TREASURY COMMITTEE QUESTIONNAIRE

Response submitted by Jon Cunliffe, the UK's current Permanent Representative to the European Union, on 1st October 2013 in advance of his pre-appointment hearing, on 14th October 2013, before taking up the role of Deputy Governor for Financial Stability, Bank of England.

PERSONAL/GENERAL

Question 1. How has your experience to date prepared you for the role of DGFS of the Bank of England including your roles on the Monetary Policy Committee and Financial Policy Committee?

I have worked extensively at the centre of international financial and economic policy and in senior leadership and representational roles in a range of posts in HM Treasury, Cabinet Office and the Foreign Office.

I have been involved with financial stability issues for the last 15 years. I was HM Treasury's Managing Director leading on Financial Regulation (2001-2 and 2006-7) working closely with the FSA and the Bank of England. I led in the Treasury on the response to the systemic threats arising from September 11 and the collapse of Equitable Life. As Head of the Cabinet Office European and Global Issues Secretariat and G20 'Sherpa' during the financial crisis, I was closely engaged in the design and negotiation of the international response, including the development of the EU's response to the crisis and the G20 Action Plan to Implement Principles for Reform. In support of their Prime Minister, I was responsible for the UK's initiatives that led to the creation of the Financial Stability Board and established it as a free-standing institution. In an earlier position, I led in the Treasury on the international response to the 1999 Asian financial crisis.

As UK Permanent Representative to the EU and, formerly, as head of the Cabinet Office European Secretariat I have been consistently involved in the development and negotiation of EU's extensive post crisis financial regulatory reforms, ranging from the establishment of the EU supervisory agencies to reform of capital and liquidity standards, regulation of market infrastructure, and Banking Union. In previous positions in HM Treasury, I was engaged in the negotiation of the earlier wave of EU legislation to create the single market in financial services.

As HM Treasury Managing Director for Macroeconomic and International Policy (2002-2007) I was the Treasury Representative on the Monetary Policy Committee. Within the Treasury, I was responsible for Treasury's relationship with the Bank of England, including the Bank's monetary policy remit and for overall cooperation with the Bank of England. I also led in the Treasury on the 1997 reforms that established the MPC and gave the Bank operational independence on the conduct of monetary policy. As Managing Director for Macroeconomic and International Policy I was closely engaged with the macroeconomic and fiscal forecasts and their interaction with the cyclically adjusted fiscal stability framework. During this period, I had responsibility for HM Treasury's extensive work on the case for and against the UK's membership of the Euro; subsequently, in both Cabinet Office and Foreign Office I have been closely engaged with the economic and financial spillovers to the UK arising from the Euro crisis.

I have represented the UK on economic and financial policy issues in a range of international and EU fora: currently, as the UK's Permanent Representative to the EU; as the Prime Minister's G20 Sherpa during the financial crisis responsible for shaping the G20 leaders' response; as HM Treasury's G7 and G20 Deputy, Chair of the IMF Deputies committee and member of the EU's Economic and Finance Committee. These roles have all involved forging international consensus on complex economic and financial policy issues, including surveillance of the global economy, economic imbalances, sovereign debt and international banking crises, and the establishment of international regulatory standards.

In my senior posts in the Cabinet Office and Treasury, I have experience operating in complex organizational structures designed to balance, and where necessary to make trade-offs between multiple objectives and to ensure information flows as necessary between different parts of the organization.

Question 2. Do you intend to serve your full term?

Yes.

Question 3. What do you see as the main challenges you will face as Deputy Governor with responsibility for Financial Stability over the next five years? What criteria should be used to assess your record as Deputy Governor?

I see the four main challenges for my term as Deputy Governor as:

i) ensuring macro-prudential supervision is a well understood, credible and effective operational reality;

ii) influencing, completing and implementing the international regulatory reform agenda;

iii) implementing in the UK an effective and credible resolution regime and ensuring central counterparties are safe and sound so as to address the problems of too big to fail, and;

iv) making the new Bank structure work to its maximum potential.

i) Macro-prudential supervision is in its infancy. The financial crisis has illustrated that to maintain financial stability, in addition to proper, effective supervision at the firm level, there is a need for a top-down perspective on risks to the stability of the financial system as a whole. The overall level of risk in the financial system, the linkages between different parts of the system including unregulated parts, and the adequacy of current prudential standards in light of the evolution of the system must also be subject to oversight at the 'macro' level. But, in contrast to monetary policy, experience of how to conduct macro-prudential supervision is limited. The UK is at the forefront internationally in this area; macro-prudential machinery has been established and policy frameworks, analytical tools and policy levers are being developed. There is however still considerable uncertainty about how policy will operate, how it will assess and seek to mitigate risks to financial stability and where the boundary lies with micro-prudential supervision.

