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Witnesses: Sir Mervyn King, Mr Paul Fisher and Dr Ben Broadbent

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Members present

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

Examination of Witnesses

Sir Mervyn King, Governor of the Bank of England; **Mr Paul Fisher**, Executive Director, Markets, Bank of England; and **Dr Ben Broadbent**, Monetary Policy Committee Member.

Q1 The Chairman: Good afternoon. Governor, I thank you for coming, as I do Mr Fisher and Mr Broadbent. As I have just explained, we are likely to have three votes during this sitting and, normally, we would all have to disappear for 10 minutes, but we have agreed to an informal pairing among ourselves so we will carry through despite the Divisions.

There are quite a lot of subjects that we would like to cover, but could we start with quantitative easing, on which we have a number of questions? I should like to start with one which may seem a little off-beam but which is terribly important to a lot of people. We have had a lot of focus since the Budget on the "granny tax", but I think that much more serious for those shortly to become pensioners and future pensioners are the current implications of quantitative easing. I have to declare an interest in that I am chair of three pension funds and am very much aware of the impact on those. Because of the current heavy purchase of gilts, as you know, and both through quantitative easing and through foreign purchases, gilt yields are very low. We hope that it is a short-term situation, but annuities are now well below the level at which they were available only a very small number of years ago and are permanent for those who take them out. Despite the improvement in assets among the pension funds, pension deficits are again rising very fast. That is entirely because of the effect on liabilities and the way in which they are calculated, with the consequence that the decline that we have seen in recent years, or the number of companies getting out of defined benefit schemes altogether, has recently accelerated. That consequence is long term, too, because I do not suppose that many of them will go back into defined benefit schemes. So the QE is short term, but the effects are long term. I recognise that quantitative easing policies cannot be altered purely because of the effect on pensioners, but I wonder whether the Bank is concerned about this and whether it has given thought to anything that can be done to mitigate its effect.

Sir Mervyn King: Lord Chairman, good afternoon and thank you for giving me the opportunity of coming. There are two distinct aspects to the question that you just posed. One is the development of pension plans in the United Kingdom, particularly defined benefit pension plans. The very unfortunate demise of defined benefit plans largely predates the Bank's asset purchase programme. So I am concerned about what has happened to the pensions industry and defined benefit pensions in particular, but I think that they reflect a much wider set of issues and blame for their decline cannot be laid at the door of our asset purchase programme.

The Chairman: But it has had quite an effect in the past 12 months, or even longer than that.

Sir Mervyn King: Let me explain why it may not have had quite as big an effect as some people think. The second aspect of the question is the effect of our asset purchase programme on lowering longer-term interest rates. Let me go to the question of annuities. There is no doubt that our programme, which has ensured lower short-term and long-term interest rates, has reduced the returns to any individual or family with their savings invested in a deposit account. To the extent that people had accumulated their savings in a deposit account, whether in a bank or building society, they will clearly have lost out relative to a world in which there were higher interest rates, other things being equal. To the extent that people had purchased annuities from savings that had accumulated within deposit accounts, then the lower annuity yields will undoubtedly lead them to be in a worse financial position. However, most annuities are not purchased out of savings that have accumulated in deposit accounts; most are purchased out of savings that have accumulated in marketable assets, be they equities or bonds, government bonds, gilts or corporate bonds. At some specified age, those savings are converted into annuitised form. The income from those annuities has not been affected in any way by our purchases. That may seem strange at first sight. It is very important to understand this, because I think that many of the people commenting on it do not. The only way in which we can lower annuity yields is by raising the prices of the assets on which those yields are calculated. In other words, when you have a stock of equities or bonds of any kind which you then convert into annuitised form, the coupons on those bonds or the dividends on those equities are not in any way affected by our operations or, if they are, we simply increase them because we have maintained economic growth at a faster rate than would otherwise have been the case. So we have been supporting the income on those securities. The only way in which annuity yields fall is the mechanical consequence of our asset purchases raising the price of those assets in the market, so that when they are then annuitised, with an unchanged flow of coupons and dividends, then the annuity yield appears lower. But the annuity yield falls by an amount which is purely the arithmetic offset to the higher asset price in the first place. Let me repeat: to the extent that people have saved in deposit accounts only, they will have lost—there is no doubt about that—but to the extent that most annuities to provide a pension have come out of savings that were accumulated either by individuals or pension funds in marketable assets, the annuity yield fall is simply a reflection of the fact that we have pushed up the price, because the coupons and the dividend yields are completely unaffected by our operations.

The Chairman: And on defined benefit schemes?

Sir Mervyn King: The same proposition will hold. To the extent that a fund is going to pay for a pension, the dividend yield and the coupons on the existing stock of assets have been unaffected or, if anything, supported by our actions, and the apparent lower yield is simply a reflection of the higher prices resulting from our asset purchases. It is true that where pension funds start with a deficit, it may appear that our operations increase the deficit, but that is not to say that the whole operation of the pension fund is made more difficult. It is simply that if you start with a deficit and any long-term interest rate goes down, the deficit will appear to be bigger. Those pension funds that were balanced and had assets which matched their liabilities, which is a sensible way to run a pension fund, will not have been affected.

The Chairman: I think that a lot of pension schemes would like to get into that latter position but were not so before this whole programme began and had deficits which have risen substantially.

Sir Mervyn King: It is true that deficits which pre-existed have become bigger—there is no doubt about that—but that is a different proposition from the one which is advanced by many people who say that, just because annuity yields have gone down, pensioners are worse off. That simply is not true, because the income that is generated from the assets that have been annuitised has not changed and the annuity yield appears lower because the value of the asset has been increased through our asset purchase programme. The only way in which we can affect annuity yields is by pushing up asset prices.

Q2 Lord Forsyth of Drumlean: Do you accept that growing pension fund deficits mean that resources which would otherwise go into creating jobs and investment have to be put into the pension funds to deal with this anomalous assessment of the deficit?

Sir Mervyn King: I do not think that it necessarily means that investment is lower; it means that savings in a certain form will need to be higher. In the long run, you would expect that to flow through into higher investment.

Q3 Lord Forsyth of Drumlean: But if you are sitting on a board and you suddenly find that your pension deficit has increased, you have to put funds in to reduce it. The deficit is calculated on the basis of what is happening on gilt yields. Therefore, it sucks resources away which would otherwise be invested in other activity. I sit on a board which has done that.

Sir Mervyn King: Indeed, but to the extent that you had gilts in the fund to begin with that were adequate to meet future liabilities, the lower yield will simply be the arithmetic offset of the higher price of those gilts, and the income that you will get from the gilts is unaffected.

Lord Forsyth of Drumlean: Yes, in a perfect world.

Sir Mervyn King: No, it is not a matter of a perfect world. Companies that start with a deficit have undoubtedly found themselves in a more difficult position, but if you take individuals who have annuitised their own savings, the lower annuity yields have not made them worse off. The value of the assets has gone up.

Q4 The Chairman: Most pension funds have a lot of equities on the growth side of their portfolio. It is not all of them—a lot of them are now trying, obviously, to reduce risk—but they still have a lot on the growth side which is not in gilts.

Sir Mervyn King: It does not matter what the asset is. The only way in which our asset purchases can lower annuity yields is if they increase the price of the assets such that when a company offering an annuity calculates the yield that it can afford to provide it realises that the coupons and the expected dividends on those assets provide a lower yield because the price has gone up.

Q5 The Chairman: That is a very interesting answer and I think that many people will look with great care at your assessment. Undoubtedly in the pension industry, there is great worry about it.

Sir Mervyn King: I said that there were two distinct aspects to this question. The reason why we should be concerned about pensions and the pension fund industry is not the operations that we have carried out but the decline of the pension fund defined benefit scheme over a long period and the existing deficits that were there. That is the real source of the problem.

Q6 Lord Forsyth of Drumlean: I understood the problem to be slightly different, Governor. If you have a pension fund with a mixed range of assets—you might have some gilts and you might have some equities—the effect of these very low yields is that the deficit grows and, in order to maintain the position responsibly as a company, you have to put additional resources into the pension fund. Those resources come from what would otherwise be spent on creating new jobs and employment.

Sir Mervyn King: If long-term interest rates go down, it is certainly true that the cost of making pension provision for a given scheme has gone up. However, in terms of the pre-existing liabilities of the fund, provided that it has purchased assets which match the pension fund liabilities in duration and so on, then both sides of the balance sheet are affected in the same way. But there is no doubt that the impact of lower rates, other things being equal, pushes up the cost of pensions as such—we see this in our pension scheme at the Bank. However, the very low rates of increase of money wages are lowering the cost of defined benefit pension funds by a significant amount, because, typically, a big part of the cost each year to a defined benefit scheme that is linked to final salary is adversely affected by having to make provision for revaluing all the earlier years' service to a higher final salary. When wages are rising at a lower rate, they are a much smaller component of the overall cost. That can offset the impact of the lower interest rate.

The Chairman: I do not want to pursue this much further, but an awful lot of pension funds are not in a position of matching assets and are therefore concerned at the present time. Anyway, we must move on to other aspects of QE.

