor alluded to, the money market fund system did get bailed out in the United States; Fannie and Freddie were bailed out. So parts of the unregulated sector ended up being brought within the safety net and some weren't. But my bigger point is that one of our goals—not just in this country, but internationally—for precisely the reason you say, is to bring market discipline back within the banking system. It is completely unacceptable to us that the first line of defence should be management. And the second line of defence the regulators. We want to put in the way the board, the auditors, the equity holders and, perhaps most important of all, the bond holders. One of the things we're working on internationally is trying to come up with regimes that would mean that when big banks were in trouble, the bond holders lost money and effectively recapitalised the banks, rather than the taxpayers. If we can achieve that in a safe way—and there are hazards in attempting this, obviously—that would make quite a bit of difference, because it would reintroduce market discipline back into and around the banking system itself.

Q26 ***Lord Tugendhat:*** The question I am going to ask you follows, I think, quite well out of the discussion. In a recent speech, and I think you've just referred to it, you noted that since the 1960s, the assets of UK banks have increased from 40 per cent to over 460 per cent of GDP and the bank leverage ratios have been very high. So does this suggest to you—I think it does, in view of some of your public comments—that we should have a version of Glass-Steagall here in the UK? Indeed, you have become rather identified, I think, with the view that there should be a version of Glass-Steagall here in the UK.

Mr King: As I said just now in answer to Lord Lawson, I don't want to put a particular proposal on the table. I do think this is something where we need to hear first from the Independent Banking Commission and hear their views, and I don't want to make life difficult by putting out a specific blueprint for how to do it. Indeed, I think it will need a combination of measures. I suppose my reaction to the numbers that you pointed to was that one thing that clearly went wrong in the build-up to the crisis was that monetary policy did, in my judgement, a pretty effective job of ensuring that inflation was close to target and, as a result, that economic growth was relatively steady. You can't abolish the business cycle; no point pretending you can. Nevertheless, it was relatively steady. What we could not do by pursuing the policy: the level of interest rates that were necessary to meet the inflation target was not the same as the level of interest rates that we would have chosen in order to stop this extraordinary rate of expansion of the banking sector and the shadow banking sector taken together. One of the most astonishing facts in the build-up to the crisis was that in the five years leading up to the crisis in 2007, two-thirds of the total credit extended by our banking sector was not to households, not to companies, not to the real economy at all, but to the other parts of the financial sector. Therefore I think the conclusion is that, at the very minimum, you need some other policy instruments to prevent that rate of expansion of balance sheets. Now, that's one of the tasks of the Financial Policy Committee. Structural issues are very important, I think, as Lord Lawson alluded. I do think that we should look more deeply at the challenges of designing the appropriate banking system, not least because it has changed quite dramatically from the last 30 years, and the banking system we have now is very different from the one that we had 40, 50 years ago, and we need to ask questions about whether that's appropriate. One can take different views on that, but I think that the robust conclusion from this is that monetary policy is not a suitable instrument for trying to prevent excessive expansion, or indeed, excessive contraction of the banking sector. Other policies are needed to deal with that.

Mr Tucker: Nor, I think it's worth saying, do we embark on the FPC holding out the prospect that we can completely smooth the credit cycle. The goal is to restrain those parts, those phases of the credit cycle that are truly threatening to stability. If you like, not all bubbles end in complete tears for the whole of society. The dotcom bubble was largely in the equity market. The telco bubble in the early part of the decade was much more threatening. The reason I mention this is that as the months and years pass we're going to have to work hard to get across what it is we are aiming to do and what it is we're not aiming to do, and the time for that, of course, will be when the legislation is framed and the objectives of the FPC are put into statute.

Q27 ***Lord Tugendhat:*** Just one very brief supplementary: these are extraordinary figures reported at 460. Do you know off the top of your head, or would you be able to tell us, how that compares with other comparable OECD or EU countries?

Mr King: Well, I had numbers in the speech for the United States, where it's similar rates of expansion but at much lower levels. So instead of it being the banking system having assets almost five times GDP, which is the case in this country, in the United States, it's around one times GDP. That's why it's so important that we take a lead in this debate of the "too important to fail" question, because the United States—or for that matter, China—can afford to have banking systems that collapse every now and then. They're very big. Even a big banking system is still small relative to the size of their economy. We can't. If we want to be a truly international financial centre and a global banking centre, we have to solve this problem.

Q28 ***Lord Lawson of Blaby:*** May I have one brief supplementary? You said earlier, Governor, that it was very difficult to say what the effect of QE would be because you don't know what the counterfactual is or you don't know what would happen otherwise. Nevertheless, I can't believe that within the bank you have not done some work on this. If you have done any work on assessing the effect of QE, if you would let us have a note, that would be very helpful.

Mr King: The man who knows all about this is sitting on my right. Perhaps one sentence from him and then he'll send you a note.