The new arrangements are now up and running and must protect and enhance financial stability today as well as in the future. The challenge is to implement a cogent, comprehensive macro-prudential framework that is well understood, particularly across the financial sector, and has public support. This will require learning by doing. It will also require, inter alia, improvements to the coverage and quality of data, better analytical tools including stress testing, further development of indicators of risk in the broader financial system, increased understanding of how macro-prudential tools work and communication. I cover these in more detail in the answers to questions 5 – 11 below.

I would suggest my record against this challenge should be judged on two main criteria. First, that, as possible threats to the stability of the financial system crystalise, we can demonstrate that the FPC has been forward looking and used the available tools to seek to reduce the impact on financial stability. As part of this, the Bank will need to have in place a suitable machinery to support the FPC's analysis and decision making, including through a rigorous assessment of how the FPC's tools have affected outcomes. Second, that there is in place a transparent, comprehensive macro-prudential framework that is well understood, particularly across the financial sector, and that has broad public support.

ii) A failure of international cooperation and governance of a globalised financial sector was, in my view, one of the root causes of the financial crisis. International structures were too weak: to identify and counter risk in the international system as a whole; to develop sound prudential standards and to implement them consistently to prevent regulatory arbitrage; and to resolve internationally systemic financial institutions. At the nadir of the financial crisis, the major economies of the G20 recognised both the need to reinforce the international machinery by creating the FSB and the need to set out a time bound programme for developing and implementing comprehensive regulatory reform.

A great deal has been achieved since then, in the FSB, in Basle and in other international fora, particularly in the development and calibration of international capital and liquidity standards in the banking sector, in reducing risks in derivative markets and in establishing resolution regimes. But as this work has moved into the national (and in the EU's case, regional) implementation in recent years there has been growing risk of fragmentation and inconsistency of application. Major elements of the programme remain to be completed and implemented.

As home to the world's largest international financial centre and with a financial sector with a balance sheet 6-7 times GDP, it is crucial to the UK's financial stability that there is effective global and European macro-prudential surveillance and strong, consistently implemented international standards and EU rules.

The Bank is now at the forefront internationally of macro prudential supervision. The challenge is to use its international and European relationships, its analytical expertise and its role as macro and, alongside the Financial Conduct Authority, as micro supervisor to the world's largest financial centre to ensure the international regulatory reforms are completed and, equally important, consistently implemented. This will require the further development of the FSB's surveillance and peer review mechanisms. It will also require the completion of the G20 programme of financial reforms, crucially on the shadow banking system and resolving the problem of internationally systemic institutions that are 'too big to fail' (see my third priority, below). In Europe, the Bank will need to play a leading and influential role in the EU macroprudential surveillance body, the European Systemic Risk Board, forge a strong relationship with the new Euro area banking union and ensure that the high-level design of EU financial regulation is consistent with the broader international reform programme. I cover this in more detail in my answer to question 9.

I would suggest that the record against this challenge be assessed by completion and implementation of the G20 reform programme, evidence of the Bank's input into and influence on the process and, in the EU, the strength of the Bank's role in EU surveillance and its relationship with the new Euro area Banking Union.

(iii) Addressing the problem of too big to fail, domestically and internationally, is a vital part of ensuring the UK's financial stability. I will, as Chair of the Bank's Resolution Committee, have particular responsibility for ensuring the Bank is ready to resolve potentially systemic UK financial institutions without taxpayer support should they fail. Legislation to introduce bail in powers is in train, both domestically though the Banking Reform Bill and, within Europe, through the Recovery and Resolution Directive. Much remains to be done, however, to ensure that the largest UK banking groups are structured in a way that is conducive to effective resolution with sufficient loss-absorbing debt in the right parts of the groups. International co-operation will be crucial for resolution of international groups. A priority will be securing an international agreement on minimum levels of debt that could be used to absorb losses in a resolution. More progress is needed also to develop and agree credible cross-border co-operation agreements as required by the Financial Stability Board's Key Attributes.

The Bank needs to make sure it is fully prepared to provide liquidity assistance, as necessary, to support the recovery or resolution of a distressed institution. As Chair of the Bank's Emergency Liquidity Assistance Committee, I will lead on Bank's preparations, including by taking forward the recommendations of the Plenderleith Review.

Mandating that all standardized derivative contracts are cleared through Central Counterparties (CCPs), simplifies the network of derivative transactions by concentrating counterparty credit risk on CCPs (see also answer to Question 5). CCPs will, therefore, be a crucial link in the system: we need to avoid creating a new class of institution that is 'Too Big to Fail'. Supervision of the largest central counterparties (CCPs) in the UK will, therefore, be crucial. In my role as Chair of the Bank's Financial Market Infrastructure (FMI) Board, I will lead the oversight of that supervisory work. CCPs need to have the highest standards of risk management, adequate loss absorbing capacity and effective and credible recovery and resolution plans, should risk management fail.

My record across this area should be assessed by the effectiveness and perceived credibility of the Bank's resolution planning for large, potentially systemic, institutions including non-banks, with a significant presence in the UK; and the effectiveness of these plans in the execution of resolutions if and when they occur.