Q7 Lord Forsyth of Drumlean: The quantitative easing programme, I think, is enormous and the largest of any country in the world—£325 billion. Can you explain how you will unwind from that position? It seems that if interest rates go up, there will be a reduction at least in the mark-to-market value of the gilts which have been purchased. How do you plan to unwind from what is an enormous accumulation of government securities?

Sir Mervyn King: Let me correct the impression that you gave at the beginning. If you look at the increase in the size of the balance sheet of central banks relative to GDP since the crisis began, you will see that there has been almost exactly the same increase in the United States, the euro area and the United Kingdom. All central banks have broadly increased their balance sheet, interestingly, by roughly the same amount. They have done it in slightly different ways, but the increase in the balance sheet is broadly the same. The committee in thinking about how it would unwind this stimulatory effect of asset purchases has concluded in a preliminary way that the first move would in all probability be an increase in bank rate. Then, when we were fairly confident that we were in a period when we would be likely to want to tighten over a period of six months or more, we would announce that we would sell gilts through an auction process, the mirror image of the process that we have used to purchase the gilts. So the market would know over six months, because we would tell them, roughly what the programme of asset sales would be. That would mean that we would be able to co-ordinate with the Debt Management Office and ensure an orderly method by which these assets would be sold. That would be pre-announced; we would carry it out. One would expect that then gradually to push up long-term interest rates, which would be the desirable outcome given that we would want to do this only at a point when we were trying to tighten policy.

Lord Forsyth of Drumlean: Would that then not result in a loss on the nominal value of the gilts, if they were being sold before—

Sir Mervyn King: It may offset the very large mark-to-market profit that we have made so far. I do not attach any value to it at all, but if you take the mark-to-market profit, it is very large at present and that would gradually disappear as we sold the assets back.

Lord Forsyth of Drumlean: So you see that as covering any future losses?

Sir Mervyn King: Yes, but I do not myself see that this is a terribly interesting calculation. That is for two reasons: first, these assets are effectively issued by one part of the public sector and bought by another; and, secondly, the real purpose of doing this is to ensure that the economy grows at a faster rate than would otherwise have been the case. The benefit of that will outweigh anything remotely comparable to the mark-to-market, ultimate profit or loss on the scheme, in just the same way as when we change interest rates normally, there are movements in gilt prices up or down.

Q8 Lord Forsyth of Drumlean: Would you buy a 100-year bond?

Sir Mervyn King: As governor of the Bank of England, I can assure you that I do not engage in any financial transactions. That is a calculation on which I shall reflect carefully. When I leave the Bank at the end of June next year, it will feed into my calculations as to what I do with my portfolio.

Q9 Lord Hollick: On the same topic of quantitative easing, an interesting calculation is the Bank's estimate of growth arising from QE, which I think has ranged somewhere between 2% and 8%. How have you calculated that? To what extent do you think further QE is necessary in order to try to get what is very sluggish growth actually moving forward more effectively?

Sir Mervyn King: Any calculation of the quantitative effect has to be very speculative. We think that we were able to identify, when we started our asset purchase programme, the impact on gilt prices and long-term interest rates. Because the programme was not really anticipated, you could see the market respond to the announcement of the programme. With second and subsequent waves of the programme, it is much harder to calculate the market response because the market was learning to anticipate that we might announce further asset purchases and therefore gilt prices moved a lot earlier than the announcement of the programme itself. However, based on the initial response of the markets and the change in long-term interests, we tried to calibrate broadly what the impact on growth and inflation was. I do not myself attach enormous weight to the accuracy of these estimates, but we did our best. It is a very uncertain calculation but, to be fair, estimates of what ordinary interest rate changes do to the economy are also very uncertain. On that first part, we have made our calculations and we have published an article saying what we thought the effects were, but they are not very precise estimates. There must be big standard errors around those estimates.

Q10 Lord Hollick: One very much hoped-for consequence of QE was that it would free up banks' balance sheets to lend more to industry. I am sure that your postbag is as full as those of many of the people around the table today with complaints from small and medium-sized businesses, which are a very important component of growth and job creation. They simply cannot get bank loans and, to the extent that they can, the bank loans are on far worse terms than they were able to obtain for the last few years. Clearly, this is a real problem and a serious impediment to growth. What can the Bank do about this to ease the situation for small and medium-sized businesses?

Sir Mervyn King: Not a great deal, because I think that the help that is required by small businesses really needs to come through the banking system. The reason for that is that one of the main purposes of a banking system is to develop a network of local managers, if you like, who develop expertise in assessing the credit risk of those who come and say, "We would like to borrow, please." That is something that is very hard to replicate.

What has been interesting about the past three years is that one of the benefits of our asset purchase scheme has been that we have been able to ensure that the corporate equity and the corporate bond market have functioned pretty efficiently—they have been normal really right through this crisis—so that large companies have been able to go around the banking system and borrow directly from the market by issuing bonds or equity. Since the bulk of investment is made by those large companies, I am not sure that it is fair to say that growth has been significantly adversely affected by the fact that banks have been deleveraging and not lending to companies. There is a stronger case perhaps for saying that the fact that banks have reduced the supply of lending to the housing market has possibly affected house prices and maybe the expenditure that follows from a higher level of house transactions than we are seeing at present. In any event, I think that big companies can obtain money, and some of them have large cash balances, too.

So I think that the small-company problem is a narrowly defined problem. It is important because much innovation comes from small companies, but the figures are not enormous. We reckon—this is a very rough estimate—that, in a normal year, the amount of net lending to the small business sector would be about £10 billion a year. Last year, it was about minus £5 billion. The economy is not growing very rapidly at present so you would not expect this to be perhaps a normal year, but we are talking about looking for some mechanism to change net lending to small companies from minus 5 to plus 5. The banking system is very important. We have a highly concentrated banking sector, where a large part of the lending is done by the four biggest domestic banks. That is atypical for a developed country, and so the fate of the small business sector depends to a large extent on the fate of those four individual banks, which are in very different individual circumstances.

Basically, you come down to the fact that either you have got to decide that you are willing to direct those banks—particularly those that are largely state owned—to give more credit to the small business sector or you have to provide an incentive to those banks to be willing to do so. That is, if you like, to give the banks a financial incentive to lend more to small businesses than they are clearly willing to do at present. That has to be a judgment by the Government as to whether they wish to do that. There is a scheme that has been introduced by the Government, and we will see how effective that is. But I think that it has to be one of those schemes to intervene. It requires a direct intervention in a very targeted type of lending to small businesses, and that is something that ought to be done by Government and has to be done, in my judgment, in one way or another through the banking system.

In the long run, there may be tremendous opportunities to develop new sources of lending for small businesses, either through increasing competition in the banking sector—to which I personally attach a good deal of weight—or possibly through finding new ways such as specialised markets and instruments that can be created to help small businesses. But those are definitely for the longer term and are not going to solve the problem in the next two years.

Q11 Baroness Kingsmill: You have talked of the crisis, but the crisis has been going on for such a long time that it almost does not feel like a crisis anymore. It feels like this may be steady state. Do you think that we have to recalibrate—this is a slightly philosophical question, I suppose—our expectations about growth? Can we anticipate, or is it a feasible thought, that we could have a neutral growth economy? Is growth an essential issue?

Sir Mervyn King: I would like to think that we can go back to the sort of economic growth rates that we saw in the past, and I think that those people who are struggling on low incomes would feel that it was rather a policy of despair to say that we cannot achieve growth. I would very much hope that we go back to the sort of growth rates that we had before, and I see no economic reason why we cannot do so in the long run. We had what I called the NICE—non-inflationary, consistently expansionary—decade, and I think that once we come through this crisis we will be able to get back to that sort of period again, but it will take some time.

To me, it still does feel like a crisis. The financial sector is not back to normal. We are going through a major process of deleveraging and we still have some way to go in that respect, and we also have the problems in the euro area. I think that it will still take a number of years before we are through all of this and back to something that can be thought of as normal. But when we do get back there, I would say two things. One is that we will be in a much better balanced state than we were when we went into this crisis. We should have done a good deal to reduce our trade deficit and I hope that some of the imbalances in the world economy will be a lot less. We will also have a financial sector running at much smaller levels of leverage than it was using prior to the crisis, which means that our financial system should be a lot less vulnerable. When the Vickers reforms are introduced, I think that those will help, too. All of those changes mean that, when we go back to normal, we will have a much more robust economy, and I see no reason myself why the economy cannot grow at the sort of rates that it did before.

Q12 Baroness Kingsmill: Do you care to put a time on that?

Sir Mervyn King: No, I am not prepared to put a time on it. When the crisis started, I would certainly have hoped that we would have been back to normal by now and we are not, and there is still a very long way to go. The experience of history suggests that financial crises take a lot longer than you think to get through, but one day you wake up and you are through it.

Q13 The Chairman: Let me ask a last question on QE. How likely is it, do you think, that more quantitative easing will be required? If so, will it take the form mainly of gilt purchases?

