Responses to questions for Mr Andrew Bailey from House of Commons Treasury Committee

Personal/general

1. Do you intend to serve the full term for which you have been appointed?

Yes, I intend to serve the full term. I have a record of seeing jobs through in the Bank of England. I took over as Chief Cashier of the Bank at the end of 2003 in quite difficult circumstances and spent just over seven years in the role. I am very proud of what the Banking Directorate achieved during that time. My approach to the PRA-to-be has been similar over the last, nearly, two years, and I can assure you I will stick to the task.

2. Please explain how your experience to date has equipped you to fulfil your responsibilities (a) as Deputy Governor for Prudential Regulation and (b) as a member of the Financial Policy Committee.

Let me start with the role of Deputy Governor for Prudential Regulation and Chief Executive of the PRA.

I have experience in prudential regulation going back to the late 1980s. For around four years at that time I was heavily involved in the implementation of Basel I and subsequent agreements on the policies towards market risk and group supervision. During this period, I was also heavily involved in international policy negotiations. From this, I developed a strong understanding of the basic building blocks of prudential supervision, and the strengths and weaknesses of the Basel I framework.

Subsequently, I had a long period of my career when I was not involved in prudential supervision but had a series of roles in the Bank of England, all of which have provided valuable experience for my new job. I had two periods working in the Banking Directorate, latterly as Chief Cashier, which – I like to think coincidentally – have been times when the Bank has been involved in resolving failed banks. The first period covered the resolution of National Mortgage Bank (my first), and the Bank of England's "behind the scenes" operations to manage the failure of Barings for which I was responsible. The second period, as Chief Cashier, coincided – in my later years in the role – with the financial crisis, during which I led the Bank's support operations and resolution actions for failing banks. These experiences have been invaluable in helping me to understand how banks do (and do not) work effectively. There are in my view few better learning opportunities than to be responsible for resolving failing banks.

During the crisis period I therefore had to manage and take responsibility for very difficult and high-profile operations. I was also responsible for the Bank of England's use of the so-called London Approach, under which it can apply its powers of persuasion to overcome problems of lender co-ordination in the restructuring of company debt. This provided me with very valuable insights into the issues around loan restructuring for non-banks.

During the second half of the 1990s I was Private Secretary to the then Governor, Eddie George. This included the period in 1997 when the Bank was given independent responsibility for monetary policy, and the creation of the FSA (the latter in more difficult circumstances). Having been present at many of the founding moments of the Tripartite system, I can well understand why the system suffered from structural failings which ultimately damaged the response of the UK authorities to the crisis.

My time in charge of resolution at the Bank during the crisis obviously gave me a close insight into the working of the FSA and the difficulties it had experienced with prudential supervision. I felt that this meant it was sensible for me to play a role in the new arrangements when the Government announced the changes to financial regulation. To that end, I joined the FSA at the end of March 2011 (though retaining my position as an Executive Director of the Bank of England in view of my responsibilities there for the work to create the PRA) in the role of Director responsible for prudential supervision of banks and Deputy Chief Executive Designate. Just over a year later, when Hector Sants left the FSA, I became Managing Director for prudential supervision covering the full scope of the PRA-to-be. It was around that time that the FSA implemented so-called Internal Twin Peaks, creating the shadow FCA and PRA run by Martin Wheatley and me reporting to Adair Turner. For the last year I have therefore been undertaking much of the future role of Chief Executive of the PRA. This has obviously given me a great deal of experience of what is likely to lie ahead. It also means that I have taken the leading role in creating the PRA as an institution.

I can cover the FPC more briefly since a good deal of the experience described above is relevant. I have been a member of the Interim FPC since last Spring. Between 1999 and 2004 I was Head of the Bank of England's International Economic Analysis Division, and while the work of this Division was to serve the MPC, it required the intellectual and analytical rigour that also marks out the FPC. Moreover, before joining the Bank in 1985 I had a university research background.

Summing up, my career has combined analytical experience and a strong background in managing operations. As Chief Cashier I was responsible for managing the Bank's banking, payments and banknote operations as well as bank resolution, amounting to around 450 staff. I have therefore substantial experience in getting things done.

3. **Which of your speeches or publications are of most relevance to your future roles?**

The following are speeches and papers that have been published which I think are most relevant to how I intend the PRA to operate, and how I will carry out the role.

Documents
PRA Approach to banking supervision (October 2012)
PRA Approach to insurance supervision (October 2012)

Insurance supervision
The evolution of insurance regulation: a shifting scope and new frontiers (February 2013)

Banking supervision
Prudential regulation: challenges for the future (October 2012)
The future of banking regulation in the UK (October 2012)
The challenges in assessing capital requirements for banks (November 2012)

4. What do you regard as the main challenges that you will face as Deputy Governor of the Bank of England and chief executive of the Prudential Regulation Authority in the next five years? What criteria should be used to assess your record?

I see two main challenges ahead, and I stress that there is no order of importance here as they rank equally in my view.

The first challenge is to promote the objectives given to the Bank for financial stability. This means building two successful and lasting institutions within the Bank, the PRA and the FPC. Parliament has given the PRA clear objectives around the safety and soundness of banks, insurers and major investment firms, and the protection of insurance policyholders. For banks, our objective will be amended as a consequence of the legislation to implement the recommendations of the Independent Commission on Banking.