(iv) Finally, the new Bank structure offers the opportunity to recognise and exploit the interaction between macroprudential policy and, on the one hand, monetary policy and, on the other, micro prudential supervision. By bringing all these under one roof, rather than housed in separate institutions, systemic risk should be more easily addressed and coordination cost and frictions should be minimized.

As the only Deputy Governor to sit on the FPC, MPC and PRA Board, my challenge will be to ensure that information flows across functional responsibilities, that interactions between monetary stability, financial stability and micro-prudential regulation are recognized and managed effectively. This needs to happen without blurring or diluting the specific responsibilities and accountabilities of the FPC, the MPC and the PRA Board.

The record should be assessed against how well the Bank group functions as a whole over the period, how the trade offs and spillovers that will inevitably occur have been addressed and how the key elements of the Bank group work together. I expect that the Court oversight committee will provide very helpful assessment in this area over the period.

Question 4. Which of you publications or papers are of most relevance to you future role as Deputy Governor?

None. Given my role as a civil servant, I have not any published relevant material in my name.

FINANCIAL STABILITY

Question 5. What do you view as the main threats to UK financial stability at present? What other risks would you want to monitor closely in the future?

The main issues at present are in my view the transition back to more normal conditions in the UK and global economy and the possibility of further instability in the Euro area.

On the first, global short-term interest rates remain at an historic low, though following recent increases, medium term forward rates are now closer to their historical average. Low interest rates can encourage households and firms to take on additional debts and may also encourage intermediaries to lever up in order to boost returns. An abrupt normalization of interest rates could threaten financial stability if UK borrowers struggled to service their debts and if intermediaries with leverage were shown to be vulnerable to a fall in asset prices. Although they have deleveraged following the crisis, UK households remain highly indebted by historic standards. The FPC statement following its meeting on 18 September reported on preliminary work by staff at the Bank and FCA, which found that a moderate rise in long-term interest rates did not pose an immediate threat for banks and insurance companies. However, the work did not consider more significant stresses nor potential amplification channels. An abrupt correction in global interest rates could also have an impact on UK stability through international channels such as a sharp and synchronized deterioration in emerging market economies, particularly those with vulnerable external positions.

Clearly, given its historic tendencies, the UK property market will always be a key area of the FPC's domestic focus. In the past, UK property market downturns have been associated with periods of significant weakness in the wider economy. In financial stability terms, credit losses on UK mortgage lending have historically been small relative to banks' capital. Losses on commercial property lending, and riskier lending to households have, however, been an important driver of bank failures following a property bust. As the recovery in property prices takes hold it will be important to keep a close eye on lending standards to ensure the system does not become overly exposed to a correction in property prices further down the line. Should risks emerge, the FPC has a range of tools available (see my answer to Question 8).

On the Euro, though economic prospects and market sentiment in the Euro area have improved considerably over recent months, internal and external structural deficits remain high in the Euro periphery as do unemployment rates. There remains a substantial distance to travel to put in place the structures to support banking union and the monetary union more generally. The risk of a political or market event sparking a further bout of instability remains material. Given the sizeable economic and financial links to the UK the Euro area continues to pose a threat to UK financial stability.

For the future, I would single out: (i) the risks that will arise as a consequence of the current domestic and international reform programme; (ii) operational resilience in the system and cyber threats; and (iii) risks arising from institutions that currently could not be resolved in an orderly manner without taxpayer support.

On (i) the current reforms are intended to redistribute risk inherent in derivative markets to the market's infrastructure, notably central counterparties (CCPs) where it can be better measured and managed. This will place much greater weight on the prudential standards and supervision of this infrastructure to ensure this risk is extremely well managed. To cater for a failure of risk management, we need to ensure that CCPs have effective and credible recovery and resolution plans. We must avoid CCPs being a new class of "too big to fail".

We must also expect the reforms to lead to pressure for firms and activities to move outside the regulated perimeter to the 'shadow' system. The FPC has a statutory role for monitoring risks outside the regulatory perimeter and advising

HM Treasury on changes in the boundaries around and within the regulated sector. Risks inherent in particular activities in the financial sector need to be managed consistently regardless of the type of firm in which they occur. And in this respect, we will need also to drive forward the UK's implementation of the FSB's policy recommendations on shadow banking system together with forthcoming EU legislation (see Question 9).

There will also be pressure for firms and activities to move to jurisdictions in which standards and their application are weakest, creating risk in the international system and pressure for a 'race to the bottom'. This will need careful monitoring, domestically and internationally. (See also answer to Question 9).

On (ii), the concentration on capital and liquidity standards, and the resources devoted to it in the firms, since the crisis may have deflected attention from operation risk and resilience. That has been underlined by recent IT failures on both sides of the Atlantic. An emerging and growing risk is the threat of cyber attacks disrupting key parts of the infrastructure, including the banks as operators of the payments systems and disruptions to key parts of the financial market infrastructure.

