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Banking Supervision and Regulation

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Minutes of Evidence

TAKEN BEFORE THE SELECT COMMITTEE ON ECONOMIC AFFAIRS

TUESDAY 20 JANUARY 2009

Present	Best, L	MacGregor of Pulham Market, L
	Currie of Marylebone, L	Moonie, L
	Eatwell, L	Paul, L
	Forsyth of Drumlean, L	Tugendhat, L
	Kingsmill, B	Vallance of Tummel, L (Chairman)
	Levene of Portsoken, L	Vinson, L

Examination of Witness

Witness: Professor Geoffrey Wood, Cass Business School, examined.

Q1 ***Chairman:*** Good afternoon, Professor Wood, and thank you very much for sparing some time to be with us this afternoon. You are in fact our first witness in this inquiry, so we are delighted to see you. Would you like to make any introductory statement, or would you like us just to move straight on to questions?

Professor Wood: Not a full-scale statement, but I would like to make five points which may or may not arise from the list of questions, so I thought I would get them in now just for future reference. First, I think in looking at the current episode it is important to remember that Britain had a remarkable period of financial stability until quite recently. We had no major banking crisis between 1866 and 1979 and it would, I think, be worth reflecting on why there was that tremendous contrast. Secondly, we should also, I think, as the counterpart of that, consider whether there is anything special about the last 10 to 12 years which led us in this direction, anything special in the economic environment, for example. Thirdly, we have obviously had a very dramatic outturn to events. That does not necessarily mean we had a big dramatic cause. We might look for big causes but also for lots of small ones. A fourth point: the connection between monetary and financial stability. One aspect of this has been given much attention. There is a pretty good relationship between low inflation and financial stability, but are there other possible connections we should explore, connections which might involve, for example, thinking again about the mandate of the Bank of England? Finally, a point on incentives. Much attention has been given to incentives in the private sector. We need to think about incentives in the regulator, and by that I do not by any means mean only or most importantly salaries. I think we need to consider the structure of the regulator and the varied responsibilities. It might be useful if I could illustrate that point. The FSA is concerned with consumer protection and also with making sure firms are stable, managing the capital, and so forth. If you are going to protect a consumer in the financial sense one of the best things to do is to keep his bank running. If you are concerned about financial stability, the best thing to do might be to close his bank down. This suggests that there is inevitably a tension in an organisation which is charged with doing both, and we might want to think about that. That is it.

Q2 ***Chairman:*** Thank you very much. Before I ask the first question, I would like to declare an interest as a member of the International Advisory Council of Rothschild et Cie and of the International Advisory Board of Allianz, which has holdings in Dresdner Bank. If I may jump in at the deep end, the credit ratings agencies have a key role to play in the bond markets and indeed in the regulatory system and at present bond issuers pay the rating agencies to assess their own bonds. Do you think that is a sensible way of paying for credit ratings?

Professor Wood: I used to answer "Yes" to that question. I have changed my mind, I think, or certainly thought about changing my mind, for two reasons. First, I discovered that it did not use to be always the way. Sometime in the past I discovered from reading the *Financial Times* weekend magazine, bizarrely, which had a very good article on ratings agencies about two or three weeks ago. They pointed out that until comparatively recently, 10 to 12 years, it was the person who was buying the security who paid for the insurance. I think that is quite important. So that is important. Secondly, I used to maintain that even if that were not the case, the concern for the long running reputation would preserve integrity regardless of who was paying, and I am sure there is some influence of that, but perhaps the influence is too slight.

Q3 ***Chairman:*** So you would prefer it if piper were not paid, as it were?
Professor Wood: It would remove a very obvious conflict. Since it worked in the past, the argument that it cannot work must simply be wrong.

Q4 ***Chairman:*** So there would be no risk that there would be less information production if it were done that way round?
Professor Wood: There would be fewer items of data, but that does not mean that there would be less information.
Chairman: Thank you. I am very grateful.

Q5 ***Lord Tugendhat:*** You have said that you do not think there would be less information available if it was done the other way about, but why do you think the reputational sanctions have become less effective in the credit ratings market? It reminds me a little bit, of course, about Alan Greenspan talking about how he had always assumed that people would be acting in a particular way, and they were not, but there has been this underlying assumption, which seemingly has been proved wrong, and I wonder why you think that is?
Professor Wood: I am not sure that it has been proved wrong. It might well have been. But another consideration takes us to the environment we have had over the past 10 to 12 years, which has been a remarkably stable one. We heard it described as an end to boom and bust in this country, but also it was referred to in the United States as the great moderation. Economic environments have been very stable everywhere. People may simply have become over-optimistic in the ratings agencies and it is very hard to disentangle these two effects, the lesser attention to long-term reputation and the greater economic stability. Of course, another point might be that the corporate form of these agencies has changed somewhat. They have moved away from the original partnership or the very small number of shareholders to form to a much more widely held company.

Q6 ***Lord Tugendhat:*** Can I just press you slightly on that? In recent years it has become increasingly the practice that the enterprise seeking the rating and the agency have in a sense worked together to agree a formula. Now, does that not signify—how can I put it?—a greater degree of willingness on the part of the rating agency to find a way around issues rather than to meet absolute standards?
Professor Wood: The two can be the same thing, can they not? You can meet absolute standards with the existing structures of debt, or you can suggest, "I know another form of debt which will meet your requirements and will attract, for the following reason, a higher rating." I agree it does not look good, it does not smell good, but it does not necessarily have to be not good. One would have to look into the detail of particular transactions, I think, but the starting point—I come back to that—I would be much more comfortable with the older form of paying for the ratings agencies. There is no doubt of that.

Q7 ***Lord Eatwell:*** If I could move to the next question, which is, do you feel that ratings-based financial regulation has been effective? The use of these ratings is often justified on two grounds, that they are more accurate indicators of risk than regulators could create for themselves, and that they are not subject to the biases that self-assessment by regulated entities would cause. Nonetheless, giving ratings quasi-legal status in regulations could reduce their effectiveness and I wonder how this strikes you.
Professor Wood: I think using ratings in regulation is very sensible. You can certainly look at them, by all means, but relying on them exclusively is relying on one source of information, and information gathered for a particular purpose. Ratings agencies, for example, tell you things such as the probabilities of default. They do not tell you anything about liquidity and by and large they do not look at the quality of management. You remember the CAMEL system, as it is called in the United States, capital, assets, management, earnings and liquidity. All these matter for a bank but ratings agencies do not look at most of these. So it gives you some information. The regulator should look at it, but not only at that by any means.

Q8 ***Baroness Kingsmill:*** There is a saying which says you do not want too much innovation either in your 747 pilot or in your banker and I wondered if you could give us some sort of insight into what accounts for the growth in the market of the CDSs and the CDOs. Why has there been so much growth in this area?
Professor Wood: A combination of things. Demand. It gave people a wider range of securities to hold. The demand was probably always there. It was, I think, boosted by the period of great economic stability and unusually low (by historical standards) interest rates, so people had to try new products to maintain their returns. Then in addition you had supply. We had many more mathematicians about who could supply these things. Whether they were supplying the sensible things or not is something we might come to, because there are certain widely known deficiencies in the models which turned out to have been more important than people thought. Also, they relied again on kinds of data which were not necessarily giving them information. To illustrate that second point, many of these financial models were fitted on large numbers of high frequency data, daily, maybe even hourly data. You get a very good statistical fit if

you do that but, as I always tell my students, you get much more interesting information with 100 years of annual data than a thousand days of daily data.

Q9 ***Baroness Kingsmill:*** Yes, but one imagines that there must have been a desire to spread risk or to share risk?
Professor Wood: People have always wanted to do that. The techniques developed. The law started to allow the mergers of commercial and investment banking and the period of economic stability led people to try things they would not have tried and were obviously risky things.

Q10 ***Baroness Kingsmill:*** Do you think they were means of a rational response to regulations or a means of avoiding regulation?
Professor Wood: Both. It can be rational to avoid regulation. It can be desirable also to respond in one way or another to regulation. I think most of them were perfectly sensible.

Q11 ***Baroness Kingsmill:*** So it would suggest that the regulations were not sufficiently widely drafted to take into account these new products, these new vehicles?
Professor Wood: No, it does not suggest that to me. What it suggests to me is that the regulations were perhaps looking at slightly the wrong thing and were being too narrowly focused and too prescriptive rather than dealing with principles, because many of these products were actually very sensible, but far from all of them, that is the trouble.

Q12 ***Baroness Kingsmill:*** There is also the issue that many of them were extremely complex vehicles and that although the creators, the manufacturers of these vehicles, understood them, often the management of the banks did not?
Professor Wood: That is absolutely right. As you may know, I am advisor to the House of Commons Treasury Select Committee and we had a chairman of a large British bank saying he did not understand some of the things the employees were selling. I thought that was appalling.

Q13 ***Chairman:*** Can I follow that up just to get it clear? Did they genuinely achieve what they were trying to achieve in terms of risk transfer?
Professor Wood: Most of them did, probably a few did not, and some were probably bought by people who did not understand them and perhaps sold by people who did not understand them.

Q14 ***Chairman:*** The few who did not, did they matter?
Professor Wood: It is actually too early to tell whether they are the source of all the trouble. They certainly matter. Whether they are the source of all the trouble it is too early to tell.

Q15 ***Chairman:*** But they could be?
Professor Wood: Yes.

Q16 ***Lord Eatwell:*** If I may just follow that up. Often the buyers of risk were financed by the institutions who thought they were selling risk?
Professor Wood: Could you expand that for me?

Q17 ***Lord Eatwell:*** In the sense that a risk buyer, somebody who is willing to take on the risk, the institutions themselves were financed by the banks who thought they were selling the risk.
Professor Wood: Far from always. I think many of the buyers were insurance companies and pension funds and they were not financed by the banks, they had a steady cash flow, and that was part of the problem.

Q18 ***Lord Eatwell:*** That was about 15% of the entire market. The rest of it was financed by banks, was it not? The risk stayed in the banking system?
Professor Wood: Sometimes, yes. But it did not necessarily stay in the banking system. You have lent the money to person A from bank B. Person A then buys the security. The security is therefore transferred to person A, but unless the security is collateral for the money which has been borrowed the risk has been shifted, at least partly, out of the banking system. So it does depend on the structure of the contract.

Q19 ***Lord Eatwell:*** As long as the risk buyer is secured?
Professor Wood: Yes.

Q20 ***Lord Eatwell:*** I wonder if I might start by reflecting on your five points? I am intrigued that you do not regard the secondary banking crisis of the 1970s as a serious banking crisis, and also you seem to suggest that the banking crisis now is a sort of unique event and we needed to look at the history of the last 10 or 12 years as the run up to it, but banking crises, with which British banks have been associated (not necessarily in the UK banking system itself), have occurred with significant regularity over the last 30 years since the great liberalisation began in 1971. So why do you confine your remarks to the last 10 years and UK territory?
Professor Wood: Let me start with the secondary banking crisis. That was in no way a threat to the UK payment system or to the UK economy. A number of small banks got into difficulties. These were small banks which had partly been encouraged to expand, not by regulation because we did not have much

formal regulation then but by the informal requirement that British clearing banks did not lend very extensively on property. So these fringe banks, highly specialised, grew up. When they failed, got into difficulties, they were not a significant problem for the UK economy or for the UK financial system, so in that sense I do not regard it as a major banking crisis as I would, for example, have regarded the Overend and Gurney crisis of 1866 as a potentially major banking crisis. That is why I set that period aside. I did not concentrate on the past and say we should only look at the past 10 years, I said the past 10 years were significantly different in economic terms from what had gone before, remarkably stable in many countries of the world. That might have led to some of the difficulties we are having. There have been banking crises in other countries around the world. That British banks were involved in them perhaps illustrates the dictum that bankers tend to remember the crises they have actually experienced. After all Lloyds Bank, which was extensively exposed in Latin America was, until recently, much more prudent and if we look at the Scandinavian and Finnish banks now they are in pretty good order compared with other banks simply because they got such a nasty fright a little over 10 years ago.

Q21 ***Lord Eatwell:*** Thank you. That helps a lot. Going back to the whole credit derivatives, CDS, CDO markets, these markets are being "blamed" by many for current instabilities. Do you think the growth of the credit derivatives markets in general, which of course has been dramatic since the mid 1990s, is to blame? It had a significant impact on the fragility of the financial system.
Professor Wood: It has been astonishingly rapid. The fact that it has grown so rapidly means that people have not had time to learn, that too many untested products have come onto the market at once. So the rapidity of growth might have been too much, but the actual growth of these products is by and large useful. People like to spread risk so long as they know who is bearing it and they can bear it adequately, and so forth. So I would say the markets are not wrong entirely, but the speed of growth may well have been the source of one of the difficulties.

Q22 ***Lord Eatwell:*** Did they also open, let us say, new channels of contagion?
Professor Wood: Yes, certainly they did. We had insurance companies linked to banks in ways they were not before, pension funds linked to banks, banks linked to banks in places where they did not they were linked because the products were so complicated. Yes, they did open up new channels of contagion.

Q23 ***Lord Eatwell:*** It is the whole so-called secondary or shadow banking system. It is not really a separate institution at all, is it?
Professor Wood: No, absolutely not.

Q24 ***Lord Eatwell:*** They are integrated institutions?
Professor Wood: As we saw these banks taking these so-called "off balance sheets" vehicles back onto the balance sheets because they suddenly discovered there was something called "reputational risk". If they suddenly discovered it, they should not have been in the jobs in the first place. They should have known it existed.
Lord Eatwell: Quite. Thank you.

Q25 ***Chairman:*** If speed of growth of new products is the core of the problem, is that susceptible in any way to regulation, or is it something we just have to live with?
Professor Wood: That is a tricky one. My immediate response would be to say it is something we just have to live with, along with frequent reminders to people to only buy products they understand.

Q26 ***Baroness Kingsmill:*** The sellers as well!
Professor Wood: That would be helpful, too.

Q27 ***Lord Moonie:*** It strikes me you are saying these were actually quite effective methods of transferring risk?
Professor Wood: Entirely, no, but in large part, I think yes.

Q28 ***Lord Moonie:*** Does that qualification result from the opacity of the risk? Had it been very transparent to those buying those obligations what the level of risk was, would that have made it more or less likely they would –
Professor Wood: That would have been much more helpful. Another problem, of course, is that many of these transactions are bilateral between bank A and bank B. They do not go through an exchange. That creates lots of difficulties. First of all, since they are not going through a central exchange you cannot measure the number of them taking place. You do not know how many there are. Secondly, there often is not collateral held against them centrally, so if a transaction fails it can cause major impediments, major problems. Thirdly, suppose an institution—Lehman Brothers was a splendid example—suddenly goes into liquidation. All sorts of bilateral transactions are frozen, whereas ones taking place across exchanges are unwound in an orderly manner. So the lack of exchanges I think was actually quite important.

Q29 ***Lord Paul:*** With a lot of these complex products which had been sold and bought, I am not sure that anybody understood what they were buying or selling, and then the regulators, whether they were able to understand or likely to understand. These complex models even created more comfort without having the basis for it. What could they have done to avoid that and how do the regulators control it?
Professor Wood: Let me say, first of all, it is not necessarily wrong to buy something you do not fully understand provided you can get someone to fix it or explain it for you. I have not got the faintest idea how my car works except that when I get in and turn the key it usually goes, and if that does not happen I can call on someone I trust to sort things out. We do not have things like that in the financial sector. Well, we do have a few people like that in the financial sector, but not many. Maybe there is a market for them. That said, had everything been more transparent so people understood what they were doing, that would have been helpful. Could we have stopped these developments? It would be very difficult. Suppose, for example, someone came along with this very nice product that I thought I liked and someone told me, "Don't buy it unless you understand it." If I wanted it, whether or not it was for my own good, I would say, "Oh, yes, I understand it. I'm going to buy it." We do have to rely at some point on people's sense.

Q30 ***Lord Paul:*** But if you buy the car you at least think that the manufacturer understands it?
Professor Wood: Absolutely.

Q31 ***Lord Paul:*** But when you are buying this complex product you thought that the seller understood it, but it turns out he did not either, so –
Professor Wood: Yes. I would not go there again!

Q32 ***Lord Levene of Portsoken:*** Could I first declare an interest as Chairman of Lloyd's. That is the other one. We are not a bank, but we do issue some publicly traded debt which is rated, and also I am a director of China Construction Bank. Can I just revert to this question of who should pay? Do you think there is a fundamental conflict of interest for agencies insofar as they are paid by the entity for whom they are assessing? After all, the agencies themselves want to get business, so if they are going to have a reputation for being difficult they may not get it. If you think that is the case, can you think of any better way of avoiding it so that those buying can get a more unbiased assessment of the creditworthiness of the people investing in it? Before we say, "Well, let the buyer pay," you may well have a debt issue where you have many, many, many potential buyers, so we need some central body. Can you suggest another way in which that could be done which removes the conflict of interest and provides a much more impartial assessment?
Professor Wood: First of all, the conflict of interest is not absolute. Remember, the person who is providing the rating, even though he or she is providing it to the person who is selling the debt, has an interest in the long-term success of the firm, so one offsets the other to a certain extent. You might want the reputation of being difficult if this reputation for you being difficult leads to people saying, "If I get my debt rated by X, then people will really want my debt." So we need to consider that kind of effect. Beyond that, it would be desirable if the buyers were paying for what they were consuming. Now, how could we engineer that? First of all, the article I read in the *Financial Times* gave me just the briefest outline of the history. It would be worth, I think, digging into that. I have not done that. But an immediately obvious method might be , for example, they could be paid for in part by the Association of British Insurers. They could collectively get some money from the members, then pay for ratings. There are many such organisations in the financial sector and they could organise themselves in this way to pay for what the members wanted.

Q33 ***Lord Forsyth of Drumlean:*** Could I just follow up on that point because I am just thinking, I am a bright thing in one of the ratings agencies and I think, "Hang on a second, there's a bubble going on here and everybody's assuming that prices are going to keep rising." How on earth could I possibly call "Stop" if everybody in the market is operating on the same assumptions and if my organisation depends on its not insubstantial revenues from the fact that everyone is having a great time and being paid huge amounts of money whilst everyone believes that prices will continue to rise in that their models, putting it crudely, reflect that kind of background? Is there not a more fundamental problem than who pays the piper? Is it not the actual ability of the ratings agencies to influence events and the mechanism by which they will achieve that in that kind of maelstrom?
Professor Wood: It is actually terribly, terribly difficult to identify bubbles when they are going on. Alan Greenspan, I have every reason to believe, is not a stupid man. He thought he had identified one and then changed his mind. Even in retrospect it is not easy to identify them. There is still dispute as to whether the behaviour of the stock market in the United States in 1926 to 1928 was a bubble or not. Serious scholars are on both sides of that argument even now. Can you argue against a consensus that things are going extravagantly wrong in some way, the markets are too high? Yes, you can. You will probably be paid for it because people like a dissenting view, simply to say, "We've looked at this

view. It's given us some comfort. We've considered it." So I think there is a market for that kind of advice. I agree, to take the example you actually gave me of some bright young person in a ratings agency, that would be hard, but a more senior person in an individual ratings agency could well find income from saying these things. They might turn out to be wrong, but they could certainly have an income from saying these things.

Q34 ***Lord Forsyth of Drumlean:*** You do not think that the product provider would decide, if there was a senior partner in one of the ratings agencies who was being difficult, that they would go to another one?
Professor Wood: If that became known the product provider would have some trouble selling his or her products. There is no perfect solution to this, but if you disseminate information, if people get a reputation for being careful and difficult, that can help the people they rate.

Q35 ***Lord Forsyth of Drumlean:*** Could I just also ask you about the Basel II and the argument which is running, which is the effect of Basel II, which requires the banks to increase their tier capital at a time when the markets are in a downward trend, has the effect of amplifying the economic cycle because it means that there is less availability of credit?
Professor Wood: It seems to me there can be no doubt that that is correct. What we do not yet know is how much it does that. We do not yet know that because bank lending has always been to some extent pro-cyclical. How much Basel II has added to is very hard to tell, but it is clear that it has added to it and it should be redesigned with that in mind. For example, the Spanish central bank has a system which is known in English as "dynamic provisioning" . As the business cycle goes on expanding, the stock of credit rises. Every new loan then attracts a higher capital charge for the Spanish banking system. That, along with the regulator's refusal to ignore off balance sheet items, to treat them as if they were off balance sheet and insisting on consolidation, is largely what lies behind Santander's going around and buying a large part of the British banking system.

Q36 ***Lord Currie of Marylebone:*** Geoffrey, it is very good to have a former colleague giving evidence to this Committee. I would like to take you back to the complexity of the financial instruments, the complexity of the financial businesses which banks run. A number of the key instruments were not traded very much and very little price discounting going on in the markets and we relied on complex financial economic models to value them. You and I know very well the limits of econometrics which some people pronounce as "economic tricks". Those models are not an adequate basis for a valuation of these things. Is it not rather worrying that such important instruments came to rely on valuations which few people could understand? I am sure many people on boards did not understand them.
Professor Wood: I think treating assets as marketable that could be priced only by marking to model was simply blind folly. If they could not be priced by marking to market, they were not marketable. So treating them as marketable when they could only be priced by the model is foolish. We do not even need to worry about how useful these models are. Then there are the well-known deficiencies of these models, the weaknesses of the extremes of the distribution, but also the fact that they were regularly fitted over fairly comparatively short runs of data. Ten years of daily data seem a lot to an econometrician, but they do not actually have much information if they come from a very homogenous time period.

Q37 ***Lord Currie of Marylebone:*** No, particularly if you are worried about crises that come along every 20 or 30 years?
Professor Wood: Exactly, yes.

Q38 ***Lord Currie of Marylebone:*** Given the complexity of the business, how should regulators react to that? We used to have structural constraints which simplified the way business could operate, Glass—Steagall in the States and other restrictions on what players did in the UK and most of those have gone. Business has become very complex. Should part of our reaction be to say, "Well, actually we can't allow this level of complexity because nobody can really understand it and therefore we need to impose, as a regulator, simpler ways of doing things," or is that a foolish way of correcting it?
Professor Wood: I do not think it is. Many of the systems, the structures, are terribly complicated. Glass—Steagall was brought in, as I read the history, on a mistaken reading of the evidence, but it may have been a good result for the wrong reasons. It did separate a highly fragile part of the banking system from the part of the banking system which actually is intrinsically pretty stable and hard really to get wrong. How hard is it to get wrong? Well, think of Midland Bank. Midland Bank was the biggest bank in the world when it opened its splendid headquarters in Poultry in 1934. It was declining ever since opening day. It took a very long time before it was eventually taken over by HSBC. That kind of business is very hard really to get wrong quickly, and it is getting it wrong quickly that is troublesome. Investment banking is easy to get wrong quickly and getting it wrong quickly does cost billions. Can we go back to the system by imposing regulation? We should consider it, but my immediate response is to say that would not be a terribly good idea because we might know the system is wrong but we do not know which

system is right. Therefore, there is an incentive, an advantage in letting a discovery process operate. The market works as a discovery process and we are actually, it seems to me, seeing the market working again. Some institutions are setting up which are now in the traditional investment banking model. They purely give advice. Other banks are scaling back very radically their investment banking arms. We could well see emerging in Britain, for example, banks which are essentially mainly retail banks, having got rid of the wholesale business because it is too hard to manage. The market is starting to sort these things out for us. We are seeing it going on.

Q39 ***Lord Currie of Marylebone:*** I am sure that is right that boards are responding and responding by perhaps simplifying the strategy, simplifying the business models, but is there not a huge amount of collateral damage that goes on in the meantime for all sorts of other players in the system, and is that not through higher costs, companies which are worried about whether they have credit lines?
Professor Wood: You mean at the moment?

Q40 ***Lord Currie of Marylebone:*** Yes, at the moment. It is a very costly way of getting there?
Professor Wood: Oh, yes, certainly, absolutely, and it is very important that the banking system be encouraged to learn in the way some of the measures which were announced yesterday will surely encourage it to do, but these things do not happen overnight.

Q41 ***Lord MacGregor of Pulham Market:*** On the point about the question as to whether regulators really understand the financial models, does that not also apply to auditors? Would you like to say something about the role of auditors in all that has happened?
Professor Wood: Well, who understands the financial models? Possibly the regulators understand them. If we look at the FSA, there are people there who are capable of understanding these things. Sometimes they did not look. If you read the history of Northern Rock, what went wrong there, the FSA just did not look. So the problem there was that they did not look. They could have understood. If they had understood, they might have said something or they might have been carried away by a tide of euphoria. What about the auditors? A traditional auditor is, of course, not qualified to understand these financial models, but auditors are not longer traditional. They employ clever young mathematicians, and I think they have to do that to protect their own reputations and protect the solvency of their own business because, unlike regulators, auditors can be sued today and that is a powerful deterrent.

Q42 ***Lord Eatwell:*** In his evidence to the House of Representatives, Alan Greenspan said, "The entire intellectual edifice of risk management has collapsed," referring actually to the risk management model. Would you agree?
Professor Wood: It is a bit extreme. I do not think the entire edifice has collapsed. I think we should have learned that these models were less reliable than we thought, that we should be much more careful, that we should make much more ad hoc adjustments for risk and that we should estimate over longer data periods, and I hope we have learned "Don't buy what you don't understand."

Q43 ***Chairman:*** Can I follow it up more broadly, because you seem to be suggesting in a way that there is a risk of a reaction in terms of greater regulation at a time when the market is solving its own problems. It has had this experience and there is a danger that there is just going to be a slamming of stable doors. Am I putting words in your mouth?
Professor Wood: Yes, you are, but they are words I would be very happy to have put in my mouth! What should we do about it? I do not think we necessarily need more regulation. We need regulation to be more considered. Again, let me illustrate by example. We are going to have fairly soon a special insolvency procedure for banks in the UK. When we have that special insolvency procedure in place, if we can close a bank when it is solvent why do we need to worry about anything else? We can close it while it is solvent. All we need to do is to watch their capital. That is a very appealing argument, but it has one defect. If this bank had been called, let us say, Bradford & Bingley or Northern Rock that argument goes through completely, but if this bank was sufficiently large so as to be called the Royal Bank of Scotland the logic of the argument applies but we just simply could not manage that bank. The resources are not available. So it suggests that we might have a different kind of regulation, really rather simple for small banks—and by small I mean up to Bradford & Bingley and Northern Rock size—simply monitoring their capital and telling them, "The moment you go below this capital you are going to be taken over, the management is going to be booted out and we shall either run the business or sell it off and the shareholders get whatever eventuates from that. A very simple form of regulation. Large banks could be regulated much more intrusively, much more thoroughly, and they could, perhaps counterintuitively, have much higher capital requirements for large banks than for small banks. Usually we say large banks because they diversify so much can have smaller capital relative to the size of the balance sheet because risks are spread. Two things are wrong with that argument. One, if a large bank does fail it causes us much bigger problems, not

just proportionately bigger but more than proportionately bigger than if it is a small bank failing. Secondly, I used to make that argument in my studies of monetary history on the development of British banking. British banks developed, they got large, they became diversified. That was true in the 19th and early 20th centuries, but if we look at large banks now, they have become large, they have become more diversified, but they have all become diversified in more or less the same way. So they are all exposed to the same kind of common shock. Therefore, simple regulation for small banks, much more intrusive, much more detailed, much more demanding than regulation for large banks would, it seems to me, be a sensible route to consider. So a different and more thoughtful approach to regulation rather than just more regulation.

Q44 ***Chairman:*** Let us talk about the large banks for a moment. Do you veer towards rules-based regulation or principles-based?
Professor Wood: Rules have to be based on principles, I guess, but basically principles because if you set up rules and it is profitable to get around them, people will try to find ways around them and if the rule was trying to be sensible it is not a good idea. So I would go basically for principles-based regulation together with fairly demanding requirements on capital. I would not worry too much about requirements on liquidity because we have a central bank to supply liquidity and it should always supply liquidity to an institution which can supply good collateral. Of course, again a large bank, the Royal Bank of Scotland—let us stick with that example—suddenly coming up to the Bank of England and saying, "Can I have a couple of billion pounds of sterling today, please?" would be seriously inconvenient so you might want also to impose more demanding liquidity requirements on them than you do on the smaller banks simply because of the possibility for destruction. Liquidity requirements are, I think, less important than some people now imply they are because we have a central bank to supply liquidity to financial institutions.

Q45 ***Baroness Kingsmill:*** Are you basically saying then that what would be desirable would be to see not more diversified banks but more diversity of institutions so that there would be big banks, small banks, medium sized banks? That seems to me the thrust of what you are saying.
Professor Wood: More diversity of institutions would be excellent. If I could really have my way we would have about 40 or 50 banks in the UK. Any one of them could then fail in a nice orderly way without giving us any trouble!

Q46 ***Baroness Kingsmill:*** You could have perhaps a bank which was designed like a utility? I do not mean a government run bank but a utility bank that was like a water company or the railways, or something, which made a profit but perhaps not as much profit as some of the others but which provided a universal service so that consumers could choose really if they wanted that kind of certainty and safety.
Professor Wood: I suspect small banks would tend to go that way simply because they would not have the size, the capacity to do more complicated things. They would do that of their own initiative. After all, we have building societies in this country. Building societies are very much on that model and they are very efficient and prosperous, and very stable.
Baroness Kingsmill: Indeed. Thank you.

Q47 ***Lord Best:*** This follows that because it is about protecting depositors' funds. Do you think it is desirable or even possibly inevitable that the Government or perhaps some other body should provide watertight deposit insurance? Are there moral or inherent hazards in such an approach?
Professor Wood: Yes, there are. The question is, are they so large that we should not do it? I think they probably should do it for a combination of reasons, the classic widow and orphan argument of economics there are some people who deserve to be protected on moral grounds. We should provide deposit insurance up to a modest limit for them. Beyond that, deposit insurance is really something you expect never to be called on, or very rarely to be called on, because it is there to provide stability for the financial system in the event of the kind of shock that we do not see very often. Now, who should pay for this deposit insurance? The Government inevitably has to provide a backstop eventually because the amounts required might be larger than any insurance fund could provide. This backstop could perhaps be in two stages. It could, for example, be an insurance fund, a pre-paid fund. The advantages of that are that it could be paid out immediately, and that is very important. Not just getting your money but getting it quickly, that is important. This fund could run out. In that case there could be, perhaps, an automatic line of credit to the taxpayer which would be required to be repaid when the financial system was in better health. But beyond that, inevitably as an ultimate guarantee, the Government would, I think, have to stand behind that system. There are arguments for and against such explicit guarantees. The argument against is that it encourages risk-taking. The argument for is that if an implicit guarantee is given, people will assume it is there anyway and they will take the risks and if you give an explicit guarantee you can at least limit it. It has been done in Switzerland. You can say, "Yes, we are going to guarantee, but up to this amount, and we mean it."

Sticking to the "and we mean it" is, of course, going to be hard, but it would be nice to have it there.

Q48 ***Lord MacGregor of Pulham Market:*** I am not sure whether it is going to be relevant, but perhaps I should declare an interest as chairman of three pension fund trustees. We come to the inevitable question now: did the tripartite system between the Treasury, the FSA and the Bank of England function effectively leading up to as well as during the crisis?
Professor Wood: On occasions it functioned with jaw-dropping incompetence and chaos. It was astonishing how badly their system worked. The Bank of England, it seems to me, was unprepared to provide adequate liquidity. It made the mistake which Walter Bagehot accused it of making in 1866. It lent "hesitatingly, reluctantly and with misgiving" and the consequence was the scramble for liquidity became worse. It is unfortunate the Bank had not learned from that episode of its own history. So the Bank certainly was deficient. The FSA was manifestly deficient. They have admitted this themselves with hindsight. The number of visits they paid to Northern Rock was very small, but that does not matter. What was absolutely extraordinary was that they allowed Northern Rock to pay a special dividend out of capital in the year Northern Rock went bankrupt. Astonishing, extraordinary behaviour to allow this when they were actually warning, "The markets are unstable. You need to be more cautious." Dazzling incompetence there. As for the Treasury, it had a very small part to play until it became time to cough up our money, so to speak, and then I suppose that was handled very well but the press relations were handled badly. You may remember when Alistair Darling was making some particular announcement he eventually ended tagging it on to a press conference he gave with Hank Paulson because they had not been able to make it ready before the stock market opened in the morning, so they had to keep it, although it was a very important announcement, until the market closed at night. There was just no preparation. If you look at the sequence of events, every time something was done by the authorities they sat back and said, "That's it, we've done it." There was never any thought, "What happens if this doesn't work?" This is very clear in the narrative of events and if you wish I can send you a paper which a colleague and I have written on this. I will send it to the Clerk and to Professor Morrison.
Chairman: Thank you.

Q49 ***Lord MacGregor of Pulham Market:*** These are criticisms of the individual institutions themselves and the way in which they acted themselves with their current responsibilities. Would you like to say something about whether you think that the fact that there were three separate ones created other difficulties which are responsible in part for the poor response in the first place?
Professor Wood: Yes. The Treasury has to be there as the guardian of taxpayers' funds. It is always involved. The division between the FSA and the Bank I do not think worked very well. The Bank can indeed get access to any information it asks for. That is actually not terribly helpful. Unless I know what to ask for, I do not get the information I want. The Bank also lost contact with markets when the DMO (Debt Management Office) was taken out of its hands. It had, in other words, very much less feeling for what was going on. It did not know what the banks would do under some circumstances; it had that feeling in the days of the discount market. They saw the securities that banks were taking. They could look at them, they could literally feel the quality, "Do we like the look of what this institution is doing?" You had that kind of test. You could not really have that test nowadays, the City has grown too big, but having the central bank, the provider of liquidity, much more involved with the banking system would be useful. Then, of course, you have got the FSA, as I mentioned earlier, charged with two entirely different tasks requiring different behaviour, consumer protection and financial stability. I think they were fairly major design flaws. We cannot go back to the old system of the Bank doing everything and getting to know the people, the system is too big, but a bit more of that could come back in, yes.

Q50 ***Lord MacGregor of Pulham Market:*** Is that really talking about better coordination, better transfer or information, or is it something deeper than that?
Professor Wood: I think it requires structural change. Simply telling people to be virtuous would not get us very far. It requires structural change, making the Bank more central in the supervisory process, perhaps giving the Bank greater responsibility in actually supervising institutions. It also perhaps means thinking about the Bank of England's mandate. Why do I say that? We had a conference yesterday. It is on the public record. Tom Huertas of the FSA, a very able man, gave a paper in which he suggested it might be prudent to change the mandate The central bank has criticised supervisors. That is true. "Why," he said, "shouldn't supervisors criticise the central bank and say that maybe the policy is too expansive, it is threatening an asset boom which is going to cause stability problems later?" Well, it struck me as quite a good idea. What could we do about it in the UK? Imagine the following happens in late 2006: Sir Callum McCarthy writes to the Governor: "Dear Mr Governor, I think the monetary policy you are pursuing is leading to an asset price bubble and that it would perhaps make us more

comfortable were you to raise interest rates a bit." The Governor writes back: "Dear Sir Callum, I agree with you. You are dead right, but we have this mandate. We cannot do it." We need to think again about the mandate, maybe broaden it or change it, and perhaps if the Bank is going to have more than one responsibility it obviously requires more than one instrument. Do not ask me what that instrument is, but there is the need for something.

Q51 ***Chairman:*** We can see from the screen behind you, Professor Wood, that the Banking Bill is being talked about in the Chamber at the moment and one of the key issues which comes up in the Banking Bill is how insolvent banks should be wound up and we would be very interested to have your views on how they should be wound up.
Professor Wood: I think what the Banking Bill is doing is pretty well right, having a special insolvency procedure for banks so that they can be wound up quickly rather than taken through a delayed insolvency procedure. Again, at this conference I mentioned yesterday the chap from Linklaters, I think it was, winding up Lehman Brothers, gave a presentation explaining the complexity of dealing with a bank such as Lehman Brothers under the UK bankruptcy code. If these organisations could be taken into a special framework while they are still technically solvent, they can continue trading and contracts can be wound up. This was done in the United States with the US branch of Lehman's and it was much less disorderly and much more rapidly executed than it can be under British law. So this new procedure is very sensible, yes. The criticism of it is that it takes away shareholders' rights. It is an interesting point. It takes away the rights of the existing shareholders who now hold the shares because they have not been warned this change is going to take place. Future shareholders are *caveat emptor*. They can see the framework.

Q52 ***Lord Tugendhat:*** Can I come back to a question Lord MacGregor asked? I am not quite sure I understood your reply. As I understood it, Lord MacGregor was asking whether you regarded the FSA's mistake over Northern Rock as endemic to the system or simply that they got it wrong in the instance and that you felt the Bank of England would not have made the same sort of error if it had had the responsibilities which the FSA in fact had.
Professor Wood: I would not attribute papal infallibility to the Governor of the Bank of England for the present or any other governor. What I would say is the FSA did get it wrong, they made mistakes, but I would also add that the structure of the system makes such mistakes more likely because the people who are dealing with these institutions do not know so much about the markets and they are inevitably being distracted by the day to day pressures of consumer protection. Consumers do not write to the FSA or the Member of Parliament saying, "I think Royal Bank is running an excessively risky business overseas." They write and say—and do it daily or more frequently—"The Royal Bank," or whatever bank, "has treated me badly." That inevitably distracts attention.

Q53 ***Lord Tugendhat:*** We are, of course, in a very serious situation now, but putting that to one side, when one looks at the mistake over Northern Rock where can one put it in the sort of scale of error compared with the Bank of England's problem with Barings some 13 or 14 years ago, I cannot remember, or even with BCCI? There are two examples.
Professor Wood: Three separate cases, if I may, all quite different. Let me explain why I think they are different.

Q54 ***Lord Tugendhat:*** What I am trying to explore is whether the Bank of England, given the responsibilities which it used to have, would be less prone to make a major mistake. They are quite different errors, I quite agree with that, but the Barings one was right at the core of the bank's responsibilities and something which it completely failed to see?
Professor Wood: First of all, which of these mistakes was biggest? The one which had the biggest consequences was most certainly Northern Rock. BCCI had essentially none. That was a special case. The Bank, as you probably know, was warning that BCCI should not be allowed into this country. They were gravely dubious, but they were told it had to be allowed in because it was domiciled in one of our European Union partners, Luxembourg. There was no way of stopping that. Many of the supervisors in the Bank of England were very critical of letting in BCCI. They and many others in the City knew it was a fraudulent organisation. It was a special case. Barings, I agree, the Bank just completely messed up. Why they messed up, I do not know, but happily it was a small bank and it did not cause serious problems. So shifting responsibility to the Bank would not prevent mistakes. Nothing is infallible, but shifting responsibility for structural supervision more towards the Bank would shift it towards an institution which is primarily concerned with structural matters, away from an institution which is concerned with individual matters.

Q55 ***Lord Tugendhat:*** One final thing on this. One thing that worries me about giving the Bank of England responsibility for supervising banks is that its most visible responsibility these days is for monetary policy and my recollection is that when we had the secondary banking crisis, to which Lord

Eatwell referred, and I recall that NatWest was in the firing line at that time, and when we had BCCI and Barings all this rubs off very badly on the reputation of the Bank. It seems to me that if they are going to be responsible for monetary policy there is a big danger in being responsible for supervision as well because the problems in the one area rub off on the other. Given that the Bank now has monetary policy, I wonder whether it could have more responsibilities in the other area or not? I am rather doubtful that it could.

Professor Wood: Let me say, first of all, that I think your point is a very good one. It is one which was made often by Professor Issing when he was on the board of the Bundesbank for the supervisory system they have, which meant in fact that information was gathered by the Federal Banking Supervisory Agency and all passed to the Bundesbank. The Bundesbank told them what to do with it and when things went wrong the supervisors took the blame. It would be very nice to organise such a system. I doubt if we could do it. I am not suggesting that the Bank of England move into detailed supervision of individual banks, although it might supervise them if it thought they were in difficulties. What I am suggesting is that it be much more in charge of the framework for maintaining financial stability, for the rules that I have described, saying what the banks can do and what they cannot do with regard to the use of models and so forth, so not giving them detailed supervision of individual institutions.

Q56 ***Lord Forsyth of Drumlean:*** I do not want to get bogged down in the detail of the Northern Rock thing and I think I agree very much with what you are saying, but as I recall the Northern Rock position in the summer Lloyds TSB wanted to take over Northern Rock and there was a proposal put to the Government which involved Lloyds TSB being able to make the loan as security and liquidity being provided. I cannot just remember the numbers, but a very large sum. There was then a period of confusion as to what the policy was. There were arguments about moral hazard, there were arguments about what could be taken as securities, whether gilts could be sufficient. Looking back on it from where we are now this all seems slightly surreal and certainly my impression at the end of that was that not only was it not clear whether each of the parts of the tripartite structure had done its job properly but there seemed to be a basic problem that no one was in charge and that there was an argument going on between them as to what the policy should be and to what extent moral hazard should be allowed, and so on and so forth. Is that not fundamentally a problem of having a tripartite structure, that it is not absolutely clear who at the end of the day is going to say, "This is what will be done and this is the policy"? Is that the Treasury's role or the bank's role?

Professor Wood: In the present tripartite structure it is clear that nobody was actually in charge. Ultimately, the Treasury would have to be in charge because it has the money, but there is nothing to say when it takes over. So we do need to have a modification to the tripartite system where someone is clearly in charge from the beginning. That would be sensible.

Q57 ***Lord Forsyth of Drumlean:*** Who is that?

Professor Wood: Let me step back slightly. The Treasury Select Committee of the House of Commons proposed that this be a specially appointed Deputy Governor of the Bank of England, who would chair something called a Financial Stability Committee inside the Bank. As things stand at the moment, it is a slightly peculiar framework which has been put in place whereby the Governor of the Bank chairs this committee and then reports to himself as Governor on his performance. It would be interesting to be at the first meeting when the Governor decides if the Governor in his capacity as chairman of the committee has not done well. It could be a nice meeting to watch, I think! So it is not a very sensible structure and I am sure that will change, but the issue has been addressed, although it is as yet far from perfect.

Q58 ***Lord Forsyth of Drumlean:*** I do not want to prolong this, but I think it is clause 4 of the Bill. I actually put that question to the Minister at the stage of the Bill here, "Who is in charge?" and his answer was that the various parties in carrying out their respective duties which are defined in the Bill means that there is no need to have any particular entity in charge because their responsibilities are defined, but that seems to me to be where we were when we had the Northern Rock debacle and the sub-debacles?