Our general objective is to build a resilient financial system in which the public can have confidence that they will have access to the critical financial services on which they depend. An important and necessary complement to a safe and sound financial system is one in which financial institutions support the growth of credit and investment in the economy. I should emphasise that my focus here is as much on the insurance industry as it is on the banks. Insurance and risk transfer services are just as critical to a stable financial system. I am by comparison new to insurance, but I take it very seriously.

I have been responsible for setting out the PRA's approach to microprudential supervision, notably in the two documents (covering banking and insurance) that we published last autumn. These documents set out our emphasis on supervisory judgement applied against a framework of rules, but not an emphasis on more and more rules as a means to create

compliance by firms. Judgement needs to be applied in an open and fair way, and it is vital that the PRA is transparent and accountable for its actions. I put great emphasis on explaining to our staff, senior executives, board of firms and all interested parties that our supervision of firms is focused on the key threats to the PRA's statutory objectives. We must be focused, and we must avoid the sort of detail that causes supervision to lose sight of its objectives.

Judgement is an easy word to use, but it comes with challenges and we must recognise these and deal with them. We must apply judgement in a way that does not create unnecessary uncertainty. Judgement is important because we must be forward-looking, focused on the key risks to firms in terms of our objectives. But we must not allow that to create uncertainty over our likely reactions. That said, judgement can in my view be helpful in countering a culture of gaming which arises from undue reliance on rules. And, we must remember that we are supervising at least one industry which is notable for its use of imaginative innovation.

The main challenge to judgement in my view comes from an approach in Europe which seeks to use detailed rules and so-called maximum harmonisation to create consistency in supervision. I do not think this will work as intended as an approach, and I hope that we can persuade the European institutions that their best interest lies in having strong supervisory institutions that can apply judgement sensibly. It is with this hope in mind that I support the role of the ECB in the Banking Union. That said, we must be alert to the risk that other European institutions will apply pressure to adopt the approach of detailed rules.

The PRA approach to supervision is also one in which it is intended that financial institutions can fail, but that, if they do, their failure will be controlled and will not threaten the stability of the financial system. There is, of course, major work that remains to be done here, to remove state subsidy and too big/important to fail. I am fully committed to continuing to play an important part in contributing to the development of a resolution regime that can credibly achieve the end of state support. An important part of this work is also the finalisation and implementation of the legislation to implement the recommendations of the ICB.

Turning to the FPC, it is vital that macroprudential policy is effective as a complement to and alongside microprudential supervision in the PRA. Put simply, the success of the FPC means that macroprudential policy is no longer essay writing but has real operational impact in terms of its recommendations and directives. This requires rigorous assessment of risks and vulnerabilities, application of those in quantified form using, for instance, stress tests of the financial system, and a stronger understanding of risks from outside the boundaries of regulated activities. The FPC has to ask hard questions on the structure of the system, and it has to avoid too great a focus on fighting the last war. As an example, we have been through a major prudential crisis in terms of financial positions of firms, and then more recently very serious events resulting from past misconduct by firms, but we should not forget the possible impact of, for instance, cyber attacks.

As Deputy Governor of the Bank, I will also be responsible, with the Governor and other Deputy Governors for leading the institution through a period of major change. I look forward to this. The Bank has great strengths as an institution which come from its reputation, and from the quality of its staff. I am very excited that a new group of staff will be joining the Bank, and I am confident that the PRA and its staff can contribute to the new Bank. What stands out for me in the Bank and the PRA is a commitment to being very good at delivering our objectives. Much of the public profile of the Bank is naturally around the policy making functions which have a high media profile. I have also been lucky enough to work with very talented staff who deliver the Bank's operations, and most recently this has been evident in the delivery of the PRA in its new home in Moorgate.

The challenges ahead are to ensure the Bank can function in a world with more responsibilities which are effectively joined-up, to give our very talented staff opportunities to participate fully in advising on and delivering our decisions, and to ensure that the governance and accountability arrangements of the Bank deliver as promised.

In terms of how to assess my record when the time comes, I see this as very much in terms of creating stable and lasting institutional structures for financial regulation (macro and micro-prudential). The reforms of 1997 created a stable institutional structure for monetary policy, but they did not create the same legacy for financial regulation. We have another chance to do this, one that we must take.

5. How would you describe your leadership style?

I am unashamedly a hands-on leader, and I don't like being isolated from what is going on. I have had a lot of operational leadership experience, with the most pressure coming during difficult financial resolutions. That said, I have put great emphasis on recruiting and developing strong management teams throughout the areas that I have run. The PRA in my view starts with a strong management team which has a clear vision and commitment to our approach to supervision of firms. It is very important to have such a team who are, like me, committed to putting into effect supervision to pursue our statutory objectives, and to having an open style of communication and accountability.

I am also committed to running a tight ship in terms of the size and cost of the PRA. We have deliberately set out not to use the creation of the PRA as an excuse to expand prudential supervision and put up the cost to supervised firms. That is not part of our philosophy or objective and I believe it is consistent with the Bank of England's record of cost control. I thought it might therefore be helpful if I set out my thinking on the cost of the PRA.