On (iii), international action to resolve the outstanding issues on 'too big to fail' is crucial to avoid the renewed build up of moral hazard and risk in the international system. The UK's micro-supervisory regime does not operate on a zero failure basis. That approach can only work if failed firms can be resolved safely without taxpayer support. A great deal has been done, but the thorniest issues remain. Failure to make progress among the key international players, as memories of the crisis recedes, is a risk to the UK's stability that needs to be kept constantly in view (see question 9).

Question 6. What do you regard as the strengths and weaknesses of the work undertaken by the interim financial policy committee?

The interim FPC has established macro-prudential supervision as a key pillar of the UK's regulatory architecture alongside micro-prudential supervision. It has also located this responsibility as a core function in the Bank, alongside the MPC, with a real powers and a clear identity and responsibility.

By enabling the new architecture to become operational as soon as possible, the interim FPC arrangements ensured that macro-prudential considerations have been factored into the debate on capital and liquidity and the implementation of new standards. The interim FPC has put in place a staging point for the capital resilience of the UK banking system to ensure that, given current threats to stability, the system is sufficiently well along the path to the Basel III and ICB end point.

A recent strength has been the establishment of a close dialogue and coordination between the UK's macroprudential and microprudential regimes which is a key strength of the new structure. The interim FPC has also piloted the communication and co-ordination with the MPC evident, for example, in the financial stability 'knock-out' in the MPC's recent forward guidance.

The interim FPC began to put in place key elements of the macro-prudential framework with important work on examining the potential impact of macro-prudential capital tools and the circumstances in which it might use them, illustrated through a set of coreindicators. This has in turn driven the generation of capacity and capability in the Bank's Financial Stability function, helping to ensure that the Bank plays an influential role in shaping the international work on key financial stability issues.

The domestic and international debate on capital and liquidity has been complex and intense, particularly on the pace at which capital resilience should be strengthened in the face of weak economic conditions. Against this background, and starting from scratch, my impression has been that the interim FPC was, for a lengthy period, not sufficiently specific on what, quantitatively, it thought was necessary on capital. It could not therefore communicate clearly to either the micro-regulator, the industry or the public more broadly. As a consequence, progress to improve the banking system's capital position was slow. There is a clear lesson on communication for the FPC, both to the industry and to the micro-regulators. Separately, public understanding of the FPC's role and responsibilities remains low relative to the MPC.

Question 7. How do you propose to communicate financial stability policy and decisions, including the macroprudential tools? In particular, how will you communicate these to the general public?

The FPC has in my view two related but discrete communication challenges.

First it must communicate to the financial sector and those involved with it what it sees as key risks to financial stability and how it will react to those risks. The objective, analogous to monetary policy, is that if both the risks and FPC's 'reaction function' are well understood, then financial sector agents will factor these into their risk taking and their risk management, and adjust their behavior at an earlier stage in anticipation of FPC actions. If the FPC is successful in supporting a return to a long period of stability, it will need to ensure, as memories of the recent crisis fade, that financial market participants do not respond to apparently benign conditions by expanding risk taking excessively.

The key to this is the clarity of the framework, of the FPC's analytical tools and indicators and of the FPC's decision making. The FPC has an obligation to publish a policy statement laying out a framework through which it will decide on the setting on its macro-prudential tools. The interim Committee's draft policy statement, published earlier in the year, provides an important body of work for the Statutory Committee to build on. In addition the material published by the Committee, such as the *Financial Stability Report* and the *Record* of the Committees meetings and the FSR press conferences are important channels to show how the framework is being applied in practice to changing circumstances. This should be supplemented with speeches, articles, and private contacts. Academia can play an important role in helping to showcase the FPC's developing thinking and challenge its analytical underpinnings.

Second, it is crucial that the FPC is able to explain to the general public exactly what it is trying to achieve and how it is using its powers to do that. The FPC will also need to build a broad based understanding amongst the general public of the importance of financial stability and the actions that may be necessary to maintain it. Parliament has given the FPC new and substantial powers that affect the terms and availability of households' and firms' access to credit across the UK. If the FPC's actions and why they are necessary are not widely and easily understood the Committee's legitimacy could be undermined.

The FPC will need to use many channels through which to get its message across to the general public. In addition to material published by the Committee, such as its *Policy Statement*, the *Financial Stability Report* and the *Record* of the Committee's meetings, which are directed at a more expert audience, the FPC will need to shape a broader message through speeches, the press and educational tools. Regular hearings before the Treasury Committee are also an important mechanism through which FPC members can be held to account for their actions.

As Deputy Governor for Financial Stability, I intend to play a leading role in public communications and to use regular speeches to explain the reasoning behind the FPC's policy decisions. I will meet regularly with business across the country, both within the financial sector and outside it. That is particularly important following the financial crisis, where the trust that businesses have in the banking sector is at low levels. I will also want to explore how we can frame and deliver broad financial stability messages and foster greater awareness.

Question 8. What is your assessment of the macroprudential tools available to the FPC? Would you prefer the FPC also to have the ability to limit loan to value and/or loan to income ratios?