Professor Wood: It pretty well is where we are. "Debacle" is the right word for how Northern Rock was handled and it is completely wrong to say that the framework you describe will work so long as everyone carries out their responsibilities. That is true only so long as soon as you can foresee all future events. You just cannot do it. You have to be someone who is in charge, who can say, "These are unforeseen circumstances. We should do this."

Q59 ***Lord Levene of Portsoken:*** It seems to me that we are talking today about oversight regulation, supervision of the banks, a little bit to the extent of shutting the stable door after the horse has bolted. You have the management of the banks and what comes between them and the supervisors is when you have a board of directors. If you look in today's

Financial Times you will see an analysis of the make-up of the board of directors of RBS, the non-executives, how long they have been on the board, what they have been doing there, where they come from. Having served on a number of occasions as a non-executive, I think to a large extent they find themselves in the position where you are a non-executive of a huge organisation. You go to a board meeting, maybe, not always, once a month, are presented with a pile of papers which you cannot really study in any great detail and you are expected to opine on it. Yet when the business—and it applies to other business as well as banks—is doing well, it is nothing to do with the non-executives at all, they are irrelevant. As soon as it goes wrong, it is all their fault. Is it possible to conceive of a system whereby the non-executives have to be better qualified, have to spend more time, and obviously be compensated for it, so that there is a longstop within the bank before it has all gone wrong and before it gets to the supervisor? Is that something which ought to be looked at, because otherwise they are just there as a rubber stamp?

Professor Wood: It should certainly be looked at and it has been done. In New Zealand it is a requirement that every bank director signs a letter, I think to the Governor of the Reserve Bank of New Zealand, saying that they understand the bank's business and they understand what it is doing. When this was first proposed the then Governor, who was Don Brash, received a deputation from various bank directors saying, "This is absolutely dreadful." As he said afterwards, this convinced him he was doing the right thing! Could I add one more thing, if I may? Shareholders in financial institutions seem to me to behave in rather a strange way. Imagine if the board of Sainsbury's had gone rushing out and bought a competitor or an overseas company at the very peak of a boom and paid a tremendously high price for it. The large shareholders would be apoplectic. Why were they not apoplectic in the case of banks? I do not know the answer to that question, but they seem to be different people behaving differently and yet they are the same groups of shareholders.

Q60 ***Lord Levene of Portsoken:*** Having served on the board of Sainsbury's, I think I understand. Could I just make a point? This is not really a question, but I think it is relevant to what we are talking about. We were talking before about hiving off toxic debt and making a bad bank, if you like. I just want to make the point that in the Lloyd's which I chair, the other one which is not a bank, that was actually done and it was done with what proved subsequently to be enormous success because quite some years ago when Lloyd's got into very serious trouble, I mean at least equivalent to what is happening now, virtually meltdown, all of the literally toxic debt (because it came from the asbestos liabilities) was hived off into a new claim called Equitas, which then was totally removed from the public domain, totally removed from any public oversight and very good management put in with the remit to sort this problem. Everybody thought they would go bust very quickly and lo and behold after 10 years totally out of the limelight, they fixed the problem, sold the business at a profit, and everybody was happy. I just mention that because it is a very good model to show how, when you remove a problem like that from the public eye and got good management and they just look after that with no responsibility other than sorting out the mess, no responsibility for ongoing business, you can make it work.

Professor Wood: I think that is actually a very good model. It was the model of the original plan in the United States, as you know. The difficulty with doing it is pricing the assets properly so that the taxpayer does makes only a small loss and quite conceivably a profit after a period of years, while not at the same time absolutely bankrupting the banks. If that could be done—and I think there are ways of doing it, reverse auctions might work—then it would be a very good idea to pursue that, yes.

Q61 ***Lord Levene of Portsoken:*** I do not think there is actually any need to pass it on to the taxpayer. You just hive it off and leave it there, hopefully to be resolved.

Professor Wood: What is on the other side of the balance sheet, because the liabilities are on one side?

Lord Levene of Portsoken: In this particular case you did have a lot of assets there against that, which were probably inadequate but at least they existed, but I think once you have given it over to the taxpayer you have lost the ability of having a commercial management in there to actually run it. That, I think, is the difference.

Q62 ***Baroness Kingsmill:*** I would just like to go back a little and pursue some more of these questions about directors, and I do not mean the non-executive directors. I am wondering whether or not there should be some particular engagement—let us start with the non-executives—of the non-executives of a bank, if the government should be different from maybe from some other kind of company so that, for example, maybe they should be engaging with the regulators independently and regularly? Maybe they should have a standing committee of advisors along the lines that the MPC has, for example, to enable them to question and ensure that they understand the product. I, myself, have been a non-executive director of a financial institution and of other kinds of companies and the asymmetry of information is staggering and as a lawyer I was often terrified by it and so made it my business to get into the businesses

themselves, but it is not necessarily something which is encouraged by the management that non-executives should do such a thing. I am wondering whether or not in the case of banks in particular there should be some particular kinds of requirements (a) that they have a standing group of advisors, (b) that they are required to get into the business themselves in some way or another, and (c) that they should have a formalised relationship with the regulators. That is one point. Before we leave it, you did say earlier on that we had had an unprecedented period of growth, stability and prosperity over the last 10 to 12 years. What was different? I do not think our questioning has elicited from you –
Professor Wood: You mean why that period was so stable?

Q63 ***Baroness Kingsmill:*** And then what happened that was different. If you could answer the first part of my question first and perhaps before you leave –
Professor Wood: Yes, I want to do the first part first, because the second part really could take quite a long time! The first part first. First of all, we should not forget that personalities matter. If someone was appointed as a non-executive director of an institution and then found that the executives stopped him finding out about the institution, he really should kick up a fuss. That is the right kind of person. If they do not kick up a fuss, there is something wrong with them. Secondly, boards when they are approaching non-executive directors, should actually think. They sometimes do not. A shocking experience—I can say who it was—was HBOS. They wanted to appoint a non-executive director and they were actually surprised when this person said, "But I know nothing about economics and finance. Can I please go to Cass Business School and have a few lessons?" They said, "Of course," but they were genuinely surprised by the question. Eventually this person decided not to sit on the board, very sensibly as it has turned out. Now to come to your proposals. They are a good idea. I think regular meetings with the regulator where they report on what they have been doing and why they have been doing it could do absolutely no harm. It would keep the regulator on his or her toes as well because they would have to be up to speed in that bank. Similarly, having advisers on whom they can call, that again is surely sensible.

Q64 ***Baroness Kingsmill:*** All board directors have the right to get independent advice when they want it, but that is in circumstances of crisis. I meant on a sort of standard basis.
Professor Wood: That would be very sensible. They could have specialists on hand whom they could turn to and say, "Could you explain this to me, please?" That is a very good idea. All these proposals are, I think, very sensible. All that said, personalities matter. But the systems, I agree, could be improved. Why have we had this extraordinarily stable environment over the past 10 to 12 years? Well, I am sure your colleague Lord Currie can tell you as much about this as I can.

Q65 ***Chairman:*** Could I pause there, because at the end of this session I am going to ask you if there is anything you would like to say by way of a round-up and I wonder if you could answer that one then and we can just get a more specific question.
Professor Wood: Do the round-up now? It is hard to round up –
Chairman: Let me repeat it because I do not think I have made it clear. At the end of the session, once we have done all our specific questions, I will ask you if you want to do something by way of a round-up. I think in answer to Baroness Kingsmill, the second question would make an ideal sort of round-up.
Baroness Kingsmill: I did not feel that we had actually elicited from you the response, so it would be very nice to hear it as a conclusion.
Chairman: If you could do that, that would be great.

Q66 ***Lord Moonie:*** I think my question is probably the converse of Baroness Kingsmill's. Why should we be indulging in a special pleading for non-executive directors of banks? If it is a general principle that a non-executive director must have some knowledge of the detail of what the company the board is serving on does, should this not apply in pharmaceuticals or defence, or any other area? Why should there be a special pleading for banks?
Professor Wood: I regard this as not a special pleading but a special penalty, one might say. But having clarified that linguistic point, why are bank directors more important than others? Because if a pharmaceutical company fails, what happens? Its suppliers may lose some money. Its customers may have a temporary hiatus in what they are buying from it, but a competitor will rush in and there will not be systemic consequences for the wider economy. Banks are important in a way no other kind of firm is important. No economy can function without a functioning banking system. The greatest example of this is, of course, the Great Depression of the 1930s in the United States. The greatest depression in recorded history was a consequence very largely of bank failure. Banks are much more important than anything else, and that is why we should pay more attention to bank directors than to any other kind of director.

Q67 ***Lord Tugendhat:*** When I was chairman of Abbey National and David Currie was on the board, I remember the Bank of England mounted an exercise in which it wanted to establish an independent relationship with the chairman of the

audit committee. So they had a system whereby they dealt with the chief executive and the executives and they had a system whereby they dealt directly with the chairman, but they wanted to start dealing with the chairman of the audit committee and I remember that all of us, all the bank chairmen at the time, we all opposed that and the Bank of England had to drop the idea. But listening to you, I am wondering whether with hindsight we made the right decision at that time and whether the idea of a direct connection with the chairman of the audit committee might not have perhaps helped. The reason we opposed it, of course, was that we felt it was going to set one lot of directors against the other, that it was going to be detrimental to the unity of the board. What do you think about that?

Professor Wood: I think it is possible to have too many checks on a financial institution. The relationship between the bank and the chairman of the Audit Committee is one possibility. I think a relationship with the wider body of non-executive directors would actually be more useful because they might know a wider range of things than the Audit Commission. Also, by having a relationship with this wider body the regulators could, of course, form a view of how good these directors were. So I think one wants something like that.

Chairman: Are there any other specific questions which Members would like to put to Professor Wood?

Q68 ***Lord Forsyth of Drumlean:*** If I could ask one very brief one, which we have covered earlier, which is on the deposit protection scheme. Bearing in mind what you have said about large banks, the basis upon which it is funded, it does seem terribly unfair that mutual building societies like the Nationwide, for example, end up paying for the foolish decisions taken by large banks and the moral hazard argument has the effect of actually resulting in the most responsible and perhaps in some cases some of the smaller institutions paying a disproportionate cost. I just wondered if you could comment on that.

Professor Wood: I think you are basically correct. The argument needs to be refined slightly. In principle there is nothing to stop the board of Nationwide being as stupid as the board of somebody else, except that since they are a building society they are much more tightly regulated. In return for conforming to this much tighter regulation, they should surely be let off much more lightly in the contributions to the deposit insurance scheme.

Chairman: Lord Vinson, at this point feel free.

Q69 ***Lord Vinson:*** Thank you, Chairman. Geoffrey, we are in the middle of the greatest banking crisis probably this country has ever had and solutions are being sought in all directions. It seems to me that some of them are slightly contradictory. On one side we are trying to encourage consumer consumption to get the market rolling again. On the other hand, we have reduced bank interest rates from 2.5 to 1.5 and possibly even lower. The Shadow Monetary Policy Committee, of which I believe you used to be a member, part of the IEA, came out last week by saying that they thought interest rates should not be reduced any further than 2.5%, the argument I think being that it completely destroys the income of all those who have been saving, for the institutions such as charities and others which rely on dividend flow, and so consumption will be cut. Is there a contradiction here? Is it right to continue to cut interest rates? Have they been cut too far? This is a topical question, I realise, but it is actually part of attempting to find solutions which might have to be used again if we have another banking crisis like this.

Professor Wood: First, if I may, for clarity of the record, I was never a member of the Shadow Monetary Policy Committee. I think because I am an Aberdonian I find it difficult to sign up to a committee with which I then have to agree a common view! That said, interest rates: lowering them is undoubtedly bad for savers. There is no doubting that. Is there an offsetting advantage for the wider economy? There was initially. Pushing them down further I am very doubtful about for a couple of reasons. First of all, businesses are now themselves—and consumers—being cautious and they are somewhat more reluctant to borrow than they were. Secondly, the cost of money, whether it is 2.5% or 1.5% actually is pretty immaterial if the bank will not lend. What is much more important is to encourage banks back into the markets again by, for example, a bad bank or by, for example, something which attempts to achieve the same end without the same immediate effect on the Government's finances, which is insuring lending. Some such proposal as that would achieve the end. I think pushing interest rates down without doing that is pointless and has this harmful effect which you have mentioned.

Q70 ***Chairman:*** Professor Wood, if there are any further comments you would like to make in addition to answering Baroness Kingsmill's more general point, now is the time.

Professor Wood: I have implied already, I think, that more regulation is not what we want. What we want is different regulation, but I have elaborated that point many times so now I will just quickly deal with Baroness Kingsmill's point. There is study by an economist called John Taylor, who was on the Council of Economic Advisors under President Reagan. He is from Stanford University and is credited with inventing something called the Taylor rule for the guidance of monetary policy. He examined the various explanations for the stability of

the US economy over this period and in a systematic way knocked down one after the other and he eventually came down to an observation which we have actually known before. We had very stable monetary policy and that delivered very stable economic performance. The counterpart of that is, if we look at when things go wrong in economies, if we set aside wars, every major economic catastrophe, whether it be depression or recession, has been the consequence of a usually inadvertent (but not always) monetary policy mistake. Other policies matter, but if you get monetary policy right it is very hard to wreck the economy, and countries got monetary policy right. They were helped by a benign environment. Central banks could keep interest rates low without inflation accelerating because there was a sudden burst of goods being produced by India and by China, not just being produced but being produced at falling prices. This did not, of course, affect the underlying trend of inflation, properly defined, but it went on year after year, after year, and meant that measured inflation could stay low at very low interest rates. So we had the luck of India and China coming on-stream, so to speak, together, and Brazil and a few others, and we had in addition monetary policy which was becoming increasingly clearly focused on a long-term objective. These things combined to give us what I think is best described as the great moderation.

Q71 ***Baroness Kingsmill:*** The monetary policy, was it a mistake?
Professor Wood: The stable monetary policy was certainly not a mistake.

Q72 ***Baroness Kingsmill:*** Well, it was stable but it was based on a wrong premise?
Professor Wood: It was based on the premise, I suppose, that central banks should focus only on the consumer price index or some measure of consumer prices and that we do not need to worry about asset prices as warnings of future inflation. Now, if we get into the area of using asset prices as warning of future inflation, it is both complex and contentious, but I think it was clear that the central bank should have worried a bit more about asset prices. Once they had worried, the Federal Reserve could have done something because the Federal Reserve does not have a clear mandate to deal with inflation. Central banks which had a clear mandate to deal with inflation and nothing but inflation would have had not only to worry but to go along to the politicians who set the mandate and say, "We think this mandate is unsatisfactory."

Q73 ***Baroness Kingsmill:*** So in a small sort of domestic context, a rapid rise in house prices, asset prices versus moderate inflation rates and everything else should have been the trigger?
Professor Wood: It should certainly have been a warning. Of course, one fed the other because if we had become more stable and if this benign environment was going to last forever, then indeed assets had become less risky so they would go up in price. Nonetheless, this extraordinary rise in house prices should surely have been a warning that something strange was going on somewhere.
Chairman: Lord Currie would like one last final word.

Q74 ***Lord Currie of Marylebone:*** I wonder whether you see any merit in the sort of Minsky argument that this long period of apparent stability which went on for much longer than perhaps we have had before, the bidding down of the risk premium to almost zero, meant that the crunch when it came was just that much nastier and that it is the almost inevitable consequence of the benign circumstances which you have described before?
Professor Wood: I think it is very hard to demonstrate that with any degree of rigour, but it sounds intuitively right. Everything has become much more fragile, more risks have been taken because the climate has been benign. Then when something goes wrong the shock is the nastier.

Q75 ***Chairman:*** Thank you very much indeed, Professor Wood. That was extremely helpful and thank you for spending your time with us this afternoon. We look forward to your paper which you promised to let us have.
Professor Wood: It is quite long, you know.
Chairman: We do not mind a long read!

TUESDAY 27 JANUARY 2009

Present	Best, L	Hamwee, B
	Currie of Marylebone, L	MacGregor of Pulham Market L (Chairman)
	Eatwell, L	Paul, L
	Forsyth of Drumlean, L	Tugendhat, L
	Griffiths of Fforestfach, L	

Examination of Witnesses

Witnesses: PETER MONTAGNON, Director of Investment Affairs, Association of British Insurers (ABI) and PROFESSOR JULIAN FRANKS, London Business School, examined.

Q76 ***Chairman:*** Good afternoon Mr Montagnon and Professor Franks and thank you very much for coming. As you know, this is the second public hearing of our inquiry into banking supervision and regulation and you are very welcome. I do not know whether you wish to make an introductory statement or just go straight to questions.
Mr Montagnon: I am very happy to move straight on to questions.

Q77 ***Chairman:*** I think this is the second time today you have been doing this anyway. Are you happy?
Professor Franks: Yes, I am very happy.
Chairman: It will be open to both of you to answer each question but, in giving the second answer, where you wholly agree with the answer given by your colleague you can simply say "I agree" for the record so we know and leave it at that. I think you know the line of questioning. We are going to start on my right with Lord Best and go round the table.

Q78 ***Lord Best:*** May I just begin by declaring an interest which is what we need to do. I chair a large housing association which is deeply affected by the credit crunch since we are trying to raise several tens of millions in the current circumstances. My question is whether or not UK investors are sufficiently activist in their dealing with the firms in which they are shareholders. Would you like to comment on the extent to which UK investors can get involved and do get involved in the companies in which they are shareholders?
Mr Montagnon: It is clear that the level of activism varies; there is no typical shareholder. In general I would say longer-term shareholders like insurance companies, especially those with a sense of ownership, are more activist in terms of corporate governance because they recognise the role of corporate governance in sustainable value for them and their beneficiaries. They do also take a close interest in strategy but they are only one component of the market. If you look at some of the other types of shareholder, they are more focused on trading strategy but some hedge funds too are activists. If the underlying question is "Are we as effective as we might be?", then the answer has to be no, we need to make ourselves more effective in what we do and we are very firmly determined to do that, although we were not responsible for the crisis. I would say one other point about making activism work is that the boards to whom we speak have to listen. If they do not and will not, then it becomes very difficult.
Professor Franks: I agree with Peter but I want to add a couple of points, if I may. Peter is absolutely right that we can do more. With the new activists such as some hedge funds, some focus funds and the Hermes-kind of fund which is devoted to intervening and intervening in the strategy of companies there is a difficulty that boards feel probably under attack; boards are probably more defensive than they ought to be. It has been difficult to engage with bank boards. I ought to say that I declare an interest. With Professor Acharya I have been advising one hedge fund, Knight Vinke, which has a stake in a bank. I have to say we have not advised on the purchase and sale of the stake; we do not have those powers of prophecy, but we have been advising on certain aspects of the banking crisis and it has not been easy to engage. One reason is that if a year ago you bought 1% of a bank it cost you between £500 and £1,000 million; it is cheaper today. That kind of stake for 1% is pretty large. The average size of stake of activists in the UK and Europe is 5, 7, 8%. If you only have 1%, it is not easy to engage with the board unless they want to be engaged. Activism, as Peter has said, has some way to go.

Q79 ***Lord Best:*** Is there a distinction between shareholders in this country and in Europe in relation to the scale of their holding and therefore the extent to which they are active activists in this?
Professor Franks: I have done a study on UK activism and we are just completing a study on European activism, literally counting the activist events, who initiates them, what form they take and what value they give to shareholders. There is a difference. On the whole the legal framework in this country is friendly to activism compared with most continental

countries and indeed compared with the United States such as the State of Delaware. I could go on but I think I ought not to.
Mr Montagnon: I would broadly agree with that.

Q80 ***Lord Forsyth of Drumlean:*** First I should say that I am a partner in a firm which provides corporate finance advice although we do not advise any of the clearing banks. Could we just pursue this idea about how easy it is for investors actually to influence the behaviour of banks? You just made a point about the small shareholdings and the point about the institutions being able to meet with the banks. These meetings tend to be private, nobody knows what was said at the meetings and, let us take an issue which has caught the headlines—it may not be the most important issue—for example executive pay and bonuses, it is quite hard for the institutions who are discussing these matters with the banks if they are themselves in the same boat. For the ordinary shareholder, the ability to exercise influence seems rather limited. Would you agree with that?
Mr Montagnon: A lot of issues are bound up in that question. May I first of all deal with executive remuneration? The answer is that it is not always easy, partly because there is a market out there in which you have a lot of holders of maybe 1% who do not always have the same opinions; therefore it is sometimes possible for banks and other companies as it were to divide and rule. These issues of remuneration are never straightforward because you have to make a judgment quite often about whether you wish to maintain the management or risk losing the management or being very demanding on executive remuneration. In terms of the suggestion that fund managers are in the same boat because they are also receiving large bonuses, I do not actually believe that plays a significant role in their approach to these issues because they do take the conflict issue seriously and if it did play a role you would never see them being tough. They have obligations to their beneficiaries. It is also true that while the fund management industry may be in receipt of bonuses, there are actually quite often and normally indeed some quite important longer-term aspects to their own remuneration, so we are not looking always to the short term. On the other aspect of the question, it is actually often quite difficult for shareholders to influence bank behaviour if the boards will not listen. In the case of Northern Rock the management were not at all responsive and I understand that some of the meetings which took place were very short because the management was not interested in listening and the traditional institutions responded in the end by selling down their holdings so that at the end of the process with Northern Rock the share register looked very different from how it had done at the beginning. It is also fair to say that Royal Bank of Scotland was not always responsive and indeed on one or two occasions went out of its way to obfuscate in its dealing with shareholders. One important ingredient of a successful engagement is that there should be traction between the shareholders and the non-executive directors who may also sometimes be concerned. When that point is reached they need to work together. One side cannot necessarily achieve very much without the other.

Q81 ***Chairman:*** You say "non-executive directors". Do you mean the senior independent director normally or do you mean the lot?
Mr Montagnon: There is a cascading expectation, so that if you have difficulty or disagreement which affects the chief executive, then you would go to the chairman and if you have an issue with the chairman you would go to the senior independent director. The senior independent director is a very important figure in this but as a collective the independent directors need to be willing to take the issue on otherwise you are just dealing with one person.

Q82 ***Lord Forsyth of Drumlean:*** I apologise that I mixed up a whole lot of things, but could you just deal with the fact that these meetings with the institutions tend to be private meetings and it is not disclosed what representations have been made?
Mr Montagnon: Yes. It is inevitable that they are private because if they happen in the full glare of publicity your chance of achieving the outcome you are seeking may well be seriously impaired. It is not as though the whole body of shareholders do not have the opportunity to vote on the key issues at every stage along the way and indeed sometimes, when our members have been undertaking private negotiations with companies, one of the specifications we have made to them is that when they have made up their mind to respond, and if they make up their mind to respond, then they must make a full announcement to the market and not do a private deal with the larger shareholders because that is not appropriate.

Q83 ***Lord Paul:*** First of all let me declare an interest. I am chairman of a manufacturing group which is affected by the financial crunch. A cosy relationship always tends to be formed between the management and the largest block of shareholders; the ordinary shareholders really have no chance to ask any questions or show concern or have any attention given to them. How does that allow a situation where they can be very independent?
Professor Franks: It is almost impossible for a small shareholder to have incentives to collect information and generally to ask questions except over a very narrow range. If we are to confine ourselves to banks, for example, banks are opaque and complex

institutions. If they were not, we might not have had the regulatory failures we have seen. It is interesting to think about why they are opaque and why they are complex and two factors are interesting here: opaque and complex because banks are almost unique amongst institutions in being able to create assets and liabilities virtually overnight through derivatives and other instruments. We can transform the assets and liabilities of balance sheets hugely and quickly. How could a manufacturing company like Rolls-Royce or retailer like Marks & Spencer double and triple their balance sheet in a week or a month? Banks can do it. The second factor is that this can be done not by the board of directors, not even just by people just below the board, but by people far below the board. That of course is a great danger that the transformation of balance sheets can be done by people in the middle of the organisation. That is kind of worrying and that is why risk controls, et cetera, are so important. In that sense banks are opaque, fast-moving. What is the leverage of a bank today and what was it six months ago? One bank, UBS, changed the size of its balance sheet by 30 or 40% in the space of 18 months, contracting it after the crisis. That gives you an idea. Collecting information about banks by investors is very costly. If I am an index fund charging 30, 40, 50 basis points to investors, how much money can I afford to spend looking and understanding bank balance sheets? The answer is: not very much. Only a few investors have invested the time and the trouble and it is not fun. Some investors have gone public with their engagements. We should not understate culture and social norms here. It is not easy going public; it is not nice for the companies and it is not nice for the investors. Some do but there is a price to be paid.

Q84 ***Lord Eatwell:*** First of all I should like to declare interests as a director of SAV Credit Limited, a credit card company, and as economic adviser to Warburg Pincus and Palamon, private equity companies. From what I have heard in discussing the relationship between boards and shareholders, there is a very considerable degree of scepticism that shareholders can really have any influence on boards at all. It was even said that perhaps there would be some influence if they bothered to listen. Boards argue that they manage companies in the interests of shareholders. Is this then a myth? Do boards actually manage companies in their own interests?

Mr Montagnon: It would be very dangerous to generalise along those lines. It is quite clear that where it goes wrong then the boards are not managing the companies in the interests of shareholders and that may be one of the reasons why it has gone wrong. It is not true of all boards all the time and one of the issues here is how well the board is functioning and there we have seen problems. We have seen boards which are not functioning well as groups and it might well be helpful, particularly in the case of banks, where the businesses are complex, to put some more emphasis on board evaluation to make sure that the boards are functioning as groups. By the way, all that said, I do not think that directors generally set out not to manage the business in the interests of shareholders. Sometimes they convince themselves that they are managing them in the interests of shareholders when the reality is that they are not.

Q85 ***Lord Tugendhat:*** I have difficulty entirely following your answers. My recollection of being on boards and certainly my recollection of when I was chairman of Abbey National is that if large shareholders wished to make a point they were in a position to do it. Not all of them wished to do so. Not all of them sent very high grade people to talk to the chief executive or to the finance director; some of them indeed appeared to treat the meetings as a rather routine affair. However, my impression is that when significant shareholders—and by significant I mean either in terms of the size of their holding or of their influence—to go back a few years, such as Carol Galley wanted to know something, people told her and they would have been very loath not to tell her. There are other people like that. I remember Leigh Clifford at Rio Tinto—not a bank of course—saying how different in kind being interrogated by hedge funds was from being interrogated by long-only funds and that was because of the degree of interest they took and the calibre of the people who were involved. I must say, if I may, I find your answers a little difficult because I do not think shareholders necessarily attach such tremendous importance to a lot of these meetings.

Mr Montagnon: The importance they attach to these meetings has grown over the years and I did say at the beginning that we can probably handle these things better than we do and we want to improve. I also think you are absolutely right that if large shareholders seek information they will, generally speaking, get it. In a couple of the banks we have been talking about that was not necessarily the case. Those probably are exceptions but they are exceptions which turned out to be very worrying.

Q86 ***Lord Currie of Marylebone:*** I want to go back to the question of the sort of information and its availability to investors and indeed to boards. You suggested that decisions can be made at a low level in the organisation, well below the level of the board and that made it hard to know exactly what was happening, especially if it moved very fast. Does that suggest, if we are to have well-run banks and financial institutions more generally, we need much better control over that information and perhaps a

simplification of the business to make the flow of information easier to understand? Then, if the board has access to that type of information, surely it is relatively straightforward for that to be shared with investors and maybe part of the problem is that the board itself is not as well informed and hence the opacity of discussions between the board and major investors.

Professor Franks: I think I agree with everything you said then. I suspect boards did not understand some features of their business. For example, I do not think some bank boards understood how highly levered they were, how much debt. I think they said "Tell us the regulatory leverage. Oh, it is 6. What is Basel I cap ratio? Oh, it's 5%. Are we OK?". Well, you were not okay because those regulatory ratios were not sufficiently informative. There was not enough going behind these numbers. Banks were, on the whole, much more highly levered than they thought, than they acted. There was also off-balance-sheet finance "This is off balance sheet therefore we don't need to worry about it". Well you do because if there is a problem you are going to have to stand behind it. If you are going to have to stand behind if, what is the value of it being off balance sheet? HSBC has an important US corporation which is non recourse. On the other hand, for jolly good reasons, they say they want to stand behind it. It is important to understand that before a problem occurs, not after. Regulatory arbitrage, using money from the centre of the bank, the deposit network of the bank, which is guaranteed in part or in full by government, for other activities outside that regulatory framework. There is a lot of gaming going on; there is no question about this. I think this is well known and all those things are going to mean simpler banks. It is not just going to be more regulation: it is going to be simpler banks.

Q87 ***Lord Currie of Marylebone:*** Do you think these problems were similar in the UK, the US and continental Europe or were there very significant differences?

Professor Franks: Paradoxically the less sophisticated you were—this is one of those occasions—the better. I went into a bank abroad. It does not really answer its telephone very well and it is a bit of a throwback 20 years but it is doing very nicely thank you. They did not understand derivatives and all that kind of stuff but it is doing very well. Certainly the fact that there have been failures in a lot of markets should give us pause for thought about the seeds of this crisis and the seeds of this crisis were not just sown in boardrooms of banks, they were sown in the macro markets. Martin Wolf has written a lot about this. We should think about it carefully; it is not easy to allocate blame.

Q88 ***Lord Griffiths of Fforestfach:*** First of all may I declare an interest as vice chairman of Goldman Sachs International and a member of the board of Goldman Sachs International. You said that banks were opaque and complex institutions, which I would agree with. The question then is about the role of non-executive directors and how you would choose non-executive directors in banks as opposed to non-executive directors in non-financial institutions, whether there is any difference. Because of the complexity of the business, what sort of capacity should they have in order to gather information and to understand what is happening?

Mr Montagnon: There are three points to make here. It is quite clear that on the boards of banks you need expertise because they are complex businesses. Even if made simpler, they would still be complex businesses. Expertise on its own is not sufficient because what you do need is sufficient character to say no to the management from time to time. If you do not have that character, all the expertise in the world will not help. I do think there is another point which is relevant to this and we believe this very strongly. It is that boards and independent directors must have the right to seek and obtain information and be able to exercise that. As shareholders we would think it very important to support them in having that right. Some of the information remains confidential within the board, but if the board is not being formed properly, then you are in trouble. They do need to have the right to demand and the ability and strength of character to demand information.

Q89 ***Lord Griffiths of Fforestfach:*** Can you give me an example of what kind of information, if you had been on the board of one of the major British banks in the last two years, you would have been asking for which you feel may not have been readily available?

Mr Montagnon: One of the issues which has come to light after the event, and we still do not exactly know how it unfolded in the boards concerned, was the propensity to put some stuff off balance sheet. The boards should have been entitled to know that that was happening. They should have been able to ask. If the management is putting it off balance sheet and really hiding it, it is really difficult to know you have to ask the question. That is a very, very important aspect of this and the boards should have been in a position to have that knowledge.

Professor Franks: May I give you another example? First of all, I agree entirely with Peter about the need to seek outside advice. The non-executive members of the Monetary Policy Committee—and I know you were a member for a period some little while ago—are allowed to seek outside advice and go outside for external research. This is very important. It is interesting that for some years colleagues and I have been developing this idea. I have to say the people I

have talked to are very resistant "You're trying to second-guess management" or "You're in danger of taking confidential information outside the boardroom". This is not just with banks. Non-executive directors should be allowed to go outside and I should like to give two examples: one banking one and one non-banking one which I have been involved in. The banking one is the cost of capital for the banks. This was far too low. It simply did not reflect the leverage of the company. However, to challenge the bank and ask what the cost of capital is, you would have to have gone outside for special expertise. We have been looking at this matter; this is not an easy issue to address. It is nothing like as easy as the cost of capital for Lord Paul's company, for example. It would be relatively straightforward would be my guess. The cost of capital for a bank means understanding the capital structure and leverage of the bank and its risk. This is a formidable problem. You should not have to rely solely on internal management. Let me give you another example. I am a pension fund trustee and an advisor to another pension fund. I may be uncomfortable with actuarial valuations of our liabilities and the deficits resulting. I may want to go outside to get expert advice on valuing these liabilities. One response might be; "Why do you need to, we have experts here?" On pension fund deficits we all have a sense of how difficult they are to value. It may vary between £5 million and £20 million for the company I am an advisor to . There may be a temptation to say "If we are consistent with the regulatory rules, we do not need to do anything more than that". In my opinion that is grossly unsatisfactory. We have to use independent judgment and not rely on the regulatory rules. Indeed that is one danger of regulatory rules: they become a substitute for board judgment. This just emphasises the point Peter made: it is very important to be able to go outside for advice and expertise.

Q90 ***Lord Forsyth of Drumlean:*** Are you saying that non-executive directors of the banks were being frustrated in their wish to get information?
Professor Franks: No, I do not think either of us said that.

Q91 ***Lord Forsyth of Drumlean:*** I cannot imagine, if I really wanted to or I wanted to get external advice, that there would be resistance to that. If there were, one would leave the board. Is there any evidence that any of the non-execs in any of the banks we have been concerned with wanted to get information and were frustrated in doing so?
Professor Franks: No, I do not think either of us suggested that. I am completely ill-informed on that point. I am simply saying that if, as a matter of course, non-execs were able to do that, it would make them more informed and they could, in a constructive way, challenge the company and its views in an intellectual way, not in a destructive sense. That would be very helpful and not just for banks.
Mr Montagnon: We cannot really know what information they would have liked or whether they sought it. It would be very, very difficult to find that out. By the way, I was talking initially about internal information but I agree with what Julian Franks says about external information. The point is that if it is absolutely clear that independent directors are entitled to seek information or internal and external advice, then there is more pressure on them to do so and it is easier to hold them to account if they do not. We need to establish and make the principle very clear.

Q92 ***Chairman:*** Are you suggesting that there should be a legislative requirement or simply that non-executive directors should be more aware of doing it?
Mr Montagnon: No, it is more a combined code, kind of complier-explain level, best practice thing, not legislation.

Q93 ***Lord Griffiths of Fforestfach:*** I take the point and I see the value of what you are advocating, but it seems to me that the risk of going down that road too strongly is that you create a two-tier board and you have the possibility of mistrust arising and possibly executives wanting therefore to shield information even more from non-execs.
Professor Franks: I have to say that I certainly think that is a reasonable challenge. If I may give you an analogy, when the proposal was made to separate the position of CEO and chairman by the Cadbury and Higgs' codes of conduct, the Americans were strongly against it and still are. Conflicts will outweigh any benefits they argued and we know now, the evidence is, that it is about the one piece of corporate governance in the combined code where we have conclusive academic proof that it works for under-performing companies. If you have separation, you are probably going to be fired if you are very under-performing. If you do not have separation, you are not going to be fired. The evidence shouts from the rooftops. The objections were again "You will sow mistrust. You've got to have a sensible kind of accord between non-execs and execs that non-execs trying to inform themselves better and do a better job does not undermine the executive directors". Your voiced objection is certainly one which is very important to think about.

Q94 ***Lord Tugendhat:*** On this business of experts and outside advice, of course I agree and one cannot fail to agree that bank boards need to have a high level and probably a greater level of expertise than they have had in the past. I have to say that my

experience is that if you have on your board somebody who is very expert in the arcane and new forms of product that have been developed, this tends to make them see the world in the same way as the executive; you have two lots of people who are expert in the same rather arcane field and actually they tend to have a rather similar mindset. In my experience, far from the expert being likely to challenge the internal expert, he is more likely to agree with him. Secondly, of course I agree that people ought to be able to get outside advice, but the difficulty is that again, the more *recherché* the subject, the more closed the area in which you are operating and the more likely people are to have a similar world view. Then, of course, there is the problem of commercial confidentiality. On the whole the Monetary Policy Committee is dealing with macro subjects and commercial confidentiality is not a problem. If one is a non-exec director of a bank, the issues which have been really sensitive and have caused difficulty are quite difficult to get outside advice on without revealing information about the bank which it would be a breach of confidence to reveal.

Professor Franks: I am kind of one of those experts and am in a difficult position, I have to say, with much less experience than your own. I do not think I agree. I am a pension fund trustee, I have a lot of financial expertise and I am looking for ways of cross-checking. The issues about banks, what is their leverage, what is the right cost of capital, what is the effect of bank guarantees on their cost of capital and their capital structure are generic issues and indeed the issues I have been advising Knight Vinke on could have been at Barclays or RBS. It really would not matter. In the case of banks these issues were generic to all banks. I have been doing seminars with a bank which has been discussed. You need not discuss confidential information to get a handle on these problems. Having said that, if a non-exec is not an expert in the way you mean, even more reason to be able to consult experts so that they can get an understanding of the issues a little better.

Mr Montagnon: I should like to come back to the point I made earlier that I think expertise on its own is not sufficient. Strength of character to challenge if necessary is absolutely vital. In a board you have to have some expertise, but you also have to have that ability and you need the right mix on the board to achieve what you want.

Q95 ***Lord Paul:*** Talking about the non-executive directors and the type of products which the banks have been selling or buying and the size of them, I am not sure it was possible for the executive directors to understand what they were trading in. Is it really physically possible for a non-executive director to know anything about them?

Mr Montagnon: That is a very good question. Certainly I know that some of our members are wondering about this and are wondering, at a certain point of complexity and if the bank is doing business somewhere in the group, which is almost impossible for anybody other than those intimately involved in that business to understand, whether that is actually appropriate. At the end of the day such a bank becomes ungovernable and unregulatable and there is a question we need to think about very carefully there.

Q96 ***Lord Eatwell:*** It has been suggested to us that there ought to be a closer relationship between non-executive directors and the regulators; perhaps they ought to meet and share information backwards and forwards. Do you think that would improve the compliance relationship or would it produce something, which you have suggested, the seatbelt problem, that when people have seatbelts they drive faster than when they do not have seatbelts?

Mr Montagnon: That is not a very helpful road to drive off down, the point being that the regulators must have their own channels. The obligations of the directors are to the company and to make them have a second line of responsibility to the regulators makes it very difficult in a unitary board. I am not sure that we would achieve anything much by going down that route. Clearly if a non-executive director is concerned and frustrated in achieving change, they have the option of resigning and that in a way sends a signal to the regulators, among others. To give them, as independent directors, a specific task of sharing information with regulators would be quite dangerous to the concept of a unitary board.

Professor Franks: I would agree with Peter although it is a difficult one.

Q97 ***Lord Paul:*** To what extent are the current problems in the banking sector attributable to the problems of governance?

Mr Montagnon: There was a failure of governance and that is part of the issue. The problems we have been facing go back a long way into the macroeconomic imbalances, the liquidity which was created from those and also to some extent to the incentives behind the Basel capital requirements and the accounting standards which actually drove some of this business. It is very difficult to say it was the cause; it was one aspect. It is probably true that some of the pressures on banks and other businesses which arose as a result of this enormous liquidity were such that they were really pretty hard for everybody to understand and resist.

Professor Franks: I agree with that. We have had a systemic crisis of huge proportions and the idea that executive or non-executive directors should have somehow foreseen this when regulators could not and

governments could not is putting unimaginable burdens on boards. In that sense I absolutely agree. However, I do think, with hindsight, we should not quickly go for the regulatory lever until we understand the problem more. I do not really understand the problem sufficiently. The profit margins on corporate loans were miniscule and reflected a view that banks did not need equity, they could just borrow, get a spread and lend on. I do not think the leverage of banks and why they were able to borrow cheaply was adequately understood. They could borrow cheaply because markets thought they were guaranteed or their deposits were guaranteed, by the Government. When the markets caught on that they might not be, the run began. I do not think this was well understood and it was most unfortunate and that is a lesson we will have to learn.

Q98 ***Lord Paul:*** Governance means either fraud or something or other but nobody has challenged anybody with that. The only thing which has been talked about is greed and the extra bonuses, et cetera. The whole thing seems to have lost sight of what they were doing. That is the impression one gets.
Professor Franks: It is very difficult to understand fully today the answer to your question. I certainly worry about the myopia of some compensation plans, the drive for size rather than profitability. I am sufficiently old to say that I remember, 40 years ago when I borrowed from a bank, it cost me 3% over base; when I borrowed a couple of years ago it cost me 67 to 70 basis points over base. Do I think it was wise to lend me so cheaply? No, I do not. I have to say that I am now paying 220 basis points, which I am not very happy with, but it is much more sensible. The margins on bank loans were crazy. I know senior people in banks would say they did not pay enough attention to their balance sheets "We wanted the deal. We wanted to preserve our market share". The impact on balance sheets is now becoming hugely more important and I think that is long overdue.

Q99 ***Chairman:*** How important do you think that legislation is in facilitating good corporate governance? Do we need any new corporate governance legislation in the wake of the crisis? Some people have even suggested legislation on pay. I would be interested to hear your reactions.
Mr Montagnon: Legislation must provide the right framework in which governance can operate. For companies to be accountable to shareholders means that the shareholders must have rights. One aspect of this which I do think is important because the crisis started there is that it is important for shareholder rights in the United States to be increased because their shareholders by and large have no right to dismiss directors and so could not hold companies to account even if they wanted to. For shareholders to exercise their rights means they must have access to basic information. The art is to get the framework right and then ensure that the various actors are properly incentivised to do what they need to do to make the accountability chain work. On the specific issue of remuneration, I am not sure that legislation would help. I do believe though that in banking, particularly in banking, because of the nature of the business and the cyclical nature of the revenues, there is always going to be a tendency to have a high component of variable pay in the mix and that does create a situation where employees will want to grab as much bonus as they can while the going is good and might encourage them to take short-term risks. If that happens, then in the extreme the business itself can be put at risk. The issue for remuneration in banks is one which should be seen in this context. As shareholders, we would like to see more disclosure, not in the remuneration report on the way the directors are remunerated, but in the business review of the way in which the entire board is recognising and managing these risks. We also think we would agree with the FSA that it is sensible to look at this process and make some assessment of the impact of remuneration on the riskiness of the business as a whole and factor that into their prudential supervisory approach. Beyond some more transparency, or some more narrative disclosure requirements, we would not actually see any formal requirement here, but we would think that the regulators are right to look at the risk aspect of this.
Professor Franks: I want to stress that I think we should not regulate in haste. We do not understand the origins of this crisis adequately and Sarbanes-Oxley was a good example of regulating in haste. Having said that, there is one area of legislation I think that could be helpful to look at and that is the election of directors. At the moment boards really nominate directors. It is not easy for shareholders to nominate directors. It would be worthwhile looking at what mechanisms could be put in place that would allow shareholders to nominate directors more easily. If I could just come back for a moment to your view, there are almost 300 cases where activist shareholders have intervened, many of them in public, some in private and in that sense that is consistent with your view that there are quite a lot of interventions, many of them hostile however. These people are not invited for tea or to stay for tea. You may have been very welcoming to criticism but you should not assume that boards in general are as welcoming, especially when they are underperforming, especially when you want to change the management of a company. It is not easy to go inside a boardroom and say to the CEO that he should spend more time with his family. That is not well received. Yet in half the cases we have studied there is a change in management. That explains the hostility and the difficulty. The election

of directors, making it easier for shareholders to nominate, is an area well worth looking at. I thought that before the crisis and I think that after the crisis.
Mr Montagnon: I have to say that I have some reservations about that. If you make it too easy for the shareholders to put up a slate and nominate, then you will very quickly undermine the unitary board. A unitary board is actually something which is of quite considerable value which we have here and we would wish to preserve, where all the directors are collectively responsible for all the decisions. The problem can perhaps be better addressed by requiring directors to stand for re-election more frequently. This is not a formal position of the ABI but we are interested in debating it at the moment. If all directors were to stand every year it would be clear when there was dissatisfaction growing and that would be a signal to the board that it needed to look to its own renewal. I prefer that route rather than encouraging selective dissidence.