The starting point was to set a budget for the PRA in its first year which is no higher than what we think the PRA would have cost during the next year under the current FSA set-up. To this end, we froze the PRA headcount early in the transition process (around two years ago) and have been vigorous in pursuing that approach since. Consistent with the Bank of England's general approach we have set a budget in future years which is no higher

than a flat real cost of operation. This is the baseline approach we have taken for the PRA. There are a number of further points I would draw out on the PRA's budget:-

- The flat real cost budget applies to our annual regular (or recurrent as we call them) costs. There are also non-recurrent costs for projects that are not expected to be permanent. Last year, the major element of these for the FSA was the cost of preparations to implement the EU Solvency 2 Directive for insurers. I have recently written to the Parliamentary Commission on Banking Standards on this subject, and would be happy for that letter to be shared with the Treasury Select Committee. Last year the FSA levied £15mn in respect of Solvency 2 costs. For the next year, we intend to levy just £0.1mn. The difference reflects cut backs that we have applied to Solvency 2 preparation costs. Although it is hard to be sure of the final cost of Solvency 2 preparations given the uncertainty on timing and substance, I expect the overall cost to be considerably lower than previously estimated. This will be a saving for insurers.

- In the early years of the PRA, we are using part of the budget to fund investment in systems which will replace those legacy FSA systems that the PRA will in the meantime continue to use. The PRA will also pay an annual fee to the FCA for the use of these systems. I expect that the cost of operating the new systems will be lower, though at this time I cannot estimate that saving.

- Likewise, in the early years of the PRA we will be recovering the costs of setting up the new arrangements, and this will fall away after five years.

- Finally, the PRA levypayers will have to bear their share of the legacy FSA pension deficit once a new valuation has been done. At this time, I do not have an estimate of this cost.

I hope that this description of the approach to the PRA's budget makes clear my commitment to keep a tight rein on spending. I also welcome the National Audit Office undertaking value for money assessments of the PRA once it is up and running.

Financial stability and the Financial Policy Committee

6. How would you define financial stability?

The experiences of the financial crisis have caused many people, me included, to modify their definition and thinking about financial stability. Like quite a few people, I would now put more emphasis on a stable system being one which can continue to deliver critical financial services to the public without disruption and dislocation to the economy in the face of a wide range of severe shocks (both economic and operational). In this context, the PRA is charged with ensuring the safety and soundness of the firms for which it carries out prudential supervision, and for the protection of insurance policyholders. But we have also made clear

that we do not intend to achieve financial stability by maintaining a regime in which firms cannot fail or one where the dependence on taxpayer support continues. We regard this as counter to establishing a healthy and stable financial system; rather, orderly failure in which firms do not disrupt the supply of critical financial services is consistent with the PRA's objectives.

7. What do you regard as the strengths and weaknesses of the work undertaken by the interim FPC?

The Interim FPC has been given two tasks: first a 'paving' task in terms of setting out the tools that it thinks should be at its disposal, and the framework within which those tools should be used; and second, it has been functioning as the macroprudential regulator, albeit without the full set of eventual tools. The first activity is an important investment for the future, which has recently led to the publication of a discussion paper on "Instruments of Macroprudential Policy".

The FPC has two objectives, namely the resilience of the financial system and, subject to that supporting the economic policy of the Government, including its objectives for growth and employment. Resilience is defined in terms of taking action to remove or reduce identified systemic risks. The FPC has focused to date on, risks in the banking system, and in doing so has provided valuable guidance on the overall objectives of firm level liquidity policy in the banking system. Last June, the FPC and FSA provided clarity and guidance on how banks could expect to use their liquidity buffers; the FSA changed its stance on such buffers; and the Bank of England extended its liquidity insurance tools. I judge these interventions to show encouraging signs of success. To be clear, there is still a need to identify and seek to remedy blockages to small firm finance, but the last nine months have seen a change in bank's funding conditions and growth in loan availability, most notably in mortgage lending.

That said, the Interim FPC has been working in conditions where there remain questions over the appropriate levels of capital buffers to be maintained in banks. The recommendation given by the FPC to the FSA in November is in my view appropriate in that it frames the question around the proper valuation of assets, a realistic assessment of future conduct costs and prudent calculation of risk weights. None of these areas is easy in terms of determining appropriate levels of capital buffers to meet possible losses in the future, but the FPC has in my view asked the right questions in a way that will force a more consistent answer. This is the sort of discipline that was lacking in the previous system.

My assessment of the weakness of the FPC's approach to date in this area is that it took time to frame the question, and particularly in a way that can be explained to the public and financial markets. Regulators have to be very careful not to create unnecessary uncertainty, and I think the FPC will need to consider its style of communication, and will need to invest heavily in building an understanding among the public and a consensus in favour of its objective of resilience which can readily identify itself as such (ie active not just positive acceptance). The history of the MPC suggests that this task can be achieved, but we should

bear in mind that the FPC has come in to being in much more difficult circumstances than was the case for the MPC, and it is operating in a field of policymaking which is less well defined than was the case for the MPC.