My initial view is that, taken as a whole, the FPC has a powerful set of tools. Its directive powers over the counter-cyclical capital buffer and sectoral capital requirements will enable it to increase resilience in the banking system to meet general or specific risks. Its powers of recommendation, including on a 'comply or explain' basis to the regulators, are very wide ranging. The Committee also has a specific role in making recommendations to HM Treasury on the regulatory perimeter.

A strong case can be made that the FPC should also have a direction power over the leverage ratio and I note the Treasury's intention that, subject to review, this should happen in 2018, when the Pillar 1 Basel 3 treatment for the leverage ratio is set to be finalised. The leverage ratio/leverage will be a very important indicator for the FPC to monitor closely, especially given concerns about the calculation of risk weights. In the interim period, the FPC can issue comply or explain recommendations to the PRA on the leverage ratio. See also my response to Q10, below.

Powers of direction over LTV and/or LTI ratios can mitigate threats to financial stability by reducing lenders' exposure to losses following a fall in property prices, whilst the FPC's sectoral capital tools can be used to ensure banks have sufficient capital to absorb losses should they occur. The FPC can already issue recommendations to the regulators on underwriting standards and affordability tests, including restrictions on LTV and LTI ratios. I note that the Chancellor has also announced that the FPC will have a role in making recommendations to HM Treasury in its annual reviews of the terms of the help-to-buy scheme. LTV and LTI tools would be different in kind to the FPC's other directive powers in that they would bear more directly on what credit is available to individuals rather than on ensuring that the banking system has the capital resilience to bear risk. While this does not to my mind rule out giving such powers to the FPC (such tools have been used elsewhere), it does raise the hurdle for demonstrating that they are a necessary part of the FPC toolkit. This is an area that in my view merits further consideration.

In general, macroprudential regulation is still at an early stage of development. There is much to be learned about how the FPC's macroprudential tools operate in practice, their transmission mechanism and overall effects. In my view, the toolkit as a whole will need to be kept under review and reassessed at some future stage in the light of experience and of further developments in the micro-prudential regime.

Question 9. What will your priorities be when negotiating international financial regulations? What risks are there to the United Kingdom from current international financial regulation negotiations? Do you have any concerns specifically about the effect on the UK of particular EU initiatives?

The size and international nature of the UK's financial sector and our membership of the EU and of its single market mean that the UK's financial stability is no small part dependent on effective global and European macro-prudential surveillance and sound, consistently implemented international regulatory standards and EU rules. My over-riding priorities in addressing international and EU discussions and negotiations will be to ensure that standards and rules are soundly based, are beneficial to the UK's financial stability and are being implemented consistently. The challenge on international standards is to complete the G20/FSB action plan and maintain effective international surveillance to ensure the regulatory reforms are consistently implemented across countries. The FSB and international standard setters are part way through a large and comprehensive work programme. The key priorities within that are completion and implementation of the capital and liquidity framework, implementing credible resolution regimes to remove the problems of Too Big to Fail, implementation of OTC derivatives reforms while avoiding fragmentation of international markets and shadow banking.

The EU is likewise part-way through a very large programme of regulatory measures, part of which represent the implementation, in the single market, of the G20/FSB regulatory reforms. Key priorities in Europe include agreement of the new rules on banking recovery and resolution and on deposit guarantee schemes; structural reform of the banking sector (Liikanen); ensuring that CRDIV is enhanced to adopt the liquidity coverage ratio agreed recently by the Basel Committee together with other forthcoming reforms, such as the leverage ratio and the net stable funding ratio; finalising the Solvency II legislation for insurance, and the suite of measures that comprise the Euro area banking union (see below).

Influencing the agenda of the European Systemic Risk Board, which brings together central bankers, insurance and bank supervisors and securities regulators, will be an important priority for the UK. We will need to ensure the ESRB places due weight on threats relevant to the UK. Where the ESRB follows up that assessment with recommendations, we will need to make sure those recommendations are given proper weight with a co-ordinated response across the Euro-system.

The main high level risks to the UK in relation to this extensive programme of international and EU work are that as the memory of the crisis recedes, the international community does not follow through on the G20 commitments due to 'reform fatigue', vested interest and the erosion of political support. There is also a significant risk that reforms are implemented nationally and regionally in a way that fragments international markets or encourages financial sector actors to arbitrage and shift activity between jurisdictions.

The interaction between international standards and EU regulation is extremely important for the UK given the international reach of our financial sector and the fact that due to the single market in financial services, much of our financial regulation is determined in the EU. It is crucial to guard against the risk of divergence and to ensure that EU regulation implements international standards effectively. More generally, the pressure to make progress and the nature of EU legislative process creates a risk of poor quality legislation. And, because the scale, complexity and international nature of the UK's financial sector is without equivalent in the EU, there is always for the UK the risk that solutions that work for the majority cannot easily take account of some of the challenges of maintaining financial stability in the world's leading international financial centre.