Q100 ***Lord Best:*** Could regulations sometimes undermine the monitoring incentives for investors in financial institutions either deposit insurance regulations undermining monitoring incentives or regulation becoming a substitute for shareholder monitoring and shareholders trust supervisory monitors and back out themselves?
Mr Montagnon: There is a risk of this but I am not sure that it is a large one in practice.
Professor Franks: I worry that regulatory rules become substitutes for independent judgment on boards. Actuarial deficits, Basel I tier 1, Basel II tier 1 ratios, if you can tick the box it is fine. It is not fine. I suspect our actuarial deficits for pension funds are seriously wrong. The regulator has said that. We should exercise far more independent judgment and I worry about the incentive effects on regulation. What to do about it? I do not know but I certainly worry about it.

Q101 ***Lord Forsyth of Drumlean:*** Now that the Government have become a major shareholder in more than one bank do you think that there might be a tension between perhaps the government's legitimate policy objectives and the interests of the other shareholders. If you do think that this might be a tension, what are the best means of trying to resolve it?
Mr Montagnon: There are several risks here. The UKFI is a large holder of banks and an insider as well in the sense that it is not seeking to trade the shares. This has always been an inhibition to institutional shareholders; they do not want to be made insiders and lose their ability to trade. The Government are more like a private equity investor and like private equity they are looking to exit. That means that its time horizons may well be more short term than the time horizons of traditional institutions and is also risk that the Government could encourage decisions, for example of capital raising, which would go against the interests of other shareholders. I think there are potential tensions, but I have to say that to date we have been very pleased with our contacts with UKFI. They have said publicly that they wish to behave as a value driven investor and we support that. If they do pursue policies orientated towards long-term value creation, we believe rather strongly that they will be able to exit their investments eventually at a better price to the taxpayer. That is actually a very important convergence of our interests and the Government's interests. That said, the Government have policy interests and we know what some of these are: ensuring the flow of lending to provide working capital for sound businesses. Those sorts of policies probably should apply to all banks. When the Government are trying to make general points, they need to be quite clear to the industry that they are making general points and not specific points to that part of the industry they happen to control. We are going to see how this process works but I have to say that at the moment we have found that we have had good contact with UKFI and we will try to maintain that going forward.
Professor Franks: There is the law of unintended consequences. Here there is a real danger. You can understand the Government's taking of stakes in banks, quasi nationalisation, state aid to many areas, the need, to get the credit flowing, telling the banks where to lend, is an incredibly difficult position and that is why I say it is the law of unintended consequences. I hope Peter is right that he can see how the Government will extricate themselves from this. I take a more sanguine view: it will be far more difficult for them to do so and the consequences may be longer term.

Q102 ***Lord Forsyth of Drumlean:*** It will be one of the unintended consequences that there could be a higher cost of capital.
Professor Franks: Yes. Here is a paper by Professor Sapienza, who, as the name sounds, is Italian and she has looked at state-owned banks in Italy versus private banks. State-owned banks are less profitable, they lend at lower interest rates and they happen to lend where their political interests are greatest. We are not Italy—I say that not for good or for bad; I am an admirer of Italy; I am sure God is Italian—but nevertheless we should worry. If we do not worry, the law of unintended consequences will work.
Lord Paul: Do you think it is really fair for a big shareholder to tell a management what to do on behalf of the other shareholders?

Q103 ***Lord Eatwell:*** Could you give me another example of a situation in which a majority shareholder does not determine the policy of a company.
Professor Franks: Let me answer your question and thereby answer Lord Paul's question. I agree with you entirely and the evidence is overwhelming. Large stakeholders attempt to extract private benefits of control; there is overwhelming evidence for this. It does not depend on a country and of course it is irresistible for a large shareholder to wish to influence the policy of a company. If it were a private large shareholder, we would say absolutely it is natural and it is obvious. I would be amazed if the Government resists the temptation and if I were in Government I am not sure I would wish to resist the temptation.
Mr Montagnon: Yes, but the directors of the companies have a duty towards the shareholders.

Q104 ***Lord Eatwell:*** And what happens is that the majority shareholder then kicks them out and has his own slate.
Mr Montagnon: It is still a legal obligation.
Chairman: The fact that we have overrun indicates and reflects the interest you have given to us. Thank you both very much indeed for coming.

Examination of Witnesses

Witnesses: Professor William Perraudin, Imperial College, London and Dr Jon Danielsson, London School of Economics, examined.

Q105 ***Chairman:*** Good afternoon Professor Perraudin and Dr Danielsson. Thank you very much indeed for coming. I am sorry we have slightly overrun but it is such a large subject and I suspect we will be spending a lot of time in our questions to you on financial models. May I stress that if you agree with the person who answered the question first and you are second simply say "I agree" in the interests of progress. Have financial institutions been adopting the right approach to financial model development?
Dr Danielsson: I would not think so. The financial institutions have become dependent on a model in place of perhaps a more intuitive management; that is models have become a tool for these institutions to look at the state of the business, the risk of loans, where to allocate funds, et cetera. We are talking about banks here. In my view in a way models have replaced human intelligence in banking and that is one of the key reasons why we are in the crisis we are in.
Professor Perraudin: I do not think it is possible to understand risk in banks and the complexity of that risk without using models. It is necessary for senior people, for regulators, to take a view on business approaches and broad strategies but I tend to think that there are no alternative models in the way that financial firms currently operate. The models which have been used have been insufficiently comprehensive and they have left out categories of risk in a way which is hard to justify but became an industry practice. It was conventional to think of different types of exposure without taking account of certain types of risk. In fact, in trading books for example, people did not really consider the possibility that exposures would become illiquid, so you would be left with large positions which had appeared to be safe but if they were illiquid the true price might move a long way and you would not actually be able to trade out of a position. In general there was an insufficient understanding of the importance of liquidity both liquidity in instruments, the fact that it could suddenly become the case that you could trade out of a position, and also liquidity in the sense that financial firms presumed that they could always finance positions. They presumed that the liability side of their balance sheet was secure. That is a massive gap in the understanding of risk as it has turned out.

Q106 ***Lord Eatwell:*** Let me put the question this way. When he gave evidence to the House of Representatives, Alan Greenspan said, amongst other things, that the entire intellectual edifice of risk management has collapsed. Presumably, from what you have just said, you would not agree with Mr Greenspan. What you were saying, as I understand it, was that risk management was inadequate because it failed to take into account a series of risks which had now become evident. I wonder whether it is possible for a firm to manage the risks to which it has been exposed, even if it calibrates them effectively and comprehensively, if some of those risks are externalities and arise from systemic risk to the system as a whole, rather than as a result of the activities of the individual firm.
Professor Perraudin: The problem of understanding feedback from other firms' actions and other firms' positions is very challenging and it is particularly challenging when there are new markets. So the structured product market had existed for a long time but not on the same scale, not encompassing the range of underlying assets which were gradually swept up into it. In effect it was a new market where people were trying to understand risk when it had only been there for five years on that scale. Understanding feedback is a tremendous challenge. From the point of view of single institutions, if they really could look back historically and understand

the episodes in the distant past which resembled the types of things that have now happened, then they would probably have been sensibly more cautious. If you compare banks with insurance companies, insurance companies' risk management practices in some ways were much more primitive than banks but they have always had a preoccupation with the price of re-insurance. Basically they were always worried not just about the asset side and the possible claims but the price of re-insurance was something they were always trying to understand with stress tests or models or whatever. With the banks, people were not worried about the chance that the spread between LIBOR and gilts would suddenly explode. Nobody understood that that could happen. Looking back historically, one can find episodes where that gap opens up. If you look at other countries you can see episodes. In summary, I agree that it is much more challenging when you have to look at feedback, particularly in the new markets. The rational response to that is to use stress testing, is to try to collect data and look back as far as possible and make analogies with things which have happened in the past and which could now affect risk going forward.

Q107 ***Lord Eatwell:*** May I just interrupt you there because you have just made a very important point and I should like to follow up on that? Would it be possible to have systemic stress testing? We actually did have systemic stress testing for Y2K and the regulators have done it for avian flu but they have not done it for financial risk. Should there be a regulatory organised systemic stress test?
Professor Perraudin: As I understand it, the IMF does require people when they visit to look at the quality of financial systems in different countries and they do do some stress testing and encourage countries to look at stresses across different institutions. The German authorities have been quite active in pushing firms to perform uniform stresses. I guess you are suggesting that these stresses should be more imaginative and try to take account of feedback.

Q108 ***Lord Eatwell:*** Yes.
Professor Perraudin: Certainly there is scope to do that and it is a sensible thing to do. If I look at the financial crisis which has happened, there are certain things which would have helped by making people a bit more conservative here, a bit more conservative there. As I see it, there are very specific things that went wrong and one should not take one's eye off the ball. One should try to remedy those things and fill in the gaps and push the firms to do things in a better way. A Luddite approach, where you say okay, no models, is not an option.

Q109 ***Lord Tugendhat:*** You must be right when you say that a Luddite approach, saying no models, is not an option. You made a very interesting point when you talked about the lack of history. I am struck by the fact that when people talked about health and guarding against an outbreak of avian flu comparisons were drawn with 1918 and with what happened then. In Western Europe, where we have very long records, people do refer back a long way over the weather. There is an interesting dichotomy in Western Europe where we can do that and Australia where they cannot and they do not know how serious the drought is because they do not have a very long period for seeing whether there have been similar ones. Coming to your point, it seems to me that people were so mesmerised by the beauty and complexity of the models and the apparent precision of the models that they ceased to look at history and tended to suspend judgment. When you have a very beautiful machine, people can somehow feel that the machine will do everything and they forget to make their own judgments.
Professor Perraudin: The broad business strategies of a lot of banks were not built on models. The overall levels of liquidity and of leverage were the decisions of senior people. They were not asking their quantitative analysts to do the calculations and convince them that that was the thing to do. In particular areas the models did lead to overconfidence in the rating of structured products and to some extent the whole emergence of the shadow banking system, which was all based on the fact that you could get a rating. You could get a rating for a credit vehicle so it seemed a tempting off-balance-sheet arbitrage that you could set up which would generate profits without damaging the institution or increasing risk in the institution. There was overconfidence in the use of models in certain areas. I do not think the overall strategies of lending and leverage were the results of the models.

Q110 ***Lord Tugendhat:*** I wonder, in the case of Northern Rock where they had devised a wonderful system and it did not take account of the fact that the credit markets could seize up because credit market never had seized up, whether maybe Northern Rock is an example where the strategy was based on a model.
Professor Perraudin: We come back to the point Professor Franks was making and the point I was making. Julian was saying there was a major crisis where people did not understand that this could happen. I was saying that the implications of liquidity and the possible drying up of liquidity were not understood. That was the root cause of a lot of what has happened. Particular firms which followed an unsecuritised model of banking turned out to be terribly vulnerable to that particular risk which

occurred. It is that risk which was not understood, was not included in models, senior bankers did not properly understand it, regulators have no notion of it and Basel II made rather perfunctory mention of liquidity. That is the root of the whole process and then particular institutions turned out to be vulnerable. Other institutions which turned out to have a rather good outcome may have had a good outcome because they were unsophisticated and they had low understanding of possibilities so they followed a very conservative approach. You have a shock of a nature which was not understood and then you see the different firms and the different business models followed by the firms being affected by that. Again, one should not take one's eye off the ball. The crisis has come from a particular set of events and they need to be sorted out and firms and regulators need to react to that in an intelligent way.

Q111 ***Lord Forsyth of Drumlean:*** Is not the point that if you think you have a model you rely on it? I once had a new car and I set the satnav to get me to somewhere in Norfolk. After we went past the same place for the second time my wife said "This is not working". I said "No, it's a very good system, I've read about it, it's working". We discovered that the system was set so that we were in Holland and not in Britain and therefore it was not working. Is it not rather similar, that people come to believe in the models and they suspend their common sense, especially if they are making a lot of money at the same time?

Dr Danielsson: I agree very much with the premise of your question about the historical perspective. If you look at the history of financial crisis—we have a history going back many centuries—the drying up of liquidity is a very common theme, so anybody who had looked at the historical record in the context of Northern Rock would have been worried. This comes back to Lord Eatwell's question about this model. Allow me to outline a little bit how the modelling process works in a bank. The way this happens, and this is very much encouraged by the regulations, is that you take one or two or three or four years of data. You take historical data only spanning a few years. You put that into a statistical model and that model tells you your future outcomes. There are a few problems with this. One is that if the market has been going up in the previous years you continue to forecast the market going up; models are pro cyclical, they encourage bubbles. At the same time, in a recession, as we are right now, the models tell you things are really, really bad so you are not going to lend. In a slightly different context the banks have been prudent under Basel II in not lending because they are told to by the regulatory process being imposed upon them; the models are telling the banks not to lend. The problems with this type of process—and the same applies to risk—if everything is going up, the risk is small so we get into a world where we believe risk is low and prices are going up. This continues for a while until the markets and the risk are completely out of tune with the underlying economic reality. At some point this bursts and this is where we get a real problem because at the time the bubble bursts the world changes. The data becomes relevant and the models we had up until that point become relevant. This is what the economists call a structural break. The models become least useful at the point when we need them the most, in crisis. This is the real danger and we get slightly seduced by it. I think there is a general view among people who are not experts in the field of models. They look at engineering, they say "We can build jet aircraft. We can do that thing". Models work in various wonderful mysterious ways. We do not know how our computer works but we know it works. That is all we need. You tend to think the financial models are of the same sophistication and they are not. The reason is that in financial markets we have intelligent human beings reacting to them. If a bank constructs a model forecasting prices or forecasting risk, everybody in the bank and outside will try to outguess it. It changes the world; creating a model changes the world. I am not really anti model; indeed what I teach at LSE is exactly financial risk modelling. I recognise the limits perhaps because I am one of the people doing this stuff. They are extremely useful in day-to-day risk management in banks. The way banks use them is to model their risk of small frequent events on the trading floor; somebody making decisions does not go out of line. They are not designed and I do not think we have adequate models today to deal with the systemic component, the financial crisis component of what is going on. No. This is a very active research area. I know the Bank of England are looking at this, I have some work on this, others have some work on this, looking at this stuff. This is still in the research stage and we are not yet at the level when we can adequately model systemic risk.

Q112 ***Lord Griffiths of Fforestfach:*** Let us assume that you are non-executive directors of a bank and you had a board meeting and the chief executive said that the next item on the agenda was risk and you know about models, you also know about financial history and you know generally you are economically literate. How would you make up your mind as to how you come to a conclusion about the management of risk by that institution, the amount of risk it is taking?

Dr Danielsson: You are pointing to a very important problem and this is something which is criticised but not understood. The problem is that people who best understand what is going on in the banks are the most

junior. It is the guy with a new PhD or fresh out of LSE. They get high salaries; they know this stuff because they know the state-of-the-art academic stuff. The higher up you get in the hierarchy of the bank—this is not only a problem with non-executives, this is a management problem in general—the less you understand what is going on. You see the profits. Then you get a risk. A risk is a loss centre and you spend a lot of money on risk management but you are convinced, a why-do-we-care type of attitude. This has been prevailing and there is a general problem with the financial system being too complex. So exactly the question you would like to ask cannot be answered. Looking towards the future, we should identify where the fault lines are in this process and we can identify fairly simple rules to prevent this type of systemic risk, rules which anybody, including non-technical non-executive directors, would understand immediately and avoid the complexity.

Q113 ***Lord Griffiths of Fforestfach:*** What would those rules be like?

Dr Danielsson: One of the questions we have on this list applies to CDOs and CDSs. I could get into that if you wish. I should like to take the example of Lehman Brothers. Lehman Brothers went under because of fears about what is called a credit default swap. A credit default swap is insurance on debt. You go to Lehman Brothers and say "I own these bonds. I'm worried about them. Can you give me insurance?" Lehman Brothers act as insurance against the bonds. Then the problem is that Lehman Brothers issue the insurance, then they want to hedge the risk, they go to somebody else, they buy risk and people buy insurance on insurance on insurance. The total amount of insurance bought in the system multiplies to maybe 10 times GDP, 10 times the economy. In the case of Lehman Brothers this was a few hundred billion dollars. Because this stuff is so complex, nobody really understood what Lehman's liability was and this was one of the biggest reasons why Lehmans went under. Then when the courts sat down a few weeks later, they did the calculation and they figured out that the net loss on Lehman's CDSs was $6 billion. If they had known that previously, the chances are that Lehmans would still be alive. Simple reform which would eliminate a lot of risk would take those off balance sheet. It is over-the-counter instruments such as CDSs. Make them subject to central clearing—perhaps trading but clearing is more important—which means that anybody looking at this at the press of a button could figure out the net, not the gross, position of Lehmans but the net position. They would say "$6 billion. There is no problem". That is the type of sensible reform we could take which to me makes a lot more sense than trying to make the system yet more complex.

Professor Perraudin: Ultimately it is very difficult for people on the board of a bank to have a complete understanding of the risk management beneath them. Safety issues in a chemicals company would be the same. These things require some degree of delegation. Broadly a sensible risk management system would be one that is comprehensive in its measurement of risk. One of the problems that UBS faced was that they had pockets of exposure to sub-prime-related structured products through their own holdings, through a fund management operation that they had taken over and there was no comprehensive analysis that made them realise that in effect they had doubled up and were really seriously exposed. A unified view of risk, which takes account of risk in a reasonably comprehensive way with a sensible framework for risk modelling and then a stress testing programme, forms the basic element of a well-run risk management operation. Then a real concern about liquidity obviously. If you look in the US, banks submit some returns or descriptions of their risk management processes which are in the public domain. It is interesting to read the descriptions that Goldman Sachs produced two or three years ago, all full of discussion of liquidity and the requirements to manage liquidity and you do not see that in some of the other institutions. That is a big lesson, so that should obviously be a major area of concern.

Q114 ***Lord Currie of Marylebone:*** Given what you were saying about the knowledge, about the models being at a rather junior level inside banks, relatively young people, it is not terribly surprising perhaps that the lessons of economic history tend to be forgotten. We teach statistics and econometrics rather divorced from economic history. Given the weaknesses of the modelling which you have described—and I can well understand that as a reformed econometrician myself—how was it that the regulators put such weight on these models. Why were they not scrutinising, interrogating them more seriously and actually pointing out some of the deficiencies which might have headed off some of these difficulties?

Professor Perraudin: You have to realise that there are different types of models and regulators put quite a lot of weight on the very simplest models or the lowest level models in which banks try to work out their own internal ratings or indicators of credit quality for all the names to which they have lent. That is the bit of modelling which the regulators have built a superstructure on in Basel II by letting banks work out capital based on that. On the more complicated portfolio models, there is a regulatory requirement constructed on top of the trading book models but the portfolio models of a complex structural sort which the banks use for their own economic capital purposes have not been directly employed by the

regulators. The regulators took a conscious decision in Basel II not to rely on the banks' understanding of correlation between different names, to restrict the regulatory capital system to depend upon banks' understanding of the single name predictions of default probabilities.

Q115 ***Lord Currie of Marylebone:*** I understand the point that the simpler models are incorporated into regulation but what about the regulators scrutinising the models that banks were relying on for their risk management processes? Why were they not scrutinising while auditing those models and interrogating them to make sure that actually the banks were taking account of the risks that were out there in the marketplace?
Professor Perraudin: That economic capital modelling is required of banks in the Pillar 2 requirements of Basel II. That is a very big job to ask the regulator to do at a time when they were putting in place all the systems of measuring exposure and measuring default probabilities. In a way the timing has been unfortunate because I am sure that, as the implementation of Basel II goes on, there would have been and now there will be a lot of focus on portfolio models. Up to now, because the regulators have been so focused on internal ratings and validating those models, that has taken their focus away from these other things.
Dr Danielsson: A little bit of history. The reason why the Basel II process, which is the state of the art we have to take, looks the way it does is because it was the state of the art in 1995. It was roughly designed in those years and what we are now stuck with is a regulatory system which was designed over ten years ago, locked in by the year 2000. All the criticism which has come subsequently has not affected the process because everybody was locked into a methodology they could not politically deviate from. There is an inherent problem in the regulatory process in banking because we have a 15-year-old philosophy. Secondly, I think the regulators got lazy. The regulators said "We can look at the models and they can tell you exactly how risky they are. We do not have to look at management, we do not have to look at anything else, we just look at the models, we look at the output and that tells us what we need to know". The regulators substituted a more detailed look at the banks with just looking at outputs from models. They got lazy.

Q116 ***Lord Forsyth of Drumlean:*** I hope you do not mind me following up on my satnav analogy with the model. It does strike me that if the banks discover that the model is underestimating risk and the regulator is looking at the same screen, the same model, then there is a huge incentive for them not to change the model because it is going to increase the cost of capital; there is a perverse incentive. Not only do you have regulatory capture but you also have an incentive for them not to adjust the model in the light of experience. Would you agree with that?
Dr Danielsson: Absolutely. I have been in a similar situation with a satnav and I can sympathise very much. The way these models are implemented in banks, especially when it comes to regulatory purposes, means it is very hard to change them. They decide on a thing and use it for months or even years on end. The regulator, in our case the FSA, is increasingly involved with the modelling process. So the way it works is that if the model is under-recording risk, it is to the banks' benefit. The banks would like the model to have the risk modelled as low as possible. I sometimes say that the chief officer of a bank should be called the chief risk maximiser. It is in the banks' direct interests to model risk as low as possible while it is as high as possible. That is one of the key problems of relying on it for a regulatory purpose; the incentives are completely the opposite.

Q117 ***Lord Best:*** Is it sensible for models to spread into the measurement of operational risk, risk that poor management systems result in losses, with capital then set aside against those risks? Is this an appropriate way of thinking through the system?
Dr Danielsson: Operational risk is one of the worst examples of trying to find a risk and you don't find it where it should be. Here is what I mean. One of the biggest operational losses last year was SocGen with the rogue trader and €10 billion. It is another example of operational risk. Some of the biggest elements are exactly the things you cannot know. So the problem is that you have this notion called "operational risk" and it is supposed to tell you the risks of the operations. If it does not really capture the key risk categories, it provides a misleading signal to everybody involved. You believe this is the risk but the risk is elsewhere. Operational risk modelling is very dangerous.
Professor Perraudin: I tend to think that modelling operational risk and setting capital is in some ways hard to justify. There is one aspect of it which may be worth noting which is that the level of capital within a financial institution becomes a bargaining point between different bits of a bank or whatever sort of firm it is and operational risk should really be tackled not with capital but with better controls and inspections and monitoring. That is what sensible firms will engage a lot of effort in. The one good aspect of trying to calculate operational risk capital and attribute it to different divisions within a bank is that then the divisions may have incentives to improve their own controls and to try to bargain against having a capital charge. Ultimately operational risk can only really be tackled both by regulators and senior bank managers, by improving

controls and monitoring. You could think that a capital system would be a way of putting pressure on a derivatives trading operation that is offshore to change what it is doing in order to get concessions from the rest of the firm or from regulators.

Q118 ***Chairman:*** Would a simpler form of regulation in which bank models have no place be more effective? We have been hearing suggestions, for example, of going back to the Glass-Steagall Act, a structural form of regulation based upon narrow banking separating the commercial and investment banking elements. We had a flavour of this in response to an earlier question about a more conservative institution which was based on structures of 20 years ago. Would that be preferable to the current system?

Professor Perraudin: If you look at old-fashioned banks, operating with limits set on sectors or countries or particular names, as soon as you start thinking about the nature of limits and the fact that they are not necessarily sensitive to the quality of the individual name, they do not reflect correlation across names. If you think about old-fashioned banking, given the complexity of the credit world we now face, it is not sensible to try to return to that kind of situation. Models have their limitations obviously, but in essence they are a way of trying to see through the complexity of a very complicated set of financial instruments, so I do not see that we can get away from that. Regulators need to have a view through that complexity, just as the senior management in the firms do. I think that models are essential to give senior people intelligence about what is going on. The measurements they produce may then also be effective in giving incentives to people down in the hierarchy and in particular firms to avoid risk taking. There is not an alternative, given where we are. If banks were just issuing loans and all the massive range of financial instruments that is currently available was not there, then we could return to the nineteenth century, but it is not possible now.

Dr Danielsson: May I add a little historic perspective to that? In 1933 about 28% of the US banks failed. In the Great Depression no Canadian bank failed. There was a difference between American banks and Canadian banks at that time. In the US banks were primarily engaged in narrow banking in a narrow geographical area while in Canada the banks were countrywide. The diversification of banks engaged in many different activities did help Canada vis-à-vis the US in otherwise very similar economic circumstances. It also helped this country at the same time. The diversification we have been engaged in in many different businesses is a better model than a bank engaged in a simple narrow business.

Q119 ***Lord Eatwell:*** I want to return to the issue of ratings agencies and models. I have a series of points. First of all, quite sophisticated international financial institutions were ready to accept rating agencies' assessment and indeed still do; they are still the key parameters defining a lot of borrowing capabilities and so on, the price at which you can borrow in the marketplace. Given that the ratings agencies depend on the models as well and rating agencies models indeed are often significantly behind what could be called the cutting edge, it is quite interesting, is it not, that they have become such a central element on which markets depend. I would be interested if you could comment on that. The second issue about ratings agencies I should like your comment on is that, facing the requirement of transparency, particularly in the United State, ratings agencies are required to expose their models to their customers. So the banks could then build products to model. Was that a process which in itself created significant risks? If many banks are building products to the same model, the products will all tend to look the same and when there is a market movement correlations between them will be very high.

Dr Danielsson: The process you have described is what the econometricians call data mining. It undermines the integrity of the statistical process. To answer your first question: why do the banks like the rating agencies? The answer is profit. What the banks wanted was to create sophisticated financial products. They wanted the products to be so complex that neither regulators nor the clients, in the end not even they, understood what they were up to. By having a very complicated system which the rating agencies used to rate this as AAA, they could go and sell it on to unsuspecting clients. So the banks like the rating agencies because they validate exactly what they were up to and remember that bonuses are tied to short-term performance; so long as you got your bonus you were perfectly okay. There is one example where the rating agencies' model failed and this is the sub-prime issue which was widely discussed some time ago. The sub-prime started in the United States in 1994 at the beginning of the business cycle. When the business cycle is going up you do not have correlated defaults; people default because they get sick, they lose their job or whatever. So correlations were low and in some cases the rating agencies assumed correlations were zero. However, as we know, and in this country you have 500 or 600 years of mortgages, defaults rise sharply in downturns. You do not need to be a quant to know that. They ignored that reality because the data did not contain the recession therefore you did not get highly correlated defaults. It is a clear case of fixation on the model which said everything was fine. If they had had a data sample going back a few years to 1992 when the last recession was, they would realise that the whole process was flawed.

Professor Perraudin: I am glad that you have raised the issue of rating agencies. I do not really agree with the flavour of the discussion we have been having, the concerns you have had about models and the notion that they are prevalent in banks. A lot of decisions have been made not based directly on models. The models really have very dramatically affected the way that the rating agencies have looked at risk, in the structured product market in particular; the corporate ratings market has not been affected significantly. In evaluating structured products, that has been completely dominated by rather simple models applied in a not completely satisfactory way. That has had very bad implications. We got to a situation where people trusted the rating agencies to give a view on complex securities and then would make a buying decision on the rating. Then, in the summer of 2007 we flipped to a completely opposing view where people hardly had any trust in the rating agency assessments of structured products. For example, you can have AAA-rated structured products in a particular asset class that have discounts ranging from 2% below par to 50% below par, so a massive range of prices for the same rating. We have seen that since the middle of 2007 when confidence evaporated. That has been a really regrettable aspect of the last two years and the rating agencies were using models which were probably over simple; they were also not using them in a proper way, they were not doing surveillance, they were not repeating the analysis of different deals. They were paid up front for rating things, so they would run the model and then the analysis would sit on some analyst's work station and nobody would re-assess that deal. That whole sub-prime area or structured products in general was a train wreck; ultimately there would be a big downturn and the rating agencies would not see it coming because they were not repeating their analysis.

Q120 ***Lord Forsyth of Drumlean:*** Why did they not see that coming? These are all clever people. It is very hard to grasp why they did not.
Professor Perraudin: People accuse the rating agencies of having the wrong incentives because they are paid by the people they rate. They have tremendous incentives not to get it wrong because they were deriving most of the profits by 2007 from structured product rating. In 2006 the majority of Moody's earnings was coming from rating structured products. They had massive incentives not to get it wrong but they were not managing the rating process internally as they should have done. They were not repeating the analysis, tracking the structured product market in the way they should have done. They were paid up front; they would typically be paid mostly at the beginning when a deal was initiated and much smaller payments down the line. That was presumably a feature of it. That has had a great impact because the reason why the banks have been so vulnerable is that nobody believes their earnings statements. They all think there are still lots of losses to be made. The reason they do not believe earnings statements is because each bank knows that every other bank cannot really value its structured product book and the reason that is the case is because the market has so completely evaporated that nobody was trading these things. The lack of guides on valuation and the ebbing away of confidence in the rating agencies has been a tremendously bad outcome. The origins of that are probably in an excessive use of rather simple models and their inappropriate use in surveillance in keeping track of what was going on.

Q121 ***Chairman:*** I have always felt that this was one of the crucial elements of what has happened in the last two or three years. I wonder what you would do to avoid it in the future.
Professor Perraudin: I was co-opted onto the IFF group which looked at the rating agency role in the crisis and we had a lot of discussions of these aspects. The banks, because of pressure from the regulators, have incredibly scrupulous attention to detail in the management of data, the coding of models. Elaborate processes are required of them so when the way in which the rating agencies have managed their process of doing analysis was discussed people were very surprised that ratings were not constantly refreshed, that there was no industry standard database structure with everything audited, everything checkable six months down the line. Some of that comes from regulatory pressure and clearly the rating agency processes of managing what they do have to be subject to regulatory pressure. In the use of models it is not just the type of models that people use, it is the way they use them. That has to be done in a structured, well ordered way.

Q122 ***Lord Tugendhat:*** Would you expect in the future after all that happened that the ratings given by the rating agencies would deviate to a greater extent from each other than they have in the past?
Professor Perraudin: It is interesting. If you look at ratings for the same deal by different rating agencies it is sort of surprising that they come up with very similar ratings. If you go through the exercise of calculating ratings using a methodology ostensibly similar to the one that the rating agency uses, you see systematic discrepancies in different parts of the market. Clearly there is a kind of fudge factor at the end which has made the rating agencies move their ratings a bit more together. Maybe the spirit of your question was to say they are using models so do they not agree too much? Actually, when you look at the detail of it, you find that their different models ought

to have given a wider range of ratings but actually they did not, they were rather similar. That comes because there is only one class of structured product where ultimately the numbers come directly from a model. With all the other more complicated structured products there are fudge factors or there are different criteria which come into play in a rating committee. Ultimately the rating agencies were looking at what their competitors were doing. Again, this was a feature much more of the structured product market than the corporate ratings market. It was more competitive in the structured product because there was no duopoly. When you have a duopoly, they do not actually compete terribly much. The fact that there were three companies there—because Fitch was very significant in structured products but not in the corporate rating—did make them look more over their shoulder and worry more about market share, particularly in new areas. We are moving away a bit from models here but I do think even here it is useful to understand or to note that the models are only part of any analysis even within the rating agency structured products.

Dr Danielsson: There are two elements involved in this. One is the model and the other is the stuff you put into the assumptions. Given the assumptions, there is usually only one correct solution. There is no surprise; there are differences but generally speaking there is no surprise that if you agree on the assumption you get the same answer, otherwise it would be slightly suspect. You would expect to get the same answer or very similar answer from different rating agencies with minor differences. The problem is the assumptions were wrong but what they did with them was mathematically correct, mathematically consistent and therefore they agreed. The problem was in the assumptions, the input not the actual process.

Q123 ***Lord Griffiths of Fforestfach:*** If you take the CDO and CDS markets, they are some of the most lightly regulated markets in the whole of the financial system. If you had, for example, a clearing house for CDS transactions, would you think a clearing house was a step forward and helpful? If you did have a clearing house, what sort of reporting requirements would you make and what would you actually publish for the general public in terms of the information that was provided for the clearing house?

Dr Danielsson: I think there is no alternative to a clearing house. The advantage in what the clearing house does is the following: it makes instruments to be roughly standardised. If Goldman Sachs does something, then if HSBC does something, they look the same. That means that you can look at the Goldman Sachs instrument on the same thing and you can look at the HSBC instrument on the same thing and you know they are the same. At the moment Goldman Sachs and HSBC have a financial incentive to make them different, so the bank would like its bank to have a unique instrument with the same thing or different parts of the bank would like to make them different. The only way to solve a problem is a clearing house mechanism whereby these products become standardised so that you can look at them. Reporting would not solve the problem.

Q124 ***Lord Griffiths of Fforestfach:*** If you did have that, what would the clearing house report, what would it publish?

Dr Danielsson: To whom?

Q125 ***Lord Griffiths of Fforestfach:*** That is the question. To the market participants.

Dr Danielsson: The clearing house could report to the bank itself its gross and net positions. The bank today does not even know that. It knows gross positions but not net positions. So the bank would know its net position. The clearing house could report to the Bank of England and the FSA the gross and net positions of everybody operating in England and they could even net across the country. You could have a gross and net position for the country. You could probably do the same for the whole world. You would report the individual element to the bank, you could summarise statistics of the gross numbers to the public but then the Bank of England and the FSA would know the full picture.

Professor Perraudin: I can see that there are advantages from having a clearing house perhaps in greater transparency for outsiders, in particular regulators and maybe to some degree in standardisation. I do think that the disaster we have just had is all to do with structured products. The corporate credit world and all the single name credit instruments, of which the CDSs are the main example, have done reasonably well in all of this. It has not been a source of great instability. That market has been somewhat strained but it has basically been doing its job. All of the complicated systems which the banks all have for managing their counter-party risk have also done reasonably well. The banks which had a netting agreement with Lehman Brothers which was probably, at the end and maybe even earlier on, collateralised so they would take the tens of thousands of exposures they would have to Lehman Brothers and work out their net exposure to them and then that net exposure would be covered by collateral which would be posted frequently, daily or even more, that whole set of mechanisms has performed quite well in all of this. I think that the real problem is in the structured products, the multi-name credit derivatives and the major problem is the lack of transparency, the evaporation of confidence in the

rating agencies, the fact that nobody has been trading so nobody believes the prices. That has been the source of the major dislocation in the securities market.

Q126 ***Lord Currie of Marylebone:*** How much genuine risk transfer happens in the CDO and CDS markets? We have heard rather different views of that, as to whether it was genuine risk transfer or whether it was reduced in the need for regulatory capital.

Professor Perraudin: It varies. It varies across country and across institutions. Within Germany quite a lot of banks were using structured products as a form of funding. They would issue structured products and raise money but they would retain all the economic risk on balance sheet. There were other institutions in the UK that successfully securitised credit card exposure and other things like that and did it rather adroitly. The regulators under Basel had certainly been pushing the market towards one in which the risk transfer was genuine and I am sure, if all of this had not happened, we would have continued in that direction with capital requirements being used to make sure that things were more and more risk transfer. There are many hedge funds out there and institutions completely unlike banks that have taken on significant amount of risk. There is variation across institutions and countries but there was a growing amount of genuine risk transfer.

Dr Danielsson: I would broadly agree. I do think the CDO and CDS markets do provide a very essential function to the financial system in general and a bigger more important function to the economy of this country. The danger is that this market is going to be overly regulated to the detriment of the entire financial system and the City of London in particular. We do need to find a way to address these issues. While the system probably broadly nets out but does provide vast numbers of risk transfers, the problem is if you cannot get the picture, if you cannot do the netting but only the gross exposure, it looks horrendously large and looks as though it might contribute to systemic risk. If you find a way to net out the exposures across the system, it has continued to provide a useful function of risk transfers and my hope would be that it continues to do this in the future.

Chairman: On that note may I thank you very much indeed for steering us through these very complex areas. Thank you very much for coming.

TUESDAY 10 FEBRUARY 2009

Present
Best, L
Currie of Marylebone, L
Eatwell, L
Forsyth of Drumlean, L
Kingsmill, B
MacGregor of Pulham Market, L
Paul, L
Tugendhat, L
Vallance of Tummel, L (Chairman)

Examination of Witnesses

Witnesses: Mr Peter Cooke, former head of banking supervision at Bank of England, Mr Michael Foot, former head of banking supervision at Bank of England and currently Chairman Promontory Financial Group (UK) and Sir Callum McCarthy, former Chairman of Financial Services Authority, examined.

Q127 ***Chairman:*** Gentlemen, welcome to the Economic Affairs Committee and thank you for finding time to give us some evidence this afternoon in our inquiry on banking supervision and regulation. This is the fourth public hearing of our inquiry. Members have already declared any interests on the record at earlier hearings. If you could speak reasonably slowly and clearly that would be helpful both for the benefit of the stenographer and for Members; and if the first time you speak you could introduce yourselves that would also be helpful, particularly for the benefit of the web broadcasters. Would you like to make any introduction remarks or shall we go straight into questions? Straight into questions. Today's commonly held view is that the current financial crisis can be attributed to the greedy and rash behaviour of various bankers but financial services are arguably the most heavily regulated sector of business with the key objective of curbing excessive risk taking and its potential consequences. So this afternoon we would like to explore with you why the regulatory arrangements proved apparently not up to the job or were ineffectively applied or had unintended consequences and unfortunate ones at that, or some combination of the three. With those thoughts in mind perhaps I could start off by asking you whether bank regulations in recent years have really concentrated upon the right things and, in particular, should regulators have paid specific attention to bank liquidity risk? When you answer you do not all three have to answer; if one answers and the others are happy with it just nod and if you want to add to it then feel free to do so.

Sir Callum McCarthy: I am Callum McCarthy. I think we have to recognise that there has been a fundamental misjudgement in the regulatory framework (I have distinguished between regulatory framework and supervisory practice, and there have been failures in supervisory practice which we can also discuss) in that we have underestimated the amount and misjudged the quality of leverage in the financial system. I think that there was a misjudgement of the ability of banks to manage their own risks and as a consequence of this we have fundamentally allowed the system to operate with too little capital or too great leverage. Associated with that, as your question implies, is an emphasis on capital as the fundamental measure and a relative neglect of liquidity. I also think that there has been a problem in terms of supervision in that inevitably supervision tends to look at issues institution by institution and there has been an overall failure in what I would loosely call macro prudential supervision. So for all three of those reasons I think there have been some fundamental mistakes, which need to be put right.

Q128 ***Chairman:*** To add to that, is it difficult for bankers to pick up systemic risk on the macro level? Is that really a responsibility for regulators rather than the bankers themselves?

Sir Callum McCarthy: I think that at a global level, at a European level and at a UK level we have not been good enough at aggregating the risk associated with each institution and thinking of the systemic risk that that poses. There are a whole series of issues associated with that which need to be dealt with.

Mr Foot: Michael Foot. If I could add to that, I think one of the big problems here has been one of the points Callum made, specifically that the amount of cross correlation between assets has been grossly underestimated and that is one of the reasons that has gone into all the mistakes made in the calculations in Basel II and the modelling that was done there. That has given a spurious degree of comfort to the numbers that have come out and the rest of it and that is what the last 18 months/two years has demonstrated was completely wrong. To go back to your first question on liquidity, I always think that liquidity is an even harder subject to discuss internationally than capital because every money market in the world is different, every structure is different. It took about 20 years, probably from Peter Cooke's time onwards, to get even a broad agreement on what constituted capital and how to look at it. I would say that if we are now going to make the same

effort in liquidity, which is important internationally, then that is going to be extraordinarily difficult. In this country the first liquidity paper I was ever involved in when I was at the Bank of England was actually in 1980 and for 24 years when I was involved with the Bank of England and then the FSA there were constant dialogues about sterling liquidity with a lot of handwringing about the difficulty of dealing with liquidity in foreign currencies.
Mr Cooke: Peter Cooke speaking. It is a big subject and I could say a lot about it. I perhaps can be allowed, as the old man, to go back to the beginnings of the Basel Committee where we found it possible to look at capital adequacy in the major banks of the world but as soon as we started to look at liquidity adequacy we were bedevilled by all the complexities of the structures of money markets, of the different regimes and regulations that apply to those markets, and it was quite impossible to find any common basis for an international standard. I recall with some nostalgia the situation in 1955 when I joined the Bank of England, when there was a 30% liquidity requirement on all the clearing banks and that was mostly held in government securities, which was a pretty big cushion and a pretty good protection against what were then rather pedestrian institutions. The current level for most major international banks is some way considerably below 5% and that, I think, has been one of the problems.

Q129 ***Chairman:*** You are not suggesting, any of you, as I understand, that because this is difficult to tackle that it should not be tackled?
Sir Callum McCarthy: I think the opposite, Chairman.