Mr Dale: We have done some work. We've summarised that in various articles and working papers and we can make those available to the Committee. I think the simple summary statistic which we're most certain about, because of the problem with the counterfactual, we think roughly the £200 billion of asset purchases we undertook reduced long-term gilt yields by around 100 basis points. They then feed through into other asset prices and through into the economy, but the bit we're able to judge most precisely and gauge precisely, as used here with great grounds of uncertainty, the bit we're least uncertain about is that initial impact, where we think it would reduce gilt yields by around 100 basis points.

Q29 ***The Chairman:*** It would be helpful to have that further information, thank you. I was going to say one final question on auditors which Mr Tucker raises, but before I do so, can I ask colleagues if there are any other questions they would like to ask? Well, as you probably know, our main inquiry at the moment is into the Big Four, in particular of the auditors and choice and competition in that market. But what has come up in our discussions is some considerable criticism and comment about the role of the Big Four fundamentally, the auditors of the banks, who in the run-up to the financial crisis signed off the banks as going concerns, even though many collapsed soon afterwards. Does the Bank have a view as to whether this was a failure of audit, or if not, what else should be done to address this problem?

Mr King: I don't want to comment on what happened in the past. I'm not in a good position to do so. We weren't supervising or regulating banks, and I suspect that it wasn't just auditors, it was many other people, including the financial press, that lauded the success of these institutions, only to discover that they failed a few months later on. I think looking forward is more important and we certainly would think, in our spirit of supervision, in changing the style of culture of supervision, that it is very, very important for the regulator and supervisor not to try to do everything themselves, and have a regular dialogue with auditors and to make sure that auditors feel a responsibility for drawing to the attention of the supervisor matters that concern them. Now, this is difficult, because there is client confidentiality, but within that, it does strike me as very important not to pretend that the regulator can see things if the auditor just hasn't bothered to look at it. I mean, we must use the auditors who are experts in this area, and have a conversation and ask them questions and see whether concerns emerge. That has to be an important part of the way supervision is conducted in future.

Q30 ***Lord Lawson of Blaby:*** So far as you are aware, did that happen?

Mr King: I do not know. I honestly do not know.

Mr Tucker: But it is a question of recovering some of the things which were introduced in the late 1980s that followed the review that you asked for, when there certainly was a dialogue between auditors and bank supervisors, and that's something which we are very keen to ensure happens in the future.

The Chairman: It's very helpful to have that comment, because that's an issue which has come up in our discussion of auditors and I suspect it will certainly be one of the proposals that we come forward with.

Q31 ***Lord Hollick:*** One of the things that's come up in our inquiry, I know, is that there's quite a widely-held view that IFRS has been part of the problem and that, in particular, the mark-to-market rules had served to present an over-optimistic, glossy view of the state of the bank, and that the absence of the traditional auditors' scepticism about a true and fair view and prudential state of affairs has meant that we've ended up with a box-ticking process, which has not been helpful. Now, it seems to me that is a problem that is heading your way, as you look to the auditors to provide you with information which is going to help your new regulatory responsibilities.

Mr King: It's very important when looking at accounting conventions, I think, to acknowledge two points. The first one is that it is only a number, and if you therefore try to use it for looking forward to make future judgements, you need to recognise the enormous uncertainty about what could happen in the future. The second is that no management should ever use accounts as an excuse for imprudent behaviour. One thing that struck me about the use of mark-to-market accounting was that in the good times this was very convenient to people and, in some cases, returns were marked down as a profit when, if I use the insurance example, many of the elements of those profits were bound at some point to be offset by future losses down the road. Now, whether or not it makes sense to count it as a profit is a judgement, but it cannot be an excuse for managers to pay out as compensation or pretend that this is a sustainable profit level when it clearly isn't. No insurance company would count premiums as profit. They don't. This needs to be taken into account when looking at banking behaviour. But once the crisis had occurred, those people who didn't like mark-to-market, who may have used it on the way up, then tried to conceal the current state of affairs by saying, "We must not use mark-to-market", concealing from many people the true state of losses that had arisen. We have to recognise that the idea that there is one number that is going to accurately capture the risks and challenges facing an institution is very silly, and that when a crisis occurs or there's a downturn, those people who have made loans need to form a prudent judgement about what is likely to be the expected losses. How that's accounted for is something which I'm quite happy to leave to the accounting profession, but in terms of behaviour, trying to think about where the losses could occur in the future, the fact that the accounting convention says you don't have to recognise a loss until the lack of payment has occurred doesn't seem to me a very sensible or prudent basis to make business decisions. But business decisions need to be separated from saying, "Well, this is what the accounts say we can or cannot do".

Mr Tucker: If a firm wants to mark to market part of its portfolio, it has to recognise that in consequence it has exposed its accounting measure of solvency—and therefore its company law measure of solvency is exposed—to swings in the value of those asset prices. Therefore the regulatory standard setters need to be more alive than they have been to the behavioural consequences of accounting policies. The accounting policies may or may not be flawed, but once they've been adopted, they're a given, and the standard setters and the supervisors have to be alive to the behavioural consequences of them, and the management of the firms themselves can't opt for mark to market for part of their world and not live and breathe it. Some firms live and breathe mark to market. For some, it was an accounting policy which then shot them. Now, whether the flaw was in the accounting standard or in the management of the firms or on the regulatory regime, I wouldn't like to say, but the three things need to be joined up.