8. How should the FPC communicate financial stability policy and decisions, in particular to the general public?

There is no doubt that macroprudential policy is less well understood than monetary policy and in important ways is more complex to explain. In broad terms, the FPC can pull more levers, and thus its decisions do not reduce to a signal quantified outcome. I have given a number of speeches on this topic, some of which I have identified in the answer to Question 3, and I intend to continue to do so. I think that it is a duty of belonging to the FPC to take time to explain our objectives and activities to a wide range of audiences. Building a body of understanding and support for the FPC is vital work if we are to achieve the same institutional reputation that the MPC has achieved. As part of this work, I visit different parts of the UK, using the Bank's network of Agents, and spend time meeting with contacts who are interested to know more about the FPC and PRA. I have also sought to use media interview opportunities to promote the role of the FPC

9. What is your assessment of the macroprudential tools that will be available to the FPC? Would you have preferred the FPC also to have the ability to limit loan to value and/or loan to income ratios?

The FPC asked for three macroprudential instruments as direction powers: sectoral capital requirements, the leverage ratio and a power over the countercyclical capital buffer. The Government has proposed to grant the FPC these powers, although power over the leverage ratio will not be granted before 2018 (and subject to a review in 2017). These three tools are an appropriate starting point. Macroprudential policy is a developing area, and the Committee recognises that there is uncertainty about how its tools will affect credit conditions. It will keep the impact of its use of the instruments under review and it may also conclude that it needs additional direction powers.

Even where it does not have direction powers, the Committee will be able to make recommendations to the PRA and the FCA on a comply or explain basis. During the Committee's interim phase, the FSA has taken several actions in response to FPC recommendations to tackle risks identified by the Committee, as well as supporting other aspects of the interim FPC process. My experience to date is that these tools are appropriate and well understood by the FPC and supporting staff.

In March 2012, the FPC considered recommending that it have direction powers over loan-to-value and loan-to-income ratios, but decided it would not advise that the statutory FPC be given such powers in advance of further analysis, reflection and public debate. I should note that this was before I was appointed to the Interim FPC. Such instruments have advantages and disadvantages. On one hand, there is experience in some countries of using

such tools to limit financial instability, and the tool would enable the FPC to act on all regulated UK mortgages, even if the lenders are not prudentially regulated in the UK. On the other hand, it would be difficult for the FPC to determine sustainable levels of property prices, and the Committee noted that the tool would have direct effects on individuals and businesses.

I accept that the loan-to-value/income tools are very powerful and its use by an unelected body would need careful debate. I say this because I am uneasy about the FPC's position being compromised by difficult political-economy considerations. There are in my experience two areas of lending which over time have proved to be difficult in this country, namely high loan-to-value mortgage lending and lending to small firms.

I suspect that the root causes of both are more structural issues, not least that they have more of the characteristics of equity financing than typical loan contracts. I make this point because it is not clear to me that the FPC should seek to use its tools to regulate something (in the case of high LTV lending) which has a more structural element. In other words, the terms of access to high LTV loans is an issue at all times rather than only at times when a countercyclical policy would suggest action. That said, it is still open to the FPC to recommend that steps should be taken to increase the cost of high LTV lending by changing the regulatory capital requirement against such loans.

10. How powerful will the FPC's powers of recommendation be?

The Financial Services Act 2012 states, in section 9Q, that "The Financial Policy Committee may make recommendations to the FCA and the PRA about the exercise of their respective functions" and that "if the recommendations are expressed to be recommendations to which this subsection applies, the body to which they are made must as soon as reasonably practicable (a) act in accordance with the recommendations, or (b) if to any extent it does not, notify the Committee of the extent to which it has not acted in accordance with the recommendations and of the reasons for its decision."

As such, the FPC will have a powerful power of recommendation. The PRA will have a PRA Board, constituted of the Governor, Deputy Governors for Prudential Regulation and Financial Stability, the CEO of the Financial Conduct Authority and at least three independent directors. The PRA Board will discuss all recommendations made by the FPC to the PRA, and direct the work that should be carried out to meet the recommendations. The PRA Board will therefore have the role of deciding whether they agree with the recommendations made by the FPC and in what form and over what period of time a recommendation should be implemented.

Prudential Regulation Authority

11. What are the principal challenges in creating the PRA within the Bank of England?

I believe there are three main challenges facing the Bank of England and PRA: a numerical increase in the number of staff; cultural differences; and undertaking insurance supervision for the first time.

The creation of the PRA will see the Bank of England grow, in headcount terms, for the first time in the memory of staff there. The number of staff in the Bank will grow by over 50% with the addition of 1070 PRA staff. Since the Chancellor of the Exchequer's announcement of his intention to create the PRA in June 2010, we have been working to ensure that staff can move successfully from the FSA to the PRA. This has involved leasing a building in the City close to the Bank; a major IT project to link the two organisations; as well as a change to supervisory focus. This work will be completed by so-called "Legal Cutover" on 1 April 2013.

Since the supervision of banks moved to the FSA from the Bank of England in 1997, there has been a substantial divergence of culture between the two organisations. The primary reason for this was that the FSA was made from an amalgamation of numerous different regulators, so developed a very different approach to that of the Bank of England.

Substantial changes have been made in prudential regulation at the FSA since the start of the financial crisis. The FSA began a programme of "intensive and intrusive" prudential supervision. This had some successes in rectifying the pre-crisis failings of not concentrating sufficiently on prudential supervision, but such a process can lead to extremely detailed work.