Q130 ***Chairman:*** It is an imperative, is it not, to try and tackle it?
Sir Callum McCarthy: Yes.

Q131 ***Lord MacGregor of Pulham Market:*** Should regulation extend to the so-called shadow banking sector, and perhaps I could elaborate on that a little? I am thinking particularly of Structured Investment Vehicles which do not have banking licences but are generally financed by short-term liquid loans. I understand that a recent analyst estimated that shadow banks created approximately half of new credit in the United States in the last two years. They are not regulated, they are off balance sheet and indeed often created to be off balance sheet and it is not a transparent market.
Sir Callum McCarthy: Could I say two things about shadow banking? One is that in a way I wish that the problems had actually originated in the shadow banking, non-regulated, sector. The reality, which is much more serious, much more sobering, is that these are a set of problems that have originated in the most mainstream institutions which have been directly regulated. That is a much more worrying thing for any of us who have had regulatory or supervisory responsibilities. The second thing I would say is that in relation to special purpose vehicles, clearly one of the things that were wrong with Basel I was the treatment of special purpose vehicles. It was something that Basel II was putting right but in Basel I it was a mistake in the system. But I do not belong to the strong body of people who believe that these problems originated in shadow banking; this has not originated in hedge funds; it is not principally a private equity problem. There is a problem with the off balance sheet treatment that was being dealt with under Basel II after a very protracted process to produce Basel II, but I think that the reality of the problem is more worrying than the question implies.
Mr Foot: Could I just add something? I do not disagree with that but I do think, particularly in America, that there is another aspect which one might bear in mind which is that there has been quite a lot of pressure from the shadow banking sector. What you get as a regulator is your banks turning up and they say, basically, "Our competitors in other countries are getting a better deal so make the liquidity arrangements lighter, make the capital hits lighter." If they do not say that they say that "There are large numbers of other financial institutions who are taking our business away," and that is where the shadow banking, particularly in the States, as you say, was doing a lot of business I am quite sure that in America, and to some extent in the UK as well, what we saw of that as the regulators was a number of people turning up and asking for, effectively, easier competition terms because they were losing market share.

Q132 ***Lord MacGregor of Pulham Market:*** Both answers do not quite answer the question as to whether more regulation should be extended to that whole sector. I understand your point about there being the greater problem elsewhere.
Sir Callum McCarthy: Can I say that I always have difficulty about a question which is simply in terms of regulation being extended because it depends on the nature of regulation and what is done. One of the great dangers that we face is a belief that by purporting to extend the scope of regulation we are actually going to achieve something, and before being able to answer your question I would like to understand what form of controls you think are the appropriate controls for off balance sheet vehicles.

Q133 ***Lord MacGregor of Pulham Market:*** I think that is the question we are asking you.
Sir Callum McCarthy: My answer is that I think it is sensible, as Basel II would have done, to absolutely close the loophole that became a very large loophole

of allowing a number of things to be taken off balance sheet—I am absolutely in favour of that, yes.

Q134 ***Lord Forsyth of Drumlean:*** I would like to follow up on this idea of Basel II and the regulatory arbitrage. I am fascinated, Callum, by your view that the problem did not arise with special investment vehicles and things of that kind. It is popularly believed that the existence of the regulations themselves encourage people to devise off balance sheet schemes. What would be your view on that?
Sir Callum McCarthy: I think that is undoubtedly the case; that is why I think there were, as it were, pernicious elements as well as beneficial elements about Basel I; it is why I think it is a loophole that should be closed and I am pleased that Basel II was closing it.

Q135 ***Lord Forsyth of Drumlean:*** But is the corollary of that not therefore that the regulation actually encouraged the activities that resulted in systemic instability in the system?
Sir Callum McCarthy: I think you have to recognise that wherever you draw a boundary you are going to encourage people to migrate to the other side of the boundary—that is an inevitable occurrence in life and you had better recognise that when drawing the boundary.
Mr Foot: Even within the boundaries, if you take, for example, endless arguments about types of Tier I capital, for example, most regulatory arbitrage or indeed most arbitrage of any kind is really about convincing the regulator that this thing looks like a duck but convincing the market that you are selling it to that it looks like an elephant, and if you can do that then you will make money. There were constant efforts made to convince the regulators that it just fell this side of the boundary rather than that side of the boundary, but then the elements of it which were somewhat different were often sold in the market place as bringing value added aspects of innovation.

Q136 ***Lord Forsyth of Drumlean:*** Rather like Lord MacGregor I am therefore rather puzzled by what one does. If you invent more regulation and more complexity then presumably you create more opportunities for people to come up with clever schemes to get around the regulations and create complexity and instability. If one looks at the commentary today the whole thing is the fault of greedy bankers. If one takes the view that bankers are greedy and presumably they have always been greedy what changed to create this catastrophic consequence that we have had?
Mr Cooke: I really left regulation at a time when excessive bonuses were not there on the skyline at all; banking still largely was a bit dull. I think it was probably an American import which led to the creation of the bonus culture and added to that the abolition of Glass Steagall to some extent also added weight and speed to that process. It is difficult, looking at the market place as a whole, to see how one can justify the excessive concentration of this particular phenomenon in the banking sector; it does not really exist to anything like the same degree in any other parts of the economy, and I think that has been something that has not been picked up on as quickly as it might have been over the last decade or so.

Q137 ***Lord Forsyth of Drumlean:*** You think it was the bonus culture and not actually the very low interest rates and banks struggling to try to make a margin and devise ways of doing so within the regulatory framework?
Sir Callum McCarthy: I think you have to look at what has happened over the last two years in the context of the huge imbalances in the world economy, the extraordinary availability of cash, the phenomenon normally described as the "search for yield"—all those are fundamental influences. Any discussion of the present problems which omits those factors I think is a very incomplete discussion.

Q138 ***Lord Best:*** Unless any of my colleagues want to stay with the issues around the Basel Accord I wanted to move on to a broader question and looking at whether there is a case for limiting the size of banks? Whether bankers got to the point of believing that their bank could become so big that it could never be allowed to fail and whether one ought to introduce more competitive arrangements to limit the share of the market that any one bank has. Is size an issue for banks?
Mr Cooke: Can I jump in on that one? I think it is very difficult to contemplate containment of a bank's size. There probably are in reality a number of banks in most major economies that can reasonably be regarded as too big to fail. I think it would be certainly contrary to the desirability of good competition to do away with many of these banks and have a smaller concentration globally and I think the banking system is almost certainly likely to deliver institutions that will fill the gaps. Banks, if they get very big, can potentially be regarded as over-mighty subjects perhaps, but I think on the whole the economics of consolidation in the banking sector in the last generation has been an inevitable feature and I think it is very difficult to see how you could actually limit the size of a particular banking institution, particularly in the global market place.
Mr Foot: I have to say that the thing that does worry me is the "too difficult to manage", not so much the too big to fail—I think we have probably gone past that point. I used to look at Citibank and I wondered how any group of human beings could actually run that entity and for a few years now the market may

remember that and discourage such things. I think that is the area to focus on. Competition is important and if you take something like the current Lloyds TSB, Halifax merger, perhaps to me the worst part of that is the loss of competition there will be and one will have to hope, as Peter says, that other institutions come out to make up the gap. But in many of the areas like payments mechanisms and ordinary things like that, or even the international flows of business, if you go from being a trillion dollar bank to a two trillion dollar bank the economies of scale really are not all that great, I suspect; and/or the competent authorities can actually help you maintain some of those by having a large number of slightly smaller players. We are never going to go back to having in each country only banks that are all small enough that they could fail. I am rather hopeful, for some time at least, that the market place and maybe regulators too will frown on the ever expanding and widening activities that some of these banks have.

Sir Callum McCarthy: Could I add one additional point, which is I think that there is great benefit in trying to make changes to the system which increase the threshold level for when a bank is too large to be allowed to fail. To stop or to reduce the transitional costs of failure would be a very good thing, by for example making it easier for the business of a bank to be transferred from a failing bank to another bank. It would reduce the transitional cost of failure. There are a number of things like that that should certainly be done.

Q139 ***Lord Currie of Marylebone:*** Part of the complexity has arisen from financial innovation and in your judgment what is the balance for financial innovation between that which is genuinely welfare enhancing and that which is essentially aimed at dodging regulation, getting around regulation? The shadow banking system itself is an innovation in itself and how far is that driven by regulatory consideration?

Mr Foot: I think there is a third very important consideration as well and that is that a lot of the innovation has occurred because people have taken very different views about the value of the innovation; so you have a ready buyer and a ready seller who have different expectations about the outcome. Some of the facts will now demonstrate that some of those views were right and some were wrong. Clearly over the years there have been some financial innovations that have had tremendous benefit to the ordinary people in the street—collar and cap residential mortgages would be a classic case in point, we would not have had those. The ability of a company now to cheaply guard against exchange rate changes, changes in the price of its key commodities and so on, all of those things have been real benefits and the scale of the innovation means that the costs of the means of mediation necessary to achieve that has gone down a lot. Yes, some of the exact structures may have been created but one of the issues I have been looking at for a completely different purpose was whether in the case of Granite being set up by Northern Rock, why did it have to be done in Jersey? And the answer to that is that actually there are a number of jurisdictions around the world—probably now including the UK given the changes in laws—where exactly the same thing could have been done. I really would not want to stress too hard the regulatory arbitrage aspect.

Mr Cooke: Generally I would say that welfare enhancing can be demonstrated where innovatory products are being developed for the benefit of the public but not when they are being developed for the benefit of the bank, very simplistically. I think probably that difference stands out.

Q140 ***Chairman:*** So by extension you are saying that over the counter transactions are probably the dangerous ones, is that right, because they are not necessarily for the benefit of the public but, as it were, between two banks?

Mr Cooke: I think that a lot of the creations of the banking sector and its management to enhance profitability and grow the balance sheet by various means are probably not welfare enhancing to the world at large.

Q141 ***Baroness Kingsmill:*** It seems to me that a combination of innovation and greed in the financial sector is pretty toxic, and as so is proved; and some of the aspects that you are discussing, that you are mentioning now, could have arisen because fundamentally, at the retail level in any event, the banks simply were never competitive and therefore because they could not make any money in ordinary banking transactions they innovated to produce things like PPI, which were pretty awful products in themselves.

Mr Cooke: I think all bankers that I know, certainly, would contest the view that there is no competition in retail banking. I think there is certainly a sense in which banks have been driven to more exotic and more potentially rewarding business in order to enhance their profitability. But it comes back to a very fundamental point which goes to the heart of the debate about what you do about this system, and that is whether banks are in fact shareholder institutions which are run by the management for the benefit of the shareholders or whether there is some degree to which they are run for the benefit of the depositors. I think there is a sense in which the pressure to produce profits for banks has tended to underplay the importance, if you like the utilitarian importance of the banking sector to depositors and the safeguarding of those deposits. Any banker in the 19th century

would have regarded the safeguarding of his depositors' money as a prime concern. Now I think that bank managements are much more concentrating on—or have been much more concentrating and perhaps should review that bias—the return to shareholders.

Q142 ***Baroness Kingsmill:*** Can I ask Callum McCarthy if he thinks that the banks at the retail level are truly competitive?
Sir Callum McCarthy: I think in the UK there is a huge problem because the claim that retail banking is a free service is manifestly untrue; to be fair to banks they do not make it quite in the simplistic terms that I have described it, but there is a very significant problem. I think the underlying essence of the problem is quite fundamental and it is that you are dealing with customers who in many instances are not equipped to make a judgment about the services offered. The level of financial literacy in this country is disastrously low; it is something that has to be improved. It will take decades to improve. It is something where the FSA is trying to make a significant change by its activities. But it is the fundamental responsibility of government not of any regulator to produce people who are numerate and literate and financially literate and that makes it very difficult to compete. I think that the level of competition is quite restricted in many ways.
Chairman: I have to ask Members and witnesses if we are going to cover the ground to take questions slightly more quickly.

Q143 ***Lord Tugendhat:*** Can I come back to the point about size? It seems to me that there is a great difference between size *per se* and the speed with which a bank becomes very large; in other words, you can have an organisation—Shell is a quintessential example—that has been very large in its industry for a very long time and is accustomed to handling very great size. HSBC is another example. There is a great deal of difference between that and something like the Royal Bank of Scotland, which grows from being very small to very large in a very short space of time. As we are now in the situation in which things that were previously unthinkable are now thinkable I wonder what you all feel about not so much putting limitations on size—because I agree with Peter Cooke on that—but limitations on the rate at which banks can transform themselves from being very small to being very large?
Sir Callum McCarthy: I think one of the things that should certainly be considered is what capital requirements you are going to impose upon banks relative to the speed with which they are growing the balance sheet and that, I think, is a fruitful line of inquiry. Could I make one additional comment? Although we have talked all the time about banks I am very conscious that there is a problem in thinking in terms of banks as distinct from insurance companies and as distinct from securities companies—after all, one of the major episodes in the last year has been AIG, not in relation to AIG's insurance business but in terms of a different bit of its business. The most critical time during the last year has been in relation to Lehman's and the decision in relation to Lehman's and that was not in a narrow sense a bank.

Q144 ***Lord Tugendhat:*** Glass Steagall, in a nutshell would you favour the reversion to the Glass Steagall type of division or not?
Sir Callum McCarthy: No.
Mr Foot: Nor me.

Q145 ***Lord Eatwell:*** I would like to go back to the issue of regulation and then to regulatory failure. First of all, Michael Foot said in answer to the first question that cross correlations were grossly underestimated. I went to a conference at the Bank for International Settlements in 2004. There was about two days of papers and almost all of them were about the underestimation of the cross correlations. Here is a respectable institution, there are distinguished academics giving in papers and their warnings were completely ignored and I would like your reflection on why, given the fact that these models were criticised so severely by distinguished people, their views were completely ignored. The second point then is how is it that exactly these models, the inadequacy of which I think you have quite rightly pointed to, became the basis of Basel II, became the core of Pillar I Basel II?
Mr Foot: Because by 2004 most of the mathematical work underlying Basel II had been basically set up. I agree with you, one of the issues to me is how the quants managed to basically fool us all in many ways and I think it is a particularly fair question. In particular, the regulators' typical way of responding has always been to take a number, a value at risk number, for example, in a tail and multiply it by some number. What we now know is (and it may be actually because of the changes in the market structure that were going on while all this work were going on) that actually the losses *in extremis* have been far, far larger than any of those numbers could have suggested. Once you have decided, as Basel II did, to go for basically modelling based on the banks' own data and these models demonstrate satisfactory back testing and all the rest of it in the period that they had again, now we can say that obviously the absence of a really serious piece of bad volatility in that was unfortunate—more than unfortunate. The Basel people contained the technical experts from the Fed and the OCC and the FSA and the Bank of England and the BaFin and the rest of it, this was

where they had got. I agree with you that there was something wrong with that process but it was almost written, once you had decided you were going to base it on internal models and given that this work started in the late nineties/early 2000 it was pretty well set by then.
Mr Cooke: Part of it is past experience, as the stockbroker tells you, is no guide to future performance and one of the things which they did not necessarily manage to factor in was the possibility as something as extreme as has occurred in the past year or so.

Q146 ***Lord Eatwell:*** The same thing happened in the autumn of 1998, although in specific markets which led to the collapse of LTCM; that was a case of severe model failure designed by very distinguished model makers.
Mr Cooke: Yes.

Q147 ***Lord Paul:*** Let me come to supervisory roles. Supervisory intervention in solvent banks has been frowned upon because it would disenfranchise the shareholders, but shareholders are a very little part of the bank—there are government guarantees, there are depositors' guarantees. So what kind of supervision should be possible without being told that there is an intervention?
Mr Foot: Every day in every solvent bank there is a lot of regulatory toing and froing going on; there is a dialogue all the time about risk controls, about capital requirements, about all sorts of things. I think where the regulator understandably gets very edgy is where that could tip over into effectively being a shadow director of the bank. There are some extraordinarily difficult issues. In my early times as a regulator Direct Line were busy growing their business and the insurance industry was coming in and telling the regulator that this was going to lead to disaster for the industry, Direct Line would fail, consumers would be damaged. Fortunately the regulators at the time had the courage to leave it be and the consumers, as a result, basically got access to a far better product provided by a wide range of firms, Direct Line included. So there is a real danger of this. There are plenty of examples where regulators around the world have intervened with a bank that is on the face of it solvent because they see trends—it might be the speed of growth, it might be risk control weaknesses, whatever it is—that worry the regulator and they see that these have to be fixed. So there is intervention and dialogue all the time.

Q148 ***Lord Paul:*** Is there some kind of a gap between the image which the depositor has versus what is possible because the depositor thinks that it is an industry which is well regulated and supervised and he is safe. On the other hand, what is coming through is that that safety is more imagination than a real one?
Sir Callum McCarthy: I think you have to look at supervision, regulation and deposit insurance as part of a continuum. One of the things that has become clear in Britain is that the original deposit insurance arrangements that we had two years ago neither were quick enough in their action nor gave enough certainty and confidence to avoid a lack of confidence suddenly materialising—that is one of the many lessons of Northern Rock. But I do not think it is supervision by itself; it is supervision and deposit insurance within the context of getting the right regulatory structure.

Q149 ***Lord Paul:*** When you deposit money in the bank you do not think of the limit that your deposit insurance is; you think the money is safe not because you are going to be paid by the insurance.
Mr Foot: We have a very good example of somewhere like Guernsey where after Landsbanki they are now at last deciding that they want banks to put very clear simple statements when they take on new depositors, for example saying in a case like Landsbanki that you should be aware that this money is being up streamed to the parent in Iceland or into the UK. In other words, there are no assets locally but if things go wrong you can be protected. As Callum says, as financial literacy is so low, unfortunately that will not greatly help but there are some things that you can make some steps towards.
Sir Callum McCarthy: And there are dangers which the present circumstances are illustrating very clearly and also were illustrated very clearly during the savings and loans crisis in the United States of everybody believing that all their deposits were safe, because if that happens you find that there is a retreat to banks offering more and more generous terms on a less and less responsible basis. So it is a difficult balance to strike.
Mr Cooke: It is an eternal debate really and I do not know if we will ever find an adequate answer but I just make the comment that I do find it just a little bit disappointing, while accepting the need to protect depositors, the extent to which *caveat emptor* as a concept has just flown almost totally out of the window in recent years.

Q150 ***Baroness Kingsmill:*** We have talked quite a lot about the formal regulation of the banks and I wondered if you had any comments to make about the governance of the banks by the non-executive directors and if you felt that their responsibility should be different from those of an ordinary plc; that they should have access perhaps to formalised information gathering; that they should have access in a formal way to the regulators of the institutions.

Do you have any views about how these banks could be better governed in that sense?
Sir Callum McCarthy: The fundamental responsibilities of a board remain the fundamental responsibilities of the board, whether it is a bank, insurance company or motor car company. I actually think that there are some pretty significant problems because the accounting for banks and, even more, the accounting for insurance companies is, I think, significantly more difficult than the accounting, say, for a motor car company.

Q151 ***Baroness Kingsmill:*** Also, if a bank fails it is very much more serious for the economy as a hole.
Sir Callum McCarthy: The externalities are much greater. I hope that nobody would become a non-executive director of any company without ensuring that he or she could have access to that appropriate information. One of the things that the FSA did—and I am sure still does—is to have direct discussions with the non-executives of banks and to have those discussions independent of the executive team. So all those things are important things to build on, but clearly they have not worked well enough.

Q152 ***Baroness Kingsmill:*** One of the interesting things this morning, I listened briefly to the performances of the banking chiefs being interrogated by the Treasury Select Committee and one of the questions that was asked was did the FSA interview non-executive directors; and in ensuring that they were putting in proper people, was there any attempt and of course there was not. I wondered whether you thought that might be something which might reasonably be introduced, that the FSA should take responsibility for ensuring that they were fit and proper.
Sir Callum McCarthy: The FSA does have a responsibility for ensuring that people are fit and proper.

Q153 ***Baroness Kingsmill:*** Indeed.
Sir Callum McCarthy: And discharges that responsibility.

Q154 ***Baroness Kingsmill:*** None of these people have been interviewed at all by the FSA.
Sir Callum McCarthy: But there are a series of issues. It would be possible to make a requirement that every non-executive director of a bank should have a banking background and that would have clear implications for all sorts of issues like diversity. It is not an obviously correct answer but there are things that could be done and, indeed, I think it important to have the levels of standards of ethical behaviour and competence which are there. But it is difficult. If I look at the non-executive directors of Northern Rock, the Assets and Liability Committee was chaired by somebody who had a long and distinguished career as a commercial banker in this country; it had an ex member of the Court of the Bank of England as a senior director; it had a very well known fund member as a non-executive; and so on. That was not obviously in any way a poor set of non-executives.

Q155 ***Baroness Kingsmill:*** So you think the government's arrangements are adequate as they stand?
Sir Callum McCarthy: No. I have said that it is manifest that in a whole series of ways the boards of a number of banks and other financial institutions have not distinguished themselves. There are a whole series of things that people have to think about and improve on.

Q156 ***Baroness Kingsmill:*** What would you suggest, for example?
Sir Callum McCarthy: I think it is essential that the people should have the information; you should have enough people who can really challenge the executive team. But you should also recognise that even when you have that you will get boards that make mistakes and it would be simplistic, it would be a wonderful world if we could avoid mistakes by just making sure that we had the right people in corporate governance.

Q157 ***Lord MacGregor of Pulham Market:*** Can I follow that up very quickly? In the case of Northern Rock I was fascinated by what you said; the FSA report shows some internal mistakes or not very good processes in relation to Northern Rock. Was that because the board of Northern Rock seemed to have non-executives who had long banking and financial experience?
Sir Callum McCarthy: No. The things that went wrong within the FSA were things that went wrong within the FSA. But one of the things that did not go wrong, if I can put it that crudely, was not over reliant on the board. The people who were the non-executives on the board of Northern Rock were people who, by background, skill, training, etcetera—there was good reason to believe could have discharged their duties well, and I think that applies in a number of instances.

Q158 ***Chairman:*** One of the problems that seem to have arisen over past years has been the complex and opaque nature of some elements of securitisation and I wonder if you could let us know whether you think that derivative contracts should be more standardised or is there a case for compulsory disclosure of the details of CDOs—collateralised debt obligations?

Mr Foot: My vote would go very definitely to getting them into a centralised clearing system or on exchange and I have been saying that there is a window of about a year or 18 months while people have lost courage, the people who would like to keep things as they are because the over the counter stuff is highly profitable and highly opaque—it gives a lot more room to make money if you are doing that. But for 18 months or so it might be possible to get these things changed, certainly with a centralised clearing house. In terms of transparency I do not, to be honest, know what good that would do. Who would read it and who would understand it? I am really not sure that is the case. Clearing up the mess if things go wrong, of course things will be lost by standardisation; some contracts which would ideally be two months and nine days will have to be two months or three months. I think that is just tough.

Q159 ***Chairman:*** The downside is the dis-benefits, the cost of having an exchange approach are fairly small by comparison to the benefits?
Mr Foot: I personally think so, particularly in terms of cleaning up when things go wrong.

Q160 ***Chairman:*** Is that a feeling that is common between the three of you?
Sir Callum McCarthy: I think a movement towards a central clearing system is going to happen; it should happen; and will be highly beneficial.
Mr Cooke: I would agree with that, except I would just say that that does not necessarily preclude some diversity in the nature of the contracts that are actually handled through that exchange. One does not want to totally stifle innovation.

Q161 ***Lord MacGregor of Pulham Market:*** Should financial institutions with access to state support be inhibited in some of the things that they do, particularly in going into unproven financial securities, etcetera?
Sir Callum McCarthy: This is in relation to those institutions that the government has a shareholding in?

Q162 ***Lord MacGregor of Pulham Market:*** Correct. Or substantial state support, not necessarily shareholding.
Sir Callum McCarthy: Yes, provided that we understand the reasons that Michael explained a moment ago. I think a number of things have been beneficial. It is a good thing that people can get interest rates or foreign exchange swaps and hedge their exposure in a number of ways. I think it would be very sensible. One of the things for all banks, whether there is a state support or not, is that there should be a proper costing of the cost of credit associated with trading activities. If I look at one of the things that went wrong within the risk management among banks and securities houses and insurance companies that was not properly done. That is something that undoubtedly has to be done.

Q163 ***Lord Forsyth of Drumlean:*** I have one quick question which we have just touched on a little and that is the subject of bankers' pay and bonuses and the relationship that there may have been to this crisis to that. You, Callum, mentioned Lehman's, which, as you say, was not really a bank. Lehman's, of course, when it went down precipitated the loss of confidence with catastrophic effect, but in the case of Lehman I think I am right in saying that almost all the bankers were paid in shares and I think it was equivalent to writing your letter of resignation if you went to see the Chief Executive and suggested that you might be selling some of your shares. And as a result a lot of the Lehman's people have lost everything that they have earned over many years. I appreciate that that does not create a lot of sympathy but it does actually make me wonder whether this emphasis that has been put on not having cash bonuses or making bonuses less over a period is perhaps not as obvious or clearly the solution to this problem that people might think. I wonder what you think about that and whether you think there should be more regulation in this area or whether it relates to what Baroness Kingsmill was saying about the role of the people on the remuneration committee and seeing that there are sensible schemes.
Sir Callum McCarthy: I think the points you make show that the question of bonusing is much more complex than most descriptions of it suggest. I do think that there is scope for the regulatory framework to examine the way in which people are rewarded, the implications to risk taking and to adjust the capital that a bank, an insurance company or securities house is allowed to hold in the light of that, and I think would be a very sensible thing to pursue and develop.

Q164 ***Baroness Kingsmill:*** Would you agree that in some cases the bonus culture has distorted the pay levels in banks very much, especially at more junior levels? Many people were very poorly paid on a month to month basis at the more junior levels of banks and relied very heavily on their bonuses to bring them to a reasonable pay. Do you think that is something that should be changed—abandon bonuses?
Sir Callum McCarthy: I am not sure if I agree with the factual basis of the question.

Q165 ***Baroness Kingsmill:*** We have focused on the very senior levels of people who were very well paid and also the higher bonus but there were very large numbers of people lower down in the banks that

relied on their bonuses to bring their wages to reasonable levels. You do not think that would have made any difference overall?

Sir Callum McCarthy: In terms of financial stability I do not think that is a major factor and I am trying to think whether I really believe the factual basis.

Mr Foot: It might be true among people who do not have much influence on the outcome of the bank; but to take traders, for example—the early question—it works very well with senior executives, you can imagine continuity and you can imagine tying people in longer-term—but it is very much harder if you are running a team of foreign exchange traders, as I once did, for example—these guys want paying now. They get quite a substantial income and then they get substantial bonuses on top and they are the ones who can do tremendous damage to the bank. It will need a change there as well as at senior executive level.

Chairman: Thank you. We have come to the end of our time. Thank you very much for spending some time with us and for your very interesting and informative answers.

Supplementary memorandum by Peter Cooke

SOME COMMENTS ON THE CURRENT SCENE AND ITS ANTECEDENTS

Peter Cooke is best remembered for his chairmanship of the so-called Cooke Committee at the BIS—more formally known as the Basel (then, Basle) Committee on Banking Supervision. He was responsible for formulation and introduction of the first risk-weighted capital rules for major international banks, now known as Basel 1. He was also Head of Banking Supervision at the Bank of England.

Following his retirement from the Bank in 1988, he was for a decade chairman of the global regulatory advisory practice of PricewaterhouseCoopers in London. He has also been an advisor and non-executive director to a range of banks and other financial organizations. He is a member of the CSFI's Governing Council.

It would be a brave man who attempted a definitive analysis of the causes of the present turmoil. It would be an even braver one who offered a definitive recipe for a solution to the crisis. The debate will run for a long time. What follows are just some personal thoughts, drawing on past experience.

Three caveats should be applied to my comments. First, it is now exactly 20 years since I laid down my regulatory baton; the world has moved on and the financial environment has changed enormously. Second, I have no wish, in an "I told you so" mode, to add to the burdens of those who are currently wrestling with the challenge of restoring confidence and good order to the international financial system. Third, memory is fallible and large chunks of what could well be relevant background have disappeared into the deep well of recollection never to be recovered. But I plunge on nonetheless.

When I began my sentence as a bank supervisor in the mid-1970s, markets were very different to today. Globalisation had hardly begun to manifest itself. Supervisory co-operation between national bank supervisors (they still characterised themselves as supervisors, not regulators) was in its infancy.

Nevertheless, the aftermath of the first oil shock and the collapse of several banks, notably Franklin National in the US and Herstatt in Germany, in the early 1970s, persuaded the G10 Governors (whose banks at that time held 90% of the world's cross-border banking business) to anticipate and improve their ability to deal with shocks to the international system. This need was recognised particularly by the UK, which had had to cope with the fallout of the secondary banking crisis. The Governors' debates at the Bank for International Settlements led to the formation of the Basel Supervisors Committee to maintain an overview of cross-border banking business, while a parallel body—the Euro-currency Standing Committee as it was then called—focused more on monitoring macro-economic developments. In the UK, at a national level, the governor's eyebrows were still a potent force, and in the City the ultimate sanction was still to be blackballed from the Club. The UK, unlike many of its developed country confreres, still had no legislation covering the banking industry as a whole, only a smattering of laws governing certain aspects of business undertaken by banks. It could be said that the UK had supervision (of a sort) but little regulation, whereas other major countries had regulation—a framework of law covering banking businesses—but little ongoing supervision beyond monitoring certain legal imperatives.

It was all a very different world to today.

But change was on the way. The practice of banks keeping hidden reserves was increasingly being called into question. Competition and credit controls, introduced into the UK in the early 1970s, removed the earlier system of ceiling controls on bank lending, which acted as a prudential, as well as a monetary, control

technique. Banks were set free to determine their own levels of lending, and the growth of the euro-markets greatly increased the wholesale funding element and the cross-border exposure within banks' balance sheets. At the same time, these trends put pressure on banks' capital adequacy and led to the supervisors' efforts, in the 1980s, to achieve some capital underpinning to the international banking system—in particular through the provisions of the Basle Accord on Capital Adequacy in 1988 (or Basel 1 as it has come to be called).

In the subsequent 20 years, many of the changes then beginning to occur have moved on apace. Transparency has increased (most would say improved), enabling the marketplace better to assess the soundness of banking businesses, hidden reserves have gone, and the accountants have won the day on mark-to-market valuation—further reducing the banks' ability to cushion against shocks. Major banks (who may now be regretting it) persuaded the supervisors to agree to reduced capital adequacy requirements when "justified" by sophisticated modeling techniques, instead of being bound by the much cruder measures of Basel 1—which they claimed unreasonably constrained their competitiveness and their profitability.

But, most significantly, those 20 years have seen an enormous growth in banks' access to a global funding wholesale deposit market, rather than relying on the traditional retail deposit base of banks' non-banking customers.

All these developments, for better or worse, have reduced the ability of banks to run their own businesses soundly without being knocked off course by unanticipated macro-economic or macro-prudential developments. It has become more and more the case with this inter-twining of global banking business that, in the words of the Tom Lehrer song, "we'll all go together when we go".

There seem to me, however, to be two features of the banking industry that have not changed, and to which supervisors should always have careful regard.

The first is the herd instinct. Whatever the merits, or demerits, of a new technique or new product, bankers all too often feel they should follow their peers for fear of losing out to the competition. I recall a conversation with the chief executive of a UK clearing bank, at a time when some constraints on the expansion of lending were being advised by the Bank of England, who said that he could not afford to follow a more cautious policy because it might cause him to lose market share—which, once lost, was not easily recovered.

The second feature of the banking business, often quoted, is that bankers never learn from their predecessors' mistakes. Similar misjudgments seem to be made every time a new cadre of management comes in and the macro-economic cycle comes round again.

On the first characteristic of bankers, when I was a supervisor I used to recount my supervisory nightmare. The scene was a mega international conference hotel at which a whole fleet of stretch limos was drawing up to the entrance, disgorging its cargo of prosperous bankers. On the back of each of the limos was an identical bumper sticker. It read: "Two million lemmings can't be wrong." Another recollection that demonstrates how bankers don't change that much is from the time of the Mexican default crisis in 1982. I was in Toronto for the Annual Meetings of the IMF and World Bank. A senior central bank Governor quoted to me the comment of a very senior international banker who had said to him: "Times are terrible. Even those who cannot afford to repay have stopped borrowing."

Turning to the present situation, I should like to comment briefly on four aspects. First, the interaction of monetary/economic and prudential policy; second, the interaction of capital and liquidity management; third, the role of capital in the banking system; and finally, the management and regulation of bank liquidity.

1. *Monetary/economic policy vs prudential policy.*

The objectives of these two aspects of public policy can be in conflict. For instance, one of the early arguments for taking responsibility for prudential supervision away from the Bank of England was that it could find itself being pulled in different directions on policy issues—most particularly, that a need for monetary tightening could put undesirable pressure on banks' balance sheets, and thus have an impact on the soundness of the system.

This has never seemed to me a very powerful argument. I still believe that the different demands of monetary or general economic policy and prudential policy are best handled by a sensible balancing of the two within the same agency. Accordingly, it has always been my view that the supervisory role should not have been removed from the Bank. Furthermore, the financial stability role and the overall macro-judgment that needs to be made about the state of the market as a whole, although not perhaps as much to the fore in the Bank's priorities as they could have been in recent years, are best undertaken alongside responsibility for the supervision of individual institutions and within the same supervisory authority.

Politically, this may not be a policy option now. But one possible variant could be to adopt some of the features of the German system, as I remember it, whereby the Bundesaufsichtsamt—the Federal Regulatory Agency—had overall responsibility for the legal regulatory framework, but much of the contact with and supervision of individual banks was undertaken within the Bundesbank's regional network. The tripartite arrangement introduced in the UK a decade ago is now widely criticized. It is fair to say that each party has a role to play, but I believe the responsibilities could be better drawn. I have always felt that a clear distinction can and should be made between, on the one hand, the systemic soundness of the banking system and the soundness of the individual institutions within that system and, on the other hand, the official regime created in response to the demands of consumerism and the official response to those pressures through consumer protection legislation and the day-to-day relationship between consumers and financial services organisations. Insufficient attention seems to me to have been given to this division of the different aspects of the regulation of financial markets: they are very different sorts of regulation.

I note in passing, with regret, that the old dictum of "*caveat emptor*" seems increasingly to have been consigned to the wastepaper basket.

2. *Capital and liquidity adequacy.*

Capital adequacy has always been a cornerstone of the market—and of banks' own assessment of financial soundness. In recent years, however, I think it has been overemphasised (perhaps because it is more easily measured) at the expense of liquidity adequacy—which, in "olden days", was given equal prominence by the market and by banks' own managements. It has been too readily assumed that if adequate capital can be demonstrated, liquidity will always be forthcoming.

When I first came into banking, more than 50 years ago, the major banks in the UK maintained a 30% liquidity ratio in cash or readily liquefiable assets—principally UK Treasury bills or gilt-edged securities. I believe the current liquidity ratio of major banks—similarly defined—is in many cases below 5%. How much better it would be for banks to have the old liquidity cushion or something like it, with indirect government support through open market operations, rather than direct intervention in the form of partial nationalisation. In our early discussions in Basel, the importance of the twin pillars of capital and liquidity adequacy were well recognized. But proposals on liquidity, seeking to explore possible common approaches to its management, always foundered because national regulations, the structure of national markets and the importance of different elements of liquidity for national monetary techniques and objectives made efforts at standardization much more difficult than in the case of capital. Maybe more effort should have been, or should be, devoted to standards for liquidity to run alongside those for capital.

3. *The role of capital.*

Capital and liquidity, but particularly capital, are only buffers—a first line of defence. But capital itself is underpinned by confidence. If confidence is lost, then no amount of capital will save a bank, as recent events have shown. I believe it is correct to say that every bank that has failed in the last two or three decades met the supervisor's minimum capital requirement at the time.

Watching recent events, it has been very difficult to understand how the precise amount of new capital granted by governments to troubled institutions has been arrived at. Optimally, it should have been based on a supervisory assessment of the extent of the deterioration that has occurred in an individual bank's balance sheet—and thus the amount of new capital required to plug the gap. Just as likely, I suspect, is that, with little time to make a detailed study of the book, it was rather the amount that, it was judged by supervisors, would be seen by the market as filling the confidence gap.

In the 1970s and 1980s, the major banks in France and Japan, to name but two, were trading happily with capital ratios of around 2%. They could do this, in the case of France, because they were at that time nationalised and, in the case of Japan, because the markets believed they were part of "Japan Inc"—and that the Japanese authorities would always stand behind them. In the event, the Japanese pushed the boat out too far—and the subsequent correction led to the stagnation of the 1990s. In the same period, the capital backing of the Swiss banks was in excess of 10%. These inequalities were mitigated, to some degree, by the Basel Accord of 1988 which introduced a significant convergence of major banks' capital requirements. But I think that today there is still a considerable divergence in different parts of the world on what constitutes "adequate" capital to fit a country's particular economic circumstances—witness the numerous efforts in many countries to bolster individual banks' capital to different perceived desirable levels. In reality, after these moves, I suspect that there is now plenty of capital, on traditional measures, in most major banks. An increasing realization that this is the case may help open up banks' willingness to lend to each other again.

Basel 1 had only limited objectives: to level the competitive playing field and to establish a floor, or base, level of capital adequacy for international banks to underpin the soundness of the international financial system. It had inconsistencies and some broad brush generalisations, particularly on readings of risk. But it never pretended to be the last word: rather, it was the first step in assessing the soundness of a bank, and a much more detailed assessment of different aspects of a bank's business was required. Also, it was always promoted as a minimum level, not necessarily a sufficient level. But it came, perhaps inevitably, to have something of the character of a tablet of stone, and major banks began to wriggle under the supposed constraints it created through its application in different national regimes.

Basel 2, now up and running—albeit haltingly (although I am not sure where it is going), is currently the name of the game. It goes much wider, of course, than just capital adequacy, with its more sophisticated analysis of risk and its emphasis on the other two pillars of supervisory controls and market discipline. It is no doubt a valuable aid to national supervisors against which they can test the adequacy of their own systems. But it seems to me to be too complex ever to be acceptable in its entirety as THE global system. Moreover, some very significant problems seem to have emerged in the first pillar of capital, in particular, supervisors' willingness to rely on the judgement of rating agencies and the bank's own models in setting their standards.

4. *The management and regulation of bank liquidity*. I have already referred to some aspects of bank liquidity and the feeling that it has been perhaps the poor relation in recent years as far as regulatory attention is concerned. But the comprehensive collapse of the wholesale market in the current crisis has been an unexpected phenomenon, fuelled by the lemming-like behaviour of the banking sector and not forecast by even the most doom-laden pundit. Furthermore, I am not sure, even with hindsight, that the experience of earlier banking crises could have given clues to its likely severity.

The major new feature of the market in recent years has been the growing practice of packaging or wrapping assets, credit default swaps and all the associated exotica, and marketing them in such a way that the original assets (usually credit enhanced and given a status they did not always deserve) seemed to disappear into the ether; they could not easily be unbundled or tracked or, importantly, fully taken on board in assessing risk in the marketplace. This development has markedly exacerbated the merry-go-round of the wholesale markets—and has greatly muddied transparency overall so that it became very difficult for banks, faced with uncertainty, to judge the current strength of their counterparties in the market. At the same time, in an unprecedented peaceful decade in international banking, politicians were keen to see continuing growth in the real economy and were happy for banks to inflate their balance sheets to that end. Regulators in many countries took their eye off the macro-prudential consequences of this trend.

It was the unchecked growth of this new market and the associated acceptance of this trend by the regulators which, I believe, has had most to do with the unprecedented loss of confidence among banks, many of whose directors (either individually or collectively) have admitted to not fully understanding the new instruments being created or the risks being run. The sub-prime lending crisis in the US may have been a serious collective rush of blood to the head by the banking industry, but it can hardly have been the trigger for the global crisis without other underlying causes being present at the same time.

Recommendations…

Beware the herd instinct among bankers. And remember: "bankers never learn from their predecessors' mistakes"

Incidentally, the culture of greed, so frequently commented on, which has so seriously damaged public confidence in bankers, certainly needs to be contained. Bankers themselves must pay more attention to the importance of balancing their responsibility to shareholders with that to their depositors.

So, we are where we are. It is inconceivable that the major banks in the developed economies will be allowed to fail. Hopefully, the injection of new capital into many of them will be sufficient to restore confidence and enable them to absorb the asset impairment that is yet to be fully revealed. But it is still difficult to judge what precisely is the amount of capital that will satisfy these conditions, or the liquidity regime that should be devised. Repairs to the system will almost certainly take some time and the international banking system will limp along for a while. In the UK, some public ownership was probably a necessary part of any effort to stabilise the market. Its undoing however will not be easy. Confident interbank lending has still not resumed and, looking forward at the moment, I can see no clear way to achieve the withdrawal of the public sector's involvement—assuming, as I imagine most would agree, that this is a desirable medium-term objective.

One final thought. The global character of the crisis has raised the issue of a global regulatory body to oversee the global marketplace and to anticipate future systemic threats.

Interestingly enough, this brings us back to the seminal thinking behind the creation of the Basel Committee almost 35 years ago. But the market is so much bigger now and the players infinitely more numerous, so a more heavyweight body may be required—an international organisation, designed to be not a doctrinaire global regulator and rule setter, but rather one with a macro-prudential brief to monitor, advise and influence trends and developments in the global marketplace, with an authority that national bodies on their own cannot possess. This will not be easy to achieve. The seeds of such a body can be seen recently in bodies like the Financial Stability Forum at the BIS. But more teeth and weight (internationally agreed) will be needed. Creation of such a body may well need to be part of a global review of the panoply of official bodies contributing to the goal of sustaining international economic growth and development in a capitalist world, perhaps including redesign of the Bretton Woods institutions created for an earlier economic order. Grandiose stuff, but I suspect we will have to think big to get ourselves out of the mess we find ourselves in.

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Examination of Witness

Witness: Lord Burns, a Member of the House of Lords, Chairman of Abbey National (and former Permanent Secretary at HM Treasury) examined.