Q32 ***Lord Lawson of Blaby:*** I know, Chairman, you wanted to bring this to a close, but just to come back, it does seem a bit surprising that the auditors, looking at this huge expansion in the balance sheets and so on, didn't feel the need to at least flash a red light or a warning bell, don't you think?
Mr Tucker: As the Governor said, it's hard for us to know how close or not close they were to the audited firms during that period, because it wasn't part of our formal responsibilities at that time, so I would be speculating.

Q33 ***Lord Tugendhat:*** I don't want to ask you to look back, but I'd like to ask a question looking forward. Lord Lawson asked a question about the flow of concern from auditors to regulators, but looking at it the other way round, if there is an area of concern to the regulator either about the sector in general or about institutions in particular, do you think it would be helpful for the regulator to ask the auditor particularly to look at that matter and to give the regulator a report on how the auditor feels about it?
Mr King: I think that may well be very sensible. Now, I'm not an expert on the complicated relationship or the legal and confidential responsibilities of auditors to their clients but, as I said before, the way we want to conduct supervision will certainly involve conversations with the auditors and they will therefore be responsible for providing us with accurate and good judgements about what they have seen and their impression of the institution. I think the most important thing in this area is to realise that any one set of numbers, be it mark to market or any other set of conventions, may well be the answer to only one question, and there are several questions that you could put about a company or a bank to which maybe different calculations are the right answer. The idea that there's just some magical set of numbers, which in all the circumstances are the only ones we want to look at, is a very dangerous philosophy. I think having an ability to ask questions for the whole approach to stress-testing of banks that's emerged in the last two or three years has enabled the regulators to ask "what if" questions of the banks—"What would happen if . . . ?". That will become part of our supervisory approach and philosophy too, to have the ability to do that, rather than just the banks downloading masses of information to us, which may or may not turn out to be useful. We want to be in a position to ensure that the institutions themselves are monitoring the risks and have access to the information so that we can ask for it when we think it's appropriate and not be swamped by their filling in boxes and sending stuff off to us, which may or not be useful. So there will need to be a change in style and approach, and the sort of questions you've raised are very germane to that.
The Chairman: Governor, you and your colleagues have been very generous of your time this afternoon, and you've certainly given us a most interesting and worthwhile exchange of views on a wide range of topics, and views that we will clearly ourselves wish to think about. I'd like to thank you very much indeed. I hope that we can give some thought to how we can get a wider circulation for the exchanges this afternoon, than just for those in this room, because I think there are many points that would be of greater interest to a wider public. But can I thank you again very much indeed for coming, and we hope that before too long you will come back again.
Mr King: Thank you very much, my Lord Chairman.

Supplementary letter from Mr Spencer Dale, Executive Director and Chief Economist, Bank of England

At the hearing of the Economic Affairs Committee on 16 November, Lord Lawson enquired about published material on Asset Purchases and their impact. In response, I promised to make available to the Committee some of the analysis that the Bank had published on the effects of Asset Purchases. A selection of articles and speeches is enclosed. It contains:

1. A transcript of the Governor's 5 March 2009 interview with BBC television in which he explained the nature and purpose of the MPC's decision to inject money directly into the economy through asset purchases. http://www.bankofengland.co.uk/monetarypolicy/assetpurchases_stream.htm

2. An *Inflation Report* box from May 2009 setting out the channels through which asset purchases are likely to influence nominal spending and the factors influencing the effectiveness of purchases. http://www.bankofengland.co.uk/publications/inflationreport/ir09may.pdf
3. A *Quarterly Bulletin* article from June 2009 which covers similar ground to the *Inflation Report* box but in more detail. http://www.bankofengland.co.uk/publications/quarterlybulletin/qb090201.pdf
4. My speech of 12 March 2010, "QE One Year On", which set out my view on the theoretical foundation for unconventional monetary policy and some estimates of its impact on gilt yields. http://www.bankofengland.co.uk/publications/speeches/2010/speech428.pdf
5. Bank of England Working Paper No. 393, which was first published in July 2010. This paper covers the impact of asset purchases on financial markets. It provides greater detail behind the estimates reported in my speech, as well as analysis of impacts on other asset prices. http://www.bankofengland.co.uk/publications/workingpapers/wp393.pdf
6. A selection of speeches by other MPC members, setting out their views.

   "Money, Banks and Quantitative Easing" by David Miles, 30 September 2009 http://www.bankofengland.co.uk/publications/speeches/2009/speech404.pdf

   "Quantitative Easing: an Interim Report" by Charles Bean, 13 October 2009 http://www.bankofengland.co.uk/publications/speeches/2009/speech405.pdf

   "An unconventional journey: The Bank of England's Asset Purchase Programme" by Paul Fisher, 11 October 2010. http://www.bankofengland.co.uk/publications/speeches/2010/speech453.pdf

I hope that this is of interest and I would appreciate it if you could arrange for circulation to Lord Lawson and other Committee members. I would of course be happy to respond to any questions or queries the Committee may have on the impact of Asset Purchases.

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