As a result, I have looked to introduce a supervision approach where prudential supervisors concentrate on the biggest risks to our statutory objectives posed by the firm, rather than pursuing a myriad of issues that in some cases resulted in the FSA being more like an internal audit function than a regulator.

This approach requires rigour in the assessment of risks posed by firms to our objectives. It also requires an ability to be prepared to make judgements, assess their priority and stick by decisions on their importance. I think that we have already seen a strong improvement in the quality of prudential supervision, but we should be under no illusion that there is further to go, and that in our line of activity the constant changes in the world that we supervise means that we have to change ourselves.

There are a number of important areas of the PRA's activity that we recognise remain to be tackled fully. Under the so-called Steady State programme of work which will build on the work of the programme to create the PRA, there will be an overhaul of the approach to seeking and managing data requested by the PRA to further its objectives. Data are obviously important to a supervisory authority such as the PRA. The history and legacy of

the FSA indicates the need to improve the approach towards requesting and processing data. The PRA will not overburden firms with unnecessary data requests, and will build systems to allow data to be submitted and used efficiently by supervisors. That said, one important fly in the ointment on this front is the impact of the enhanced European data reporting standards. We have assessed that in some areas these requirements could lead to an increase in data submitted by firms by up to ten times the current amount. Some of these extra data may turn out to be of use to the PRA, but I cannot believe that such a large increase could be justified on the basis of needs.

12. What will "judgement-led supervision" consist of in practice? Can you give examples from your recent work at the FSA?

The most high profile case to point to is one I discussed with the Committee in July 2012 regarding the management culture at Barclays. Throughout 2011 and early 2012 there were a number of instances where Barclays were "gaming" the FSA. As the Committee knows, I discussed this with the Board of Barclays, and subsequently Lord Turner wrote to the Chairman of Barclays. This is the type of action that the PRA will, if necessary, take. Moreover, I regularly meet with Boards, and will raise concerns with them.

Another example is capital levels. Basel II introduced the ability for banks to create model-based approaches in order to determine their capital requirements. Some of these models, particularly in the area of commercial property, were, simply not of the right standard. Banks were able to arbitrage the models, and some bad models were approved. In response to the crisis we have taken action in order to apply judgement to rectify the failures in these models by adding what is known as a Pillar 2 capital buffer. To put this into numbers, since 2008, Pillar 1 capital in the major UK banks has increased from £151bn to £186bn. Pillar 2 capital buffers, set using supervisory judgement, have increased during the same period from just under £20bn to £150bn.

13. Would the new Prudential Regulation Authority have benefited from a specific secondary competition objective?

There are in the current form of legislation in our area of policy two approaches to a secondary objective. Parliament has chosen to use the "have regards to" form to set out its intention on competition, which means that when considering its statutory objectives, the PRA must have regards to competition. The alternative is to set out – as for the MPC and FPC – a secondary objective which is subordinated in the sense that it is "subject to" achieving the primary objective(s). Also, the FCA has a primary competition objective. It would not in my view make sense for the PRA to have a primary competition objective, which would confuse the FCA's role, and I would be against this. As to the alternatives, I don't have a strong preference.

14. What opportunities and challenges do you foresee being created by developments in financial regulation at international level?

Most policy for prudential supervision is now developed at the international level, and that is entirely sensible given the international nature of major banks. The insurance industry is not as well advanced on this front, but a number of major initiatives are under way.

Typically, policy is created in the Basel/Financial Stability Board arena, but in the EU is then implemented into law via EU legal processes. Some policy comes directly from the EU processes, and this model is more common in insurance (or, at least, it would be if Solvency 2 is finally agreed at some point). The FSB has been a welcome addition to the landscape by acting as a spur to drive on progress in the very necessary but ambitious agenda created by the experiences of the crisis. My best guess is that as we hopefully move into a more steady state world following the completion of much of this agenda, some rationalisation of the Basel/FSB architecture of policy-making bodies should be possible, but that is something that will probably happen quite naturally.

The European processes are something in which we invest substantial resource and effort, and this is necessary given the impact that they can have on our approach to supervision. Like the Government, I welcome the creation of the Banking Union with its stated aim of giving the European Central Bank the leading role in exercising supervisory authority, particularly over the largest banks in the Banking Union area. I will certainly support the ECB in their work to build the capacity to do this task, because for the PRA it will be important to have the ECB as an effective counterpart. That said, I do not support the UK joining the Banking Union because it is an intended solution to the problems of banks operating in the euro area. Moreover, and to qualify this comment, it would be incorrect and putting too much pressure on the Banking Union to think that on its own it can solve the problems of the euro area, but if done well it can certainly help.

But the EU processes also create difficulties for the PRA, and this could be an area of future tension. The PRA approach is quite clearly one which uses supervisory judgement against a framework of rules. In the EU processes I see a pressure to create more binding rules at an ever more detailed level, and to use the so-called maximum harmonisation approach which in effect means that the rules set both the minimum and maximum standards to be applied. Failures of past supervisory judgement have led to a pressure for more rules in the European Union, as has the pressure to preserve the Single Market. I strongly support the free trade underpinning of the Single Market, but I do not see ever more detailed rule-making as a sustainable solution to the identified problems, and nor is it necessary to achieve the free trade objectives of the Single Market. Supervisory judgement in the application of rules has to be exercised within an institutional structure that has authority. The PRA will benefit from the authority of the Bank of England in this respect, just as I hope the ECB will exercise similar authority in the Banking Union. But there has to be scope for these authorities to exercise judgement because they are dealing with risks that may appear in the future. This

distinction between a forward and backward-looking approach lies at the heart of the difference between applying judgement and ticking boxes.