Q166 ***Chairman:*** Lord Burns, welcome back to the Economic Affairs Committee and thank you for finding some time to give evidence to our inquiry. I do not have to ask you to speak slowly and clearly, that is the nature of the game here as you know. Would you like to make any introductory remarks or shall we go straight into questions?
Lord Burns: No thank you, but I would like to say that I am very pleased to be back with this Committee, although I think I probably preferred it on that side of the table!

Q167 ***Chairman:*** As a former Treasury Permanent Secretary and indeed as Chairman of a bank do you think that the Tripartite System of regulation has fared well in the current banking crisis or not?
Lord Burns: I think that undoubtedly it has been challenged during this crisis, particularly in the early stages. My starting point is that regulatory systems, in a sense all over the globe, have been challenged by this crisis so I would not particularly pin the blame for that upon the Tripartite System. I would also say that when the Tripartite System was set up and when the Memorandum of Understanding was put together we always knew that it would be these sorts of circumstances that would actually cause the greatest tension. And, indeed, in the Memorandum of Understanding there is quite a lot of attention given to the issue of dealing with crisis, both financial crisis and operational crisis. During that period, 1997, I acted as a bit of an intermediary between Treasury ministers and the Bank of England and we spent a long, long time on the whole issue of this type of event although possibly not as serious as this. But more particularly, on the question of lender of last resort, there was quite a big debate about could you leave the lender of last resort responsibilities with the Bank of England; what else could you do with them; and what would be the Treasury's role in this as the provider of any significant sums of money? One of the slightly paradoxical things of course is that much of this was all set up on the basis of the Treasury instinct that the Bank of England was always too ready to rescue banks. This was a view that ran quite strongly through the walls of the Treasury and therefore much of the arrangements that were set up and the allocation of responsibilities were designed to try and make it just a little bit more difficult for the Bank of England to get engaged in this. Again that was reflected in the MoU. Of course, I do not think anybody quite anticipated the situation where, from what I read in the newspapers, possibly it would be the Bank of England that was dragging its feet over the question of the use of lender of last resort facilities. There was a period—and again I am just commenting from looking at it from outside—when I felt that possibly the Treasury was not as much in charge of this process as it would have been under the old arrangements and that there was a period at the beginning when, looking at it from the outside, they had some difficulty in using these mechanisms. Personally I do not think that this is a huge issue in relation to the problems that we have faced. The other area that I would point to is the whole question of the division as between what you might think of as the responsibility for macro supervision and the position of the banking system as a whole—and the systemic aspects of it—and the responsibilities for supervision at an individual bank level. When we were drawing up those arrangements back in 1997 there was quite a lot of concern to ensure that there was not too much overlap. We did not want to leave the supervision side of the Bank of England the same size as it had been and have another very large body

in the FSA. I just wonder sometimes whether in the pressures to avoid overlap we did not end up with some under-lap and the macro prudential issues have fallen a bit between the cracks. It is a long time since I was closely involved in this and I have to press my memory quite hard to recall it. But there clearly have been some difficulties. As the crisis has gone on my observation is that things have improved quite significantly and the cooperation and the interchange has been more effective.

Q168 ***Lord Eatwell:*** On the Tripartite Structure, it is very obscure, is it not? If you try to find out anything about how it works you go to the website and it says, "None of these papers will be published; that is it, folks." We have a website, here is the Memorandum of Understanding in which the wording is set out and then it says, "Meetings have taken place" and that is it. Do you not think it would be helpful if we knew more about how this organisation worked or did not work?
Lord Burns: I think it would and I would also be quite interested to know how often the senior committee met—I suspect not very often—and what were the topics they were interested in. I do not want to overdo this. I spent a lot of my life engaged in trying to make sure that those things we did not wish to make public were not public and it is not really right for me now to immediately jump to the other side. It has been a relatively obscure process but I do not think I am breaking any confidences to say that it was itself set up, and the whole MoU was designed to try to resolve some quite serious tensions between the various bodies as to how it was going to work, given the division of responsibilities in the very broad sense. I look back to the world when it was just the Treasury and the Bank of England—an arrangement that had been working for a long, long time. At almost every level within the two organisations people met on a very regular basis and when there were problems there would be differences of opinion but in the end accommodation was reached usually relatively quickly. Having a third member in this and having written down the MoU seems, if anything, to have slowed down the process of cooperation in the early stages. But that is an outsider's view.

Q169 ***Lord Forsyth of Drumlean:*** I do not want to be too controversial but it does seem to me that it was a great system for when the sun was shining and when you say that the Tripartite Structure has got better recently I would agree with that, but is that not because it has disintegrated and it is now the Treasury that is calling the shots? If I take you back to the Northern Rock crisis in the summer, when Lloyds TSB wanted to take over Northern Rock and when the Bank of England took the view that they would not accept a mortgage broker's securities, we have moved quite a long way—we are now taking car loans and goodness knows what else—and where it would appear that both in the case of Northern Rock and in the case of HBOS it had never occurred to anyone that the business model might be a little bit weak and relying entirely on wholesale markets. So trying to be fair it does seem that you have the Monetary Policy Committee setting interest rates according to inflation, creating very low interest results which have resulted in the banks devising all kinds of clever products. You had the FSA, which we know from the Northern Rock report, not even going to look at the business model and discuss it with them and the Treasury were clearly keen for more effective action, as you have hinted, than the bank would provide. To sum it all up have we not got there because the tripartite model ensured that no one was actually in charge and there was no coordination of monetary policy, banking supervision and regulation? Is it not necessarily to revisit this now?
Lord Burns: I agree with the issue that it did take a while before the Treasury really got itself in charge of this process. I think that was one of the possible effects of learning how to use for the first time this Tripartite System in a crisis; just what the respective responsibilities were and what the Treasury's powers were. I have mentioned already that involved in this somewhere is the whole issue that what you described as the business model—and what I described as the issues of macro prudential supervision—probably did not get the attention that they need. The difficulty though with the whole subject of prudential supervision—and I watch this from a distance of course—seems to me that it is one of those areas where nothing happens for a very long period of time and then every now and again you get quite a serious squall. It is not easy to staff one institution let alone two institutions, to have the skills and the background to be there waiting for when one of these events begins to build up. You can argue that this one was on the make for five or six years and I have some sympathy with that, but, nevertheless, there is an area of what you call the business model and what I am calling macro prudential supervision, which obviously has to be dealt with. Indeed it is an area that seems to me would benefit from overlap rather than from under lap.

Q170 ***Baroness Kingsmill:*** In the UK Northern Rock was very reliant on securitisation. How important do you think the securitised debt market was in the UK mortgage market in the recent boom times? As I said, Northern Rock was very reliant on it in the sense that 40% of its total assets were in the form of securitisation assets, whereas Abbey and Alliance and Leicester were high but not as high as that. What is your view about that because what that meant was that there was a whole other market through shadow

banking institutions which grew up around that and perhaps needed a different form of regulation and it would be very interesting to hear your views.
Lord Burns: Undoubtedly the whole issue of securitisation played a huge role in terms of what happened over the last seven or eight years. You only have to look at the numbers in the Crosby Report of what happened to the aggregate numbers. I think it is very difficult to avoid the conclusion that it did help to fuel the mortgage market, particularly in some of the more sub-prime areas. I think the result of it was that we had some very aggressive lenders, particularly using the independent financial advisers, as the channel. Indeed, by 2005-2006 in the case of Abbey we were finding the pressure from this really quite intense—margins on mortgages sold through intermediaries were down to almost zero. We in fact pulled back quite significantly and it created a very difficult situation for us. Of course it also became a very important part of the boom and we saw the enormous spread of buy-to-let mortgages and self-certification mortgages, and it is that which to a significant extent has unwound. Much of that securitisation in the UK, unlike some other countries, I understand, involved quite substantial overseas investors.

Q171 ***Baroness Kingsmill:*** Much of it took place through institutions which were not as heavily regulated as the banks themselves and many of the banks had off balance sheet vehicles through which securitisations of this kind were provided.
Lord Burns: I think the issue about how regulated they were relates more to the people who in a sense were investing in them rather than the people who were creating them because the role of the banks in creating these things remained highly regulated and was very closely supervised. But it became a process which allowed a lot of people to enter this market and become investors who did not have the same kind of supervision, regulation or the same kind of capital behind them. It all helped to build up this great pyramid of activity.

Q172 ***Baroness Kingsmill:*** I am still trying to get at what your view is about what should be done about that. Is it the sort of thing therefore that one size does not fit all as far as regulation is concerned and maybe there needs to be some specific kinds of regulation to get the shadow banking world under control?
Lord Burns: My personal view is that the issue of capital requirements is a very important part of what lies behind all of this. In financial services, if people find ways of getting round the requirements for capital then they are capable of making substantial returns on their activities. The result is that those activities tend to explode and they bring with them certain types of remuneration practices. I think the biggest lesson of all from this crisis, as far as the regulators are concerned, is that both liquidity and capital have to continue to be the main means of supervising people and one has to work very hard to avoid people escaping from the net. There is always going to be a certain amount of gaming here. Any regulatory system produces incentives by which people seek to get round them and out of that typically comes some nice little pools of profits and those tend to blow up. Much of what we saw during this decade I think is reflected in that.

Q173 ***Baroness Kingsmill:*** Does it generate real economic value?
Lord Burns: Some of it does. There are instruments and there are ways of doing things which I think do provide options and products for consumers that are to their benefit, which otherwise would not exist. But it also brings with it a risk and, as we have seen, when that risk becomes enormous then we have the potential for something that is really extremely unpleasant. I am sure that what will happen now will be the chase to try to further regulate financial institutions and to pay much closer attention to capital requirements and various ways of seeking to prevent people arbitraging those capital requirements.

Q174 ***Lord Paul:*** A growing body of academics suggest that securitisations were structured so as to generate the highest possible rating for a given credit quality. If I can ask the question, how does Abbey structure its securitisations?
Lord Burns: I would say that the Abbey securitisation programmes were designed in part because of the old Basel I requirements in terms of the amount of capital that was required against mortgages. People found that through the process of securitisation less capital was required—probably, I think, quite rightly. Incidentally, in the process they brought a lot more people in as investors in those mortgage assets and I think this did distribute quite a lot of risk. Personally I do not think there is a problem with securitisation as such, particularly of prime mortgages. But, like many things, it grew where people managed to find ways of exploiting them and ways of turning them into a healthy, profitable business and it ended up growing far too rapidly. The Abbey structure for securitisation is perfectly straightforward; it is not at all complicated and there is nothing strange about it. It is simply a way of being able to take the risk off the balance sheet and to spread it to a wider range of investors.

Q175 ***Lord Paul:*** It is the perception that these securitised products are seldom more than just good enough for the ratings they receive. How close is the

relationship between the bank and these rating agencies?
Lord Burns: My experience is probably relatively limited on this because the Abbey's securitisation programmes have very much been to do with prime mortgages. But they are obviously structured the same way as all of these things are—with different segments and the riskiest part we have kept ourselves. Clearly, the rating agencies are involved in that process. But where the issue of the rating agencies became much more of an issue, I think, was when people began, out of those securitisations, to create ever-more-complex products and where they were seeking to enhance the ratings and security of things probably beyond where they deserved to be. However, if you look at it in terms of what it was that we were doing, we were doing something that was relatively simple and relatively straightforward, and I do not think there is much issue about the rating agencies. Indeed, the record of those securitisations has been exceptionally good and in terms of loss are as close to zero, I think, as they could be.

Q176 ***Lord MacGregor of Pulham Market:*** You have put the emphasis on prime mortgages and that is what you had in Abbey, but of course the problem was with all the sub-prime mortgages. As I understand it, it was very difficult for a lot of the purchasers of those to really get beneath and see how poor the sub-prime mortgages were and, therefore, they did rely on the rating agencies, so a great deal of the apparent validity of these securitisations rested on the ratings that the rating agencies gave them. Can you see any way of putting that right? Was it fundamentally a fault that the rating agencies themselves were paid by those who were providing the securitisations and were not able to look beneath the surface?
Lord Burns: I have to say, I have very little experience of this and I know no more about this than I read, like everyone else. I have not been actively engaged in it. In other non-banking work I have been in dealing with rating agencies and with a sort of quasi-securitisation. I have to say, my experience on that occasion was not at all that the rating agencies were a pushover or the fact that we were employing them made any difference. The whole thing remained quite a tortuous negotiation of just how the debt would be structured. After all, their reputation in the end depends upon their success in doing the job that they are doing on a repeated basis. In my perception, I think the problem arose simply, in what is probably well-expressed as the whole Greenspan Doctrine; that people believed that, by this process of distributing these products and by combining them in various ways, they were able to generate things which had a greater degree of certainty about them than turned out to be the case when we were faced with a systemic problem. Again, I regard it more as a macro mistake than to do with the rating agencies, although there is a big battle going on clearly with the rating agencies about what it was that their ratings were supposed to be telling you about the risk associated with the products. But I have yet to be persuaded that who pays the ratings agencies was a big issue.

Q177 ***Lord Eatwell:*** Clearly, one of the many advantages in having you here is that you have experience of two national supervisors or regulators, and I was wondering if we could look at two aspects of regulation as you have seen it in action, firstly, the approach to liquidity either by the British regulators or the Spanish ones and, secondly, if you could reflect at all on the now-famous provisioning system required by the Spanish regulators.
Lord Burns: Well, my observation is that the Spanish regulators, the Bank of Spain, have come out of this crisis as well as anyone has. The arrangements that they put in place following some of their banking failures back in the early 1980s are a very good example of learning from past experience. It is not so much on the liquidity side that I see any differences—it is more on the capital side. First of all, of course they have insisted on the Spanish banks holding capital against any off-balance-sheet vehicles. The result was that those vehicles were then not profitable, so the banks did not pursue them and the result has been that no Spanish bank has been involved with these things. They have not had the asset-backed security problems that others did.

Q178 ***Lord Eatwell:*** Did the Spanish banks complain that they were being prevented from making any profitable business?
Lord Burns: It is very interesting you should say that because there was a certain amount of frustration that was growing by 2006 and the beginning of 2007. Sitting on the Board of Santander, I could just begin to see a certain amount of frustration at the amount of earnings that some of their competitor banks were generating through this means. They like looking at league tables and looking at the performance of other people and where they stand. I think it is probably the case that several times the issue was raised with the Bank of Spain about whether or not they were being harshly dealt with, but the Bank of Spain remained quite solid about it. The Spanish banking system anyway is essentially a retail banking system, and it does not, by its nature, have the big wholesale aspects.

Q179 ***Lord Eatwell:*** What if we were to introduce the sort of counter-cyclical system in Britain? If we did that in the UK, what do you think the impact would be?

Lord Burns: I think the impact would be to slow down the rate of expansion during the upside. But, most of all of course, what it does mean is that you generate provisions and you generate reserves during the upswing which then puts you into a much better position when a problem arises. Basically the Spanish system says that every time you sell a loan, there is a probability that it will go wrong and, therefore, you should provision against the quantity of loans that you sell and not wait for them to go wrong. It is a statistical approach. To the extent, therefore, that your total provisions exceed your specific provisions, you have got to hold those as general provisions and put them into your reserves. The result is that, when this crisis came—and the Spanish property market, after all, is suffering as badly as anybody's property market—the banks have been in a position of having much greater reserves. They have been able begin to charge off some of their specific provisions against their general reserves and it is a stabilising factor. I think that, because you are having to provision against things, it probably does affect the rate of growth. But it leaves you in a much better position at the top of the cycle and for the subsequent downturn. I am quite confident that we will see this applied much more generally now around the world as a method. It is one of those cases where the accountancy rules and the tax rules about specific provisions, I think, misled people into thinking that that was the only way in which you should behave as well.

Q180 ***Chairman:*** Does the Bank of Santander's Spanish approach affect you as a subsidiary in this?
Lord Burns: Yes, well, we have put in place the Spanish approach, although we do have a certain amount of argument with our accountants about this and how to do it because sometimes they think that we are being over-cautious in provisioning. But yes, we have moved to that system.

Q181 ***Chairman:*** Do you think that regulation should be centred on the home country or the host country?
Lord Burns: Well, the Santander banks in this country are regulated by the FSA and the FSA then speak with the Bank of Spain about the important issues to do with Santander's businesses in the UK. There is a certain amount of additional time that is required by having to go through that process, but I think it works all right and I have no complaints about it at all.

Q182 ***Lord Tugendhat:*** We have heard a great deal recently about what the effects of regulatory intervention on banker compensation might be. Now, given the world into which we are moving as distinct from the world that existed before the crisis, what do you feel, Terry, would be the effect of some degree of regulatory intervention, and of course it is likely to differ from one jurisdiction to another, but clearly the range of activities that banks will be able to engage in will be more limited and, if there is some degree of regulatory intervention in different jurisdictions, do you feel that this will lead to a migration from one to another, or how would you see it?
Lord Burns: I am not terribly keen on the idea of regulatory intervention in compensation arrangements. I do think this is a matter for the Board and for investors. On the other hand, I recognise as well as anyone else that we are going through one of those periods when this has become an issue of the moment. I have no objection at all to regulatory intervention or government intervention in those institutions in which the Government has had to provide assistance and are playing a major part. My thesis that I mentioned earlier is that basically the compensation problems tend to emerge in those areas where excess profits are being made,. And that is very often as a result of inadequate capital requirements and you get these pools of profits, but it is almost entirely in the wholesale end of the business that you have these issues. We have virtually none of this at all. What happens is that you get an area where a small number of people are working in a unit which is generating some very large levels of profits and, not surprisingly, the competition for the best people to work in those areas means that you end up actually allocating a certain proportion of the profits to the people who work there. And they end up with some very large rewards. It is very unattractive and it is very frustrating for many of the other people in the company. But it is a sort of product of, what I think of as, the capital requirement arrangements, the nature of the business and competition for people. I am not quite sure, but it seems that the best way to deal with this is to avoid the situation arising where there are these excess profits. But, apart from that, there will be a lot of difficulty over a longer period of time with intervention. I am sure it is manageable in the short to medium term to have some kind of restraint and it would be helped if those areas of the business are not going to be making the types of returns that they have been making because it is that which causes the problems. We see it in various other walks of life. As many of you know, I am always very keen to talk about football and you see it just as easily in that market where some additional money comes in and people then start bidding for the best talent and it is actually very difficult to restrain it. As I say, it is very much a wholesale banking issue, it is not a problem that we face in retail banking. I am also somewhat concerned at the general attack upon bonuses in the way it has come. I think we all know from all of the companies that we have been involved

in that most people nowadays, at the senior levels in companies, are paid a combination of fixed and variable remuneration. The problem is that the variable remuneration has been labelled as "bonus" rather than as "variable remuneration". Where I have sat on remuneration committees, people's compensation is best thought of as being their fixed pay plus their target variable compensation. And that system, for most activities and for the retail banking side of banks, works, it seems to me, reasonably well. Where you have a problem is with those high-flying areas which suddenly generate very large amounts of profits and the compensation arrangements there are very difficult to handle, and I have had experience of dealing with that. But competition for talent at the time seems to be the main issue. I am sure that there will be some intervention in those areas. And again I think you can have a certain amount of capital intervention because, if people are growing those parts of the business rapidly and are relying upon them very heavily, it seems to me that that is a perfectly adequate reason why they should be required to hold more capital against that type of activity. That itself could serve as a bit of a dampener. But we are heading here into a world of mad dogs' legislation—it seems to me, we are heading here into territory where we could make some quite serious mistakes about compensation.

Q183 ***Lord Forsyth of Drumlean:*** Just on this issue of remuneration and compensation, I have two questions really. In respect of the banks which have been bailed out, the Royal Bank, where the Government is a major stakeholder and clearly there is an enormous political problem with the bonuses, what do you think of the idea of taking the so-called "toxic assets", which some people say should be put in a bad bank which will eventually come good, taking the toxic assets and putting them into a bonus pool and paying the bonuses as part of that class of toxic assets so that, when they come good, if they come good, then the people who were responsible for buying them will get the benefit of them? The second question, which also relates to bonuses, is that at the moment anyone who needs to get elected is having a go on bonuses, but one of the things that slightly worries me is that at least 50% of these bonuses, if you take tax and employers' National Insurance contributions, was going to the Treasury in the form of revenue and how significant do you think this whole change in the structure of banking and the effect of any moves that are taken regulatorily will be in terms of the City and London as a financial centre?
Lord Burns: On the first item, if we were to have a so-called "bad" bank with toxic assets, I would be extraordinarily surprised if the people who were working in that bank were not going to be incentivised in terms of the returns that they managed to achieve from the toxic assets. It is certainly what we did when we were running down the wholesale bank at Abbey in the early part of this decade.

Q184 ***Lord Forsyth of Drumlean:*** I was suggesting that the bonus pool is £2 billion and you distribute it as a share of these assets so that, if there is an upside, they get the benefit of it, otherwise they are landed with the—
Lord Burns: It sounds a rather complex device.

Q185 ***Lord Forsyth of Drumlean:*** I believe that some banks, like UBS, are doing it.
Lord Burns: Well, that is very interesting. You are quite right, there is a huge problem with this. I think that, with the banks where there is very large government intervention in them, there is a serious issue, particularly, as with many investment banking activities that I observe, there may be some contractual element to this. But there is also quite a large discretionary element to it as well. As I say, fortunately I do not have to deal with that. I thought you were going to go on and ask in the second part about the consequences for the PSBR and the effect of the disappearance of this stratum of our banking system and the taxes that they would otherwise have paid. Is that the question?

Q186 ***Lord Forsyth of Drumlean:*** Yes, and also the knock-on effect for the City in the future.
Lord Burns: I think it is quite serious. I think the prospects for the PSBR in this country over, say, a seven-year period look to me to be horrendous because the financial services sector has been a very important provider of tax revenues and we are going to lose quite a substantial amount of that. That is going to add to our woes on top of the cyclical element that we are also seeing. But I think that is fairly well-recognised now. I think the only debate is about the scale and the moment of it and, therefore, over what time period it will have to be corrected.

Q187 ***Lord Forsyth of Drumlean:*** Just to follow up, it is a serious point that the wholesale bankers have been paid these enormous bonuses, but, as you say, there has been the rather overheated period we have been through, but, nevertheless, they are quite mobile.
Lord Burns: Yes.

Q188 ***Lord Forsyth of Drumlean:*** Presumably, we do want to keep these people in this country and at the same time run a system which commands public acceptance.
Lord Burns: Even if nobody moved—if everyone stayed where they are at the moment—I think there would be quite a big effect anyway because this element of economic activity, I suspect, is going to be

rather smaller in the period ahead than it has been. This is like taking out a segment of your economy and at some later stage clearly there are going to be issues about the competitiveness of London versus other centres. And issues of remuneration will crop up. But there is going to have to be a lot of thinking about remuneration and particularly variable pay and whether it should be in cash; whether it should be in stock; for how long people should be required to hold the stock; and what safeguards should be built into it in the event that the particular trading activity turns out to be less profitable than was thought at the time. Over the next few months and years, I am sure that a good deal of effort will go into trying to design some systems which do align to a better extent the shareholder interest and the interest of the individual.

Q189 ***Lord Currie of Marylebone:*** I would like to ask you about the complexity and scale of many modern banks. One of the previous witnesses said they did not really understand how the board of, say, a major US bank could understand the nature of the activities it was engaged in. That is a rather worrying situation and there are two possible responses. One is that you could imagine regulation delivered to the size of banks, although it is hard to see how that would work and the effects on those banks, but I wonder whether an alternative is that management itself will come to the conclusion that actually they have got unwieldy organisations and they will simplify these organisations and, therefore, perhaps there will be a natural tendency in that direction, so just your observations on the complexity and scale of many modern banks.

Lord Burns: I think there is a big difference between issues simply of scale and of complexity. Santander, which I now observe at close quarters, is a very large bank, but it is essentially a retail bank. It is operating in different continents and it does get some significant benefits of scale. It uses the same IT systems, it uses the same risk control systems, it uses the same audit systems, the same branch control systems, and the result is that it can reduce costs in an area as a proportion of income very substantially. But it is basically the same model that is being taken to different countries where the biggest difference then is the particular type of products that you sell where there are some quite substantial differences of course between customer taste. I think that is a very different type of world from the one where you take a bank and just make it ever-more-complex by adding on different types of activity. I think there is a very serious issue here of scale and whether or not the management and the Board are capable of dealing with something which becomes very complex. In particular, the role of the non-executive directors, I think, becomes an even greater challenge when you have that kind of complexity because the skills that are needed for some parts of the business are quite different from the skills that you need for other parts. I think this is something that the regulatory process should take into account, (I am sorry if I harp on about this), in terms of the capital requirements that it places upon banks. I think that the more complex they are, then that is something which, in the sort of reviews, et cetera, that go on, should be taken into account in terms of fixing its capital. There is no doubt, there are some synergies. I see in the Abbey business. In fact we do not have a large treasury operation, but we have one that is big enough and it spends quite a lot of its time generating structured products to sell through retail outlets. Having them within the same business is helpful because you can have conversations about which particular products you want to sell and then they can set about seeing whether they can design them at what sort of cost and what sort of margin you might get out of them. The question is how far there really are synergies that are useful and how far there is complexity which just increases the problem of management. But banking is not alone in that and I think most businesses have to ask themselves the questions as to whether or not scale through complexity is manageable or not and whether you really have got the skills to do that. I think banking is a special case because there are some aspects of banking where you can build up complexity quite quickly, and I am quite wary of that. I think the example of the British banks, particularly the retail banks, which have gone in for more complex activities, has been a very sorry one.

Q190 ***Lord Best:*** You said a little bit about banking supervision in Spain and you are probably in a unique position to get this overview. Are there lessons that we could learn from the success, as you were describing it, of the Spanish system that we could apply directly and easily to the UK? Can we lift some of the best from Spain and just get on with it?

Lord Burns: Well, I think the two elements which I have mentioned will undoubtedly receive quite a lot of attention and I think over time I would expect to see some aspects of them being used elsewhere. The first one is the provisioning system—the "dynamic" provisioning system, as they call it; and the second is the use of capital requirements to constrain the sort of activities that you, as a supervisor, become fearful of. I would not want in any way to portray what they do as being perfect. I simply say that I think they have come out of this better than most other supervisors and largely for those two reasons. They had their fingers burned some years ago and they set about designing a system that made sure that you erred on the side of prudence,—that you erred on the side of having more capital, having more reserves and being ready for the rainy day because they had seen the rainy day. And they did not want it to happen in the

same way again. I think we are going to be going through a similar kind of analysis. There is a danger that you end up of course making too great demands for too much capital and too much liquidity control systems. That would not be at all surprising, given what we have been through, because regulation very often itself becomes a lagging mechanism relative to the issues of the time. But I would expect that is the direction that we will be heading.

Q191 ***Chairman:*** Can I just ask a final question and it is back to governance because, under the current governance arrangements of PLCs, including banks, it is now virtually impossible to have a non-executive who has been on the board for a full economic cycle. Given the turnover of executives, it probably means that the chances are fairly low of having anybody who has been on the board for a full economic cycle. Do you think that is a risky thing or absolutely irrelevant?

Lord Burns: I think we should be much more tolerant of people serving longer terms on the boards of banks than we would be in some other activities. I just overheard the end of the previous witness session and some of the questions about non-executive directors. It is a very difficult role in a bank. I do not think that our corporate governance in the UK helps in that respect because we have an emphasis upon diversity, people coming with different types of skills, and the notion that there should be a fairly regular turnover. But it is an industry where the skills do matter. Most of the people who are good at it have jobs elsewhere and you actually cannot get them on to the boards that you want. To do it thoroughly probably requires spending rather more time on it than would normally be the case of a non-executive director here. And it then gets much more into the whole area of how close are you getting to doing executive work. The Santander Risk Committee, which includes some non-executive directors, meets on a very regular basis and it means that those people are spending a much larger proportion of their time there than they would in this country. You then run up against issues of whether you have one board or people who are spending a much larger proportion of time on it and, in a sense, are closer to being insiders than others. So I think it is quite a complex area just how one deals with it. Again, I think the problems are greater with wholesale banking and I think they are greater with corporate banking where the whole issues of risk and looking at limits and deciding on exposures is something which has to be done on a fairly regular basis. With retail banking, you are really getting the statistics. If you are selling lots and lots of mortgages, you are following the trends and you are trying to look at what is happening to various ratios and what the default levels are. When it comes to wholesale banking and to corporate banking, people have got to get in much closer to the analysis of individual companies. How non-executives contribute to that process, whilst maintaining a unitary board, I think, does present some challenges.

Chairman: Well, thank you very much indeed. It has been a very helpful session.

TUESDAY 24 FEBRUARY 2009

Present	Best, L	Levene of Portsoken, L
	Currie of Marylebone, L	MacGregor of Pulham Market, L
	Eatwell, L	Moonie, L
	Forsyth of Drumlean, L	Paul, L
	Griffiths of Fforestfach, L	Tugendhat, L
	Kingsmill, B	Vallance of Tummel, L (Chairman)

Examination of Witnesses

Witnesses: Professor Charles Goodhart, London School of Economics and Professor Enrico Perotti, University of Amsterdam, examined.

Q192 ***Chairman:*** Good afternoon Professor Goodhart and Professor Perotti. Thank you very much for sparing the time to attend the Committee. We have read with a great deal of interest the recent papers of which you have separately been co-authors. This is the fifth public hearing of our inquiry into banking supervision and regulation and Members have already declared any interests on the inquiry at earlier meetings. It would be helpful if I could ask you to speak reasonably slowly and clearly for the benefit of the stenographer and Members, and that when first speaking if you could introduce yourselves, especially for the benefit of the web broadcast. Would you like to make any introductory remarks or should we move straight into questions?
Professor Goodhart: My name is Professor Charles Goodhart and I am Emeritus, which I think means without merit, from the London School of Economics! In a sense I think I have made my introductory statement by giving you a chance to read the draft of the Geneva Report we did on "The Fundamental Principles of Financial Regulation". That really sets out very clearly my views about the longer term reform and structure that we should reach in financial regulation.

Q193 ***Chairman:*** Professor Perotti, do you want to say anything else by way of introduction?
Professor Perotti: My name is Enrico Perotti. I am a professor in international finance at the University of Amsterdam, currently visiting the University of Oxford. I will have something specific I would like to discuss in this Committee and I will try to make sure that I do.

Q194 ***Chairman:*** Perhaps I can ask the first question, which is do you think that financial regulation has been appropriately focused in past years? In particular, did the regulations place too much emphasis or stress on the riskiness of individual banks relative to the safety of the financial system as a whole?
Professor Goodhart: The short answer to that one is yes. One of my other activities is that I have been writing a book on the early history of the Basel Committee and banking supervision. When the Basel Committee first met the exercise was really to examine the different approaches of financial regulation in the different countries to try and get an idea about what was best practice. Best practice was really defined or determined as being what the supervisors and regulators, who were then mostly from central banks, although not entirely, thought was best practice in the individual banks which they then looked at. They never really asked themselves the question why should we regulate banks at all? They never asked themselves the question why should there be any regulation of banks? Out of a number of reasons for regulation one which does not affect banks that much, except for certain things such as clearing houses, relates to the control of monopolies, in which a number of your Members are well experienced. Then there is the problem about consumer protection, which is known in the jargon as "asymmetric information". But the most important one is externalities, which really means that the costs of certain developments—in this case bank failure—to society are a great deal higher, or can be a great deal higher, than the costs to the individual institutions and the bankers and shareholders of the banks involved. So what really matters, as we now see very clearly, is systemic problems—not the problems of the individual institution. Indeed I think it is arguable that the purpose of the Basel Committee on Banking Supervision set themselves, which was to try and make individual institutions behave better, was actually an inappropriate exercise for regulators and supervisors to do anyhow because the return for good behaviour really accrues to the bankers themselves. The problem is that the bankers do not have sufficient incentive to be concerned with the effects that their failures and their difficulties may cause for society as a whole. So it was much more important that the regulator and supervisors should worry about systemic influences than about the individual

influences, and they concentrated virtually entirely on individual behaviour without worrying at all about how the system as a whole might react and the interactions among the system as a whole.

Q195 ***Chairman:*** Professor Perotti, do you take the same line?
Professor Perotti: I would add only two words. All systems suffer from the general economy's tendency to think of one market at a time, so one bank at a time. So they produce a system of static defences of people like the Maginot Line, which could very easily be bypassed by regulatory arbitrage. So the focus on individual banks failed to see how much the financial system is interrelated, which causes the externalities to which Professor Goodhart alluded. I think it is appropriate to consider how individual banks may protect solvency but the goal of Basel was to stop, to save the system as a whole and on that ground there was very little thinking going into what would happen upon a crisis of confidence—and it is in the interrelation between banks that then the pressure would come to bear. I think we do not think enough about that.

Q196 ***Chairman:*** Can either of you shed any light on why you think it is that the regulators overlooked the systemic and concentrated on individual banks?
Professor Goodhart: A slightly flip answer is that they tried to keep economists away from the supervisory area. It was an area which, for a long time, was regarded as being one where sensible, experienced bankers knew better than anyone else and sensible, experienced bankers tend to concentrate on the individual rather than looking at the system as a whole. But the theory and analysis of financial regulation is at least 40 years behind the theory and analysis of monetary policy more generally.
Professor Perotti: I very much second that. My experience there has to do with being a frequent visitor to the research department of the IMF and talking often to people who view the financial system in developing countries and others and there is a divide between those who are experienced in prudential supervisory regulation in the financial economy standard. The first group believes that it is all about experience and imposing rules while economists tend to think in terms of the facts and incentives, and unfortunately the first group was very guarded and protected its own and I think we have to learn from that. But if you ask what else, there is a responsibility among economists as well from using tools that in a sense rely on a standard assumption. We had a set of assumptions that we kept repeating that were not appropriate. We kept believing that we could just extrapolate from past experience and predict the future. That meant that we kept assuming that house prices could not fall in all US states at the same time because that had never happened before. So we used econometrics to predict the future, even though relying on extrapolation meant we were creating problems down the line. We made assumptions even as micro-economists that even if you could study opportunistic or distorted behaviour in any market that all the other markets were okay, and we assumed that the rest were okay. What was happening was that problems were building up in different markets and we did not see the interrelation.

Q197 ***Lord MacGregor of Pulham Market:*** Turning to the UK alone for the moment, we have taken a lot of evidence as to the tripartite system and whether that worked or whether there may have been gaps and so on in it. Particularly looking to the future, I would be interested to know how you feel that the responsibility for financial supervision and regulation should be apportioned?
Professor Goodhart: In the Geneva Report we advocated that there should be what we described as macro-prudential regulatory controls which try and introduce some counter cyclical counterweight to the pro-cyclical effects of Basel II and the accounting systems of mark to market that we now have have brought about. We have been suggesting that there are a number of macro-prudential controls that ought to be introduced, which are quite separate from the kind of conduct of business controls and looking at the individual behaviour of the individual institutions, which again are micro-prudential issues. We have suggested that the macro-prudential controls ought to be given to the Central Bank because they are macro; they concern interrelationships between markets and between banks and institutions, and that kind of study of interrelationships and study of markets is really the function of the economists and the economists are much more prevalent and have an influence in central banks—some people would say too much influence nowadays—whereas the micro-prudential and conduct of business work should continue at the FSA level.

Q198 ***Lord MacGregor of Pulham Market:*** Lord Burns suggested just in a recent session that of late the macro-prudential controls had "fallen between the cracks".
Professor Goodhart: There were no proper macro-prudential controls.

Q199 ***Lord MacGregor of Pulham Market:*** Neither in the banks of the FSA.
Professor Goodhart: Or in any country. Again, for example, the fact that the cycle in housing in virtually every country has been made much worse by the cycles in the loan to value ratios. When everyone is feeling optimistic at the top of the boom you get

institutions—and Northern Rock is the most famous one in this country—where the loan to value ratio goes over 100; then when everyone draws in their horns, when they become cautious and they have a great deal of fear and worries the loan to value ratio goes down to about 80 or even 75. This provides an enormous greater stimulus to the cycle—very, very pro-cyclical—and one of the suggestions that we have is that this macro-prudential instrument, which I think should be undertaken independently by the Central Bank as part of the armoury that Central Bank should have. I very much agree with what the Prime Minister suggested the other day, that at the height of the boom some institution, preferably the Central Bank, should ensure that loan to value ratios and maybe loan to income ratios do not go beyond a prudential level.

Q200 ***Lord MacGregor of Pulham Market:*** That would mean that there would have to be some duplication of effort and certainly a lot of cross-party discussions between the Central Bank and the FSA, for example, on these sorts of issues?
Professor Goodhart: Certainly, but there should be now. And certainly when the macro-prudential instruments do get applied—as they will do in future—there will need to be more coordination, again also with the Treasury and the Chancellor as well. When one is dealing with financial stability it is a different kind of world from dealing with monetary policy and the choice of interest rates. When one is dealing with financial stability, there is really no alternative but to have the kind of tripartite system which we were beginning to have, but in which the Central Bank did not have enough instruments—it had responsibility without power.

Q201 ***Lord Griffiths of Fforestfach:*** What exactly would you put under macro-prudential controls?
Professor Goodhart: Three areas: the counter cyclical capital requirements, which will be related to leverage, maybe to the rate of growth of the total assets of the institution and some kind of liquidity control, which was given up. Effectively liquidity regulation was abandoned during the course of the last 40 years. And some control over the key parameters in the mortgage market. I think that those are the three main areas that Central Bank, with the responsibility for financial stability, ought to command.

Q202 ***Lord Best:*** Would you apply at that time regulation more widely than just to the banks, to the shadow banks as well? Should every systemically important institution be regulated or will that simply lead to new forms of regulatory arbitrage around the system?
Professor Perotti: I think this is a critical question because there will be more regulation coming forward but that means that there will be a boundary between the regulated and less regulated area and this is where we have suffered a lot of our arbitrage in the past. So my proposal that I have outlined in my short document is that whatever steps we take to control the liquidity risk, which is ultimately what led to the spread of the initial crisis to this current proportion, needs to incorporate the relationship with the regulated and the unregulated parts, meaning that although we do not need to regulate all financial intermediaries—only those who can lay claim to the public support—we do need to regulate the relationship between, say, hedge funds or Special Investment Vehicles with the banks or other regulated institutions, and basically the only way to regulate to avoid systemic risk is to fully charge in a regulation sense the banks for any interaction they would have with these operators. So that upon the contingency of a crisis when all the problems come back to the regulated parts that that is fully recognised in the regulatory framework. In other words, if there is going to be any charges for creating too much liquidity mismatch, too much maturity mismatch in the balance sheet, for the banks there must also be a charge for the banks to provide lines of credit for any kind of support or external intermediary which has a high maturity mismatch. It cannot be possible to create just outside the door a structure to which the bank remains committed to support yet is not on the balance sheet. So the regulation has to inevitably deal with the boundary by taking full responsibility for the regulatory intermediaries or any commitment they make outside the boundary.

Q203 ***Baroness Kingsmill:*** Might I ask at this point is there not a risk, in these difficult times when we are focusing hugely on regulation, that some form of regulation can inhibit both innovation and entrepreneurism, especially in some of the institutions around the banking industry. Is this not something that we should be wary of? There must be some interest in innovations and encouraging of entrepreneurism—that clearly has gone too far but there is a balance to be struck, is there not?
Professor Goodhart: Certainly and I think one does have to be very careful about unintended consequences of regulation when one does introduce it, and also to try and make the regulation under normal circumstances sufficiently light that the regulatory arbitrage that my colleague Professor Perotti spoke about, quite rightly, does not become too serious. I very much hope that the kind of counter-cyclical regulation that I have in mind will become fairly ferocious in the middle of a boom when the banks are trying to expand very, very rapidly. But

under the normal circumstances it will actually be quite light.

Q204 ***Baroness Kingsmill:*** Would you need to have a triggering event to enable you to recognise that this was one?
Professor Goodhart: Absolutely and, again, one of the problems that one finds in regulation of this kind is that what one is trying to do is to take away the punchbowl when the party is getting going. I do not know whether you have ever done this at a party where the children invite all the guests and the alcohol comes out at the beginning and you say, "That is it" and you take it all away, and you are terribly unpopular. If you go back to the subprime market, the subprime market in the US was regarded as the most wonderful invention; it was providing access to housing for the disadvantaged of America and it was politically incredibly popular—the lenders loved it, the borrowers loved it and the politicians loved it. It was one of the reasons why Fanny Mae and Freddie Mac got into trouble, because the politicians pushed subprime into them. Therefore it does mean that given the unpopularity of introducing tougher regulation, just when everything seems lovely, that you have to have a system of laid down in advance rules to say that when leverage goes above some level or when rates of growth go above some level that you actually step in and do something about it. It is exactly when an institution like Northern Rock grows by about 50% per annum that you know something is wrong, and the FSA should have known by the very fact of those very fast growth rates that something was wrong there. Very fast growth is one of the great danger signs.

Q205 ***Lord Forsyth of Drumlean:*** I must say that my experience of youngsters' parties and taking away the punchbowl is that it is at that point when all the secreted bottles of vodka arrive on the scene that you did not know about! Perhaps that is a regulatory arbitrage there! Can I just take you back to this question of macro-prudential role for the bank, which I certainly agree is missing and needs to be there, but in various bits of evidence we have had and the stuff I have read, those people who argue against that say that this idea of going back to a supervisory role for the bank is misguided and that the bank would not have the necessary expertise and that there would be a huge requirement in terms of duplication, and that it would not work. Could you just say something about what you think the staffing and the resource requirements might be if the bank were to take on this kind of role?
Professor Goodhart: Let me start by saying that the costs of the current financial crisis are going to amount to ten per cent or more of GDP. Compared with the cost of this kind of crisis the resource costs and the costs of duplication are actually just minimal—it is pigeon feed.

Q206 ***Lord Forsyth of Drumlean:*** How many pigeons would it fee? What sort of size are they?
Professor Goodhart: The Bank Supervisory Department, before it was sent over to the Financial Services Authority was, I think, somewhere around 250 people. Not all of them were necessarily that highly paid. It would take a couple of hundred—less than 1000 I would have thought but several hundred—of reasonably well qualified people. Remember, there would be duplication; they would not be doing the micro-prudential, whereas when the banking supervision was done within the Bank of England they did the micro as well as the macro, and not very much macro—they were mainly doing the micro prudential work. And quite a lot of the macro work is already effectively done by the markets division within the Bank of England. Paul Tucker is the kind of person who does this kind of exercise, and knows all about it.