Sir Mervyn King: I do not know whether it will be required or not. The committee meets every month and we make a fresh judgment each month as to what we think is necessary. We do not just say, "Let us forget it now for three or four months and come back to it". We examine it every month, and we are prepared to change our mind each and every month. I am not going to anticipate what we will decide.

I think that if we were to do more—and I stress "if"—it would be in the form of conventional gilt purchases, yes. That is the way in which we can increase the amount of money in the economy. The point that I would stress, which most people seem to forget, is that people seem to focus on the first-round effect of our gilt purchases. What we do when we buy gilts, say for £50 billion, is to inject £50 billion-worth of money into the economy. That goes to private agents, who could be pension funds or all kinds of people who sold the gilts to us. They are very unlikely to want to hang on to cash; they will want to invest in other assets. Some of them may want to go back into gilts and some into corporate bonds and all kinds of assets, and they in turn would be spending money, which will be received by other people who in turn will be spending. There are second-round, third-round and fourth-round and so on effects. From the second round onwards, it is the private sector that decides what assets are bought. Sometimes people will say, "It would be much more sensible to buy private sector assets than public sector assets", but that is for the market to decide. If people want to buy private sector assets, then in the second, third, fourth and fifth rounds they will buy private sector assets. The money does not disappear—it does not leak away anywhere—but stays in people's bank accounts; it is just that the ownership of that bank account moves round the economy until it gets into the hands of people who are content to hold on to the additional amount of money that we have created. In that process, the prices of a very wide range of assets, both financial and real, can adjust. That is actually how monetary policy works, and it works in that way even when we are in the normal period when we change interest rates rather than engage in asset purchases.

So I do not think that it is sensible to say, "This is terrible that we buy gilts. Why do we not buy private sector assets?" It is for the private sector to decide what private sector assets should be purchased, and if there are assets that they are not buying that people think somebody should buy, that is basically a statement that the Government should intervene and buy something for which there is no private sector demand. That may well be a good thing to do, but that is why we elect Governments to make that kind of decision; it is not for central banks to make that sort of decision. If we did, you can be absolutely certain that either this Committee or its counterpart in the other place would be immediately demanding what authority we had to make these credit allocation decisions, and the answer is none.

Q14 Lord Forsyth of Drumlean: Governor, your deputy, Paul Tucker, said in a speech in November: "Our ability to sustain exceptional monetary stimulus has, I should reiterate, depended on the credibility of our commitment to low inflation over the medium term being preserved. I worried that chatter in the markets in late 2010/early 2011 marked incipient signs of fragility in that credibility". Clearly, there have been factors beyond your control, such as rising VAT and energy costs, playing a large role in keeping inflation above the 2% target in recent times, but do you think that the Bank's inflation-fighting credibility has been damaged?

Sir Mervyn King: I do not think so. Clearly, we are not happy with the outcomes of inflation in the past few years, but they have, as you pointed out, been generated by external factors which it would not have been sensible for us to try to offset. We are not complacent. We look very carefully each month at the inflation outlook and we worry about where inflation will go. If you look at the conventional indicators of credibility, inflation expectations, there is no sign that they have moved up. As we have just been discussing, long-term interest rates are low; measures of inflation expectations from financial markets are low and stable; survey estimates of inflation expectations in the long term are pretty much where they have been right through a period when inflation averaged around our target; and short-term inflation expectations have come down as inflation itself has moved down. Those measures do not really show any signs of loss of credibility. Perhaps most important of all, wage settlements and average earnings are rising at a rate below that which we would normally associate with meeting the inflation target. I do not believe that there is any loss of inflation credibility in that sense. Obviously, people are worried about what has happened to their standard of living. They are not content with what has happened in the past few years. Many people, when asked, will say, "Well, this inflation rate has squeezed our living standards". In fact, it is not inflation as such that has squeezed living standards; it is a price-level shock from outside: energy prices, food prices and VAT. That has been the squeeze on living standards, of which a higher measured inflation rate is the symptom but not the cause. Inflation has not reflected more rapid monetary growth or the normal factors that you would associate with monetary policy having allowed inflation to get out of control. If anything, it is the opposite: money growth and wage growth have been below the levels that we would associate with getting back to normality.

Q15 Lord Levene of Portsoken: Governor, good afternoon. I should for the record declare an interest as the chairman of NBNK. I want to expand on the question that you answered from Lord Hollick. I understand what you said about local banking helping local companies, especially small businesses. What effect do you think the actions of the Bank of England may be having on productivity growth?

Sir Mervyn King: If anything, we are trying to support it by ensuring that growth, although not particularly exciting, is still higher than it would have been had we not taken action. If we do not support activity in the economy at present, we run the risk of creating levels of unemployment that could persist for long enough that they then became difficult to bring down. That is one reason why we have clearly followed the mandate that we were given, which was to ensure that we avoided unnecessary volatility in output. We have been through a pretty extraordinary time. In terms of the falls in output, this is deeper than anything since the 1930s and it has persisted for quite some time. It is clearly something which, initially in 2008-09, was seen around the world. Since then, the emerging markets have recovered, but the industrialised world has continued to experience problems. It is just taking a long time to get out of it, as the chairman of the Federal Reserve made clear early yesterday or the day before. I think that we have done something to prevent productivity and growth falling even faster than would otherwise have been the case, but there is still a long way to go to get back to levels that we would regard as acceptable.

Q16 Lord Levene of Portsoken: Do you think that the commercial banks are adequately following your lead on that and do you have any other ways of persuading them of the way in which they should go?

Sir Mervyn King: Obviously, we have no powers at all at that stage. We are neither the regulator nor the Government.

Lord Levene of Portsoken: That is why I said “persuading”.

Sir Mervyn King: The banks clearly face immense pressure in funding markets to reduce leverage. Banks are not refusing to lend just for the hell of it; they are facing much higher funding costs than prior to the crisis. Even though funding costs have come down in the first couple of months of this year, they are still higher than they were a year ago because of the problems associated with the developments in the euro area. The difficulty is that, prior to the onset of the crisis, people were willing to lend money to banks, whether for a short period or a long period, at interest rates or a premium over bank rate of very small amounts, because people thought that banks were safe. What happened in 2008-09 has destroyed that belief and it will take many years to get it back. So the premium at which banks can raise money over bank rate is still considerably higher than it was. That is likely to affect the level of bank rate itself for some time to come, but it is clearly also putting pressure on banks to raise funding to demonstrate that they are not dependent on official funding—I think that UK banks are doing pretty well at that. We are beginning now, despite the impression that some people took away in 2007-08, to get to the point where people can see that UK banks are far less dependent on official funding than many banks in the euro area, which will help them in the long run. They are a credible institution to lend to and fund. But it is not as cheap as it was, which is clearly affecting the cost of funding. One of the reasons why the Bank of England has stressed the importance of greater competition in banking, and in particular new entrants, is that new entrants by definition do not have the legacy balance sheet problems which are precisely the cause of the difficulties facing many existing banks and which have made life tough for them. So this is a good time for us in the UK to try to expand the size of our banking sector by encouraging new entry.

Q17 Lord Tugendhat: Let me just ask a question about growth following Lord Levene's questions. I remember last year's royal wedding being blamed for a hiccup in the growth figures at the time. This year, we have the jubilee and the Olympics. What impact do you feel they will have on growth, and will they require any adjustments to policy that might not otherwise arise?

Sir Mervyn King: I will give you a brief answer to that. Perhaps I could then ask Dr Broadbent to come in, who understands a lot more than I do about the quarter-to-quarter movements. We expect, quite possibly, a fall in output in the second quarter, followed by a rise again in the third quarter, because we will lose an extra day's work. It does not necessarily follow that a whole day's output is lost in that quarter because of the additional bank holiday. Last year, we saw that pattern of a weaker Q2 and a stronger Q3, and we would expect that to happen again this year.

Dr Broadbent: The Bank estimates the effects of the Olympics precisely to be relatively small. It is mainly, as the governor says, that the Diamond Jubilee will basically lose us some output through people taking a day off, which will detract from growth in the second quarter and then add back a similar amount in the third quarter. That is not the sort of thing, because it is so short term, that policy should or would respond to. Fortunately, there are much greater sources of volatility in output which policy has to worry about.

Q18 Lord Tugendhat: So you are expecting a dip—correct me if I misunderstood you—because of the extra bank holiday, so the jubilee is like the royal wedding. You are expecting a revival in the third quarter, but given the total disruption that is going to descend on London—people are trying to play it down but it is going to be dreadful—and the fact that everybody will be glued to their televisions, especially if we are getting some medals, I would have thought that it was slightly optimistic to assume that the third quarter would see a revival.

Dr Broadbent: There will be things going in the opposite direction. There will be people spending more money, particularly overseas visitors. Output has to be provided to meet that extra demand, and, of course, it is a time of year when lots of people take holiday anyway. So I think that the overall assessment is that the total effect will be small and that the main distortion for the third quarter is the fact that you are starting from a lower level than you otherwise would because of the Diamond Jubilee holiday.

Lord Tugendhat: Taking the year as a whole—

Dr Broadbent: By the time we get to the second half of the year, annual growth rates will be unaffected by those things.