Three broader developments in EU financial regulation require, in my view, close UK attention and engagement: first, the pressure to move to maximum harmonization of legislation, together with the shift of regulatory activity to the European Supervisory Agencies (ESAs); second, the increasing tendency for EU legislation to prescribe interaction with third countries at an EU level, particularly in relation to mutual recognition; and last the move towards Euro area banking union.

On the first, maximum harmonization legislation through EU regulations, unlike EU minimum standards, means that member states cannot set tougher regulatory standards for firms in their jurisdiction. That can pose risks to UK financial stability in areas where, due to the risks posed by the size and nature of our financial sector or by the state of national economic and financial conditions, we might believe tougher rules are necessary. This was a key issue in CRD IV in relation to the FPC's ability to increase capital requirements and may well become a key issue again, for example in the context of EU discussions of further standards still being finalised at G-20 level (for example leverage ratios). Moreover, because maximum harmonization regulations are directly applicable in national law, the quality of legislation becomes even more important. On the other hand, maximum harmonization regulations are more likely to ensure consistent application across all member States. In the same way, the movement towards a single EU rulebook with the detailed rules increasingly being made at EU level in the ESAs again can make it more difficult to tailor rules to our specific financial stability needs but is intended to deliver a more consistent implementation across the single market as a whole. It puts a greater premium on the Bank being able to influence the EU legislative processes including in the ESAs.

On the second, there can be considerable merit in EU level negotiation and authorization of third country 'equivalent' regimes particularly in areas where there are clear international standards and important financial stability considerations, such as derivatives. The EU's greater weight relative to individual member states can be brought to bear in negotiations and, though not a financial stability consideration, there can market opening benefits also of mutual recognition. But it is important that this EU level approach is used where it is fully justified and as a financial stability not a trade lever. It should be outcome based and applied where there are clear international standards on which to base an equivalence regime.

Finally, a successful Euro banking union is of key importance in strengthening the financial stability of the Euro area, as the Euro crisis has demonstrated. Given the economic and financial links between the euro area and the UK, its success is important to our financial stability. The scale and coverage of the ECB as single supervisor and of the proposed single resolution mechanism, make it of key importance to ensure these institutions of the banking union and the Bank work closely and harmoniously together. And, as the key elements of the banking union – the ECB as common supervisor, a single resolution mechanism and more integrated deposit guarantee machinery – progress, it will be important to maintain that EU financial regulation and the rules of the single market are set by the EU as a whole.

Question 10. What do you consider to be the most important conclusions and recommendations of the Parliamentary Commission on Banking Standards, with respect to your new responsibilities?

I understand the Bank will shortly set out publicly its intentions for responding to the PCBS recommendations that are relevant to its objectives. I intend to participate fully in that work. In terms of the FPC, on my initial view, I would pick out three aspects of the recommendations that are relevant.

The first relates to the leverage ratio, where the PCBS has asked HMG reconsider its position and, in the absence of change, for the FPC to publish, by year-end, its own assessment of the appropriate ratio together with its views on whether the ratio should be a regulatory front-stop rather than a back-stop. There are still issues of definition around the leverage ratio and as yet no international standard has been agreed. As I have set out in my earlier answers, there is a strong case that it should be part of the FPC toolkit. It can however, generate a perverse incentive for banks to invest in riskier assets and so my initial view is that it should be, in the main, a backstop not a front stop.

Second, effective market discipline relies on investors having adequate information on the risks that banks are running. The PCBS report draws attention to the importance of robust and regular dialogue between external auditors and supervisors and of bondholders and shareholders having access to adequate information. A particular shortcoming exposed by the crisis has been with accounting standards, which have allowed banks to delay the recognisition of credit losses with the consequently overstatement of capital ratios. Work to address this will require significant international cooperation.

Third, the PCBS draw attention to dangers of risks moving out of the banking sector only to reoccur in highly-leveraged shadow banking activity. As I have set out in my earlier answers, this is a real risk. The FPC has a clear role to play in this area given its statutory responsibility for making recommendations to HM Treasury on the appropriate boundaries around and within the regulatory perimeter.

Two important issues for the PRA Board to take forward are a new Senior Persons regime, where key responsibilities within banks are assigned to specific individuals, and governance reforms to ensure non-executive directors, supported by a risk committee, provide appropriate challenge to the executive.

Question 11. What research priorities will you set the Financial Stability area of the Bank in your first year?

This is an area where I will need to develop my thinking with other members on the FPC and the executive team. On my initial view, I see two sets of important research priorities for the Financial Stability area of the Bank.

First, FS needs to continue to build its framework for understanding and modelling the impact of prudential policy on financial stability. A clear priority here is modelling the transmission mechanism of macro-prudential policy, both with respect to the existing directional tools on capital requirements and potential new tools in other areas, such as liquidity and margining requirements. As well as assessing the impact of tools on financial stability, the FPC will, given its secondary objective, need to understand their impact on credit conditions and economic activity more broadly. Understanding the first-round impact of prudential tools on economic growth will also be of interest to the MPC.