Q207 ***Lord Eatwell:*** I am wondering about the triggers associated with your macro-prudential rules, which seem to me to be relevant to this issue of balancing responsibility between the FSA and the bank. For example, when you were discussing leverage you seemed to suggest that as a firm's leverage rose then that would be a signal to limit the growth of the borrowing by the firm; so that would be a micro trigger, so to speak. Whereas when you were talking about growth of asset prices as in the housing market, one imagines that you look at the housing market as a whole and that is a sort of macro trigger. I was wondering in this view of macro-prudential regulation where the actual information systems which trigger the regulatory acts are located?
Professor Goodhart: You can interrelate them easily enough; in other words, you have to, I think, relate them to the individual bank, but you can make the penalties for the bank's capital requirements be a function both of what is happening overall and what is happening with the individual bank. So that if bank expansion overall is going ahead very fast, then you would be even tougher on the individual bank which was growing very fast. But if the individual bank was growing very fast when the banking system as a whole was moving ahead quite slowly you might say to yourself that that might not be cyclical and the bank has a better business plan and we do not impose such a high penalty on fast growth. So the faster the system as a whole is growing the greater the penalty of being out in front as the individual bank.

Q208 ***Lord Forsyth of Drumlean:*** Can I take you back to capital adequacy and the cyclical problem, which I know you have been drawing attention to for

many years. Can you help me a little because I do not fully understand how, if Basel II was based on the premise that it should try and create a kind of international level playing field, that would work if we had changes to the rules to allow for counter-cyclicality, given that different countries will have the economic cycle operating in a different phase.

Professor Goodhart: You have put your finger on what I think is the most difficult issue overall, and that is that in order to try and have a global financial system or a system that is common within a smaller area such as Europe, there is a desire to have a level playing field so that everyone effectively has exactly the same requirements irrespective of the location of operations. The moment you start talking about counter-cyclical operations you run into the problem that cycles are at very different stages in different countries and that, in my view, means that except where the federal system is sufficiently strong, as it may become in Europe—so that you could do this at a Euro zone level—that you actually have to go back somewhat and give more power to do this kind of counter-cyclical variation and the liquidity management to the individual nation state. In other words, it is shifting the balance from home country control to host country control, and I think this is particularly important, if I might say so, in the context of what is happening in Eastern Europe at the moment, because Eastern Europe is an area where most of the banks are foreign-owned and effectively with home country control. The Eastern European financial authorities had no ability whatsoever to prevent the flood of money coming into Eastern Europe in the course of the last few years, which brought about really quite expansionary and inflationary conditions and very large current account deficits, which now that we have a reversal are leaving Eastern Europe in a very difficult economic condition indeed. To that extent I think that the kind of approach that I advocate does actually imply that in those areas, which do not have a strong federal centre, there is a greater return to host country control.

Q209 ***Lord Forsyth of Drumlean:*** Just very quickly on this issue of pro-cyclical effect, one does get into the position with mark to market accounting where you end up arguing that you should not value market assets down at a time when people are most concerned about asset values in a crisis. How do you see mark to market accounting having contributed to the process and how it ought to be, if at all, modified?

Professor Goodhart: I am going to ask Enrico to comment on that. One of the things that I do feel in this particular context is that the liquidity risks, counter party risks and indeed almost reputational risks have meant that prices when they exist in markets for some of these more exotic or complex assets have actually fallen quite well below what you might describe as the present value of the expected future cash flows, and therefore that prices have actually fallen below what you might describe as the fundamentals—they have fallen really quite far below. That means that if you have a mark to market basis the banks, in my view, are actually putting on and having to put on their balance sheets values for many of their assets, which, as long as they could hold them to maturity, are well below their true longer term fundamental value. I think that that raises a problem when markets become so dysfunctional that the current market value, in so far as it can be ascertained at all, does not any longer represent the valuation based on expected cash flows. But Enrico will probably have a different view.

Professor Perotti: I would just add to that. I think that there are no good alternatives to mark to market but mark to market is an explosive mechanism when there are vulnerable situations. I would like to bring back something about which we are not talking about enough. The last crisis was not the result of insufficient capital, although that was part of the problem—regulatory arbitrage allowed the banks to de-capitalise, that is clear—the real problem was liquidity; it was the fact that too much of the rapid growth in many markets was driven by the fact that there was a lot of short term funding. It is very easy to grow fast without having to raise retail deposits—you can just borrow from the wholesale market; and it is very easy to borrow from the wholesale market and to let them lend to you on very short term because at that point you are bearing all the risk. So any institution can grow very fast by raising wholesale short term finance, and that is what often inflates assets prices—a very quick inflow, a very quick growth of some segment just founded by investors basically not risking anything because they are giving seven to 30 days' money to institutions that are regulated when in the end it will have to be supported. So I think it is the second dimension which is really important, which is liquidity risk. To the extent that we force an institution to have liabilities that are more aligned to their assets we stop the rapid cycle of capital withdrawals that comes in a panic, that creates the need to liquidate very quickly and that triggers rapid price re-pricing and then mark to market becomes a vicious cycle because every week, every month there is money that you have to repay; then you have to sell and you have to sell under extreme pressure and then prices go into a vortex. So the point is, if we had maturities that are more appropriate to the assets that are being held you are not going to have this acceleration of a need to liquidate very quickly because the money is being pulled back. We have to worry about the dynamic components of the capital structure; it is not just that it is ten per cent capital. But there is a second

dimension, which is when we look at the rest of the balance sheet of the banks, the debt, how much time has been committed by lenders to the balance sheet of the banks? If it is a month and the bank has long term commitments for loans or other assets that cannot be sold quickly then it is inappropriate—that is the risk. So mark to market becomes deadly when there are very quick withdrawals and withdrawals happen when the financing is too short term. Let me give you an example. There are two institutions in the Netherlands that have been affected in this crisis: the Rabobank, which is a very solid bank with a lot of retail deposits, which has had no problem; and AG which has also some retail banking but has been relying a lot on the wholesale market and AG has suffered tremendously because of the fact that the money just flew out of the window very quickly and they have been desperately trying to stop mark to market accounting—they keep saying it is disastrous. Their problem is that they have just come to rely too much on this type of uninsured wholesale funding and if they had sufficiently long term liability to fund for the long term asset they are probably right, as Professor Goodhart said, that the assets are worth more than the market would bear right now. But no one wants to carry these assets right now because everybody is selling. Why is everybody selling? Because everybody has to be paid short term liability. That is actually what has been the Achilles' heel of the system. The losses of the subprime would not have spread to the extent they have if it had not been for this very steep construction that was relying on very short term.

Q210 ***Lord Eatwell:*** Surely if you have your assets and your liabilities matched perfectly you do not make any money?
Professor Perotti: I actually disagree but it is true that you make less money. The point is that it is very easy to make money if you lend 30 years and you borrow seven days.
Chairman: Can I just draw attention to the time and ask both witnesses and Members if we can speed up because we have a fair numbers to get through.

Q211 ***Lord Griffiths of Fforestfach:*** Can I just clarify that? I take the point you make about the mismatching of assets and liabilities but surely if all banks had been required to do mark to market the banking crisis would have been that much less, but if you introduce and force mark to market in the middle of a crisis you make the crisis worse, for the reason you are suggesting. I think the fact that you make the crisis worse if you introduce it in a crisis is not an argument against mark to market accounting.
Professor Goodhart: I think that mark to market also got distorted in the boom because it meant that as prices went up you took that immediately into your profits and it expanded your capital so that it actually encouraged banks to go ahead. So it is just as much an amplifier on the upside as it is on the downside. That having been said, I now agree with my colleague, Enrico, that actually mark to market is probably the only defensible system; but since we know that it amplifies the cycle, both on the upside and the downside, it makes it all the more important that we introduce these other requirements and mechanisms which provide the countervailing, countercyclical impact.

Q212 ***Lord Griffiths of Fforestfach:*** Thank you for those answers. Why do you think that financial risk models so spectacularly failed to capture the risk inherent in off-balance sheet vehicles and what advice would you give for somebody who was trying to manage risk in a bank in dealing with the immediate past, which is fed into those models, and a more judgmental view of a more distant past?
Professor Goodhart: I think you have put it very nicely there—too many physicists who rely on short data periods and not enough historians who look back at the longer period. The longer the period you can look back over, the greater the range of possibilities. And it was simply because, as Professor Perotti said, the data set that they had and were using in the US, which went back to the 1950s, included no period in which housing prices went down. So if you rely purely on past data over what is still a relatively short time you will exclude a whole range of possibilities and that is what they did; they assumed that the data period encompassed the whole of the probability distribution of the future and of course it just was not true.
Professor Perotti: If I may add briefly that you should probably think of two different states. There are states in which there is general confidence in the markets, in which case you can assume that there will be some liquidity in the markets. These models assumed infinite liquidity—if you were to sell someone will buy. But that is not true in credit; in credit we know that sometimes it is not even initial price—people will not lend at any price. So there are circumstances—and those are the systemic event—in which the market liquidity will go. None of these models looked at this possibility—it was just not described. Everybody looked at individual plan series and correlation and they could not see that in a panic everything is correlated, but not because the assets are correlated because confidence is correlated. So again we come back to the issue of liquidity. When we have a crisis and everybody runs for cover that is not a normal situation; you cannot look at the time history, you have to avoid the spreading because the spreading of risk and the withdrawal of money is what accelerated correlation through forcing fire sales. But there are two states of the economy: 99.9%

of the time markets are there; sometimes they are not there but when they are not there they are completely not there. So we have to think of that contingency separately.

Q213 ***Lord Currie of Marylebone:*** Why did the regulators not order these risk models and point out the inadequacies? Is it because there were not historians at the FSA or what? We know that liquidity does drive them and we do know that there have been different episodes in our lifetime of this kind—it is not a 100-year event. Why did the regulators not pick that up? Secondly, if you are putting these macro-prudential requirements over the present regulatory system would you also want to reduce the emphasis on these internal risk models in the Basel II arrangements, since they have so lamentably failed?

Professor Goodhart: In answer to your second question, I think the answer to that one is yes. Everyone has to make their own judgment about their own due diligence and in a sense each bank's risk model, except in so far as it affects externalities, is for the bank themselves to judge. The bank ought to decide on its own risk model and it is not really for a group of regulators and supervisors and bureaucrats to decide which model is better; in fact they cannot. The idea that supervisors are better at model construction than people the banks can hire is just not true. Why did the regulators fail? I think everybody gets infected by fashion and the reason that people did lower their concern and their guard about liquidity was exactly as Professor Perotti said: people believed that these wholesale financial markets were splendidly efficient and would always work under the efficient market hypothesis. The efficient market hypothesis has taken something of a beating because these markets have not been efficient and have not worked, and when they are not efficient and have not worked under these circumstances you really need to ensure, as Professor Perotti said, that the degree of maturity mismatch is not excessive.

Q214 ***Lord Levene of Portsoken:*** It seems to me that in an ideal world—if we just go back to the question of regulation—the regulators would have a very easy job because the conduct of the banks would be flawless and they could just go and tick everything off. So you have the banks on the one side and you have the regulators on the other side. But there is an intermediary body, which is the board of the banks where you have the management running the thing day to day and you have the boards who are supposed to look at it on a regular basis. Do you think that the boards are effectively constituted? In other words, do the non-executive, the outside directors on the board, whatever you want to call them, have enough knowledge, exposure, experience and information to be able to try and pull up these massive problems that have occurred before they go too far, before it hits the regulators who in turn may have missed them?

Professor Goodhart: The non-executives on Enron, the board of Enron had the highest capabilities and highest qualities of almost any board I have ever seen anywhere. The problem is that the decisions are made by a small group of chief executives; they know far more about it than any non-executives can possibly do, and it is very difficult, I think, for non-executives to challenge them. I do not feel that the question of the make-up of the boards is actually the key issue; the key issue, to my mind, is what the incentives are for the chief executives rather than the composition of the boards. I think that there is a problem that the incentives for the chief executives of banks have been much too short term and there is a problem in how we make it somewhat longer term and I do not have a very good answer to that. The whole issue of remuneration is, to my mind, both difficult and it is not one where I would wish to try and put forward a proposal to this Committee because I do not have a good one.

Q215 ***Lord Levene of Portsoken:*** If we follow that argument where you say that the board of Enron was made out of the people of the highest calibre, that the executives just did their own thing and they had so much more information than the board that they effectively got on with it, if you follow that through you will say that the board serves no purpose whatsoever because the decisions were invisible to them and they did not have enough information. That was really the heart of my question. Should the non-executives be put in the position, assuming that they are people of high calibre, that they are provided with adequate information and adequate back-up to be able to challenge the decisions of the board to make sure that they are right because otherwise the board, as you have just demonstrated, is a rubber stamp.

Professor Goodhart: The problem is that to absorb and act on such information is enormously time consuming. If it is going to be enormously time consuming and you want very able people on the board you actually have to pay them a great deal more than most non-executives are paid. Then effectively what you are doing is making them into alternative executives themselves. I think that that is difficult because within a corporation—and I am not an expert in governance—I think that at any point of time it is essential that you have a particularly well defined channel of command and of hierarchy. My understanding of the board is that its main function is to decide whether the chief executive ought to be replaced.

Q216 ***Chairman:*** If I may intervene for a moment. On remuneration—you may not have an answer to it—do you believe that executive remuneration on banks should be encompassed by some form of regulation? Equally, do you believe that the government's arrangements of banks should also be within the scope of regulation?
Professor Perotti: My answer is yes and what I would like to add is that we treat banks as a private company, just like any other business. However, in some ways we have come to realise that they are really a bit more like utilities, in the sense that we cannot afford to live without electricity so we regulate the electricity market in various ways. We cannot afford to have roads not working and other things that are indispensible. That is why we bail out banks and not car manufacturers. The problem with boards is that it is difficult to do a remuneration but I think what we need to do is to move some of the control they have. In a sense they operate too independently. I do not know if we can put inside the board people that will take care of internal discipline, but we certainly need to indicate that the bankers are not as free to do so and dispose of money as they have. So regulation has to indicate that this is actually a regulated industry; that it is essential for public service and just general economy and as such a responsibility. That means that we are indeed in the position—in fact we must do something about creating the right incentive to explain some of their ability to fully use the assets that they manoeuvre completely at their discretion. So I think it goes beyond remuneration. There is no question that we cannot allow people to pay out profits on positions on which the risk is still to be resolved: that is one. But more generally I do not think we can solve it at the board level, we have to solve it one step above and that may well mean that we will take away some rights of private owners running the business because it is not an ordinary business.

Q217 ***Lord Paul:*** Credit rating agencies occupy a central position in the existing regulatory system. Is this appropriate? Can they really be independent agencies? How should the regulators substitute for credit ratings information?
Professor Perotti: I will be very brief. I think they are in a very appropriate position. Too much was left to their discretion and they had the wrong incentives, so I think there are three possibilities. One is that we exclude from future regulation completely; the second is that we nationalise them; and the third possibility is that we force them to be paid by investors instead of instead of insurers because right now they have had all the wrong incentive to be stamping credit worthy assets that were not.
Professor Goodhart: Could I just add that I would be very opposed to have nationalised credit rating agencies. Let us think of a French credit rating agency who was asked to rate Citroen or Renault or the French Government, can you imagine them giving anything less than treble A irrespective? The only way that you could have a public sector funded credit rated agency would be if it was not allowed to rate any single institution in its own country, otherwise I would not believe a word it said.

Q218 ***Lord Paul:*** How does having a different nationality not get into the same situation?
Professor Goodhart: We might. If there was a French credit rating agency that was asked to provide a credit rating for some British company it might have rather considerable enjoyment in lowering that rating. I think that nationalised credit rating agencies are almost a contradiction in terms; I think that is just a straight bad idea.
Professor Perotti: I am much more in favour of the two alternatives: one is moving from completely financial regulatory purpose or we enforce them to be paid by investors.

Q219 ***Lord Tugendhat:*** I have two questions. Going back to what you were saying earlier about the warning lights of Northern Rock for instance and how the regulators should have stepped in earlier when they saw certain developments, I am very struck by the lack of dialogue between the regulatory institutions and the general public. When you look at the record of Pöhl and Tietmeyer in Germany or Volcker and Greenspan in the States or indeed Eddie George here in their respective spheres, the way in which they carried on a dialogue with the general public and indeed with politicians was of a very educational sort and their speeches, I think, played a very important part in moulding both political and public attitudes. It seems to me quite apart from what the regulators ought to be required to do in the sense of you were talking earlier in answer to questions, that if they engaged in the degree of public dialogue that that too would be very helpful. I think the fact that Mervyn King has been virtually silent throughout this crisis is really quite extraordinary. The FSA has been a bit better in that respect and certainly since Adair got there, but I think that dialogue in terms of educating politicians and the public has a very important role to play in terms of underpinning whatever regulations there are.
Professor Goodhart: Yes, I agree and I think there should be. I am very much looking forward to the Adair Turner report on this whole subject, which I believe is due out in mid-March. There needs to be a great deal of discussion on this. Let me slightly turn it round another way. Whereas I think that the decision to set up the Financial Services Authority in

1997 was indeed defensible and may even have been correct, there was no public discussion at all in the Houses of Parliament about what the alternatives were and what else might have been done and what was the best way of structuring a regulatory system. It was just done and it was done very quickly without anything like sufficient discussion.

Q220 ***Lord Tugendhat:*** When we were talking earlier Lord Levene asked a question about directors and this is a question I have put before, but it seems to me that perhaps the cleanest way of dealing with this issue is through the auditors. As you know, it is customary for auditors to meet with the non-executive directors in a private session. My own experience of that is that they have not been very meaningful. But if the auditors were required by the regulators to ask certain questions and the non-executive director were required to sign off on those questions—and of course the questions could vary given the circumstances—that this would be a way of putting the non-executive directors in place of their responsibilities in a way that does not involve any great institutional changes. How does that seem to you?
Professor Goodhart: I think that would be a good idea. This has already been done, as I am sure you know, in New Zealand.

Q221 ***Lord Tugendhat:*** I did not in fact know.
Professor Goodhart: It is. All the directors, including the non-executive directors actually have to sign the audited reports and effectively commit to a statement that, to the best of their understanding, the internal control mechanisms are working well, with the effect that under the New Zealand law, if anything goes wrong, the non-executive directors are then themselves subject to civil suit. One of the issues raised was whether this requirement would have the effect of lowering the quality and the willingness of outsiders to serve as non-executive directors and to the best of my understanding it has not done so.
Chairman: Lord Levene, could you tackle restrictions on the universe of assets.

Q222 ***Lord Levene of Portsoken:*** Should there be restrictions on the universe of assets in which banks and other institutions with access to a government safety net can invest?
Professor Perotti: I think this is a very delicate question and I have a lot of sympathy for the view that we should not dictate what bankers do because of the pressures of innovation that need to take place in the system. However, I think this points very strongly to some non-standard security they have developed at frightening speed in the last few years and I am thinking in particular of derivatives, although other instruments as well. I think that there are two issues that spread the crises well beyond the initial losses and undermined confidence. The first was the ability of investors to pull out very quickly. But part of the things that triggered panic was the fact that people did not understand who was holding what and that is a very systemic problem because psychologically it makes it really impossible to trust anybody. So if we focus on the issue of systemic risk created by non-standard assets I do not think there is any reason why it should not be possible to standardise the securities that the regulated part of the financial system holds in a way that makes them recognisable, traceable in case and in any case it could be described. Take derivates; you can study any derivative position. I think most derivatives could be standardised along with not a very large number of parameters in a way that would make them recognisable and the reasoned argument for the fact that although non-standard security can take place outside a regulated system, I think within the regulated system there would be a strong case that the derivative position had to conform to very broad standard features that would actually encourage the fact that they might be more easily traced, cleared. Let us remember that derivatives started at some point in the 1980s and spread very quickly but then they became standardised by markets—most derivatives in the early stage were futures contract and optional contract trading and exchanges, which meant that there was a clearing house, there was a net position to control risk. Then the market took off with non-standard ways and, to be perfectly frank, I personally believe that 90% of the innovation there was pure regulatory arbitrage—there was very little merit to the complexity of security that had been created. I hold a PhD MIT and I studied a lot about derivative pricing and I will say two things. First of all, I do not see a lot of merit into most of the derivative work created. Second, I am convinced that however they are described as very complex, part of the reason they are complex is that they were exactly designed to go around regulation. If you want to there is no reason why you could not achieve most of the benefits of this type of contract in more standard forms. I also repeat that if there was a public initiative to force more standardisation it would maybe help the markets to create markets on which this security could be traded and managed more safely. But, again, I think this regulation should be restricted to the regulated part of the financial market; the part of the financial market that is not linked directly to the public support should be free to do it.

Q223 ***Lord Griffiths of Fforestfach:*** Can I ask you what can the public expect from regulation because it seems to me that the tougher you are in regulating a group of institutions or the tougher you are in the cycle in saying that if there is some sort of asset boom

we are going to put on tougher regulation, as a result of the last ten, 15, 20 years the genie is out of the bottle and we know that we are going to have institutions which grow up or markets which will grow up, which will attempt to undermine the regulation that we are doing. Therefore from society's point of view what is the potential that we can expect?
Professor Perotti: We did that; we created the Basel system which built a huge industry for regulatory arbitrage. Quite frankly, I think that 90% of securitisation is simply regulatory arbitrage; so we have done that already. We have to deal with the fact that there is a regulated part that is subject to public support and a non-regulated part and the problem is often at the boundary. So we cannot avoid that; it will always be there. What we have to do is as clear as possible in describing the relationship between the regulated and the un-regulated part, we need relatively simply rules perhaps subject to occasional review that make sure that the risk created outside the regulated system is not shifted on the regulated system. I think that should be the general principle and for that we need to have some forms of charging for maturity mismatch; we need to have a standardisation of security so that we know what the regulated part is doing and how it is relating to the boundary. Indeed, we need some part of a regulatory authority that just has a responsibility to look at this interrelationship on an annual basis and report somewhere. No one was reporting the explosive growth in derivatives—it was actually nobody's responsibility, and that can be addressed.

Chairman: We have time for one more question.

Q224 ***Baroness Kingsmill:*** I have one more question. Do you think that a regulatory system designed in the middle of a crisis is going to be a regulatory system that will work in normal times? Is it not a huge risk that we go too far and that we, as I said before, squash innovation?
Professor Goodhart: It certainly is a risk, but on the other hand the regulatory system that we have had has clearly failed and we are in the middle of a financial crisis of which the social cost to virtually every country in the world is now going to be enormous. We cannot simply sit and just maintain what we have, because what we have has been shown to be insufficient. I think that it is desirable to take time to decide on changing regulation; it is a longer term issue and it needs to be thought about carefully and I hope that no one will rush into bringing about massive great legislation on this on either the national or international level within, say, the next six months because I think it would be very unfortunate if that was done at this speed. But that we do have to consider our regulatory system because the present one has clearly failed to meet the requirements, as I think is self-evident.
Chairman: Professor Perotti and Emeritus Professor Goodhart, thank you very much indeed for spending time with us. It has been extremely helpful and thank you.

Memorandum by Enrico Perotti (University of Amsterdam) and Javier Suarez (CEMFI)

Liquidity Insurance for Systemic Crises[1]

Securitization was meant to reduce risk by spreading it, but in practice it did not. With hindsight, it was all about regulatory arbitrage. As banks placed long-term assets in boxes sustained by short term wholesale funding, but with the backup of their credit lines in case of trouble, they kept a significant amount of the whole risk, while reducing their own capital. When subprime mortgages were repriced, the card castle fell apart.

Yet the panic in money markets contributed to spread financial losses well beyond what subprime positions would have justified, precisely because of the massive refinancing risk to which the system was exposed. Short term wholesale lenders proved very prone to run. The extreme maturity mismatch was instrumental to the spreading of panic. It forced fire sales across all markets, which in turn caused margin calls and more panic in a deadly spiral (Brunnermeier, 2009).

Basel capital requirements are not designed to cope with systemic liquidity risk. In a panic, the issue is no longer the cost but the availability of funding. If funding fails, no reasonable capital reserve can cope with the generated trouble. Relying on frequent rollovers amplifies the speed of fire sales and the pace of repricing, feeding further reinforcement to panic.

What reforms can prevent this from happening again?

The leading argument proposes higher capital requirements indexed to asset growth, total leverage and maturity mismatch (Brunnermeier *et al.* 2009). We propose a related approach, a liquidity and capital insurance arrangement, which is simple, offers better incentives and is likely to receive stronger political support.

[1] Prepared for testimonial at the Select Committee on Economic Affairs for Banking Regulation and Supervision, House of Lords, 24 February 2009

Our proposal is to establish a mandatory liquidity charge, to be paid continuously during good times to a supervisor who, in exchange, will provide emergency liquidity (and perhaps capital) during systemic crisis. The charge would be set according to the principle that future regulation should work like Pigouvian taxes on pollution, discouraging bank strategies that create systemic risk for everyone. Hence, it should be increasing in the maturity mismatch between assets and liabilities, and should be levied on all institutions with access to safety net guarantees. Its purpose should be to make short and medium term (up to one year) bank funding more comparable in cost. Retail deposits would be exempted, as they are more stable thanks to their own insurance.

Revenues accruing from the charge would go into an Emergency Liquidity Insurance Fund (ELIF), with legal autonomy and pre-packaged access to central bank liquidity and government funds backing. Upon significant aggregate liquidity runs (critically, not concerning isolated runs at individual banks), the payment of insurance would be triggered by the relevant supervisor. This would result in immediate liquidity support, guarantees on uninsured wholesale funding, and some automatic capital injections. Specific conditions may be attached, such as restrictions on executive compensation and dividends, as well as on prudential strategic choices.

The main goal of liquidity charges is to realign funding incentives among beneficiaries of the safety net. Reducing reliance on short term market funding would reduce the spreading of panic in a confidence crisis, and ultimately systemic risk. Deposit withdrawal risk is natural, as banks intermediate between retail customers preference for immediacy and long term funding of production. A short term bias in wholesale funding is not equally justified. The lower cost of short term funding reflects the fact that short term lenders bear little risk, which is shifted to other stakeholders, such as capital and taxpayers. Thus the charges would make banks properly internalize the potential damage caused to others.

The charge for liquidity risk could be seen as a liquidity insurance premium: a pre-payment for the contingent support that banks eventually receive during those episodes. As such, it can make emergency intervention politically more acceptable, especially after the concern raised by current bail-outs.

Why are higher bank capital ratios alone not a solution to bank liquidity risk? First, banks' own capital would need to be very large during normal times. This has several disadvantages. Shareholders may be tempted to see bank capital as an asset to which they are fully entitled. Banks with plenty of capital on their books may try to "lever it up", not necessarily through leverage (which is constrained by capital requirements) but through riskier investment strategies. Additionally, shareholders' claims on bank capital are a source of trouble in bank interventions, since seizing a bank ahead of a formal default may be seen as a violation of private property rights.

In contrast, our insurance scheme arranges for a contingent injection of capital and liquidity in systemic crises only, and may trigger clauses which force prudential actions, such as dividend suspensions or other constraints on management. Unlike the *capital insurance* scheme by Kashyap, Rajan, and Stein (2008), it penalizes systemic risk creation and is more credible, as it relies on a public regulator. It is also cheaper since most of the support would come as provision of temporary liquidity.

A main advantage of liquidity charges is that maturity mismatch is easy to compute, and would discourage systemic risk creation associated with short term funding. Systemic risk, namely the simultaneous realization of correlated tail risk, is hard to estimate, as extreme co-movements are rarely observed, and may be triggered by a different asset class each time. However, liquidity runs are present in the escalating phase of *all* systemic crises and have a clearly negative amplifying effect.

Liquidity charges should be proportional to short term wholesale liabilities, weighted by the bank's maturity mismatch, which is easy to compute. They might be increasing in the slope of the short end of the yield curve (up to one year), so as to eliminate the incentives to excessively rely on short term maturity funding. With this feature, the charges would be naturally countercyclical, leaning against the wind when liquidity is abundant and the yield curve is positively slopped (common features of good economic times). In addition, if necessary, the proportionality factor may be designed to be explicitly countercyclical, collecting even more charges on short term borrowing in good times.

The scheme we propose avoids imposing rigid restrictions on banks' funding strategies and leaves to capital requirements the traditional task of protecting against asset risk. It is likely to make it more expensive for banks to rapidly expand their lending above their deposit base, but it will certainly not block it. A greater fraction of long term funding will go together with greater monitoring from the corresponding creditors. Residual short term creditors will be less prone to panic in a systemic crisis.

Skeptics may fear that the liquidity charges will encourage the system to shift short term funding to a shadow banking sector. This is not likely to occur if unregulated intermediaries enjoy limited recourse to regulated banks. For deals between the regulated and the unregulated sectors, the scheme should assign charges

increasing in the unregulated borrowers' own mismatch. To be sure, bank credit lines to institutions such as hedge funds might be treated as uncontingent commitments, and the mismatched asset funding should be fully charged. In any case, monitoring the boundary of the regulated sector is an indispensable step for any future regulation.

The international implementation of our liquidity insurance arrangement is certainly complex but most desirable. Ideally, an international ELIF should be created. Countries should choose to participate by requiring either all their regulated institutions, or at least the largest ones, to join an international ELIF, pay its liquidity charges, accept its supervision, and count on its support in a systemic crisis.

The establishment of an international ELIF may sort out commitment problems. Countries that do not join, should not benefit ex post. The scheme would constitute an explicit coordination device for the rescue of large international banks, preventing the issue of burden sharing to be left for difficult ex post negotiations. The liquidity charges, as insurance premia, provide a mutually agreed metric for systemic risk and would offer an objective basis for burden sharing. In case of need, countries might contribute to funding the ELIF in proportion to the share of each national banking sector in the liquidity charges paid during the pre-crisis period, rather than some politically debatable country quotas.

To conclude, the aim of the mechanism is to discourage the forms of short term funding that create and amplify propagation risk. It is also a prepayment of intervention costs, and a starting step to ensure that liquidity interventions occur on time and are based on ex ante rules.

February 2009

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Examination of Witnesses

Witnesses: Mr Doug Taylor, Personal Finance Campaign Manager, *Which?*; Professor John Armour and Dr Oren Sussman, University of Oxford, gave evidence.

In the absence of the Chairman, Lord Griffiths of Fforestfach was called to the Chair

Q225 ***Lord Griffiths of Fforestfach:*** May I welcome you to this Committee and thank you very much for coming. Can I ask you, if possible, if you would speak slowly and clearly for the benefit both of the stenographer and in introducing yourselves and so on. I would like to say the Chairman of the Committee, Lord Vallance, has unfortunately had to go because he is moving a motion in the Chamber in relation to a previous report of ours, so I have been asked to deputise and chair this session. Before we start, I wonder if there are things you would like to say to us in a brief introduction. In particular, could I suggest that of the questions which we sent to you that the questions from seven on are particularly for Mr Taylor and, therefore, it might be more appropriate if Mr Taylor were to concentrate on answering those rather than the first six questions. That does not mean that we are censuring you in any way or stopping you from giving a comment. Professor Armour?

Professor Armour: I do not have any particular observations to make by way of introduction.

Dr Sussman: No, I think that most of my points will come up in the answers to the questions.

Q226 ***Lord Griffiths of Fforestfach:*** In that case, I wonder if I can start with the first question, which is to what extent did the absence of specialised bank insolvency laws exacerbate the recent financial crisis?

Professor Armour: The question to ask initially is why we should care in particular about bank insolvency as opposed to the insolvency of ordinary industrial companies. We can make two distinctions about the situation of banks, both of which were present in the events of the last 18 months and both of which were perhaps exacerbated by the absence of a specialised bank insolvency law. The first is the speed at which a banking entity can fail and the second concerns the consequences of failure. The speed of failure is illustrated by the example of the run on Northern Rock. The existence of a highly leveraged entity from which funds can be withdrawn on demand makes it possible that if concerns about the future viability of

the entity become widely known, then a run can occur. I am taking a broad conception of what counts as insolvency for the purpose of this part of my answer. The weaknesses that were shown to exist in the deposit protection insurance, that is, its limited extent, clearly contributed to the problems with Northern Rock. Secondly, the consequences of failure. If a banking entity goes into insolvency proceedings—insolvency proceedings ordinarily are designed to exist purely for the benefit of the creditors of that entity—the problem with a bank insolvency is that there can be systemic consequences. A bank going into liquidation or administration can bring about the rapid imposition of losses on many other counterparties trading with the entity and this can cause a shockwave of systemic problems to spread through the system. For that externality to be taken into account, that is, the cost imposed on other participants in this, an insolvency law needs to have as one of its functions something beyond the protection of the creditors of this particular entity. The person running the insolvency procedure needs to subordinate in some cases the interests of that entity's creditors to the preservation of systemic stability, and such a power is not present in our insolvency law. The case where this actually happened and particularly exacerbated things, however, ironically was not an entity that is even covered by the Banking Act. Probably the clearest example of where there was a problem was the Lehman insolvency, but, Lehmans' UK subsidiary would not be a bank under the Banking Act. I understand that the application of the standard administration procedure to Lehmans' UK subsidiary brought about the very rapid termination of a number of positions in the market which caused considerable systemic difficulties. Therefore, the conclusion of my answer is that, yes, I think the absence of specialised bank insolvency procedures brought about difficulties and exacerbated the crisis along both these dimensions, the speed of failure and the consequences of failure, but the footprint of specialist insolvency regimes should not necessarily be limited to banks defined as deposit-taking institutions because that really only speaks to the first problem, the problem of the run by deposits, it does not speak to the consequence of failure and systemic consequences and that was illustrated by the Lehmans' subsidiary. I understand that proposals are afoot to use a power created by the Banking Act to introduce a specialised insolvency regime for investment companies as well which to a certain extent would deal with that, but when we are thinking about these insolvency consequences one should be clear that the footprint of the legislative response is not necessarily limited to banks.

Dr Sussman: I agree with most of the points that my colleague, John Armour, has made, but I would like to add one point. Particularly in banking, and because there is this externality, this value which never materialises through market transactions, bank insolvency by its very nature is bound to be more discretionary than other insolvencies. In a normal insolvency we have these market tests about how to deal with the default of the company, namely we separate the assets and the liabilities, we put the assets to a market test, we derive the value and then on the other side we have all the liabilities ranked by seniority and we pay them and that is the end of it. In the case of a bank, because part of the value that the bank is creating or destroying does not have a market test, a bank insolvency is bound to be more discretionary. A law of the type of the Banking Bill is a sufficient condition for the government and the regulators to exercise this discretion but it is not a guarantee that the right policy will be taken. We have seen in other countries, like Japan, great reluctance by governments simply to declare that some of the value they thought was there was not there. This is something that this law is not going to achieve on its own. I would say the law is a necessary condition for dealing more appropriately with the financial crisis. It is not a sufficient condition and we should not expect regulations or legal provisions on their own are going to solve the problems for us.

Q227 ***Lord Eatwell:*** One of the problems I always come up against in discussing insolvency is that an economist's definition of insolvency is quite different from a lawyer's definition of insolvency. An economist defines insolvency as the situation in which your liabilities are greater than your assets whereas a lawyer defines insolvency as not being able to meet your current liabilities. That is one of the problems I always have. I wonder if I can then go on and say, is it therefore appropriate that an insolvency regime should be managed by the courts who would take the legal position, or should it be managed by some other institution which might take an economic or financial definition of insolvency?

Professor Armour: Just on the point of the legal conception of insolvency, under section 123 of the Insolvency Act 1986 both of those definitions that you quoted, namely the "balance sheet" and the "liquidity" conceptions of insolvency, are alternative provisions for determining when a company is unable to pay its debts. I understand that in the banking context the liquidity conception of insolvency is not thought of as "insolvency" at all, as you said, from an economist's point of view. Whether that means that courts are inherently a worse place to deal with the oversight of insolvency matters, I am not sure that follows because the only reason that the legal conception of insolvency is thought of as more expansive than the economist's conception of insolvency is because the legislation so provides. There are other jurisdictions in which a purely

balance sheet formulation is employed in the legislation. Were the legislation not to include the liquidity conception of insolvency, then it would not be something that the courts would be permitted to take into account I think there is a more general concern here about the appropriateness of courts as opposed to regulators in dealing with bank insolvencies. The particular issue that we have identified, which distinguishes banking insolvencies from other industrial company insolvencies, is the concern about systemic externality, namely that there may be consequences far beyond the particular entity that is in the insolvency procedure. The decision-making process of the court is very much driven by the agenda that the parties before the court bring to it. So the point that is being litigated, and the evidence that is brought before the court, will necessarily skew the court's decision-making process into a bilateral framework, but a multilateral or "polycentric" framework is required to resolve these sorts of issues and a regulator would be much better placed to be able to do this.

Q228 ***Lord Eatwell:*** So for an economist Northern Rock was not insolvent because its assets exceeded its liabilities, but in terms of the legal procedures in this country it was insolvent. You were recommending a polycentric approach to insolvency if I heard you correctly, at least two.
Professor Armour: I am recommending that a regulator would be better placed to oversee the decisions about how much the systemic consequences associated with a bank insolvency should be allowed to cause a deviation from the preservation of the interests of the creditors of this entity: in essence, how much should the creditors be expected to carry the cost. I think a regulator is better placed to make that call than is a court because it has access to a wider range of information. As regards the test for insolvency, I do not think it makes any difference whether we are looking at a regulator or a court, the question is simply what it should say in the legislation: should it have both tests or should it just be a balance sheet test.

Q229 ***Lord Eatwell:*** Thank you. Dr Sussman?
Dr Sussman: I think the distinction that you raise is very important, the distinction between default, which is the act of a debtor coming and saying, "I cannot or will not service a certain liability that I have issued" and insolvency, which is essentially an accounting concept of the value of the assets falling below the value of the liabilities. There is an important question in the economic analysis of insolvency and this is whether in an ordinary insolvency, is the act of default a sufficient condition for triggering receivership, and the position of English law is that it is and of some other jurisdictions that it is not. Personally, I think that the English position is economically defensible and even economically desirable. I think it is a perfectly acceptable notion for an economist to say, "If you say that you are not going to honour a liability we are going to put you in receivership" and the question whether the value of the assets at the end is going to cover the liabilities or not is a question that will be answered by the end of the process. In the case of a bank there are good reasons to say that default is not a good enough test for whether to declare an institution a failure. This is because there is some other value which is somewhere on the balance sheet which is not reflected in the numbers provided by the accountants, or not even going to be reflected by a market test that potentially we might put the bank through. Sorting out this unobserved value is very important and it is more of an economic than a judicial decision and, therefore, I recommend that the regulators should play a very important role in the process, not because they are smarter or more accountable than the judges but just because it is more an economic question than a legal question.

Q230 ***Lord Levene of Portsoken:*** The Banking Bill allows for a "partial transfer" of failing bank assets to a new company for onward sale. The BBA has expressed concern that this type of transfer would undermine property rights and so could increase the cost of capital for banks and perhaps undermine London's position as a financial centre. Do you think these are serious concerns? Do their costs outweigh the benefits?
Dr Sussman: There are three questions there. The first is whether the shifting of the assets to another entity is a violation of the property right, second will it increase the cost of capital and, third, what will it do to London as a financial centre. I will answer these questions one after the other. In any insolvency, whether a bank or a private enterprise, the fact that the enterprise loses possession of some assets is not a violation of the property right but an implication of the property right. Under the legal system that we have we declare that if an institution defaults then it loses possession of the assets and that by itself is not a violation of the property right. I would say that there should be a limit on how much assets can be transferred to another vehicle and probably some of the next questions about where to draw the line is a good place to discuss that. I would say that in answer to the first point. The second point, will it increase the cost of capital for the banks, probably it will but to some extent this is the purpose of regulation. The very fact that we say that banks have to satisfy capital adequacy requirements, that they need to hold more capital than they would have held if they were perfectly competitive is a sort of tax that we are putting on banks in order to try and capture this

hidden value that is not subject to a market test. We do tax them and the whole purpose is to limit the extent to which we allow them to expand risky credit, that is the whole purpose of regulation of any kind, to levy a tax. I would say, yes, it probably will increase the cost of capital but if the regulation is properly designed then this is the objective of regulation. In answer to the third question, will it undermine the position of London as a financial centre, my gut feeling is that it will not because one of the things that this crisis has taught us is that banks are as powerful and strong as the state that stands behind them. Big banks with weak states behind them, like Iceland or Ireland, weak in the sense of the tax base that is available to them, are not strong enough and they will probably not be successful or will vanish after the crisis. I do not think this is a major concern. To some extent I think that we should worry about the flipside of this argument, and this is British taxpayers subsidising cheap guarantees for the financial stability of other countries. If refusing or declining to provide subsidised insurance is going to create a loss of business to London then this is a desired outcome.

Q231 ***Lord Paul:*** During bank insolvency procedures, how should the line be drawn between liabilities that are to be repaid and those that are not?
Professor Armour: I had some comments on the previous question.

Q232 ***Lord Griffiths of Fforestfach:*** Would you like to comment on the previous question?
Professor Armour: Would that be okay?

Q233 ***Lord Griffiths of Fforestfach:*** Briefly.
Professor Armour: The specific concern that the British Bankers' Association have, as I understand it, is with situations where there are set-off or netting arrangements between banks—so banks have lots of liabilities and claims against each other—and they are accounting on the basis that they will have a net position. In an insolvency, if what one does is simply to take the assets and shed the liabilities and then sell the assets, (that is, claims against other entities) then this obviously is better for the entity in question because it raises more money: one does not need to take the net position as regards assets, one can take the gross position. The partial transfer provisions on the face of it would appear to allow this and there is a provision that restricts the operation of netting provisions, so it would appear to allow for the transfer only of the gross assets. This would cause problems for counterparties who have settled their accounts on the basis of the net position. The British Bankers' Association's concern is that this will bring counterparties who are banks into problems with their regulatory capital requirements and, therefore, make them less willing to deal with English banks subject to the regime. In the first instance, I think that concern could be addressed by changing the regulatory capital requirements to take account of what is going on in bank insolvency law. The probability of this happening (ie the power being exercised) is very, very small I would imagine, so if that is taken into account in the regulatory capital requirement then that is not a problem. To that extent it should not affect the cost of capital, but where the regulator in question is foreign—where it is a bank that is a foreign bank—their regulator may not be amenable to changing their rules simply because we have changed our bank insolvency law and then there is potentially a real problem. The question is whether the benefits are worth it. What benefit would there be from transferring only the asset without subjecting it to the netting of cross-claims? It is not clear to me that would be something that would be obviously beneficial. It would probably make the "bridge bank" to which the assets are transferred more viable because it will have less liabilities and more claims, but it would also cause systemic consequences because all the bank counterparties who were expecting to be able to net off and were not able to do so would find themselves in difficulty. The costs of doing this could be quite significant after the fact, as well as the problems for cost of capital at the outset. So I think the British Bankers' Association have a point. More generally, the fact that this legislation is limited to banks as defined by the Act means that any cost of capital effect will be felt only by those entities subject to the Act and that may raise possibilities of arbitrage, that is, setting up entities which are outside the legislation in order to avoid this effect.
Lord Griffiths of Fforestfach: Perhaps I could say that as time is going on maybe I could ask my colleagues on the Committee and also those giving evidence if we can be reasonably concise otherwise we are going to be here for a long time because there are many more interesting questions.