Q19 The Chairman: I must say that I have always been a bit surprised that a one-day bank holiday should have such an impact on growth in the quarter, because there are businesses gaining from the bank holiday.

Dr Broadbent: Possibly, but you are losing whatever it is—5% almost—of working time. It may be a little less than that, but it is still quite a lot.

Q20 Lord Moonie: Governor, in December you said that the crisis in the euro area is one of solvency, that liquidity provision may offer only short-term relief, and that ultimately Governments will have to confront the underlying causes. In February, when referring to the UK, you said that the biggest risk to the recovery stems from developments in the euro area where concerns remain about the indebtedness and competitiveness of some member countries. Do you think that they are addressing the underlying causes of the crisis properly?

Q21 ***Sir Mervyn King***: It is hard to judge. There is no doubt that the actions of the ECB with its so-called long-term repo operations have bought a lot more time because banks in Europe can now get guaranteed funding for three years. That action has certainly provided a breathing space for developments in the euro area, although in itself, of course, it does not do anything about the underlying problems. All it does is create a window of opportunity. The difficulty is that windows of opportunity have been created regularly for over two years now, but nothing seems to have gone through those windows. However, hope springs eternal. I do not know whether they will be able to take advantage of them because it is a question of political actions. The strategy seems to be to encourage structural developments in those countries which have lost a great deal of competitiveness over the past 10 to 12 years. Over time, structural reforms will indeed improve competitiveness, provided that they are put in place faster than improvements in productivity in northern Europe. That is because this is about competitiveness in a relative sense. In the mean time, it could be a difficult and challenging period for the countries that are struggling to regain competitiveness. It is very much an open question and I would hesitate to give a firm view as to whether they are likely to deal with the underlying problems.

Q22 Lord Hollick: Given that uncertainty of outlook—of whether those countries can get through the windows—are the UK banks prepared for the worst case? Have you modelled the worst-case scenario and are you working with the UK banks to ensure that they have sufficient reserves and defences in place to withstand what could be a nasty situation once the windows are closed?

Sir Mervyn King: The Financial Policy Committee, the new policy-making committee in the Bank on which Paul Fisher and I serve, recently published a statement which makes it pretty clear that one of the reasons we think the banks should take up opportunities to find new sources of capital where they arise, either by being careful with distributions or by exploiting the possibilities of new issues where they seem to be available, is to build up a bigger buffer against potential downside risks in the euro area. The UK is exposed primarily in two ways. One is through the Irish economy where the UK banking system has large exposures to the Irish economy, and clearly adverse developments there would impact directly on the Northern Irish economy. The second way we are exposed is that while the large UK banks do not have major exposures in the form of holdings of sovereign debt of southern European countries in difficulties, they do have quite large exposures to banks in other parts of Europe, or indeed to the real economies of countries in southern Europe, so that they would be affected by a really serious adverse outcome in any of those countries. It therefore makes sense for them to make sure they have buffers of capital that would be available to absorb losses, were those losses to occur. If the banks cannot demonstrate to the market that they have a buffer of capital sufficient to absorb losses, they will find that the cost of funding will rise at a point in the future, which would make their position considerably worse. It is a difficult judgment, but we have recommended where possible that this is a reasonable moment. Clearly, we are not arguing that we are in great shape ourselves and we would like the banks to continue to supply credit to the real economy, but there are risks down the road, so it is important that our banking sector has loss-absorbing capital that is adequate to deal with any losses that occur.

Q23 Lord Hollick: Are you satisfied that the banks are responding appropriately to your warnings?

Sir Mervyn King: Yes. The Financial Policy Committee made recommendations six months ago and then three months ago and we reported on those last week. These recommendations do not have the force of statute as yet, but that will be the case when legislation in the form of the new Financial Services Bill, if it does so, comes into effect next year. We also make recommendations to the regulators. The FSA took our recommendations and went to the banks. As a result, four of the big five banks have reduced their cash distributions by a non-trivial amount. When they do pay bonuses, they take great care to reduce cash bonuses significantly so that more money can be ploughed back into the bank, providing loss-absorbing equity that in turn can finance some bonuses in the form of creating new shares which do not detract from the cash resources of the company and hence its equity buffer.

Q24 Lord Hollick: Is there a risk that the banking subsidiaries of continental European banks could use their deposit base here by swapping into euros to fund any shortfall in the funding of their domestic banks?

Sir Mervyn King: Capital can flow across borders. Our own banking system obtained a lot of funding from overseas before the crisis. Much of that has dried up either because it came from countries which were themselves in difficulties or because it came from institutions like the US money market funds, which are now facing quite a difficult new regulatory environment. All banks have been thinking about finding different sources of funding and I do not think it is something that we should worry about too much. We are trying to ensure that banks providing credit for the domestic economy look sufficiently strong in terms of their capital and liquidity buffers that they are able to secure funding at sufficiently attractive rates, and that in turn they feel able to offer credit to companies and households in Britain on terms that look reasonably competitive. That was what was damaged by the onset of the crisis. We had a very concentrated banking sector which suddenly looked extremely weak. There were high levels of leverage and those people who had lent money to British banks to enable them to lend on to businesses and families were not willing to supply that lending. British banks then had to pay a lot more for it, which in turn led to the higher margins that banks were charging above bank rate. We then had to cut the bank rate by an awful lot in order to ensure that interest rates to final borrowers did not rise, and actually came down a little.

Q25 Lord Tugendhat: Governor, I am sure that you would agree that the eurozone crisis is a complex mix of elements financial, banking and institutional. It would be invidious of you to dwell on those in great detail here but, given the institutional problems over taking decisions involving a multiplicity of Governments with different national views, do you feel that perhaps we are in for a very prolonged period of crisis management? People talk about when the crisis ends and so forth, but it seems to me that the most likely outcome at the moment—unless there is some fearful drama like $200 oil or something—is that we are just going to be faced with a long, rumbling period of crisis management, in which these dangers will sometimes look more imminent and sometimes less. There will be remissions and there will be crises. Would you agree with that analysis?

Sir Mervyn King: I think that is a very plausible description of what the future may hold in the euro area. You are a much greater expert than I am on the institutions and politics of it, but I think that the economics also play into that. The underlying economic problem is that some of the countries in the south have lost a great deal of competitiveness and they have substantial trade deficits, and those deficits would be possibly even bigger if they were to get back to anything remotely like full employment. And someone has got to finance those deficits. You cannot have a deficit unless someone finances it. Many financial institutions abroad, particularly in the US, were funding some of those deficits by providing funding for the banking system in those countries, which was in turn lending on. That source of external finance from the private sector overseas has largely dried up and much of the external deficits are being financed by official financing through other member countries of the euro area. The challenge is to find a way through this, and it is proving extremely difficult. The picture that you describe of waxing and waning, of episodes that require crisis management and no quick resolution of the underlying problems that would take away the need for crisis management, seems to me rather realistic.

Q26 Lord Moonie: Have you modelled the effects of the possible outcomes of the French presidential election?

Sir Mervyn King: No, I do not feel that my expertise remotely lies in that area. Certainly, I am happy to leave my two colleagues here to talk about models of any kind, particularly in connection with the French presidential election. Paul, you deal with the markets. What do the markets say about the French presidential election?

Mr Fisher: One of the most difficult things for the markets at the moment is trying to predict political outcomes. The markets are prepared to take a punt on economic outcomes and what the data on growth in a country might be, but trying to predict the political outcome or what the politicians might do has been the most difficult thing for the markets. That is why we have seen these periods of extraordinary market weakness, when people get into a situation where it is just uncertain what is going to happen. That was really what triggered the crisis back in the middle of July last year until the start of August, when there was a perception that the Italians in particular had lost the plot at that stage and we saw a very sharp fall in equity markets. That political uncertainty is one of the real causes of what is going wrong, and it is very difficult for us to say. I think that the governor is right that the picture that Lord Tugendhat describes is actually the optimistic one; all of the routes from here to a more normal regime in the euro area are going to be painful, but some are relatively more orderly than others. What you describe is the more orderly one. Politicians have the ability to make it more disorderly, I am afraid.

The Chairman: As do electorates.

Q27 Lord Hollick: I have just a quick follow-up question. As the governor has pointed out, somebody has got to finance the deficit of the south, and that is Germany. A fundamental assumption in all the models is that Germany will continue to do that.

Mr Fisher: That is right. Ultimately, when it comes to the shove, difficult decisions have to be made. All the decisions that have to be made on this bumpy path are deeply politically unpopular in the countries to which they are applied—whether that is the Greeks, the Spanish and others trying to restore competitiveness to their economies or the north Europeans who might have to provide the temporary financing. So, yes, each time we see these decisions getting pushed to the last moment until the politicians can convince their supporters that this is something that absolutely has to be done because the outcome otherwise will be far worse. So you are right that this sort of financing has to be part of the view.

Lord Hollick: It is a central assumption.

Q28 Baroness Kingsmill: What are your views about the current state of banking regulation? Is it working now? Are the changes that have been brought about effective? How are things moving forward in that context?