Second, in addition to understanding the impact of its tools, the FPC needs to develop a rigorous framework for assessing and quantifying threats to financial stability. Together with the PRA Board, I understand the FPC has placed a great deal of emphasis on building a programme for regular stress tests of the banking system. Both the Bank and PRA will need to build their modelling capability in this area. The FPC will also need the capability to assess systemic risks emanating from beyond the banking sector. A key part will be assessing and possibly building tools to stress test the effectiveness of CCP's risk management arrangements. In addition the Bank will need to exploit the data that will be collected via trade repositories, so as to understand the risks posed by the network of transactions within repo and derivative markets.

Good quality data, both in terms of the breadth of coverage and the accuracy of data collected, is crucial to any research efforts. I intend to strongly support the Bank's participation in the Financial Stability Board's Data Gaps initiative.

MONETARY POLICY

Question 12. What is your view of the forward guidance recently announced by the MPC? What do you think its effect will be?

I support the MPC's decision on a forward guidance framework. My view is that the MPC's forward guidance framework will provide clarity on how the Committee intends to set monetary policy so as to support the emerging UK recovery, without taking risks with price or financial stability. As the recovery takes hold, a potential danger is that market participants, firms and households get ahead of themselves and expect that policy will be tightened more quickly than warranted. Forward guidance mitigates that by making clear that the Committee does not intend to consider the case for an increase in Bank Rate, or for unwinding Quantitative Easing, until the economy has recovered sufficiently to absorb a significant amount of the spare capacity.

The unemployment rate appears to be the closest guide to the evolution of spare capacity at present. Following the exceptionally poor performance of productivity over the last five years, there is an unusual amount of uncertainty about the potential for firms to increase output without taking on additional employees. As demand recovers, one would expect that firms are likely to first use up available opportunities to increase their utilization of existing capacity before starting to hire. Holding back on a consideration of tightening policy until there has been a significant fall in unemployment offers a robust strategy for the MPC to allow the recovery to reduce the remaining spare capacity within the economy.

The main effect of forward guidance is to support confidence in a strong and sustainable recovery. By being clear that it will wait until unemployment has crossed the 7% threshold before considering the case for tightening policy, the MPC can give households and firms confidence that it will not choke off an emerging recovery before that recovering has soaked up spare capacity in the economy. The two inflation knockouts make it clear that the MPC is not prepared to take risks with its primary objective of price stability. And the financial stability knockout ensures the MPC and FPC work together to avoid a dangerous resurgence in risk-taking.

As the unemployment rate approaches 7%, the MPC will need to begin to explain how it intends it will assess the need to tighten policy after the 7% threshold has been crossed. For me, that will involve an assessment of the scope for unemployment to fall further without generating inflationary pressure together with a check on the amount of spare capacity within firms. That will require close and careful monitoring for any indications of bottlenecks within the labour market, such as signs of emerging pressures on pay that are not warranted by increases in productivity.

I look forward to discussing these issues in more depth with my colleagues on the MPC.

Question 13. What consideration should be given to asset prices, including house prices, within the framework for inflation targeting? In particular, how should monetary policy react to asset price bubbles?

The MPC's considerations of asset prices must be driven by its remit and primary objective of maintaining price stability. However, the latest remit to the MPC also recognises that, although the FPC's macro-prudential tools are the first line of defence against financial stability risks, there can be circumstances in which the Committee would allow inflation to deviate temporarily from the target to avoid jeopardizing financial stability.

In relation to housing assets, the costs of housing services forms a significant part of households' overall consumption and bears directly on the MPC's objective. Housing cost is not at present in the CPI but I understand that the ONS have developed an index for consumer price inflation incorporating a measure of the cost of housing which as a result could better measure variations in the cost of living. As experience with that index builds, it is for the government to review the case for switching the MPC's target to the new index.

More generally, the experience of the financial crisis has shown that financial instability can lead to macroeconomic instability and undermine the ability to maintain price stability. This to my mind suggests that the MPC should eschew too narrow a focus without any regard to asset price risks within the economy and the financial system. In this respect, increases in asset prices that are associated with a build-up in leverage, both within the real economy and the financial system, pose the greatest risk. Property prices are an obvious candidate here as property is usually financed by debt.

Where an emerging 'bubble' in asset prices appears to present a threat to financial stability (and hence monetary stability), the best and most direct response would be for the micro-prudential and macro-prudential supervisors to use prudential tools to ensure that the financial system is resilient to a correction in asset prices. If those prudential tools prove insufficient, then there could be a case for considering whether to use monetary policy tools, though the hurdle would be higher. That approach is consistent with the MPC's forward guidance framework, which includes a financial stability 'knock-out' when the FPC judges there are risks to financial stability posed by the stance of monetary policy poses a significant threat to financial stability that cannot be contained by the substantial range of mitigating policy actions available to the FPC, the Financial Conduct Authority and the Prudential Regulation Authority in a way consistent with their objectives.