Q234 ***Lord Paul:*** A very quick question. The bank insolvency procedures, how should the line be drawn between liabilities that are to be repaid and those that are not?
Dr Sussman: I would say that drawing the line should pretty much be done the way it is done in an ordinary insolvency, save for two or three differences between the two. One is that we do not have a market test for the assets, so we need an administrative procedure to deal with the valuation of the assets exactly because we think liquidating the assets and putting them to a market test will probably have some systemic effects that we want to see. The second difference is this externality. The externality is consistent with the extra capital that a bank has to hold as a sort of public utility, as Enrico Perotti said in the previous testimony, and this extra capital corresponds to some

social cost of a bank going bust, so this cost has to be added back into the liability side of the bank. As any liability to the state, it must be quite a senior liability. This liability should be earmarked in advance. There should be some number, just like the capital adequacy number, that corresponds to the liability to the state once a bank goes into default. Once these two adjustments are done, the rest is just like in a private insolvency more or less with two other minor modifications. First of all, the depositors are senior even if there is no legal provision that says they are senior. The other one is that there might be some junior liabilities within the bank, the liabilities that John has just spoken about, that the regulators want to honour because of reasons of financial stability. It does not mean that all the more senior liabilities automatically need to be served. It also implies that the regulators cannot read the assets of the bank as a pool of assets which is available for them to satisfy themselves, there should be a limit on how much of the assets is due to this social cost of going bankrupt, there should be a number on how much the state is going to take. If there is an extra cost of financial stability it should be funded by taxpayers' money in general, not as an unfair tax on the creditors of the bank.

Professor Armour: I would add one brief observation to that. I agree with everything that Dr Sussman has said. The consequences of putting depositors ahead of the ordinary creditors and putting the costs of any public funds which have been put into the entity in order to deal with the systemic externalities means that in ordinary times parties extending credit to a bank should take into account the possibility that they may be subordinated in an insolvency. Therefore if the bank is doing things that expose it to systemic consequences, that ought to be priced into its cost of capital. However, that will only work if parties can price reasonably accurately in advance how much the cost is likely to be, which links into the point that Dr Sussman made earlier about needing a limit to the amount which could be imposed.

Q235 ***Lord Currie of Marylebone:*** Could you explain for me the status of contractual compensation payments in administration and say whether it has any bearing upon the rather topical debate about bonus payments in government-supported banks?

Professor Armour: I assume we are talking about a payment which is to be made by virtue of a contract which was entered into before the company goes into administration: a director's service contract for example. When a company initially goes into administration the service contract would remain on foot, as entry into administration would not terminate the contract automatically. The administrator has the power to decide to remove the directors from office and if the administrator thinks that the directors are part of the problem they will exercise that power. If that happens, that will terminate the contract and the director will then be simply an unsecured creditor for the payment and they will receive the same small proportion of the face value of their claim as will the other unsecured creditors. What implications does this have for the topical debate about the payment of compensation for directors of banks that have been nationalised? The banks that are government-supported are not in administration so there is no power under the existing framework for their service contracts to be altered and the position is that the banks must stand by these service contracts. The legislation that was used to bring Northern Rock into the public sector does not contain any provision to deal with alterations to service contracts. However, looking to the future, section 20 of the Banking Act does contain a provision to alter service contracts. Even if the bank does not actually go into bank administration, but if it enters the special resolution regime, then the authorities will have the power to alter the service contracts to reduce the amount of compensation that the directors get even if they are retained by the entity going forward.

Q236 ***Lord Currie of Marylebone:*** They could take action which would mean an outcome similar to if the bank had gone into administration?

Professor Armour: Exactly, but they were not able to do so with the entities that received government support under the legislation prior to the coming into force of the Banking Act.

Dr Sussman: I think this is a very good illustration of the first point we talked about, namely if you think about a failed bank in the way I would like to think about a failed bank then the contractual obligation to a director or an employee is quite junior and, therefore, probably is not going to be honoured. However, as John has just explained, the government was very timid in terms of declaring that these banks are failing banks and as long as you do not declare failure you cannot say that some of the liabilities are not going to be honoured. It is very much the willingness of the regulators and the governments to declare failure rather than try to postpone the worst or hope that things somehow will improve. The contracts cannot be honoured but it takes the willingness of the governments and the regulators to declare a failure.

Q237 ***Lord Forsyth of Drumlean:*** When the Banking Bill left this House and went back to the Commons it had a provision included in it for the Treasury to take

control of the parent company of a bank that is part of a holding company. I wonder whether you think this provision will enhance or diminish systemic stability. I am thinking of some of the examples from the United States that have been drawn to the Committee's attention.

Professor Armour: It is very hard to say in the abstract what the effect will be, it will entirely depend on how the power is exercised. I am sorry I am not able to be more conclusive than that. This power is introduced to avoid a specific problem, which is where a particular banking entity is part of a larger group, and if this bank is then to be put into a special resolution regime it is necessary for additional commitments to be made to it from outside that entity, so when it is situated in part of the group other members of the group may be providing these commitments to it, services and the like. There is provision in the Banking Act for other members of a group to be required to make continuing commitments, so-called "continuity obligations", but the concern was that this might not be enough where the business of the banking entity is very interlinked with other members of the group. Taking control of the holding company as well would then allow the Treasury to control the way in which these other group members interact with the entity. It could avoid difficulties going forwards in resolving an insolvency situation of an entity that is linked in to other members of the group. In that sense it could help to ameliorate the systemic consequences. The countervailing problem is that by drawing some of these other entities into the resolution of the process, it is not clear to what extent parties dealing with these entities might have taken that into account, that they might be drawn in, because they might have thought, "These are not banking entities and so are not subject to the Banking Act" and that might have an adverse systemic consequence. Therefore, until one knows more about the way in which the power will be exercised then it is hard to give a conclusive response.

Dr Sussman: I agree with all the points that Professor Armour has made but I would just like to add one point. I think there is a potential here for creating lots of confusion in cross country insolvencies because in many cases the sister company will belong to another jurisdiction and that can start endless legal procedures on who has the assets and what kinds of assets should be used in order to repay some of the cost of the clean-up. I see great potential for legal haggling that will go on for years in the courts.

Lord Griffiths of Fforestfach: Thank you. We now move from insolvency law to consumer protection and the questions are being directed primarily at Mr Taylor.

Q238 ***Lord Best:*** Thank you for waiting patiently for us to get to you. A general overview, if you would. Have all the different kinds of consumers that *Which?* is interested in been well-served by Government and the various efforts it has taken over the last year? That is new borrowers of loans, mortgages, credit cards, existing borrowers and savers. How do you feel over the last year the Government has done in serving the interests of all that lot?

Mr Taylor: It is a mixed group, indeed, as you have referred to. Overall we welcome the Government actions to protect consumer deposits, stimulate lending in the mortgage sector, make repossessions a strategy of last resort for lenders and to offer support to mortgage holders via their Homeowners' Mortgage Support Scheme which comes into effect in April. I think there is a view among many consumers that the banking sector has benefited most from the decisions of the Government rather than the individual consumer and the banks have been bailed out, so to speak, bonuses have been paid, but trust is really quite low in the banking sector. Global research undertaken shows that UK consumers trust banks less than Icelandic consumers despite the near collapse of the Icelandic banking system. Our own research found that 84% of people thought the banking system needed to be reformed to avoid another crisis and only 28% trusted their banks to get them the best return on their money. From our research there is clearly a fairly low level of trust in the banking sector. We believe that what is central is that on important public bodies, and I am referring perhaps specifically to UKFI and the FSA, there ought to be explicit consumer representation to ensure that the consumer interest is used in interrogating decisions by those bodies. In terms of what the Government has done so far, I think there are some good things, but for consumer trust and confidence in the sector we would like to see a clearer representation of the consumer interest at the highest level.

Q239 ***Baroness Kingsmill:*** What is *Which?'s* stance in relation to regulation? Do you feel that the deregulation of the financial sector, for example the demutualisation of building societies and so on, has been in the best interests of consumers? Do you have any views about whether more legislation in this area is going to be of assistance to the consumer? I put alongside that, do you have any sense that there has been any mis-selling or any questionable sales practices which require legislation?

Mr Taylor: Unfortunately our research, and I think it is backed up by some of the work done by the Financial Services Authority, suggests there is often levels of mis-selling in financial services and most recently perhaps payment protection insurance has been the most obvious which has had fairly high levels of coverage and, indeed, the Competition

Commission has taken some action specifically on that. In terms of demutualisation, of course, all the demutualised societies have disappeared either collapsing, being bought or being nationalised, so they have not survived very long from their creation. If you said that deregulation does bring a greater level of products, more choice, reduced prices, that may well have been the case. For us, the issue is how you can cap the risk curve going forward. The extent to which we can get effective regulation and supervision to permit the consumer to get the best from the market whilst safeguarding them against some of the downside risk is the trick that we would like to see come out of the reviews of the banking sector in the light of the current crisis. In terms of where you started, we think that regulation and supervision should be effective, and we are not always convinced that it has been effective in terms of consumer protection, and where that is the case we make our views well-known to the Financial Services Authority. Indeed, it is part of the reason why in my previous answer we would like to see more effective consumer representation at the heart of that decision-making.

Q240 ***Baroness Kingsmill:*** The other side of mis-selling, of course, is consumer ignorance about financial products. It has seemed to me from past experience that the level of financial education is very poor and consumers often are not as aware of their rights and so on. Would you accept this is the case in the financial services sector particularly?
Mr Taylor: I think you could make the case that the financial competence of some of the directors on the banks has also been fairly low in recent times. The reality is absolutely as you say. The FSA's baseline study on financial capability paints a pretty poor picture. For example, 40% of people with an equity ISA did not realise that its value moves with the change in stocks and shares, but 16% of people with a cash ISA thought that their cash ISA did move with the change in stocks and shares. As an illustration of the level of financial capability, I think that is quite telling.

Q241 ***Baroness Kingsmill:*** In another life I came across a substantial piece of research which suggested that there were a number of people who did not realise that mortgages had to be repaid.
Mr Taylor: I have not seen that particular one.

Q242 ***Baroness Kingsmill:*** As long as they kept up their payments each month they did not recognise that the mortgage itself was a debt that ultimately had to be repaid.
Mr Taylor: While we support financial education we have to take the view that it is a fairly long-term effort and changes in the curriculum may bring about some results in the longer term. We very much supported the idea of a national finance advice network and, indeed, the FSA, through what it calls money guidance, is taking this up in order to give some fairly low level non-brand specific advice to consumers about product. The other side of this, of course, is if the products are safer, more transparent and easier to understand then the level of capability that the consumer needs in the first place becomes less.

Q243 ***Lord Currie of Marylebone:*** I wonder whether I can follow up on this question of financial understanding. I seem to remember a survey relatively recently which suggested that 25% of the British population does not understand percentages, so a mathematical lack of knowledge. If you do not understand percentages it is very hard to understand even the simplest financial product.
Mr Taylor: The previous one, which was attributed to Klaus Moser, said that 50% did not understand what 50% meant, so maybe the world has moved in the right direction. You are absolutely right, given that most financial products are represented in percentage terms, APRs for example, if a consumer cannot understand the basic mathematical formula then they are going to find it quite difficult to make any judgment. Indeed, throughout financial services products it is quite difficult for consumers to be able to relate risk and reward together and often they become bemused by the offerings that they have. Obviously under the FSA's regime advisors are meant to assist in this process but that does not always happen as well as we would like.

Q244 ***Lord Forsyth of Drumlean:*** I was just going to ask a slightly provocative question following on from this point about mis-selling and so on. The charge is sometimes made that the FSA was so overtly concerned with (consumer) issues that it took its eye off the ball on the big issues, so whilst explaining that Northern Rock should have acres of explanations attached to its products, which many people would not read and even less understand, it missed the fact that its business model was going to lead to a disaster. How do you respond to that kind of accusation?
Mr Taylor: I do not think it should be an either/or. It is quite clear that if the FSA fails in its prudential responsibilities then the consumer suffers as they have done in recent times. It should be possible to create a regulatory environment where appropriate prudential regulation takes place and appropriate consumer protection takes place. Briefly, in terms of the reams of paper, there is a strong argument that the information provided to consumers needs to be streamlined and more effective for the consumer to understand so we, for instance, were very supportive

of the summary box idea on credit card statements so that the key issues, the key features, can be easily understood by a consumer because I suspect very few people will read all of the terms and conditions they receive attached to a product. Obviously there is an argument they ought to but the reality, as we all know, is that is not what happens.

Q245 ***Lord Paul:*** How do consumers exercise sufficient due diligence in selecting where to deposit any money or any investment vehicle? He has no way of monitoring due diligence, except going by faith that the Government is watching or what they read in the papers and those are hardly financial papers. What suggestion do you have for him?
Mr Taylor: I think it is enormously difficult to suggest that an individual consumer can carry out due diligence. If I were to go tomorrow to open a current account with a major high street bank, I doubt that they would be able to answer all the questions that I might need to ask to assure myself that they were absolutely solvent. The point is that we invest in the Financial Services Authority, the Government, the boards, the rating agencies, a proxy and they carry out that due diligence on our behalf as consumers. I do not see that it is really going to be possible to change that, we will never have access to the data that is required. Indeed, if the FSA was unable to control the operations of the banking sector to exercise that due diligence it is hard to see how an individual consumer could have exercised that due diligence.

Q246 ***Lord Paul:*** The credit agencies have a vested interest because they are being paid by the financial institutions.
Mr Taylor: Yes, indeed.

Q247 ***Lord Currie of Marylebone:*** What do you make of the proposition that the authorities' response to this financial crisis has been to essentially help imprudent consumers and disadvantage those who have been prudent?
Mr Taylor: This is often played out in the issue of the balance between borrowers and savers and the impact. In the long run I think it will be overstretched consumers who will suffer most. The issue of credit card prices rising and the change in more risk-based pricing means those consumers with greater levels of debts will find themselves paying more. If you are a mortgage holder with certainly less than 25% of the equity, so you have got a high loan to value, you will have worse deals. In reality, those aspects are not seen in the way that this is playing out. To stimulate the economy clearly there has been a decision to lower the base rate and the knock-on impact of that has been a reduction in the interest paid on savings. We encourage consumers to shop around, there are still deals there with a falling retail price inflation which can be helpful to them and it is still possible to do that. We would like to see better enforcement on ISA transfers that can take time and consumers can get a better deal there. We need to look at this in a balanced way going forward. What seems to be happening at the moment is the banks are using the reduction in the base rate to increase their margins and although interest rates or mortgages are falling there is still a large spread between what that is and what the banks are paying for the cost of that compared with the situation, let us say, 12 months ago. At the end of the day we believe that when this resolves itself there will be a reassertion of the savings culture and we need to move to a situation of a new equilibrium on credit and move away from the level of indebtedness we have got now. I think that will take a little bit of time and what we would not want to see is an overnight transformation from feast to famine, so to speak. We are talking about perhaps a readjustment in the way that the British population looks at debt and savings.
Lord Griffiths of Fforestfach: I am afraid that we have run out of time in this session, but on behalf of the Committee I would like to thank Mr Taylor, Professor Armour and Dr Sussman very much for coming to us and enlightening us in the way that you have. Thank you.

Supplementary memorandum by Dr Oren Sussman

1. This note discusses the treatment of failed banks: both the legal framework for dealing with failed banks, and the public policy that should be implemented within that framework. The basic idea is that, in a crisis situation, the state should be allowed, even encouraged, to take control of failed banks, and explicitly to default on some of their liabilities. In this respect, the policy suggested in this document is closer to receivership than to nationalization. At the same time, this note identifies important differences between banks and "ordinary" commercial enterprises. Some modifications of "ordinary" receivership are therefore required.

2. In contrast to ordinary business enterprises, some of the value that banks generate or destroy by their actions is captured by agencies that do not deal directly with them. As a result, one cannot assume that the bank and its counterparties will select terms of trade that fully capture the potential value that the banks could generate. In this respect, banks are similar to public utilities. Indeed, this "externality" provides the main justification for bank regulations that are designed to decrease the likelihood of bank failure.

3. This observation has two main practical implications.

— When a bank fails, some of the cost is born by parties other than lenders and borrowers. Hence, "bankruptcy costs" are never fully materialized in market transactions.

— In order to moderate the costs of bank default, regulators should try to avoid putting the bank's assets through the market test (namely liquidation) that is the essence of an ordinary receivership.

4. It follows that regulators should use an administrative measure in order to "mimic" some of the value that cannot be materialized in market transactions. Nevertheless, once that value is accounted for, there is no reason why a failed bank should not be treated like any other enterprise.

5. It is important to recognize that the above externality is already implicit in capital-adequacy regulations. It is because of that implicit cost that banks are required to hold capital over and above that which an unregulated bank would hold. In theory, exactly the same effect could be achieved by taxing bank failure. Such a tax would decrease the value available to the creditors in case of default, would increase the cost of debt, and would incentivize the bank to substitute some debt finance with equity. However, after the tax has been imposed and banks have responded to it, a receivership-like procedure should be used to allocate the losses amongst the bank's creditors.

6. I do not discuss here the merits, in general, of receivership as a policy for dealing with failed non-banks enterprises. It is fair to say that there is no universal consensus regarding this matter. Yet there seems to be a growing awareness of its value, both in scholarship and in legal practice, even in jurisdictions, like the U.S.A, that are not historically sympathetic to receivership. It is also noteworthy that, when it comes to banks, the U.S. approach is closer to receivership than to the lenient Chapter 11 that is used in non-bank insolvencies. Indeed, the FDIC is modelled as a receiver, which is intended to take over control of failed banks, stabilize them and then auction them off back to the market.

7. The following table lays out some differences between insolvency procedures for standard commercial enterprises and banks in the light of the above analysis.

Commercial enterprise	*Bank*
The test of failure is simply default.	The test of failure cannot be default, due to the systemic panic that this may cause. Instead, failure is identified using an administrative procedure that takes into account the hidden social cost of failure.
Following default, receiver takes control.	Exactly the same should happen in the case of a bank. The owners and managers that failed the test should be deemed unfit to govern and thus would be removed.
Assets and liabilities are separated. Assets go through a market test and liabilities are paid according to absolute priority.	Putting the assets through a market test, ie liquidating them, would have an adverse systemic effect. Hence, assets need to be evaluated by an administrative procedure. Also, the externality should be added to the bank's balance sheet as an additional liability. But, these two modifications apart, insolvency should proceed as in any other receivership. In particular, equity and some junior liabilities should be cancelled so as bring the bank back to viability.
No compensation for assets that are "under water".	For reasons of financial stability, some junior liabilities, such as overnight inter-bank debt, have to be honoured. That is a matter of public policy and does not imply that more senior liabilities need to be honoured as well. *However*: since these junior liabilities are honoured for the common good, the cost of honouring them should fall on the tax-payer, and not on the more senior liabilities.
At least in English law, no issue of super-priority finance arises, since the assets are anyway separated from the liability.	In case tax-payer money is injected, and in case some non-deposit liabilities still exist, there is a good reason for making tax-payer debt senior to the non-deposit liabilities.

8. There are four reasons why a policy of cancelling liabilities should be rigorously pursued, particularly in times of financial crisis.

— To establish incentives for prudence in banking. If equity and junior debt are not cancelled in failure, then risky policies will pay in good times, do as well as prudent policies in bad times, and thus dominate prudent policies on balance.

— It is clear that market valuations have been too optimistic; the value of our assets—essentially the discounted value of the future services that they are expected to yield—has been unrealistically high. To recover from the crisis, valuations need to be adjusted downwards. In an economy as highly levered as ours, slashing equity prices may not be enough: some debt needs to be written off as well. Recovery will be accelerated if this adjustment is achieved sooner, rather than later. At the same time, one needs to recognize that excessive concentration of the write-downs in certain sectors, industries or companies is undesirable. Hence, as discussed above, there is a need to support some valuations for the sake of financial stability. Yet an unlimited extension of the safety net cannot be regarded as a recovery measure.

— The more liabilities that are cancelled, the lower is the burden on national debt. The national debt needs to be carefully monitored, since it will otherwise slow down recovery for years to come.

— Throwing all the cost of the recovery on tax payers is bound to be perceived as unfair. Hence, debt and equity write-offs will make the government's recovery measures more acceptable politically.

More specific questions raised by the committee

9. Q: *to what extent did the absence of specialised bank insolvency laws exacerbate the recent financial crisis?*

A: a good insolvency law is a necessary condition for softening the blow of financial crisis; it is not a sufficient condition. By its very nature (due to absent market tests) such law leaves much room for discretion. Had the law been there, it would have enabled action along the lines described in paragraph 8 above.

However, by itself, the law does not guarantee that the right action is taken. Indeed, the natural tendency of governments appears to be to over-extend the safety net, as for example in Japan, rather, than to accelerate the adjustment of banks' financial liabilities.

10. Q: *should bank insolvency procedures be administered by the courts, or by some other institution?*

A: Given the large discretionary component, a purely legal procedure cannot work. Regulators and government must be involved. Yet, as when a receiver is appointed out of court, injured parties should be given access to legal remedies.

11. Q: *the Banking Bill allows for a "partial transfer" of failing bank assets to a new company for onward sale. The British Bankers' Association has expressed concern this type of transfer would undermine property rights.*

A: That failed businesses lose possession of assets is an implication of property rights, not an abuse of them. At the same time, the creditors should not be liable for the cost of systemic failure over and above the externality discussed in paragraph 5 above; see also paragraph 14 below. If systemic failure were to cost the government more than it can collect from the banks, these extra costs should be paid by tax-payers at large, who also benefit from the stabilization of the economy, rather than by bank creditors alone.

Over-taxing bank creditors to pay for the cost of financial crisis would be arbitrary and unfair. In this philosophical sense, unfair taxation may be thought of as a violation of a property right.

12. Q: *Could the measures discussed in the previous questions increase the cost of capital for banks?*

A: A rigorous insolvency procedure would probably increase banks' cost of capital. In some sense, this is the purpose of the policy: capital adequacy requirements can be viewed as taxes levied on the banking system so as to avoid excessive expansion of risky credit, based on an artificial perception that capital has a low cost, which ignores the systemic cost of credit.

13. Q: *Could these measures also undermine London's position as a financial centre?*

A: This is probably not the case. The crisis has demonstrated that banks are as strong as the State that stands behind them (see Iceland and Ireland). To some extent, policy should worry about the opposite effect: how to prevent the situation where British tax payers subsidize financial stability and credit guarantees for other economies.

14. Q: *During bank insolvency procedures, how should the line be drawn between liabilities that are to be repaid, and those that are not?*

A: Conceptually, the line is drawn as in ordinary insolvency: assets are value and liabilities are paid according to seniority. There are, however, a few adjustments that need to be made in the case of a bank:

- Assets are valued by an administrative procedure, such as discounted cash flow, rather than an auction. This is because the application of a market test (ie, of liquidation) would have an adverse systemic effect.
- The externality in the cost of failure should be added as an extra liability on bank balance sheets. Like any liability to the State (ie, any tax) this one would be quite senior, and thus would affect the recovery rate to the more junior creditors.
- Retail depositors should be treated as senior, even though standard legal documentation to that effect may not exist.

15. Q: *What is the status of contractual compensation payments in administration? Is there any bearing upon recent discussions of bonus payments in government-supported banks?*

A: Contractual compensations are typically of low priority, generally even lower than equity. Hence, in case of failure they should be the first to be written down.

16. Q: *When it was returned to the Commons, the Banking Bill incorporated a provision for the Treasury to take control of the parent company of a bank that is part of a holding company. Will this provision serve to enhance or to diminish systemic stability?*

A: Limited liability implies that a receiver should not use the assets of a company to pay its subsidiary's debt, unless the debt is explicitly secured on the assets of the sister company. There are perfectly legitimate business reasons for using such cross subsidiary security arrangements (to increase borrowing capacity), and for avoiding them (to limit the spread of failure within a group of companies). Banks are somewhat different in that their senior creditors—the depositors—have no explicit liquidation rights even on assets of their own bank, let alone on the assets of a sister company. Regulators have little choice but to make up the rules as they go along.

At the same time it might be desirable to allow conglomerates to contract in advance either to limit security or to use it.

Particularly in the context of banking groups that operate across several jurisdictions and regulatory regimes, one needs to be exceptionally cautious in applying automatically the rule that a company is liable for debt of its sister company. Such assumption may encourage regulators to assume that banks are regulated by the authorities where the parent or the sister company operates, which may be unrealistic.

24 February 2009

TUESDAY 3 MARCH 2009

Present	Best, L	MacGregor of Pulham Market, L
	Currie of Marylebone, L	Paul, L
	Eatwell, L	Tugendhat, L
	Forsyth of Drumlean, L	Vallance of Tummel, V (Chairman)
	Kingsmill, B	

Memorandum by Moody's Investors Services

1. Moody's Investors Service ("MIS") appreciates the opportunity to provide this memorandum to the Select Committee. Following a brief introduction to MIS, the memorandum will explain the limited but important role of credit rating agencies. The memorandum will then comment on two particular issues relating to questions 9 and 14 of the December call for evidence namely the way forward for complex financial instruments particularly in relation to structured finance securities and the use of ratings in banking regulation.

Introduction to MIS

2. MIS is the oldest bond rating agency in the world, having introduced ratings in 1909. Today, we are one of the world's most widely utilised sources for credit ratings, research and credit risk analysis. Our ratings and analysis track debt covering more than 100 sovereign nations, 12,000 corporate issuers and 96,000 structured finance obligations. We maintain offices in most of the world's major financial centres and employ approximately 3,000 people worldwide, including more than 1,000 analysts. Additional information about the company is available at www.moodys.com.

The Role of Credit Rating Agencies

3. Rating agencies occupy an important but narrow niche in the information industry. Our role is to disseminate opinions about the relative creditworthiness of, among other things, bonds issued by corporations, banks and governmental entities, as well as pools of assets collected in securitised or "structured finance" obligations. By making these opinions broadly and publicly available, rating agencies help to level the playing field between borrowers (debt issuers) and lenders (debt investors). Specifically, rating agencies serve the market by reducing information asymmetry between borrowers and lenders. We sift through the vast amount of available information, analyse the relative credit risks associated with debt securities and/or debt issuers and provide our analysis to the investing public for free.

4. MIS ratings provide predictive opinions on one characteristic of an entity—its likelihood to repay debt in a timely manner. Our ratings of corporate issuers (including financial institutions) are based primarily on analysis of financial statements, as well as assessments of management strategies, industry positions and other relevant information. Our ratings of structured finance bonds[1] are based primarily on analysis of the transaction's legal structure, the cash flows associated with the assets on which the deal is based and other risks that may affect the bonds' cash flows. Our analysis necessarily depends on the quality, completeness and veracity of information available to us, whether such information is disclosed publicly or provided confidentially to MIS's analysts.

5. The heart of our service is expressing opinions on the relative credit risk of long-term, fixed-income debt instruments, expressed on a 21-category rating scale, ranging from Aaa to C.[2] In the most basic sense, all bonds perform in a binary manner: they either pay on time, or they default. If the future could be known, we would need only two ratings for bonds: "*Default*" or "*Won't Default*". Because the future cannot be known, credit analysis necessarily resides in the realm of opinion. Therefore, rather than being simple "default/won't default" statements, our ratings are opinions about the risk of outcomes in the future with degrees of uncertainty.

[1] In using the term "bonds", the memorandum is referring to bonds and other types of debt instruments that are rated by MIS.
[2] MIS also assigns short-term ratings—primarily to issuers of commercial paper—on a different rating scale that ranks obligations Prime-1, Prime-2, Prime-3 or Not Prime.

6. Moreover, our opinions are about the relative credit risk of one MIS-rated bond versus other MIS-rated bonds. In other words, MIS's ratings provide a perspective on the relative rank ordering of credit risk, with the likelihood of loss increasing with each downward step on the rating scale. The lowest expected loss is at the Aaa level, with higher expected losses at the Aa level, yet higher expected losses at the single-A level, and so on.

7. The predictive value of MIS's ratings is demonstrated in our annual default studies and periodic ratings performance reports, which we post on our website, www.moodys.com. These default studies show that both our corporate and our structured finance ratings have been reliable predictors of default over many years and across many economic cycles.

Is better testing and regulation needed of new financial products, especially complex securities? (question 9)

8. MIS agrees that there should be better testing and regulation of complex products. For our part, MIS has taken a number of significant steps to reinforce its procedures when deciding whether or not a rating on a new financial product is possible.

9. In particular, MIS has taken additional steps to segregate its Credit Policy function, while significantly expanding its resources and responsibilities. The fundamental objective behind reinforcing the independence of the Credit Policy function is to ensure that decisions taken on methodological or performance related issues are independent of any non-credit business objective.

10. In addition, this unit has been given additional responsibilities to conduct feasibility reviews for new products. The review process is undertaken by one or more senior managers in the Credit Policy function with appropriate experience to review the feasibility of providing a credit rating for any new type of structure that is materially different from structures that we have previously rated.

11. MIS is also taking significant steps to enhance our model verification and validation processes. Conducted by the Credit Policy function, the process reviews the key assumptions and overall conceptual framework of our structured finance models.

12. However, we believe that one of the areas that needs more concentrated and concerted attention is the availability and quality of underlying information for structured securities.

13. Similar to the analysis of other types of securities, analysing structured securities is a data intensive process. The information needed to evaluate and monitor structured transactions is granular, often relating to the individual assets[3] in the structured pool and the legal features of the structure. Importantly, detailed and high quality data are essential inputs to the analytical methodologies, qualitative judgments and quantitative models that project cash flows from the assets and allocate those projected flows to the various tranches in the structured financing. Irrespective of the rigour of the methodological approach or the model used in the analysis, if the underlying data used is of inadequate quality or stale, the resulting analysis could in turn be similarly susceptible.

14. Prospectus and ongoing disclosure rules do not require the dissemination of sufficient information about the structure or underlying assets of a securitisation to afford ongoing reliable analysis based on publicly available sources. Consequently, unlike the corporate market, where investors and rating agencies can each develop informed opinions based on publicly available information, in the structured finance market rating agencies and investors currently have the same dilemma: both lack sufficient public information about structured securities to form opinions. As a result, issuers choose to whom they provide information, which exacerbates issuers' ability to opinion shop.

15. In our view, the disclosure regime for structured instruments must be updated and enhanced. Sufficient information about transaction structures and underlying asset pools should be provided by issuers and originators to the investing public so that they can make better-informed investment decisions.

16. There are three reasons why public disclosure would be helpful:

a. first, giving *investors* access to more detailed information allows them to conduct their own analysis and develop their own independent views about securitised products. That, in turn, raises their ability to assess the work of the rating agencies and to provide a market-based quality control check.

[3] The assets are the source of payment to the securities issued by the SPV and it is therefore necessary to have credible and reliable information about the assets' characteristics. For example, in analysing a mortgage-backed security, the following types of information may be useful for each loan in the structured pool: amount of the mortgage; location of the property; ratio of the loan amount to value of the property; ratio of the loan payment to the income of the borrower; and whether the property was the borrower's home or whether it was an investment. Examples of the type of information required on an ongoing basis to monitor a mortgage-backed security include performance measures such as loan delinquencies, foreclosures and losses.

b. *Second*, requiring enhanced information in prospectus disclosures intended for investors, and making such disclosure subject to securities laws, likely will improve the information quality about structures and assets.

c. And, *third*, by making sufficient information available to investors, then it is necessarily also available to all rating agencies, regardless of whether they are selected to rate a transaction or not. As a result, all rating agencies are able to offer their views, which could broaden the range of information and dialogue available in the market.

Should banking regulations address the role of credit ratings? (question 14)

17. We believe that there are two broad categories of ratings use, with the users potentially having different objectives. The first is market use, where market participants can use ratings produced by any rating agency as they deem appropriate. Examples of market use include: issuers who use ratings because many investors demand that they do so to access the capital markets; institutional investors who use ratings in their portfolio composition and governance guidelines; and counterparties to financial contracts who use ratings as triggers to monitor borrower behaviour.

18. The second category of ratings use is regulatory use, which is an outsourcing to rating agencies of certain functions traditionally performed by regulators. The bank regulators' External Credit Assessment Institution (ECAI) designation is an example of this form of usage. Regulatory authorities have used ratings to set safety and soundness standards for numerous industries, including banking, insurance and securities, in order to limit risks and promote efficiency in the financial markets. MIS has consistently discouraged such use.

19. There is an impression among some market commentators that regulatory use of ratings caused the development and/or success of the rating agency industry. This impression, however, misconstrues the history of the use of ratings in regulation. Regulatory use occurred because rating agencies already were providing a well-known and valuable product to market participants.

20. The appropriation of credit ratings for prudential and other standards is understandable from a public policy standpoint. Credit ratings (as provided by the major internation agencies) have several attributes which make them useful to various market participants: rating symbols are easy-to-use, easily accessible opinions that are independent and relatively stable. In addition, ratings have demonstrated predictive ability to distinguish relative creditworthiness among securities and issuers. Finally, ratings provided by the major rating agencies are published for the equal and non-discriminatory use of all market participants, not just a select group of subscribers.

21. As discussed in more detail below, however, by using credit ratings as a regulatory tool, policymakers can induce market participants, rating agencies and regulators to change their behaviour.

Impact on Regulated Entities' Behaviour

22. Regulatory use of ratings encourages regulated entities to treat ratings from recognised rating agencies as interchangeable for regulatory purposes. Ratings, therefore, tend to become commoditised, which can affect the traditional incentives for these regulated entities to differentiate, or "shop", among rating agencies based on the ratings' credibility. In other words, the incentive for entities to conduct their own credit analysis and use ratings as just one of several inputs in their decision-making process is weakened if the regulatory framework permits them to use an officially recognised rating without ongoing consideration of whether the rating conveys the information they need and is of sufficient quality.

Impact on Issuers' Behaviour

23. The regulatory use of ratings introduces a new attribute into the rating agency industry that market participants find valuable: official recognition. In other words, everything else being equal, if an issuer can choose between an officially recognised rating agency and a non-recognised rating agency, it may choose a recognised rating agency because of the extra advantage it derives from getting a rating that can be used for regulatory purposes. This does not mean that, in practice, issuers always choose among rating agencies simply because of the "recognised" status. There may be a range of other considerations, including the perceived credibility of a particular agency's ratings in the market, which will influence the choice of rating agency.

Impact on Rating Agency Behaviour

24 Since use of ratings in regulation encourages an environment where the ratings from all officially recognised rating agencies tend to be perceived as interchangeable, the incentives for these agencies to compete on the basis of ratings quality and performance are diluted. This is because regulatory use of ratings introduces a second attribute along which rating agencies may compete to attract business (either under the issuer-pays model or the subscription-based model). Moreover, because credibility with investors is supported by official recognition of certain rating agencies, officially recognised agencies are in a position to compete for business from issuers (and/or subscribers) on the basis of attributes other than credibility, eg, by offering higher (or lower) ratings than their competitors, slowing (or increasing) the pace of rating actions, and/or demanding less information in the rating process.

Impact on Regulators' Behaviour

25 The use of ratings-based criteria in regulation may inadvertently lead to substantive regulation of recognised rating agencies' opinions, methodologies or rating processes[4]. Because of the use of ratings in regulation is in essence an outsourcing of portions of regulatory oversight to a private sector participant, regulators may adopt requirements that put pressure on rating agencies to homogenise their methodologies and/or performance metrics to meet the regulator's objectives, rather than broader market-based objectives. For example, bank regulators may seek to slow the pace of rating movements in times of stress, while the market may want more timely views. This is contradictory to the purpose of credit ratings, which is not to provide a common view of future credit risk, or to meet the demands of any one entity in the market. The role of ratings and rating agencies is to provide independent, objective and possibly divergent opinions about future credit risk.

26. In addition, regulators may come to place undue reliance upon credit ratings. Ratings will not necessarily speak to the risks of concern to regulators (eg liquidity risk of banks). Nor should ratings be seen as a substitute for mandatory public disclosure of information. Such moves in the information space can be seen in structured finance markets and can unintentionally miscast rating agencies as creators and enforcers of disclosure requirements thereby increasing, rather than reducing, market participants' over-reliance on credit ratings and rating agencies.

Regulatory Use of Ratings and Market Forces

27. Of course, introducing a new use for ratings does not necessarily exclude other existing uses. Ratings continue to be sought for other reasons. For example, ratings-based criteria may be incorporated into investment and portfolio guidelines[5]. Accordingly, the incentives for issuers to seek ratings that are credible with investors and for rating agencies to meet high performance standards have continued to operate and exert market discipline on the industry. If, however, these dynamics change, the incentive effects generated by the regulatory use of ratings may have a greater impact on the behaviour of investors, issuers and rating agencies.

28. MIS has historically supported the wholesale abandonment of the use of ratings in prudential and securities regulation. However, it is possible that implementing a reduction in the regulatory use of ratings now may inadvertently lead to negative consequences in an already fragile market. Therefore, we recognise that any policy decision to reduce the use of ratings in regulation must analyse carefully the potential, direct and indirect consequences of removing particular references to ratings. Ultimately, however, ratings are simply one tool that is available to market participants and regulators. We do not believe, and never have recommended, that they should be used as anything but an opinion about credit risk.

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[4] See, eg, the European Commission's Consultation Document: Proposal for a Regulatory Framework for CRAs (12 August 2008).

[5] We understand that ratings-based criteria in privately established investment guidelines typically are intended to serve as just one of several essential criteria that portfolio managers are expected to consider in making investment decisions on their clients' behalf. Moreover, we understand that these guidelines typically refer to rating agencies by name, which suggests that the individuals responsible for setting the guidelines considered qualitative and other substantive differences in various ratings when determining which agency's ratings were appropriate for use in the guidelines. Because this type of use of ratings-based criteria involves the thoughtful consideration of whether a particular agency's ratings are suited for the purpose intended in the guidelines and involves a consideration of qualitative factors, we are less concerned that the private sector's use of ratings in investment and portfolio guidelines will distort market participants' or rating agency behaviour.

Examination of Witnesses

Witnesses: Mr Robert Reoch, Director, New College Capital Ltd; Mr Paul Taylor, Fitch; Mr Frédéric Drevon, Moody's Investors Service; and Mr Ian Bell, Standard & Poor's, examined.

Q248 ***Chairman:*** Good afternoon, gentlemen. Welcome to the Economic Affairs Committee. Thank you for finding the time to be with us this afternoon to give evidence on our inquiry into banking supervision and regulation, and thanks specifically to Moody's for the written submission that you provided for us. That was very useful. This is the fifth evidence session of this inquiry and Members have already declared their relevant interests in previous hearings. If you could speak reasonably slowly and clearly, that would be very helpful for the benefit of both of the stenographer and Members. Perhaps you could introduce yourselves when first you speak, especially for the benefit of the web broadcast. Feel free to answer each question but do not feel the necessity to do more than nod if you agree with one of your colleagues who has already expressed the opinion, because we have quite a few questions to ask and if we could keep the pace up, that would be helpful. Do any of you want to make any introductory remarks? If not, then we will move straight to the questions and I will start off. Historically, investors have relied substantially on the assessments of the rating agencies to help them make investment decisions. Do you think your ratings of structured finance products in particular have led to a loss of investors' trust in the agencies' assessments and what would be the implications of such a loss of trust?
Mr Drevon: Frédéric Drevon. I am the Head of Moody's for Europe. Yes, there has been a loss of trust from investors. It is concerning because it affects the good performance of the structured finance markets. The structured finance markets are important for the financing of the economy in the wider sense. It affects the availability of mortgage loans, consumer loans, loans to small and medium-size companies, so we believe it is important that we take steps in order to bring back confidence to investors but also certain steps may be taken by third parties. In terms of the steps Moody's is taking, we are looking at reinforcing how we analyse credit risk. So we have a credit policy function we have put in place. We have looked again at how we should analyse the more macro-economic trends which may impact the credit quality of structured finance but a number of other things may be done by third parties, including the quality of data which is made available to investors.

Q249 ***Chairman:*** So the impact of the loss of trust is that investors are less confident about investing?
Mr Drevon: Yes. It affects certainly the spread levels in the market but certainly that certain segments of the markets have closed down for many, many months and it is quite difficult to see when these markets will reopen for normal activity.[1]

Q250 ***Chairman:*** I see three other nods of assent.
Mr Taylor: Paul Taylor, Fitch. I look after our global structured finance ratings. I certainly agree with what was just said in terms of loss of trust, loss of confidence. I think a couple of points are important to point out. One is that I am very happy you have focused on structured finance ratings. We have many other aspects of what we do which are working fine, albeit under some stress at the moment. I think also there is much more going on than just ratings having not performed as they should have done in certain markets. It becomes very difficult to start disentangling some of the effects where ratings have not performed versus some of the other factors going on in the markets at the moment.

Q251 ***Chairman:*** We are not here to apportion blame. Do not worry about that.
Mr Reoch: I would like to raise two points as a practitioner. So many of the investing community have mandates that limit them to what they can invest in, and those mandates are normally linked to ratings, so they will have a bucket allocated to triple-A securities, to double-A and so on. If they cannot fill those buckets, then they cannot fulfil their mandate. The second point is that right now the banking sector is ill-equipped to take on board the numerous assets that are currently held outside of the banking sector, so if those non-banking institutions are not investing and the banks currently are impotent to take on the assets they were investing in, a whole section of the financial markets has effectively ground to a halt, which ultimately will hurt people wanting to buy a house, use their credit card or buy a car.