Sir Mervyn King: I think that there are three dimensions to banking regulation. One is the structural changes that will come with the implementation of the Vickers reforms, and I think that it is important that that legislation is passed sooner rather than later so that people know what the framework will be.

The second is the dimension of European legislation and what impact that will have on regulation. Somewhat bizarrely, although the debate at present is often presented in terms of the UK trying to avoid genuine regulation of banks by European legislators, the truth is completely the other way round. The current proposals that were put forward by the European Commission would have made it impossible for any regulator, say in Sweden or in the United Kingdom, to impose higher capital requirements on its own banks in order to protect domestic taxpayers. If you have a large banking sector and the consequences of its failure would be much more damaging to domestic taxpayers because they would feel compelled to bail the banks out, in that situation—as Switzerland has done, and indeed so far as Sweden has also done, and as Vickers recommends for banks behind the ring-fence—to have a higher level of capital than previously would simply make sure that you had a safer banking system, which would help to protect domestic taxpayers. Since there is no suggestion that European taxpayers are going to pick up the bill for a national banking system if it gets into trouble, it seems reasonable to allow national regulators to protect national taxpayers but the European Commission does not want to allow that.

This is being debated at present, and the Danish presidency has put on the table a set of proposals that go in the right direction. The regulatory community of central banks and banking regulators that met last week in Frankfurt—the European Systemic Risk Board, which is a new body—agreed that we would send a letter to the European legislators pointing out that, although the Danish text is a very good move in the right direction, there are still things that have to be done in terms of allowing committees such as our Financial Policy Committee to have the freedom to impose macro-prudential regulatory requirements when it is thought appropriate in each country. So that is the state of play at the European level. It has certainly improved from six months ago, but it still has further to go before we get to the point where our own regulatory framework will be able to do what we think is the right thing.

The third element is the prospective move of prudential regulation from the FSA to the Bank of England, which we would expect to take place in the spring of next year. We are shooting for a date of 1 March, and we would very much like to do it then if we can but it will be very much around then. We are determined to bring about a change in both the style and culture of regulation and also, I hope, to reduce the cost. I think that there has been a great deal of routine reporting imposed on banks, much of which is never used, and we are very determined—Hector Sants and Andrew Bailey from the Bank have been working closely together on this—to change the current FSA in that direction. The FSA is bringing about an internal division within the FSA that will foreshadow the new prudential regulation authority on the one hand and the financial conduct authority on the other. That prudential business unit as it will be called in the FSA—which Hector Sants will run until the end of June, when Andrew Bailey will take over—has made big strides. Many of the individuals have changed and there has been a big turnover of people since the beginning of the crisis, and the style and culture will be very different.

We are determined to make that effective because one thing above all others that I think is crucial is that, after a crisis like this, although everyone seems to agree on what the main lessons were and what we have to do, you can be absolutely certain that, unless we can internalise these lessons in an institutional form, people will have forgotten them 10 or 20 or 25 years down the road. Indeed, much that went wrong was that, although in the 1930s after the great depression people did learn lessons about what should happen to the financial sector and they put in place a framework and legislation, as a longer time went on and people seemed to be having more fun doing fancy transactions, people said, "Why don't we just revoke this piece of legislation as it would make things a lot easier? It is different with us. We are smarter and more clever and more modern. We won't fall into the same trap." But we did. It is very important that we think deeply about how we can prevent not a crisis in five years' time—there will be enough memory around to prevent that—but a crisis for our grandchildren. We do not want them to suffer what the current generation has suffered through the fact that we did not remember some of the lessons that were there and evident after the 1930s.

The Chairman: Some of us remember that there were lessons to be learned from the 1970s—the period of 1973, 1974 and 1975—which were quite quickly forgotten afterwards. I fully take your point about memories being short.

Lord Levene has another question on this.

Q29 Lord Levene of Portsoken: Governor, I entirely agree with what you said. If I may say so, one of the most important things that you referred to was the big turnover in people—different people with different ideas looking at this. Are you satisfied that the PRA will be able to recruit people on the terms they have available? It will require some very skilled people to be able to do that job in the way that you are talking about.

Sir Mervyn King: I do not believe that the way to get the right people is to think that you pay a large amount of money to finance big salaries for short-term contracts. We have to create people who believe that it is a public-service calling to work in the Bank of England

and spend a good chunk, if not all, of their career as banking supervisors. The great supervisors in the US, the Paul Volckers and the Gerry Corrigans, earned far lower salaries, but they achieved a lot of reward in return, which mattered to them, in terms of being very successful regulators. We in the Bank of England have a better chance than anyone else—it is one of the reasons for returning supervision to the Bank of England—of saying, "Come and work in the Bank of England; it is a calling; it is public service and it is fascinating. But if you want to earn salaries of getting on towards £1 million, you will get not get that in the public service. You get a different lifestyle altogether". We want to create and attract people who will stay with us because it is a public service. We have been able to do that in other areas of the Bank of England's activities, and it is that which will lead to better regulation. It is having people with experience and knowledge, people who are prepared to challenge individuals in the financial sector. It is not about becoming obsessed with detail.

Citibank is quite a good example—the biggest bank in the world. Everyone regarded it as the model: to become as big as you can and to shave a few basis points off the cost of funding. The US regulators had people living inside Citibank, inside the building. You could not have had more information. It was not a lack of access to information or monitoring; it was an inability to see things in perspective. I rather doubt that the senior executives themselves of Citibank could see them in perspective. It is being prepared to say, "Come on, I have been doing this for 20 years. Your leverage is now 50:1, whereas, five years ago, it was 20:1. Don't kid me. I don't understand all the fancy arguments you've made, but I just do not believe that 50:1 is as safe as you think it is and I challenge it". That is what we will need in the regulatory community; it is not being obsessed by detail. That is why I believe that we can reduce the cost of regulation while making it more effective.

One of the things that have gone seriously wrong has been an obsession with allowing banks and insurance companies to use models to calculate the appropriate regulatory capital requirement. There is no way in which a regulator can easily assess the merits of a detailed model when you know that, when these capital requirements really matter because you need a big buffer to absorb losses and to give confidence to those funding the institutions, the models will be meaningless and the assumptions behind them will have broken down. We need to go back to a much more broad-based system that looks at key indicators of vulnerability and not pretend that we can monitor or second-guess the management in dealing with the details of every individual contract.

Q30 The Chairman: I am sure that I speak for many in thinking that what you have just said, not least in terms of public service attitudes, was said from the heart and will get a wide "Hear, hear" from many of us, and it is well worth our publicising that as much as we can.

Could I bring you back to the second of your three points, in relation to European capital requirements? I noticed that you were very tough when you said to the Draft Financial Services Bill Committee: "No one could conceive of any reason why you would object to a country wanting to impose higher requirements, for example to protect their taxpayers". It does not seem that that message about "no one" has quite got through to all the people with whom you have to deal in the European Union. What do you see as the timetable on this to try to get a proper outcome?

Sir Mervyn King: I draw comfort from the fact that most of my central bank governor peers in Europe agree with this view. An overwhelming majority of people on the European Systemic Risk Board—from all over Europe and all 27 countries—share that view. The European Commission would argue that it is trying to create a single rulebook. A single rulebook, in its judgment, means having not just the same minimum capital requirements but the same maximum capital requirements. We differ from that view for two reasons. First, we think that, even if you were a wise single supervisor in Europe, you would say to yourself, "Since we do not have a European taxpayer picking up the bill for banking crises, it is sensible, even if you were just imposing it from the centre, to allow different capital requirements in different member countries to reflect the size of their banking systems". Secondly, you would say that also if you had macro-prudential supervision. Let us say that our Financial Policy Committee imposed a higher counter-cyclical capital buffer because of a commercial property boom that we wanted to slow down. However, if there was a commercial property boom in one member country of the European Union but not in others, you would not impose the same buffer on every country; you would impose it where the problem was. I simply do not see the logic behind the view that a common approach to supervision and a single rulebook imply that the capital requirements have to be the same in every member country. I just do not think that the economic logic goes in that direction. We are continuing to make our argument and we have made real progress. The Commission has gone some way to agreeing, at least in terms of macro-prudential supervision, that there should be much greater flexibility at national level. It is unwilling to move at this stage on the maximum harmonisation requirements, pointing to various methods by which countries can find means of effectively imposing higher capital requirements, but it is the basic principle behind it which I still find puzzling, to be honest.

The Chairman: A number of colleagues want to come in on this subject, so I will turn first to a former Commissioner, Lord Tugendhat.

Q31 Lord Tugendhat: I am not going to ask about that issue.

Governor, like the Chairman, I profoundly agree with what you have said about regulation. I hope that you will be able to do it because what you have said goes against the grain in terms of the way in which people change careers all the time. I do not know about the Bank, but one has only to look at the turnover of people in the Treasury and the shortness of memory, as it were, to see how very difficult it will be to construct the model you were talking about and which I hope devoutly you succeed in constructing. The point I want to make is this. It is not just that people thought they were cleverer than their predecessors or that they would avoid the problems, but that, for want of a better word, the moral tone of banking is very different from what it was within the living memory of the people here. One can look at pensions mis-selling, aggressive tax avoidance schemes and the misleading ways in which products are advertised. There is a whole raft of things. We are not necessarily talking about casino banking at all, but about absolutely plain vanilla high street banking. One of the problems that you are up against is that banks do not appear to observe the same informal moral codes of how things should be done that would have been the case within the living memory of people like you and me.