15. Can you envisage there being conflicts between macroprudential and microprudential policy? If so, how should they be resolved?

First of all, I do not see the scope for inherent tension between macroprudential and microprudential supervision because the objectives of each have been well defined in statute. For instance, the FPC must take responsibility for risks at the level of the financial system, but it must not recommend policies on the safety and soundness of individual institutions. This is all well understood in my view.

The second protection in this area is transparency and accountability. Neither of these worked well in the post-1997 structure of financial regulation and supervision, and that is part of the cause of failure in the system. To take the role of the PRA as an example, if the Board of the PRA does not accept the full terms of a recommendation made to it by the FPC, it must explain why it is deciding not to comply with that recommendation. This will be transparent, and will no doubt be subject to review by the oversight process of the Court of the Bank of England, and also the Treasury Select Committee.

As to whether there will be conflicts, the scope for such an outcome will be reduced by the clarity with which both bodies set out their approaches to their tasks. I believe that the work done to date, and published, on the FPC's Tools and the PRA's Approach to Supervision gives grounds for optimism on this front.

16. Can you envisage conflicts between the work of the PRA and that of the Financial Conduct Authority? Can you envisage using the PRA's power of veto over FCA decisions?

There is a natural difference of interest between prudential and conduct supervision which flows from their different objectives in statute. The identification of these different interests lies at the heart of the so-called Twin Peaks approach that the reforms are about to introduce. My own experience of working in the senior management of the FSA for the last two years has helped me to understand better the issues that can arise. I think that over its life the FSA has found it very difficult to achieve a stable balance between prudential and conduct priorities. This is not surprising, or intended as a criticism, because under integrated supervision the FSA has had to balance many competing priorities from around 25,000 authorised firms. Since the introduction of so-called Internal Twin Peaks in the FSA nearly a year ago, I have observed the benefits of the separation leading to a clearer articulation of both prudential and conduct cases in areas where the two naturally come together and can (again, naturally) lead to different preferences for outcomes.

The question raises the possibility of the PRA using its power of veto over FCA decisions where differences of preference become acute. First of all, it is important to bear in mind that

the statute rightly sets a rigorous framework around the use of the veto which is tightly linked to the PRA's objective in terms of the safety and soundness of firms in the context of the stability of the financial system (the PRA's General Objective). I would note here that the veto cannot be used in the context of the PRA's insurance objective to protect policyholders, which I do not envisage at this time as a problem. As a general matter I start from the presumption that powers are put into statute to be used, so we must contemplate use of the veto (and I say that not with any intention to be trigger happy). But I can see a situation (and this is an entirely hypothetical scenario) where a major issue for the FCA which requires substantial redress and cost to a PRA supervised firm or firms could be of such scale that the PRA uses the veto to achieve a different outcome (for instance, a more elongated redress period). Also, I think that it is important not to regard such an outcome as a failure of the system of supervision. On the contrary, I can see circumstances in which it would be in the interests of both the FCA and the PRA for the veto to be used where appropriate so that there is clear transparency and accountability in the decision-making. This strikes me as better than opaque back-room compromises.

17. How will you coordinate the work of PRA staff and that of the Bank of England staff working on financial stability?

Over the last six months or so, as the creation of the PRA has become more of a reality, and particularly now that we have moved into our new home in Moorgate near to the Bank's main building. I have been keen to encourage greater co-ordination of working across many parts of the Bank. A senior member of the Bank staff has taken responsibility for a programme of work to build contact and greater understanding of the work of each part of the Bank and PRA-to-be. It is of course a reflection of the weaknesses of the previous system that this type of engagement was not more commonplace. Contact is increasing, and we have launched specific initiatives, for instance with Bank staff taking a larger role in the creation of scenarios for PRA stress testing, PRA staff providing insights for Bank staff on the impact of sustained low interest rates on insurers, the extensive work on market intelligence and substantial work around resolution planning. In my view, as the two groups of staff come together, our task is to let these initiatives take root and encourage further co-ordination.

18. Is the UK banking system too concentrated?

There is no doubt that the UK banking system is more concentrated than it was before the crisis, when the demutualised building societies were still present, and a larger number of foreign banks were active. This was certainly true of retail banking models. The crisis revealed many of these businesses to be unsustainable and to be deeply flawed in their business models. It follows that greater competition in the future must be based on robust and sustainable institutions that meet the PRA's safety and soundness objectives. I firmly believe that we cannot compromise on our objectives of safety and soundness because to do so will create unsustainable competition and trouble ahead.