Question 14. Are there circumstances where you might tolerate higher than target inflation for wider economic reasons?

The Government's remit makes clear that the Monetary Policy Committee must return inflation to target in the medium term and, in doing so, keep medium inflation expectations anchored. The remit provides for flexible inflation targeting and allows for temporary deviations of inflation with flexibility over the period over which inflation is returned to the 2% target. I am clear that so long as medium term inflation expectations remain anchored, that leaves scope for the MPC to tolerate temporary deviations from the target to avoid undue volatility in output and so support the Committee's secondary objective for growth and employment.

In practice, my view at this stage is that provided inflation expectations are anchored the Committee should in general seek to look through the direct impact that changes in various relative prices such as large movements in energy prices can have on the general price level. Such movements feed through relatively quickly into CPI inflation and, though monetary policy could be used to offset that, the effect of such an aggressive response on output would be highly undesirable.

A more difficult challenge is a set of circumstances that result in a prolonged period where inflation runs above the target. The key judgements for monetary policymakers are whether the influences pushing inflation away from the target are temporary and whether above-target inflation is a sign of demand running ahead of the economy's capacity. A sequence of shocks to the price level pushing inflation away from target for a protracted period could be consistent with price stability, so long as inflation expectations remain anchored in the medium term.

Question 15. What is your assessment of the effectiveness of the policy of quantitative easing in the UK, and of what needs to be considered when preparing for the UK's eventual unwinding of quantitative easing? What is your view of the distributional effects of QE?

The evidence I have seen suggests that the Bank's quantitative easing programme has been successful in boosting asset prices. The most direct evidence suggests QE lifted the price of government bonds and so depressed yields; that will have had the effect of reducing corporate bond yields and boosting equity prices. Though harder to pin down precisely, asset price movements during the MPC's first round of purchases appear to have narrowed the spread between the interest rate on corporate and government bonds. The recent sharp response of financial markets to changing expectations for the pace of asset purchases by the US Federal Reserve is also consistent with central bank asset purchases having a significant impact on equity and bond prices.

This increase in asset prices will have supported activity in the aftermath of the recession. In addition to the wealth effect of higher asset prices, the easing in borrowing conditions in capital markets offered larger companies a cheaper alternative to bank lending and should, therefore, have supported investment activity. The switch away from bank lending by large companies may well, at the margin, have freed up space for the banks to lend elsewhere, with some knock-on effect on bank lending conditions. I understand that the Bank's own empirical estimates suggest that QE might have boosted UK activity by over 2%.

It will be for the MPC at the time to decide on the exit strategy from QE. The MPC's forward guidance framework makes clear that the Committee does not intend to increase Bank Rate or unwind the stock of QE at least until unemployment falls below 7%. My initial view, consistent with the MPC's previous statements in the area, is that, once that threshold has been crossed, a tightening in policy is likely first to involve raising Bank Rate, if only because the cost of reversing such tightening should it prove premature would be lower. Withdrawal of QE will need to involve a programme of asset sales and/or a non-replacement of maturing gilts. These will have to be well advertised in advance and closely coordinated with primary issuance by the Debt Management Office.

In common with all monetary policy tools, QE has a distributional effect. Together with the low level of Bank Rate, it lowers the return of saving, as well as reducing the cost of borrowing. That change in interest payments does redistribute income away from savers towards borrowers. The adverse effect can be material for individuals. Some of the effects of QE will, however, have worked to offset this. Some savers will have seen the value of their assets such as pension pots increase as asset values have risen. More generally, savers are ultimately dependent on the performance of the economy in the future; by supporting the recovery through very adverse conditions - and so avoiding longer term damage to the economy's potential - the MPC's asset purchase have improved prospects for those in employment and, by supporting asset values, some of those who have retired.

Question 16. What is your assessment of the outlook for UK growth? What do you regard as the major risks to the outlook for the UK economy?

The continued recovery in a wide range of survey indicators for activity is consistent with an above trend rate of growth in the second half of the year. Together with positive news in recent ONS releases, there look to be upside risks relative to the near-term growth forecast made by the MPC in August. One risk to the downside remains political events, leading to a renewed downturn in the euro area, with the associated disruption to financial markets. The experience of the past two years has shown how vulnerable the UK economic recovery is, given trade and financial links, to the situation in the Euro area.

The forward guidance framework makes clear that the Committee intends to maintain stimulus sufficient to generate a sustained fall in the rate of unemployment, so long as that remains consistent with price and financial stability. There is, however, a great deal of uncertainty over the outlook for productivity and, therefore, the pace of economic growth required to generate a fall in unemployment. If productivity is able to recover some of the 15% or so shortfall relative to its pre-crisis path, there would be scope for a prolonged period of above-trend growth. If, however, productivity growth remains weak then the rate of growth consistent with unemployment falling to below 7% would be at or below its historical average. The outlook for productivity is, in my view, the key uncertainty around the medium term growth outlook.