Sir Mervyn King: I always get into trouble when I start to talk about the moral nature of banking, so I shall be careful, but I have a lot of sympathy for that view. What it reflects is a change in the structure of banking away from the plain vanilla banking that you are talking about, which clearly identified with customers. Most people who worked in banks came up through the branches and had experience of customers and clients. As time went on, many of our biggest banks could see the attraction of emulating investment banks by securitising instruments and making decisions through credit scoring rather than relying on a very expensive branch network. The difficulty for many of them was that they fell between two stools. They lost the informational touch with their customers but they still had a much higher cost base than the investment banks, which are fleet of foot and can change their total costs very quickly, from one month to the next. The banks certainly moved in that direction and the kind of people who run them altered from being those who were motivated by innovations related to the experience of their customers to those who were motivated by mark-to-market profits in the previous three months. You can see that vividly in contrast with the performance of supermarkets, which have increased and improved the customer experience in this country out of sight over the past 25 to 30 years. They comprise a small number of big chains with a great deal of competition between them and they are utterly focused on the customer experience. You can contrast that with some of the bigger banks, although I think that they are now all trying to change very rapidly. However, you would not have said that the biggest thing on their mind was the customer experience, certainly if we were on the receiving end. That has been a change, because many of these institutions saw themselves as big global players motivated by very large transactions. Purely in economic terms, that changes people's attitudes and the issues that people think about and that motivate them.

I have said before to a committee in the other place that one of the strongest impressions I have taken away from my time as governor is when I have gone around the country to meet people who run businesses. The people who are successful make money as a by-product of the passion they feel about their products. When they wake up in the morning, what they want to do is to make the best products, whether that be an engineering product or even a particular kind of plate. I saw a wonderful company doing that in the Potteries. These people were passionate about their products, and you can see that all over the country across a bewildering variety of businesses. If they are successful, they make money, but they do not wake up in the morning motivated by saying, "We are going to make another £200,000 today". They take pride in their products and in developing their workforce to improve their products all the time. They also take pride in their customer relationships. These companies are extraordinarily impressive because they operate with a very small number of people with high-powered qualifications, and because they are passionate about their products, they work very effectively.

You then come to London, whether to businesses or to Government, where you find hundreds of people with high-powered qualifications, but their output is tiny relative to what is being achieved out there. We find people in finance who are fascinated by the amounts of money it is possible to make on a transaction. Even within the financial sector I have come across people who have told me that, in their part of the business which had customers, they would say, "If we really improve the customer offering, over the next two years we can make a lot of money". Sometimes the response was, "But that money could be made by our trading division in one afternoon". Of course it can be made in an afternoon, but it can also be lost in an afternoon. I am concerned about the attitude towards what it is that the experience of work is trying to achieve, and that is why one of the most depressing things about some parts of the financial sector is that people seem to think that the main objective of being in it is to earn enough money to be able to leave it, as opposed to finding satisfaction and a lifelong career within it.

That is enough of the moralising on this subject. I have gone on for far too long and you have tempted me to do things I should never have done. It really was most unfair of you, Lord Tugendhat, so I think I will just stop now.

Q32 Lord Forsyth of Drumlean: Perhaps I may say, Governor, that Lord Tugendhat has done you a great service by tempting you in that direction. Perhaps I should declare an interest as a director of NBNK Investments and of Evercore Partners. I think that the committee has been moved by your vision of how the Bank of England would operate as a regulator and by your concept of public service. I want to take you back to an earlier inquiry by this committee in which we looked at the causes of the financial crisis. We considered the question that was asked by Her Majesty the Queen: why did no one see this coming? If you have a great boom going on, and with that a stampede, as well as the kind of culture that you have described operating in the banking system, with vast amounts of money being made and vast amounts of it going to the Treasury, it is actually quite hard for the regulator to stand up in the middle of the stampede and say, "Hang on here a second". With the Bank as a regulator along the lines you have described, in those circumstances how do you see it being able to stand up and cry out the old cliché, "The party's over"? How will that work? The forces are enormous because of the huge amounts of money involved, which affects both the Government and the private sector.

Sir Mervyn King: That is a very good point and it is exactly the challenge to creating a successful regulator. One reason for believing, against my initial instinct, that regulation should come back to the Bank is the observation that this is the best chance we have of creating a cadre of people with the self-confidence and, if you like, the moral belief in their role. They are not going to earn vast amounts in terms of salary, but they will have positions in the Bank that matter. Others will respect that and they will be listened to. Their task will be to look at the big developments and collectively exploit the reputation of the Bank and the power of the governor to say, "This has gone on for too long".

However, it will be difficult. Over the past five years I have seen for myself that when Governments do not like what the central bank does, it is a very uncomfortable position, but you have to stand up for what you believe in. I think that it is much harder for a regulator to do that. In 2007 when all this began, I was struck that very few people in Britain seemed to have heard of the Financial Services Authority, and that made life much more difficult. Whether it was people in the financial sector or in the Government, it was easy for people to dismiss the FSA and make it harder for the authority to do its job than it would be to dismiss the central bank. I joined the Bank of England 21 years ago this month and I intended to stay for two years, but I have stayed because the quality of the people who work for the Bank is quite extraordinary. Over the years our intake has got better and better, and I think that we are capable of attracting and recruiting the calibre of people with the independence of mind and judgment who will be prepared to stand up and say, "This has gone on for too long". We now have mechanisms through the Financial Policy Committee and the prudential regulation authority to map those concerns and turn them into actions. The important thing is to have a graduated scale of response. What you do not want is to be in a position where you express concerns and no one does anything, so in the end you are forced to make an awful judgment of whether to close somewhere down. That was really what happened in the case of BCCI. The regulators were put in a very difficult position. What we are determined to do is to put in place a graduated set of responses so that the regulators can take action early on. It will not be action that is so severe as to threaten the existence of the institution, but people will sit up and take notice. We seek to link a graduated series of prudential responses to developments as we see them evolve.

Q33 Baroness Kingsmill: I am glad you said that, because as a former regulator myself, I agree with everything you have said. Being a regulator is one of the best and most exciting things you can do, but you have to be motivated by a sense of public service.

The Chairman: As in politics too, I think.

Q34 Lord Hollick: Governor, the important line of defence which will prevent a bank behaving recklessly or overreaching itself is of course the board of directors. We have seen in the reports that have been published by the FSA that the performance of the board of directors of a couple of our banks fell well below par. They may well have been bamboozled by the models that were coming out, but they did not necessarily have the experience or the common sense to form a broader judgment. How, in what must be quite a limited gene pool, do the banks find directors who can apply that wise common sense, and how does the Bank as the regulator satisfy itself that that line of defence is there and is not simply a Maginot line for smart people to get around?

Sir Mervyn King: I do not think that the regulator should depend on non-executive directors, for the reasons that you gave. It is asking an awful lot of the non-executive directors of a complex business to expect them to see through something that is going on. The real job of non-executive directors is to choose the right person to be chief executive and to monitor that, but you cannot expect them to be experts on the models or anything else. That would be silly, in my view. It is important that the regulator should take responsibility. The reason why the non-executives are there is, in a sense, to protect the shareholders. If they fall down on their job and the regulators take action, it is the shareholders who will lose money and rightly so. The regulators have to be prepared to bail in—not the taxpayers—along with the shareholders and the people who supply bond finance. Regulators cannot really depend on the non-executives.

The regulators should certainly have a good relationship with the auditors. The auditing function is important. I know that Andrew Bailey and the FSA have worked very hard to restore the relationship between regulator and auditor that existed many years ago. I myself am desperately keen to get us away from process, where everywhere you look people think that the answer to a problem is to create some new process. That is usually a disaster, because who knows who is in charge of the process? You fill in forms; you go through very worthy discussions and people, aside, say, "Yes, we understand these risks". When it gets down to it, you have got to make some difficult judgments that are fairly limited in number. A good regulator is not going to have to make hundreds or thousands of judgments; a small number of key judgments will determine whether the regulatory process works. The big thing that we all overlooked in the period between 2002 and 2007 was the extraordinary build-up of the leverage of our major banks. That should have been a very clear signal that something was going amiss, and we all missed it.

The Chairman: Governor, the point that you make about discussions in private between auditors and regulators was strongly recommended by this Committee in one of its recent reports. I want to move on fairly quickly, but we have two more questions on this issue from Lord Lipsey and Lord Shipley.