In sum, I want to see a more diverse banking system, but not at any cost. To that end, we will be publishing changes to the prudential authorisation requirements in order to lower barriers to entry for new banks. The broad outline of these changes was described by Adair Turner in his recent evidence to the Parliamentary Commission on Banking Standards. I believe that these changes will mark an important step forward in promoting the entry of new banks in the UK market. There is a very important principle underpinning the changes that we will make on the prudential side, namely that where a bank can demonstrate to our satisfaction that it could be subject to resolution without unacceptable uncertainty about the threat to an orderly process of resolution, then we should lower the discretionary capital requirements to which it is subject (in the Basel language, this is the Pillar 2 requirement). I think that this means, given the current state of confidence around resolution outcomes, that banks must demonstrate that they can be resolved using the Bank Insolvency Procedure, based on the rapid pay-out of insured deposits. This is a cautious standard, requiring banks to demonstrate that they have implemented successfully the so-called Single Customer View (SCV) to enable depositor pay-out rapidly. This should not pose an unreasonable burden for new banks since the best time to establish the capability for SCV in a bank's systems is at "day one".

The logic of this argument on new banks is that we should implement a similar arrangement for all small banks and building societies. This approach is consistent with the principle of proportionality set out in our approach to the supervision of banks. My strong view is that the PRA must put into practice its commitment to proportionality in its approach to supervision and thus seek to encourage a reduction in concentration in the UK banking system and the availability of greater choice to consumers.

19. What risks are posed by the shadow banking system?

I define shadow banking as institutions performing activities that pose risks similar to those of banks but which are outside the system of prudential regulation (whether that is carried out by the PRA or FCA). I tend to focus on two main risks:

- that these institutions can adopt bank like behaviour when raising funds and thus engage in forms of maturity transformation (constant net asset value money market funds are an example of this risk). My view on this risk is that institutions undertaking maturity transformation require an appropriate degree of regulation through the risk that they will transmit disorderly conditions to other institutions and financial markets through a loss of confidence originating in the providers of funding. It is worth noting here that such funding has in the past been considered in a narrower context of deposit funding. It is unwise to adopt such a limited definition, and the crisis has demonstrated the presence of this maturity transformation risk through secured funding and through maturity mismatches in the terms by which institutions gain access to the financial instruments used to secure such funding (collateral term mismatches);

- the second risk from institutions that should be considered as shadow banks arises, in my view, where they are highly interconnected to other parts of the financial system, and particularly those parts (like banks) that are considered to be likely to spread risk across the system. Interconnectivity is not easy to measure and assess, but a good test for me is how easy it would be to resolve a shadow banking institution in the event of failure without causing wider concerns for the stability of the financial system. As an example, the crisis has demonstrated that even in periods of very heightened fragility the experience suggested that hedge funds can leave the scene without causing difficult disruption. But, I do not think that today we are sufficiently confident that this outcome would hold for the very largest funds. This requires a more rigorous approach to answering the "what if" type questions, but I would stress that in my view this question applies to a fairly small number of institutions.

20. What are your objectives for the regulation of the insurance industry? How do you intend to fulfil your mandate to protect policyholders?

I refer the Committee here to my recent Barbon Lecture which is included in the set of relevant speeches indicated in my answer to Question 3. My objective for the regulation of insurers is consistent with that for banks, namely to ensure continuity in the supply of critical financial services, here risk transfer and long-term savings. In the Barbon Lecture, I set out my thinking on why the PRA needs to have a policyholder protection objective (in other words, what distinguishes a policyholder from a bank depositor). A particular aspect of this issue that I highlighted in the lecture was the very long-term nature of some insurance contracts, and the ways in which those contracts tie in policyholders.

In the Barbon Lecture I sought to set out three important areas where in my view supervisory issues exist. The first area is in the life insurance field and concerns long-term savings contracts. There is a trade-off in this area between the risks (prudential and conduct) created by quite imprecise contracts (characteristic of with profits contracts) and risks created by writing such contracts with harder guarantees (where the prudential risks can be sharper). Variable annuities can have some of the latter characteristics. In my view, the issues arising from these types of contract will be important for our supervision of insurers. I should add that these risks also need to be viewed in the context of sustained very low interest rates.

The second area that I highlighted in the lecture concerns the resolution of insurers that cease to write new contracts (here, I deliberately avoid using the word "failure" because this does not account for all the reasons that insurers enter run-off). It is worth bearing in mind that today the FSA supervises over a hundred insurers in run-off. For general insurance, the objective here should be to ensure continuity of cover for the risks insured. The duration of the run-off period will typically be shorter for general than life insurance, and thus the issues are usually less complex. For life insurers, run-off can happen over many years in view of the term of contracts. Complex issues arise around term subordination (how to be even-handed towards near-term and far-term claims on the pool of assets), and the inter-generational transfer created by having very large and long-lived asset pools.

The third issue that I highlighted is work underway at present, led by the International Association of Insurance Supervisors, under the auspices of the FSB, to determine a status of systemically important insurance firms. In the lecture, I made the point that while it is important to understand the nature and particular risks of these firms, we should be careful not to apply a one-size-fits-all solution based on the bank model, in terms of the diagnosis and solutions. Put simply, the systemic importance of insurers needs to be determined rather than assumed.

Accountability and governance

21. What is your view of the Treasury Committee's Reports on the Accountability of the Bank of England (21st and 27th Reports of Session 2010–12), and on the Financial Services Bill so far as it relates to the Bank of England (1st Report of Session 2012-13)?