Q35 Lord Lipsey: I want to explore the new regulatory relationship from a perspective that we have not yet touched, that of the consumer, because I was chair briefly of the Financial Services Consumer Panel. There is often a trade-off between what prudential regulation might like and what consumer regulation might like. For example, the FSA was extremely concerned that the effect of moving against product protection insurance, which was a widely mis-sold product, would be to undermine the balance sheets of those who were selling them and therefore to destabilise the banks. In the FSA's situation, those were dealt with in a single institution. Now you will have two quite separate institutions, with the retail regulator, if I may call it that, not having any great responsibility for prudential regulation. Are you concerned that that could lead to problems for you as a prudential regulator?

Sir Mervyn King: I am not overly concerned. If the FCA were to decide that a certain product line represented mis-selling and should be closed, I would not want to step in and say, "You must keep it going in order to preserve the balance sheets of our banks". We would deal directly with the prudential position with the banks or insurance companies. It is clearly important that the two authorities can work together. Indeed, the chief executive of the FCA will be an ex-officio member of our Financial Policy Committee. The chief executive designate is already attending our FPC as an observer. I think that there will be plenty of contact and I do not see that these will be potentially really significant problems. If they are, on the odd case, I think that we have the individuals there who will find it very easy to get together and say, "Look, what shall we do?", just as within the FSA there had to be different people coming together and asking, "Well, what's the right outcome here?" It was not the same person dealing with all aspects of regulation.

Q36 Lord Shipley: Can I just pursue the issue of corporate memory, which you alluded to a moment ago? One of the great worries that a lot of people have is that corporate memory is consistently lost every decade or 15 years or so. It happened in the recent round. Are you confident that the systems of regulation being established can overcome the problem of people moving on and the corporate memory being lost? In other words, you have got to create structures that prevent the loss of corporate memory. Is that happening?

Sir Mervyn King: I am more concerned about ensuring a sufficiently strong institutional memory within the regulator. I think that the central bank and the regulator have to be the source of that institutional memory. There are some companies where, if they get into serious trouble, you would be quite pleased to see the senior managers move on. If you lost their memory, it would actually be a benefit, not a cost. I can see that, with a large institution, you want to ensure continuity of the right kind of memory, but I do not think that the regulator should intervene and say, "Your turnover rates must be below a certain figure". I think that it is the institutional memory of the regulator that matters more than that of the individual company.

The Chairman: I am anxious that we should move on because we still have some ground to cover. This has been a fascinating afternoon, but we should now move along rather more quickly. Lord Lipsey has a question that touches on what we have already discussed.

Q37 Lord Lipsey: Going back to the Vickers report we discussed earlier, are you sure that it would not have been better to have insisted on a complete separation of retail and investment banking rather than leaving the scope for gaming that may be implicit in the Vickers solution?

Sir Mervyn King: I had a lot of instinctive sympathy for that when we began to go down this road, but I think that the Vickers report is now the only show in town. The most important thing is to get on with it and put it in place. Once it has been in place for long enough, we can reflect on it and see whether there are any problems, but the most important thing now is to get on with it. The longer it is left before legislation is passed, the greater the risk that lobbying will introduce the gaming aspects to which you have referred. My feeling at this stage is that Vickers is on the table. The report was carefully thought through and it was a very high quality commission. We should just do it.

Lord Lipsey: Of course, the banks have admitted to us that it was a done deal, but they went on to say how it could not happen too quickly because of this, that and the other proviso, which perhaps bears out the wisdom of your last remark.

Sir Mervyn King: The fate of it is now in your hands.

Q38 Lord Currie of Marylebone: Perhaps I could touch on accounting systems for banks. The executive director for financial stability at the Bank recently made a speech in which he said, "But if we are to restore investor faith in banking sector balance sheets, nothing less than a radical rethink may be required". Do you support reform of the accounting systems and, if so, what changes would you like to see? How do you see this happening?

Sir Mervyn King: I am sure that there is a benefit to be had from reflecting on accounting systems, but I do not find the answers obvious. With certain kinds of banking, mark-to-market imposes a very important discipline and has real value. It is also fair to say that in circumstances such as those we saw in the second half of 2007, mark-to-market becomes almost impossible to implement because we have no idea what the prices are. So the question is how to avoid pro-cyclical behaviour. The most important point I want to make is that accounting almost by its existence is there to give an accurate report about what has happened in the past. It does not make sense to believe that accountants are there to tell investors what is going to happen in the future; investors have to assess the risk for themselves.

One of the limitations of any set of accounts, no matter which conventions you follow, is that it gives a single number to the value, for example, of an asset or a liability. However, what may really matter in assessing the vulnerability of an institution is not its current market value, because in some circumstances it may be almost impossible to sell, but the risks associated with that asset. Understanding the riskiness and vulnerabilities of the balance sheet is something the regulator has to do. It is not easy to claim that the accounts can do it for you. Accounting provides an important piece of information for investors, but I do not think that it is fair to expect one set of numbers to capture all the dimensions you need to look at in order to assess the real risks to an institution or, indeed, to the system as a whole. From the regulatory point of view, what matters is not so much the risk to any one institution—we do not want a no-failure regime, rather one where bad banks do fail—but we want to protect the system as a whole. I am sure that there are changes in accounting policies which can help, but I am struck that when we moved quite a long way towards mark-to-market accounting because it seemed to be the right way to go, we suddenly hit an episode where actually it did not seem to be right, which suggests that there is no single answer. Accounts need to provide information that varies according to circumstances.

However, it is important to know about certain things, such as the cash position and the liquidity position. The mapping from accounting profits to regulatory capital is also important, but that is not an accounting issue as such; it is a regulatory issue of whether revaluations are allowed to count as regulatory capital.

Q39 Lord Currie of Marylebone: The general point is surely that if markets are subject to swings between periods of excessive optimism and then pessimism, the changes towards mark-to-market have built those swings into balance sheets in an unhelpful way that may result in payments of bonuses and the like.

Sir Mervyn King: Absolutely. The key point you make is that these markets are subject to very large swings in sentiment; they are animal spirits and I am not sure that any set of accounts is able to handle that. But what is important is not to have a set of accounts that pretends to deal with it all.

Q40 Lord Shipley: The Bank is in the process of examining potential indicators of financial stability. Are you confident that metrics can be established that will give you sufficient warning of a looming financial crisis. A moment ago you said that you did not see the last banking collapse coming. Northern Rock happened around us very quickly. It may have been that the tripartite arrangement was partly responsible, and you might comment upon that, but do you think that what you are doing now is sufficient to give you the warning you need of another looming financial crisis?

Sir Mervyn King: I do not think that any indicator or set of metrics can guarantee to give you a warning. This has become quite a big industry. People are looking for the indicators that predicted the last crisis, but that is exactly the problem. It is a bit like asking, "Can you predict the stock market?" Common sense tells you that you cannot. However, if you run a regression or do any sort of statistical analysis ex post, you will always find indicators that predicted it, but they just tell you what happened to be the correlation in the past, not what will happen in the future. So I think that it is a mistake to look for indicators to predict a crisis because by definition a crisis is something that most people have not predicted—otherwise it would not be a crisis.

What is important is to think about the metrics or indicators that help to start the right kind of conversation. Let us take the example you gave of 2007. The metric that would have helped to start the right kind of conversation, and in my judgment always will, is the leverage regime because that is something which cannot be affected by fancy risk weights or calculations. It just tells you how vulnerable an institution is, given a loss of its assets. That is the kind of number which is going to be useful. The same is true of liquidity or cash holdings. Whatever goes wrong, at least you know that cash is the ultimate source of payment, so you will not be dependent on other sources of funding. Those things are pretty robust and therefore we should always look to them. In the same way, ratios of asset price to income can be helpful. They do not necessarily tell you that a crisis is coming, but you need to have an explanation. The growth rate of credit and money in the economy is a similar thing.

But a metric that did not work was the Basel II capital ratio, which was the basis on which we decided to regulate the banks. It did not work at all. The most highly capitalised bank in Britain in the summer of 2007 was, as you will have guessed, Northern Rock. Why was that? It was because the Basel II ratio, which came in at the beginning of 2007, said that past experience suggests that the safest assets that a bank can have are mortgages. Northern Rock only had mortgages on its assets side, and Basel II did not look at the liabilities side of the balance sheet at all. Northern Rock was in a position where it was judged by the Basel II ratio, which had been agreed by international regulators, as one of the biggest and most highly capitalised banks in Britain—so much so, in fact, that it announced that it intended to return capital to its shareholders. A few weeks later, it ran out of money. In my view, a bank that runs out of money is a bank that has gone bust. It is hard to square these two things, but what we do know about the last crisis—I shall depart slightly from my own approach here—is that if you go back to before 2007, capital ratios were not a good predictor of which banks would get into trouble. Leverage ratios were a better predictor.

But I say again that you should not worry about trying to predict things, and certainly do not waste time trying to work out what things predicted the last crisis. Rather one should try to think more deeply about the basic indicators you would want to look at to assess vulnerability against the source of a crisis that none of us could easily identify now. We do not really know how the next crisis will occur, but what are the things that would make a bank vulnerable in almost any kind of crisis? Leverage is bound to be one of them. A highly leveraged bank is going to be vulnerable, whatever the crisis. A bank with a lot of cash and liquidity will have a better chance of getting through a crisis, whatever its origin. That is not an easy answer, I am afraid, but I do not think that we should spend a lot of money on hiring economists to produce a set of indicators which then becomes the set that we all focus on.

Q41 Lord Smith of Clifton: Governor, I am told that you once said that your ambition was for monetary policy to become boring. Do you have the same ambition for macro-prudential policy and, if so, how do you hope to achieve that when the proposed instruments could prove controversial, as they will have a significant effect on the availability of credit and mortgages in particular?

Sir Mervyn King: I am delighted that it has not been boring recently, but let me try to explain what I meant when I said that I wanted policy to be boring. I meant that I wanted the decisions and announcements of the Bank of England to be relatively un-newsworthy events; in other words, for people in the economy to anticipate the decisions that we would make. In monetary policy, when interest rates would go up, they would say, "Well, it is not very surprising that interest rates have gone up; it looks as if inflation could be picking up; the economy is growing faster than we thought; it is not surprising that they have taken that action". That would equally be the case on the other side. It is that definition of "boring"—namely, our decisions being predictable—that I had in mind. I do not mean that they should be completely predictable, about which day and which meeting, but the broad direction of policy should be predictable and understandable. That is what we want to achieve with macro-prudential policy. We hope that people will say, "Well, leverage of banks is rising. Surely the Financial Policy Committee will soon be recommending that the banks acquire extra capital to reduce the speed at which their leverage is rising". If commercial property prices are rising very rapidly, we want them to think that the FPC is surely likely to be recommending that the cap or the requirements held against proper assets in the form of commercial property be increased. We hope that people will anticipate our actions.

Therefore, the precise date when we make our announcements will not matter very much. People will start to move ahead of them. One of our success stories in monetary policy is that people can see what is likely to happen and anticipate it, and we get a benefit of policy before we have had to take the action itself. Of course, you have to follow through the action, but it gives us slightly greater discretion about the precise timing.

Q42 Lord Tugendhat: Governor, I remember your predecessor saying several times that he did not want to see a regime in which nobody failed. The question was how you handled it, and you said something of the sort earlier. The problem is that when a bank fails, there is always going to be a great deal of noise surrounding the regulator. It is a little like when the Government catch spies. It is an achievement to have caught the spy but it then leads to all kinds of recrimination about why he was not caught earlier. So there will be failures and there will be a lot of noise and there will be a lot blame shifted around. My worry is that, however good your macro-prudential regime may be, this will contaminate the reputation that you have in monetary policy. The monetary policy role is difficult enough in itself; the Bank of England carries a great deal of confidence in the conduct of monetary policy. I worry that, if there are failures, as there will be, in the banking sector, it will diminish the effectiveness of your successor to conduct the other barrel of his responsibilities.

Sir Mervyn King: That was exactly why I was initially unenthusiastic about seeing supervision in the Bank of England, but the experience of 2007 suggested to me that having no responsibility at all for banking supervision provided no defence against reputational contamination whatever, partly because people perhaps did not know what the FSA was. But when Northern Rock failed, the fact that we had absolutely no responsibility for regulation and no involvement with the bank gave us no protection against the problems that came thereafter. There is one change since then which makes me more optimistic: there is now a proper resolution framework for dealing with failing banks. If that resolution framework had been in place when Northern Rock failed, we could have dealt with that problem over a weekend. It would still have caused some fuss and some noise, but it would not have looked like the rather chaotic series of events that occurred. Once Northern Rock got into serious trouble, those of us on the inside who were watching it were pretty firmly of the opinion that the only solution was nationalisation, which is exactly what happened in the end. But, politically, it was extraordinarily difficult for the Government. They did not have to hand a technical legal process, known as bank resolution, which could be delegated to a technical body such as the special resolution unit which exists in the Bank of England or the FDIC in the United States. When banks fail in the United States, the President does not have to go to Congress and demand that it nationalises the bank; the FDIC just does it over a weekend. That turns it into something which is more technical. If people lose money, there will always be recrimination and people may look back at the supervisory record, but it helps a great deal.

To go back to the question that was raised earlier about the tripartite arrangement, in my judgment, the relationships within the tripartite were perfectly successful and operated extremely well until it became clear that Northern Rock generated significant political damage to the Government. At that point, people wanted to deflect blame and to try to create a different climate of opinion. At that point only did relationships really deteriorate. Before that, the mechanism was fine. Having a resolution process in place now will make it possible for the regulators to work with that resolution unit to handle the problem that arises, in such a way as to make reputational contamination a little less likely. However, there remains a risk of that, which has always concerned me, but my experience of 2007 was that not having banking supervision inside the Bank of England gave us absolutely no insurance against that reputational contamination. We were affected in the same way as everyone else.

Q43 The Chairman: Governor, we are coming to the last topic. This Committee has just completed its report on the economic effectiveness of international development aid, which we will publish for Thursday of this week. We will then turn to the economic implications for the United Kingdom as a whole of Scottish independence. We have chosen that topic because we feel that, if there is a vote in a referendum on either Scottish independence or devo-max—we are taking Scottish independence as the likely one—it should be based on a real analysis of all the implications. We do not think that that is happening very much at present, which is why we are taking this subject on. Has the Bank done any work on the implications and options for the operation for monetary policy and bank regulation both in Scotland and the rest of the United Kingdom if Scotland became independent? If not, what are your plans for that and your thoughts?

Sir Mervyn King: I am sure you will understand if I am reluctant to enter this debate. The Bank of England today is the central bank of the United Kingdom—both Scotland and the rest of the United Kingdom. A referendum is a long way away, so there will need to be a very careful debate. In my own judgment, a lot of the issues that would be relevant to monetary policy were Scotland to become independent would be discussed after such a referendum rather than before. I am sure that your report will throw a great deal of light on all this. It is vital for the Bank of England to retain the trust and confidence of all parties that are at present in the United Kingdom and could be in the UK after such a referendum. It is important that we do not put ourselves in a position where anything that we say at the Bank can be construed by one side or another as supporting their case. It is bound to be extraordinarily tempting for those on both sides of the argument to say, "Ah, but the Bank of England said something", and they will take words out of context and claim them as supporting their position. Once there is a clear proposition on the table, the Bank, I am sure, will be able to provide some objective economic commentary on it, but there is an awful lot of discussion to be had at the political level first as to what various parties want to achieve and what solutions will be acceptable. Most of this boils down to politics. What solutions would be acceptable to the residual United Kingdom and what options would be favoured by an independent Scotland? We are different from anyone else in this debate. You may think that we are different in having a degree of expertise, though there are an awful lot of very good economists out there who can also provide you with great expertise. What is unique about us is that we are responsible for monetary policy today and it is very important that we retain the confidence of all those affected by it.

Q44 The Chairman: I understand that point, but may I press you a little further? I think that I speak for all the Committee in saying that, although some of us may have views about Scottish independence, we are absolutely clear that we want to do a dispassionate analysis of the consequences which ranges over a whole series of fields of economic implications, not just this one. It is our view—certainly, it is my view—that it is difficult to wait until a judgment has been taken on Scotland and then start looking at the implications. You need to make it clear that the debate before the referendum should look at all the implications, and we hope that our Committee could make a dispassionate contribution towards that. In the case of the Bank of England, I hear what you say, but I take it that that means either that you are not doing any work or that, if you are, you do not want it exposed to public gaze.

Sir Mervyn King: One of those two is true.

The Chairman: I hope that I know which one.

Sir Mervyn King: You and your Committee could do a great deal by way of ground-clearing and come up with some alternatives and narrower propositions which later in the debate we could provide some technical commentary on. There are so many different options here which have major political ramifications. I do not want to speculate in public about the likelihood or attractiveness of one option versus another—I am sure that you will understand that. Once you have gone further down the road in spelling out the range of options that you think need to be put before people, we can maybe provide some help in terms of technical commentary. As I said, there are some very good economists out there who are not in the position of having public policy responsibilities today. Every time that I go to the equivalent of this Committee in the other place, I only have to open my mouth to be told, "You are far too political. You mustn't comment on that". I am trying very hard not to be political, but we are prepared to offer down the road what help we can when you feel that you have got to a point where we can have a genuine discussion about monetary issues as opposed to political issues.

Q45 The Chairman: We will certainly look to other economists to come and give evidence to us on this issue, as on all the others. Perhaps I could take you up on the last point that you have made. If we have specific technical questions which we would like you to comment on—and it is for you to comment or not—it would be helpful to have some response at that stage when we are further down the road. I think that you will agree that this is an extremely important issue. Therefore, it is very important that there is a full public debate of all the implications before the final decision is taken.

Sir Mervyn King: This is an extremely important question.

The Chairman: Governor, I thought that today's session might have been quite technical—and, indeed, it was—but you have said some things also about attitude, about principles and about conduct that rarely appear in Bank of England publications and which certainly deserve much wider circulation. I am sure that I speak for all of us in saying that it has been a fascinating afternoon. I am sorry that it has taken so long, but that is because it has been so fascinating. Thank you very much indeed and we will look forward to another occasion before too long.

Sir Mervyn King: Thank you very much, Lord Chairman.