Accountability is crucial to the success of the Bank of England in its new roles. The 1997 reforms were a success in this respect in terms of the arrangements for the MPC. But the same was not true for financial stability and financial regulation. The new legislation has set out clear objectives for the FPC and PRA, and I welcome the Treasury Committee's commitment to expanding its role in accountability. There is no doubt that public policy is likely to be done better when there is effective accountability for policymakers.

That said, as the TSC reports make clear, there is an important role for the Court of the Bank of England in providing oversight of the actions of the Bank. Formally, the legislation does not provide the oversight of the PRA by the Oversight Committee of the Bank's Court, but the Court has decided that it will take on this role in practice. I support this decision. It means that the Court will exercise oversight over the PRA Board of Directors.

The Treasury Committee has rightly indicated that the Court needs to be an effective and transparent governing body responsible for both the overall management of the Bank and for ensuring that the policymaking responsibilities are discharged effectively. I welcome the role of the Oversight Committee in retrospective review of policymaking, and the commitment to ensure that this role is distinct from that of the actual policymakers who are individually accountable for their judgements.

22. How can the FPC and PRA be properly accountable to Parliament while maintaining necessary confidentiality?

I agree with the recommendation made by the Treasury Committee in its report on accountability of the Bank of England, namely that the Bank/PRA "will need to explain its decisions more fully to Parliament than has been the case with some regulators, for example the Financial Services Authority".

Of course, confidentiality of information is an issue, as is the risk that explicit public comments by regulation can contribute to a loss of confidence among the public. That said, the financial crisis has provided a stark reminder of the public interest in the performance of banks and their regulators. I hope that a lasting solution will be found to the public money/too big to fail issue, but that is not the limit of the public's interest in banks, given their crucial role in providing critical services, including credit creation. This means I think, that in spite of confidentiality concerns, there will need to be much greater transparency than in the past. All participants will need to live with this and accept that the world will not be the same again. That said, there are of course limits to transparency where commercial confidence is at issue, and indeed there are other legal requirements that limit open disclosure. I would therefore suggest that the Committee considers how it could take evidence in confidence.

23. What role should the Court of the Bank of England perform? How can it be made more effective?

In my answer to Question 21 I emphasised that Court will have a very important role in providing oversight of the policy actions of the Bank. This role sits alongside the responsibilities of the Court in respect of the strategy, management and budget of the Bank. Although I have not been a member of the Court until now, I have attended meetings over a long period of time, and this has provided a good insight into its workings. My overall conclusion is that where the Court has been asked to undertake a role of oversight, it has done so effectively and with energy. In saying this, I should note that today's Court is very different to the Court of ten or twenty years ago. As an example, the Bank now has a functioning Audit Committee, which was not a feature twenty years ago. A good example of the outcome of Court's oversight is the strong budget discipline that I believe has been exercised by the Bank.

The said, it is imperative that Court can in future ensure that the Bank's policy committees (MPC, FPC and the PRA Board) are performing competently and executing their responsibilities appropriately. Mark Carney set out the following roles for Court in this area in his submission to this Committee:

- observing, and reporting on the effectiveness of, the way policy is made;
- giving assurance that the policy process is as transparent as possible and that information is not withheld without very good reason, from Parliament or public;
- commissioning reviews, by independent experts and by policy-makers, of past policy settings;
- overseeing the response of policy committees to the lessons in any such review.

I agree strongly with this assessment of the oversight role of the Court to be exercised by the new Oversight Committee. The Court will have my full support in establishing and performing these functions.

24. What is your view of the structure and inter-relationship of the Bank's committees? Could these be made more effective without loss of transparency?

Modern central banks, like the Bank of England, have developed highly stylised forms of committee decision-making which place a strong emphasis on deliberation and reason-giving for decisions as much as the decisions themselves. In other words, explaining and justifying decisions is an important part of good public policymaking, and in doing so individual policymakers should be willing to learn from one another. I certainly subscribe to this view, and that members of each committee should be able to learn from the views of members of the other committees on their respective areas of policy responsibility. Good policymaking is therefore more than a process of aggregating the preferences of individual policymakers found in isolation.

In future the Bank will have three policy-making bodies, the MPC, FPC and the PRA Board. They will be different as a consequence of their different objectives and tools. The MPC uses one policy tool at a time, and while the thinking around policymaking is highly sophisticated, the outcome is focused on a single setting of a tool. The FPC has multiple tools in terms of its potential policy actions, and it can (and typically will) be using several tools at any moment in time. This is well understood as a consequence of the nature of financial stability, but challenging in terms of the clarity of explanation. The PRA Board has to deal with many decisions at any given point in time, and the fact that its objective and tasks directly impinge on concentrated private interests (those of the firms it regulates). It has a similar basis for its public policy objectives, but a very different operating environment in terms of the nature of its decisions. This difference was in the past a reason for the separation of microprudential supervision from the Bank of England, based on the conclusion that it was a very different task which had more in common with other areas of financial regulation. This was in my view a mistake, and the commodity of interest between microprudential supervision and macroprudential and monetary policy outweighs the differences.

Until the FPC and the PRA Board are properly up and running it is too early to say how they could be made more effective. That said, my clear preference is that there is transparency between the committees of the Bank and opportunities are found for members to discuss issues of common interest. This is already starting to take place, but to be clear I do not believe that this should compromise the separate formal decision making processes, and thus I do not see an advantage in joint policymaking meetings and the like.