Q252 ***Lord Forsyth of Drumlean:*** May I just pick up on that point? I am wondering, if someone working for one of the credit agencies at a reasonably senior level had formed the view that the products which were being rated were inherently unsafe, in other words, if they had had the foresight which one or two people had in the market, I am wondering whether they would actually be able to change the behaviour of the credit rating agencies given that so much revenue was associated with rating these products and for an individual or a group of individuals within one organisation to stand up and say, "Hang on a second, I think something may be going very badly wrong here," how would that process actually work? It seems to me that, in a situation where everyone was

[1] Mr Drevon refers in his reply to the affects of a general loss of confidence in the markets.

making lots of money and believing that values would continue to rise, and believing in the products, to actually call a halt and say "There is something wrong here" would be very difficult. Is that wrong or am I just being cynical?

Mr Bell: I think it is important to understand how ratings are created and how ratings are ascribed, particularly in structured finance, which is that all ratings are ascribed by committees of analysts. Ratings are not mandated by the business management of the company. Criteria are also created by analytical teams rather than by people who are involved in the actual generation of cash. I should have introduced myself. I am Ian Bell. I run structured finance in Europe for S&P. As the business leader for that group, I have absolutely no rights whatsoever to either dictate criteria or to overrule or dictate or mandate any rating in structured finance. Similarly, just to pick up on one of the points that has been made about assumptions that values would always go up, in structured finance at high rating levels we have never—and I think it is the same for the other agencies—assumed that values would go up. We have always assumed that actually values would decline in our rating scenarios. Admittedly, we did not assume they would decline quite as much as they did.

Q253 ***Lord Forsyth of Drumlean:*** Yes, I understand the point about the arm's length but the fact is that these committees of analysts got it very badly wrong and my question was, if someone in, say, Standard & Poor's or some other rating agency took the view that we were in the middle of a bubble and things were getting dangerously out of control and the methodology was wrong, how would they actually call a halt, given that so much revenue and so much of the income of the rating agencies depended upon them, and given the structure that you have just described?

Mr Bell: We have a criteria function, so somebody who would have been concerned would have raised this issue with our criteria structure, which is not part of or embedded in the business structure and is not run by business people. They would have raised it all the way to the Chief Criteria Officer, who has the power to change the criteria and say, "We won't be able to rate any more on this criterion because we think it is over-optimistic." That is how it would have happened. That is a function that is not susceptible to override by the business people or by the business management.

Mr Reoch: If I could raise two points, I cannot put a specific date on this but when the securitisation of commercial mortgages first started some years ago, as I recall, either Moody's or Standard & Poor's came out with a methodology that was noticeably more conservative than the other two, and stuck to their guns and, as I recall, lost out on being a favoured rating agency in that sector, so in the commercial mortgage-backed sector, certainly in its early years, only two of the three rating agencies dominated. The third stuck to more conservative ratings. Because their ratings were lower, they were not selected to rate so many and obviously there were revenue implications to that. So I think the industry has shown it has the capacity to make a decision which is in apparent disagreement to its two main competitors and stick to it. The second point I would like to make is that during the boom we have all witnessed, from the practitioner's point of view, there is an element of speed necessary in investing process because, in days long forgotten, there was surplus cash with performance targets to be met, and I think the rating was a necessary tool. The practitioners would see the ratings, see the return was adequate and would invest. It was not really for the agencies at that point to question them. They were doing their job and I think the investing community was in a big rush to invest all their funds, which they had plenty of, and meet return criteria which they had to meet on an annual basis. So there may have been a pushing noise from the banks but there was also a very strong pulling from the investors to get money invested and move on to the next transaction.

Q254 ***Lord MacGregor of Pulham Market:*** I just think this is a very crucial area, so I would like to probe you further, and only on the role of the rating agencies, not the investors and the banks. In your very helpful and interesting paper from Moody's you said these default studies that you were doing "show that both our corporate and our structured finance ratings have been reliable predictors of default over many years and across many economic cycles." I am sure you may have seen the commentary piece in the *FT* yesterday and I just quote one paragraph: "The record is gruesome. By one industry estimate, 60% of structured issues were rated triple A against 1% of corporates. Many of these are now bust . . . " and so it goes on. Why did you get it so wrong?

Mr Drevon: Historically, again, if you look at the performance of structured finance, in fact, it outperformed corporate ratings or bank ratings for many, many years. In fact, what we were hearing back from the marketplace was "Your ratings are in fact too conservative." That was a recurring theme on the structured finance side. The origin certainly of numerous downgrades that we have seen in structured finance really came down to the sub-prime-related areas that we have seen in the US market. The sub-prime problems affected a huge number of transactions directly or via credit derivatives transactions, and with respect to the sub-prime area, we certainly alerted the market and modified our methodologies going back to 2003 but

we were not in a position to really completely anticipate the magnitude of the problems. So there is an element of seeing the problems coming, adjusting our views about it but the magnitude was beyond what we had expected.

Mr Bell: I think also the reality is that the majority of structured finance products are not bust. The actual number of defaults in highly rated structured finance products is in tiny proportions in the entire universe and very high proportions in the US sub-prime, where everybody acknowledges something went awry. But the statement that the majority of structured finance products are bust is not true. The percentage over the last 30 years is that something like 1% of triple-As have ever defaulted, and even that is a high estimate. As to the comment about 60% versus 1%, I think that misunderstands the dynamics of both the corporate market and the structured finance market. The reason was not that we were 60 times less conservative with structured finance than we were with corporates. There was a time when most corporates that accessed the bond market were triple-A. Corporates chose no longer to be triple-A because they felt there were better returns for shareholders lower down the rating scale. That is a corporate decision. I do not question it. So the reason why so few corporates are triple-A is not because we were more conservative but because corporate themselves have chosen to play in a single-A or double-A space; they feel that provides the best return on their capital. The reason 60% of structured finance products are triple-A is because they are structured products. So you can structure the product to reach whatever level of rating you wish it to reach. You provide more and more protection in order for it to reach the level of triple-A. Because they were structured, they were structured as triple-As. It is a choice of the issuers that they wanted to structure triple-As. They could have structured triple-As, they could have structured single-As, double-As or double-Bs. So it is not a conservative level.

Q255 ***Lord MacGregor of Pulham Market:*** I must say, these sound to me more like excuses than explanations. Can I ask you one further question then? In a number of your paragraphs in Moody's paper you refer to the underlying data being of inadequate quality or stale, so that the resulting analysis could in turn be susceptible. You make a number of points about the lack of sufficient information, and I thought in footnote 3, where you are talking about the sub-prime, you asked a lot of questions about the actual loans, detail about the loans, and I wonder: did you actually get the information that you are suggesting would have been required in that? In other words, it does seem that it was not transparent, there was a lot of inadequate data, and you made false ratings on the basis of the fact that you could not get the real information.

Mr Drevon: I think there are a number of different topics in this. First, the availability of information. There may be a difference between what is being made available to a rating agency as opposed to what is being made available to investors. That is certainly a first issue in terms of the disclosure standards in the market and the transparency of the market. We typically would obtain additional information than the market was obtaining as a whole. With respect to sub-prime, we did in fact obtain very detailed information. For each loan we would typically obtain 50 different fields, pieces of information. That is quite significant. The track record in fact went back in time for a number of years. The problem with data—and it is not just sub-prime related data—is that it is not necessarily the quantity of the data or the depth or the duration of that data that matters. It is more the quality and how relevant that data is to your analysis. If there is significant fraud, our analysis is not going to be reliable and not going to be based on useful data for us to perform our ratings activity. Similarly, if data is not disclosed according to the high standards, as we see more on the corporate side, it does create an additional element of uncertainty. We incorporate that into our analysis and we address these issues for our ratings methodologies but there is certainly, I think, scope for improvement in terms of the data standards not only being made available for Moody's but for the market as a whole.

Q256 ***Lord Eatwell:*** Mr Drevon, when you finished your first opening statement, you started talking about the future and you said "we are reassessing our procedures". Now of course, up until now you have essentially rated credit risk. You have not rated liquidity risk, macro risk, any of those dimension risks. It has been uni-dimensional. You are now talking about a multi-dimensional aspect of rating. I do not see how that would work. You have five or six or 10 different lines. If it is triple-A here, it is minus 72 here, it is plus five here, I do not see how that is going to work. Moreover, you are going to have to take account of the correlations and the impact on correlations of different forms of risk. That is where Mr Bell's story falls apart because he told us, "Oh, yes, we can actually structure all the protection you like but that depends on you knowing what the correlations are and the correlations not changing under pressure of, for example, liquidity issues. If they do, your rating falls apart and all your protection falls apart. So it is a question really to both of you in the sense that I do not understand how you are going to have multi-dimensional rating. Your nice uni-dimensional rating was great. You were just rating credit risk, and everybody thought that meant liquidity risk, macro risk, and so on and so forth but

it only meant credit risk. Once you put in everything else, your credit risk numbers become questionable, do they not?

Mr Drevon: Our ratings address credit risk. There is no doubt about that. We have no intention of changing that. It is a one-dimensional system. It is a fairly simple approach going from triple A to C. It is not a pass or fail system. It is about probabilities of default. We intend to maintain that system but we can incorporate in the quality of our ratings further dimensions which influence credit quality, and macro-related risk will influence financial risk across many different types of categories. That is something we can incorporate within our existing rating scale. There are additional elements which may be of interest to investors. Those could relate to how volatile a rating potentially could be. That is an interesting element. We in fact intend to publish a separate, additional measure which will address specifically that point in addition to our ratings. Investors may be interested in understanding the potential for liquidity of an instrument. That is something we do not have expertise in. We do not believe it is possible. It is almost a digital answer. Yes, there is liquidity or there is none any more. So we will stay away from that but to the extent that there are measures which are of interest to investors and relate to our core expertise around credit, we intend to provide that information to the marketplace.

Q257 ***Lord MacGregor of Pulham Market:*** We have had a number of criticisms about the fact that issuers pay for their own ratings and there were some queries raised about the conflict of interest. Are you satisfied that the current system under which issuers do pay for their own ratings is sustainable?

Mr Bell: There is undoubtedly a potential conflict of interest with an issuer-pays rating. We have been aware of that, the market has been aware of that, and what we have done, in our view, is we have managed that conflict. In terms of the sustainability of the model, the big issues, we personally as an agency have no attachment to that model. We do not believe it is the only model which we can operate and we do not believe it is the only way in which a rating can be created. However, if you look at the alternative models, they run into difficulties that usually are worse than managing the conflict with the issuer-pays model. The classic example is the investor-pays model. First of all, that has a conflict too because investors also have interests and their interests may be almost invariably mirror images of the interests of the issuer but that creates a conflict of interest with the investors and what they want. Also, the investor-pays model suffers from a free rider problem, which is that if the investors pay, why would they pay for something that is public? The way in which the investor model works is by simply giving to the investors who pay knowledge of the rating and its underlying analysis, and that takes a huge amount of transparency out of the market. It creates effectively an insider dealing when some players know what the rating is and others do not, unless they pay for it. As you look at the various models, you very quickly come across difficulties that are difficult to overcome and are usually worse than managing the issuer-pays model. We are not particularly attached to the issuer-pays model. If somebody can come up with a better model, we will happily endorse it.

Q258 ***Lord MacGregor of Pulham Market:*** Do you not think it would be in your interests to come up with a better model? At the moment the only safeguard for you is reputational risk, and reputation is not good at the moment. Is it not in your interests to find an alternative?

Mr Bell: It is absolutely in our interests, and we have been trying but we are not coming up with anything and so far nobody else seems to have come up with anything either.

Mr Taylor: The challenge we have is if you focus too much on the process of ratings, so the meltdown, the failures in the ratings themselves, it has not really been the process, I do not think. It is the analytics. We missed on some of the assumptions we should have been applying. To put things into context, if you take sub-prime, which we were just talking about, the average triple-A credit enhancement for a US sub-prime deal is about 25–30%. We wanted credit enhancement of something below those senior notes of 25–30%. If you compare that to, say, a prime mortgage transaction, so the best borrowers, the average numbers were something like three or four per cent. Obviously, the problems were in the deals with 25–30% cover. The reality in those deals is they are starting to show performance of something like a 40–50% default level, which is unprecedented. So we had assumed that they were bad, they were bad loans, we expected to see much more defaults and losses, but our assumptions were not high enough. You can apply that in most areas where the ratings have fallen down. So it is the analytics themselves that we have had to focus on and improve, I think, more so than this idea of issuer-pays conflicts with our process, which is an easy one to talk about because it is obvious there is a conflict, and we do not deny that at all. It is about how you manage that conflict. To answer an earlier question directly, one of the most important things we have done, I think, within structured finance at Fitch is to put more people into the process so that we can stop the process. We can look at the trends, look at the macro analysis and say, "Something is not quite right here. There are too many deals getting done, house prices are inflating", a control function that is away from the people in the line doing the transactions as they come in and

dealing with the external parties. That is the analytical process, not the governance process.

Q259 ***Lord Best:*** My question is about securitisations. To what extent has the market for structured finance products been inspired by attempts to avoid capital regulation rather than by risk-sharing? If risk-sharing is the motive, is it ever actually achieved by securitisation? Has that worked?
Mr Bell: I think some people would argue it has worked too well, by spreading the risk across the globe. I think to some extent it is a false dichotomy. The fundamental premise of structured finance is that it allows two things to happen. It allows investors, be they pension funds, insurance companies, large money market funds, around the world to invest directly and to lend directly to people they could not possibly have lent to directly before, be they mortgage borrowers in the UK, credit card users in Germany, small and medium-sized companies in Europe. If you are a Japanese pension fund, structured finance allows you to lend directly to these people even though you have no presence in the country. The other side of that equation is that it allows financial institutions that do have branch networks, who have relationships, who have name presence, to make use of the distribution channels and generate these loans without having to put capital against them, to the extent that the loans are really made by the Japanese pension fund, so that it is not one or the other. It is risk-sharing because it allows investors around the world to lend, which has historically—and there is academic research tied to this statement—led to much lower borrowing costs for consumers, for medium-size companies, for small companies, and it allows the banks to make use of their distribution network without making use of their capital because they have genuinely shifted the risk. I think, in that sense, securitisation did work. As I said, some people would argue it worked too well, hence the fact that German Landesbanks are taking losses because borrowers are not paying in Nevada on their sub-prime mortgage. They did share the risk.
Mr Reoch: I think the important phrase here is risk-sharing, because in the early days of securitisation the originators were banks—sometimes corporates but mainly banks—who wanted to manage their balance sheets either because they had a capital problem and they genuinely wanted to reduce their risk to liberate capital, or they had a leverage problem; the balance sheet was too big, too much debt, and it was cheaper to sell assets than to raise new capital. Crucially, in that early stage of securitisation, the assets that were put into a non-bank vehicle and sold to investors, the risk was shared because the banks maintained some or all of the first loss piece of the vehicle that was sold, so they still had the correct alignment of interest, they still would monitor the borrowers as they would have done if the loans or other assets remained on balance sheet. The tipping point was when the market grew at a faster rate than banks wanted to manage their balance sheets, and indeed, the investment banks, who did not have balance sheets to manage, wanted to get a piece of the securitisation action. The so-called arbitrage securitisation market started where any bank would set up a vehicle, source the assets from anywhere, not necessarily their own balance sheet, with the sole motivation of making money. There was no desire to manage risk on balance sheet, manage capital, managed leverage. It was merely a process of buying assets cheaply, putting them in a vehicle and selling them effectively at a higher price than they bought them. Crucially, the older balance sheet securitisation or balance sheet CDO, as they used to be called, was not necessarily a lucrative transaction in its own right because it benefited the bank in so many ways, ultimately reducing the bank's cost of capital, reducing its leverage, perhaps increasing its credit rating. There were a myriad of reasons. So the tipping point, which was possibly around the year 2000 or 2001, was when the demand for securitised product exceeded the supply and we had the birth of the so-called arbitrage business, where the motivation was not risk-sharing.

Q260 ***Lord Currie of Marylebone:*** Can I move on to the role of ratings in regulation? Arguably, ratings play at least two roles. One is certification of quality and the other is indicating compliance with regulation. You could argue those two roles are possibly in conflict. In view of the answer to Lord Eatwell's question, that actually you are measuring only one specific component of risk whereas there are multiple risks that regulation should be dealing with, do you think the hard-wiring of ratings into financial regulation was a mistake that contributed to some of our difficulties now?
Mr Reoch: Actually, no, I do not. The hard-wiring came in with Basel II and Basel II has not yet been implemented by the US banks and was only implemented by European and Asian banks over the last couple of years. Prior to that, the ratings environment did not play a part in the calculation of regulatory capital. It might have done in the use of internal capital models but the pure regulatory capital which was visible was not a function of credit ratings. I think it might have done, and indeed, there is evidence that some use of securitisation very late on in the process was motivated by capital but I think the damage was done long before Basel II came in. I think you have raised a very important separate issue, which is that by hard-coding ratings into the process, you have created a very pro-cyclical capital structure, where during the good times the rating agencies will upgrade companies, resulting in banks holding less capital, and of course, right now just the

reverse is happening, so the banks are having to set aside more capital to meet their capital requirements just at a time when, of course, capital is starved, so you have a very pro-cyclical arrangement, which is, of course, discussed elsewhere and is an area of much academic debate but I do not think that that hard-coding contributed significantly to the crisis we are discussing right now.

Q261 ***Lord Currie of Marylebone:*** But you would say that it would be undesirable for the future of financial regulation to have that hard-wiring?
Mr Reoch: There is clearly a desire to link capital to risk and, for less sophisticated banks, a credit rating is a very easy measure of the individual risks. So there is some merit in linking capital to risk.

Q262 ***Lord Currie of Marylebone:*** It is easy but, in the light of what was said in response to Lord Eatwell, it is only one aspect of risk. Financial regulation has to be concerned with much broader risk.
Mr Reoch: I agree, so rather than saying I think that credit ratings should not be hard-coded, perhaps we should be saying there should be additional measures, for example, allocating capital on the basis of a mismatch between funding, where long-term assets are funded with short-term liabilities, perhaps on some measure of available liquidity, dependent on money market funds versus longer-term borrowing. I would suggest that additional measures are needed rather than tackling the rating issue.

Q263 ***Chairman:*** Just before we go on, in Moody's written submission you showed a little uncertainty about the use of ratings for regulatory purposes. Is that correct?
Mr Drevon: We have consistently argued against reliance on ratings in the regulatory framework, and we have done that for many, many years. Our concern has always been that it had the potential to modify the behaviour of a number of different market participants. Their focus was not necessarily on understanding the rating, understanding the methodology, but looking at the rating which is the most favourable for the regulatory requirement at that point in time. It creates a potential for changes in behaviour from the regulatory point of view. They may be interested in greater control over the opinion. They may desire forbearance in ratings. It does not create incentives for rating agencies to provide better quality ratings because there is a commoditisation of the rating product. So we have consistently argued against that reliance. We have, however, indicated in the note that we provided that, should there be a change in the regulatory framework, it has to be done in a managed and controlled way as we are in a very difficult environment and it would not be desirable to add further volatility or uncertainty to the financial markets.

Q264 ***Lord Forsyth of Drumlean:*** I wonder if I could just explore with you, and perhaps you could explain in layman's terms, the role that your models played in all of this. At the risk of boring colleagues, if I can give you an analogy, I bought a new car and it had a satellite navigation system in it which had had rave reviews. We set off in it, and my wife said, "It's going the wrong way" and I believed in it. It was only after we passed the village for the second time that I realised there was a problem and when we looked into it, we found it was set as if we were in Holland and not in the UK. I wonder to what extent your models were actually set for a different planet to the one that we were on. To put it perhaps more precisely, we have had some evidence, for example, from Professor Goodhart, who argued that an over-reliance on post-war data caused agencies to assume that the US would never see a simultaneous drop in house prices in all states, and there are other examples. I just wonder, were these models that you were using and, of course, which others were using as well, just set in the wrong way because you had not taken sufficient account of historical data over a sufficiently long period. That is what I was getting at when I asked my first question: were people just assuming like my children, who assume that every year things get better because they have never known anything else, whereas my grandparents have a very different view of the world. Were your models too influenced by our children's view of the world rather than a greater historical perspective?
Mr Bell: I think there is a number of different strands to this question. Often people say the issue is your models. Trying to put it in layman's terms, there are three components here: the model, the input of the model and the output. The model is the kind of set of algorithms which modifies the input, adds the number, subtracts, divides to produce the output. The issue that you allude to about historical data is really in the input side. It is what are the assumptions that you make about how bad things can get at certain levels of probability rather than about the mechanics of the model itself. There are some issues with models, and we have had issues with models raised during this crisis, but what we are looking at where certainly US sub-prime things went very clearly awry is in the inputs. It is in the assumptions of how bad things were going to get. There, oddly enough, it was not because we were not relying sufficiently on historical data; it is because we relied actually quite strongly on historical data. We have historical data going back to the Twenties, for example, in US real estate, and it is that historical data that led us to the conclusion that the likelihood of a recession that would engulf all the United States,

with no real regional differentiation, was not impossible—of course it was possible. The triple A is not a guarantee that the bond will perform. It is simply a statement that, in our opinion, it is unlikely not to perform, very unlikely not to perform. It is that historical data that told us that the likelihood of an across-the-board real estate recession in all the states with no regional differentiation was extremely unlikely. So it was not that we did not rely enough on historical data. We relied quite a lot on historical data but one of the facts about our business, which is ultimately predicting the future or having views about the future, is that sometimes things turn out unprecedented, and what we saw in this crisis in a number of different areas is unprecedented change which the historical data did not bear out.

Q265 ***Lord Forsyth of Drumlean:*** Would common sense not have told you that, with such an unprecedented boom going on in housing, it could not go on for ever?
Mr Taylor: Hindsight is a wonderful thing, of course.

Q266 ***Lord Forsyth of Drumlean:*** It was not just hindsight. Lots of people were warning about this for a very considerable period of time.
Mr Taylor: Yes, they were. In fact, we put a paper out in 2005 saying exactly that. We tightened our criteria. We moved our enhancement levels up. We did not move them up anywhere near far enough. There are many, many people now who seem to have spotted what was going to happen; if you actually go back and look at the facts, and probably the best example is the BIS, they were not talking about the magnitude of what was going to happen; they were talking about direction. So lots of people talked about direction; no-one really got where it was going to get to. Maybe there were one or two people out there, and good for them, but certainly the majority of people, even when they talked about bubbles and direction and things building up, just missed the magnitude.

Q267 ***Lord Forsyth of Drumlean:*** Let me give you an example, which is perhaps a little unfair, which our advisers have given us. It is a conversation that took place in 2007 between Robert Rodriguez, the CEO of First Pacific, and Fitch, during which Fitch told Rodriguez that a two per cent fall in the US residential property market would be sufficient to cause losses to holders of the triple-A tranches in mortgage-backed bonds.
Mr Taylor: I am very surprised by that statement.

Q268 ***Lord Forsyth of Drumlean:*** So am I!
Mr Taylor: I cannot believe that is correct. Just in terms of the analytics, it does not work like that. It does not work that way. We build in house price falls in our assumptions. It is way in excess of two per cent.
Mr Reoch: It might have caused a valuation change, which, if you chose to liquidate your position on that day, would be a realised loss, but if they had held the position to maturity, that statistic is unlikely to result in a realised loss.
Mr Bell: I think it is true of all three agencies, and I would endorse entirely what my colleague has said. We assumed at triple-A levels very substantial losses, and particularly in the sub-prime area even more substantial losses because they tend to be cheaper houses. All our assumptions, all our models assumed ever more severe house price declines, including very substantial house price declines in triple-A. What happened in sub-prime—and we can talk about if you wish. It is a very peculiar situation—is house price declines were greater than the ones we assumed, but we did assume house price declines, and I am sure the other agencies did as well.
Mr Taylor: Putting it into context, the number I gave earlier about how we had 25–30% credit enhancement on average on sub-prime mortgage-backed bonds in the US at triple-A. In very simple terms, that is assuming half of your loans default and you lose half your money on those loans, to put it into perspective.

Q269 ***Lord Tugendhat:*** Can I ask you a different sort of question, before coming back to these other matters? What arrangements did each of you have for avoiding special relationships between people from the banks and the other institutions you were rating and your own people? What rules did you have and do you have about the acceptance of corporate hospitality and recording of it? To what extent do you monitor the movement of people in and out of your institutions with the people you rate? Perhaps each of you could be kind enough to answer that, please.
Mr Drevon: With respect to your last point, we have what we call a "look-back" approach for our analysts, leading to an entity which they have been involved in the rating of; we would go back and look at the ratings they have assigned and reassess whether there are any issues with those ratings, and generally, we have a number of compliance-related matters that involve how we interact with our issuers, and the most significant are that our analysts are not involved in the commercial side of any decision. They are kept separate from those matters. They have obviously very severe, restrictive rules around the trading of securities, certainly with any related issuer or in the wider context. Those are the normal compliance rules you would expect to see to try to establish best practices in terms of interacting with the issuers that we rate.

Q270 ***Lord Tugendhat:*** What about the acceptance and recording of corporate hospitality?

Mr Drevon: We have typical rules—I do not have the exact amount but we would have to limit the amount that any employee would receive as a gift. It would normally be a very small amount. Rating agencies have not been typically in an environment where we have been lavishly received by issuers or banks or customers. That has not been the relationship over the years, in fact. In many respects, it has been a much more conflictual type of relationship, where issuers always wanted our ratings to be higher and were unhappy with the results, and certainly we had to manage that relationship following our best practices internally.

Q271 ***Lord Tugendhat:*** What about Fitch?
Mr Taylor: The SEC have actually just passed a new regulation. We are regulated, of course. I think $25 is the limit on accepting gifts from outside parties. So there is a hard number there which has recently been introduced.

Q272 ***Lord Tugendhat:*** Recently?
Mr Taylor: It is being introduced or has just been introduced. The SEC are going through a number of reviews of the agencies. That is one of the requirements that have been introduced.

Q273 ***Lord Tugendhat:*** In the past did you have a limit?
Mr Taylor: We had internal policies. I am not sure they specify the exact amounts but they were very similar to Moody's and, I am sure, S&P. We had a pretty clear code of conduct and compliance issues internally. I would also stress that we have each been looked at by the SEC. We are regulated in the US under the Credit Rating Agency Reform Act of 2006. Apart from a few very well publicised emails that came out of that process—and there were millions of emails that were looked at—actually, certainly from Fitch's point of view, we actually had a mostly clean bill of health. They looked at our internal procedures and processes. I think they had eight individual items. We had a private letter from the SEC and there were eight individual things, which largely revolved around record-keeping and how we track our data. Nothing fundamental.

Q274 ***Lord Tugendhat:*** If somebody was offered an outing to the opera in Milan, for instance, as distinct from London, would that have been recorded?
Mr Taylor: The person in Milan should have been in compliance—

Q275 ***Lord Tugendhat:*** No, I mean a person in London is offered an outing to the opera in Milan as distinct from the opera here.
Mr Taylor: Of course, it applies globally, yes. The policy applies to individuals globally, of course, yes.

Q276 ***Lord Tugendhat:*** So it would have been recorded?
Mr Bell: In the case of S&P it would have been prohibited.

Q277 ***Lord Tugendhat:*** It does not sound as if it would have been prohibited with Fitch.
Mr Taylor: We would not have recorded it because it would not have happened is the way it should be. I cannot guarantee that everyone has been 100% compliant for ever in the firm but we have never uncovered anything. We have an internal audit function. We have not uncovered any of those serious breaches of compliance.

Q278 ***Lord Tugendhat:*** Coming to a specific thing, many people were very confused by the ratings in some of the structured products, and in particular the constant proportion debt obligations being rated triple-A when they paid a return of two per cent over Libor when the corresponding spread for most triple-A corporate bonds was 0.2%. I think this was a Moody's issue and I wondered if you could explain the background to that.
Mr Drevon: Sure. If you look at the spreads of triple-A instruments and not specifically only CPDO instruments, in fact there is a great variety of spreads over the relevant index. In fact, if you go back in time, not so long ago very mainstream securitisations were in fact offering spread similar to two per cent. What would typically explain a spread which would be deemed quite high would be lack of liquidity, complexity of the instrument, or investors or other parties not necessarily agreeing with the rating output. Those are typically the three options or combinations of that. So it was not necessarily something unusual and something that you would see typically for fairly new and innovative products in the marketplace.

Q279 ***Lord Paul:*** For quite a long time now, six months, anything you read, etc, has not come up with any solution as to what went wrong. Everybody knows that there has been a great crisis, everybody thought bankers were very respectable and conservative, they thought the rating agencies were very conservative—what went wrong and who is responsible for it? Can you throw some light on your various parts?
Mr Reoch: I think it is a myriad of issues which would take way beyond the time we have available but, clearly, the role of securitised products, and indeed credit derivatives generally, cannot be ignored. What it contributed to was a combination of increased

leverage in the system, allowing a relatively small amount of capital to be put up to take on a correspondingly large amount of risk. It also, crucially, facilitated the ownership of assets to be less complex. Let me clarify that. The majority of assets that people want to invest in are either in the wrong place, sitting on a bank's balance sheet and therefore unavailable to funds, or they are difficult to own legally or from an accounting or tax point of view. Securitisation opened up, basically, banks' balance sheets to the non-bank world in a very efficient way. Whilst that for a while assisted the management of banks, it ultimately meant that a large number of institutions were taking on risks that they possibly were not qualified to know about. The question, for example, on AIG has dwelt on why they were using credit derivatives where perhaps the question should have been what they were doing investing in sub-prime real estate. So much of what we are talking about today is a vehicle which enables risk to be moved from the place where it was originated, where arguably probably people do know about it, to virtually anyone anywhere in the world. The question is, do we focus on the vehicle or do we focus on the application and usage of the vehicle? Unfortunately, to date the majority of criticism has been on the vehicle without questioning the motives of the people who utilised it in an increasingly efficient and ultimately dangerous way.

Q280 ***Lord Paul:*** We have been trying to put our responsibility on the vehicle instead of the fact that it is almost about straightforward dishonesty and the credit rating agencies have been certifying without putting enough insight into it. People have depended on the credit agencies far more than they were used to depending upon the accountants.

Mr Reoch: If I may intervene for a minute, you could draw an analogy with the automotive industry. Car companies make cars and people certify they are fit for the road. How people drive them is ultimately what causes accidents. If the certification is wrong, and the bearings are faulty or the brakes are inadequate, yes, you blame the agency that certified it wrongly. Clearly, some fault is due there is also some responsibility with the driver.

Lord Paul: Yes, but I do not think that analogy really fits, because at least the car agencies and the driver are able to come to a conclusion whether the driver was wrong or the car was wrong. Here we do not know who is wrong yet, except that the poor client has suffered.

Q281 ***Lord Eatwell:*** I would like to stick on the vehicle for a moment and turn to the debate about regulatory changes which might affect the credit derivatives market. There has been a lot of criticism of the opacity, opaqueness, whatever the right word is, of securitisations, and credit derivatives in particular, suggesting that actually the people who bought them did not know. In other words, you were not getting into a car that you knew how to drive; you were getting into a vehicle you did not know how to drive because you did not know what it was but you were buying it anyhow because somebody told you it was a safe vehicle. Along with that, there has been the issue, the idea, that opaqueness is increased by the lack of clearing activities, and one of the major proposals that is on the regulatory table is that there should be clearing houses for credit derivatives and you should basically have only instruments which can be cleared and therefore are relatively standardised. Would you agree with that?

Mr Reoch: You are touching on two different products here but the issues are the same in some respects. Firstly, the question of opaqueness generally. Personally, having witnessed investors making decisions in the boom times, sitting in front of them is a 100-page document co-written by one of the rating agencies, and it was crystal clear that the person buying it was never going to read the document because it had the return they were looking for and they wanted to move on to the next deal. Personally, I do not believe more transparency would have made a shred of difference during the boom period. However, to move on to who would have benefited, I think when it became apparent there was a problem, the regulators and related central banking functions did not know where to look to find out where the risks were. There was no one place you could look. There was no handy journal that would reveal the size of the market and the sort of risks, and I do not think anyone truly knew, because this is an OTC—over-the-counter—market between two individual institutions. If we move the trading of the more plain vanilla credit derivatives on to a central institution, be it an exchange or just a central credit counterparty, for the first time there would be a place to look. First of all, all the back-to-back trades get netted down, and the currently $30 trillion credit derivatives market actually shrinks to a number closer to $4 trillion, which is the true net risk transfer in that market, nearly 10% of the number we keep seeing in the newspapers. Secondly, that one, or possibly two or three exchanges would have the information available as to how many institutions were involved, how much any one institution was exposed and how much of a particular corporate risk or other was being moved. I think yes, there is a benefit. My talk with the industry suggests that the industry has accepted that and there is no doubt that by the end this year we will have a central clearing. However, for securitised product, I do not believe that will work because every deal is different from the

last and it would be virtually impossible to create a central clearing for bespoke products.

Q282 ***Baroness Kingsmill:*** I am sorry I was not here at the beginning of your evidence, so I hope I do not duplicate any of the questions you have already been asked. The thing I wanted to find out from you is what exactly was the skill set that was required by the rating agencies for people who rate the securitised products, as opposed to those who wrote straight corporate bonds? There has been some criticism that perhaps mathematics was thought to be a more appropriate skill than perhaps an understanding of economics. Related to that, which I would also like you to think about, is were the collateralised loan obligations standardised? Were they designed to fit a template? They are thought to have been very similar in design and shape, and we wondered if they were designed in such a way as to ensure a high rating.
Mr Bell: In terms of the skill set, we hire very broadly. We have some quants, not a huge amount. My team is about 150 strong in Europe; I think I have five quants. So it is not by any stretch of the imagination a mathematically derived, mathematically driven quants shop. The vast majority of my analysts, and I am sure it is the same for my colleagues, have backgrounds in economics, have backgrounds also in the industry. We hire widely from people who have worked in banks, who have been credit officers. We also hire straight from university, people usually with financial/business school backgrounds but, more important than that, we also put a very strong emphasis on internal training, because rating agency analysts are *sui generis*. It is not a profession that exists outside, and therefore we hire these people from backgrounds, and again, very few mathematically inclined or quant people, but then we train them.

Q283 ***Baroness Kingsmill:*** Just out of curiosity—and this probably has no relevance at all to this, or it might have some relevance—what was the gender breakdown?
Mr Bell: I do not have the exact number but it is pretty close to 50-50. I think we have more women than men but I would have to check. Looking around the floor from my office—

Q284 ***Baroness Kingsmill:*** Women do stand out rather more than men, do they not?
Mr Bell: Most of my senior management is made up of—

Q285 ***Baroness Kingsmill:*** Do you want to tackle the second part of the question?
Mr Bell: On standardisation. I think it is important to see how structured finance is created. It is a structured product, so it is not something that exists already, like a company exists; it is there. You bring your company to a rating agency and say, "This is my company. What is the rating?" The structured product is basically a group of assets and you say, "I would like to issue against these assets. What protection do I need for the bonds that are going to be issued secured by that? What protection do I need to get a triple-A? What protection do I need to get a single-A?" So you indeed structure the transaction in order to achieve a certain rating. There is nothing illegitimate about that. You go to your investors and say, "What do you want to buy? Do you want to buy a triple-A? Here is a pool of assets. Do I need to reserve 10%? Do I need to reserve 20%? Do I need to read reserve 30% security credit enhancement over collateralisation in order for the risk attached to what is left to be triple-A?" So, in that sense, these deals are undoubtedly structured to meet certain rating requirements but there is nothing shady about that; it is a very open process. Also, what makes it very open for investors is that the criteria that we use to decide whether this pool is 20% or 10% or 30% credit enhancement support in order to get a triple-A, those criteria are open. You can find them on our website. You can call our analysts and they will give those criteria. There is nothing opaque going on here. So if investors are comparing two pools, one seems to have to have triple-A at 10% enhancement, another one, as Paul was saying, three or four per cent for prime residential property in the US versus 30%. They can call us or they can go to our website and see our publications and say, "Why is that 10 times more than this?" and they will get an answer. So yes, they are created for a template but not in a way that suggests anything untoward.

Q286 ***Baroness Kingsmill:*** I suppose there are those who thought that might be some form of conflict of interest between assessing a credit rating and providing rating consultancy.
Mr Bell: We do not provide rating consultancy.

Q287 ***Chairman:*** Do none of you provide rating consultancy?
Mr Drevon: No.
Chairman: So there is no consultancy.

Q288 ***Lord Forsyth of Drumlean:*** Just on that point, I am sure you must all be familiar with the work that has been done at Harvard University which suggests that bonds were constructed to fit a kind of template, and there is also anecdotal evidence that people have been using the software in order to do that, and it goes back to my point about feedback. That does seem something of a weakness.

Mr Drevon: On one side, I think we were accused many years ago of being a black box, and the response to that was being more transparent about our methodologies and providing in some cases models to the marketplace. That does create a potential for trying to game the model. There is no doubt about that, and that is a concern we do have. The solution is not to go back and be a black box. We do support the concept that we should be quite transparent about how we approach risk in our methodologies. Where we are more concerned—and I think the EU is looking into this is a possible option—is the disclosure of models, because once you provide the precise tool and the precise models, the ability to game a system is greater.

Q289 ***Chairman:*** Just one last question, if I may, a bit to the point, but there has been some press comment that suggests that business was so brisk at the height of the securitisation bubble that ratings for large securitisations were sometimes created on the fly, using standard models and information provided by users. Is there any truth in that?
Mr Bell: No.

Q290 ***Chairman:*** In other words, did you have to rush your fences?
Mr Bell: No. You have to distinguish between an initial rating, where a client comes to us and says, "Look, I would like you to rate my structured finance product for the first time. You don't know me, you don't know my institution and you don't know my product yet and we would like a rating." This rating will take on average between three and six months. We will go to that client, we will visit that client, we will check the underwriting procedures, we will check their system, we will understand their models, we will understand how they generate, we will go to lawyers, we will get legal opinions, we will interrogate the lawyers—a I used to be the general counsel in Europe before I did this job. We used to torture lawyers and outside firms for months and they used to hate us. It takes three to six months to do the initial transaction. Once that transaction is done, we have read all the legal documents, we have read all the opinions, we have deconstructed the model, we understand the underwriting processes at the bank, we know how these things work, we know exactly what every piece of data means, at that point, the process does become much faster, because we know the documents have not changed, the law has not changed, the legal opinion has not changed, the data has not changed, or to the extent that it changes, we can treat it. So yes, there comes a point when you can actually rate fairly fast—and fairly fast, by the way, still means a couple of weeks; it does not mean two hours. That is because you have behind that two-week process a six-month process, or a five- or three-months process, a very deep analysis. I think some commentators, who were seeing how quickly things were being done, assumed that this was all the work we had done, unaware of the fact that that first rating took a very, very long time to do.

Q291 ***Chairman:*** So for none of you was there an issue of the volume prejudicing the quality of the rating?
Mr Taylor: Maybe more simply, if you look at our ratio of transactions to analysis, it did not change during the boom times, during the 05–07 period.

Q292 ***Chairman:*** Those remained the same?
Mr Taylor: Not the same, but very close.
Mr Reoch: Perhaps I could raise one crucial point, that in the rating of corporate debt, pools of corporate bonds and loans, because of transparency and the release of models into the public domain, a very large number of investment decisions were made with no interaction with the rating agencies at all because of their shadow ratings achieved through using these available models to check that it meant that the internal rating guidelines of single A was the limit and the models were available. People would code up their own models and say, "Yes, if it were rated, it would get single A, but we don't actually need to go to the rating agencies and get the rating, we need to be sure that it would have got it", so a very large number of investment decisions were made without any interaction from the rating agencies at all.
Chairman: Well, thank you very much indeed. That has been very useful and thank you for spending the time with us.

Supplementary memorandum by Fitch Ratings

Dear Lord Forsyth

RE: MATTER RAISED DURING THE HOUSE OF LORDS SELECT COMMITTEE HEARING OF 3 MARCH 2009 ON BANKING SUPERVISION AND REGULATION.

I am writing to follow up on a matter raised by you during, my participation in the House of Lords Select Committee hearing of 3 March 2009 on Banking Supervision and Regulation. The matter was raised during a discussion concerning the role of models in the determination of structured finance ratings and the adequacy of the assumptions made. As you will recall, you mentioned as an example a conversation that was alleged to

have taken place in 2007 between a Fitch analyst and Robert Rodriguez, CEO of First Pacific. It was suggested that a Fitch analyst had informed Mr Rodriguez that a 2% fall in the US residential property market would be sufficient to cause losses to holders of triple-A rated tranches of mortgage-backed bonds. As I indicated to you at the time of the Committee hearing, I was very surprised that such a conversation would have taken place, since it did not appear consistent with the way in which our analysis is conducted. This exchange is documented as questions 267–268 within the Select Committee transcript.

Since the Select Committee hearing, my colleagues and I have investigated the alleged exchange and I am writing to you today to provide evidence that the content of the conversation reported to you by your advisers was not as Mr Rodriguez later recalled, or as was subsequently reported in a working paper published in 2008 by Joshua Coval of the Harvard Business School. Indeed, in Mr Coval's working paper, "The Economics of Structured Finance," the question and answer session that Fitch conducted in 2007 was misrepresented. Mr Coval attributed paraphrased responses as characterized by Robert Rodriguez in his speech as direct verbatim quotations. More significantly, those paraphrased responses detailed by Mr Rodriguez fail to capture the breadth, depth and nuance of the discussion that actually occurred; and reduces it to paraphrases that misrepresent what was actually said.

I have attached a summary document[6] that outlines the facts and the chain of events, along with copies of the source material in order to provide you with a complete picture of the actual exchange. I confirm that Fitch has also contacted Mr Coval directly to request that he promptly correct his publication wherever it has been published.

I hope that this information is helpful to you. Please do not hesitate to contact me should you have any further questions.

Paul Taylor
Group Managing Director
Fitch Ratings

24 March 2009

[6] Not published here.

Examination of Witnesses

Witnesses: Mr John Hitchins, PricewaterhouseCoopers; Mr Brendan Nelson, KPMG; and Mr Oliver Grundy, Deloitte, examined.

Q293 ***Chairman:*** Good afternoon and welcome to the Economic Affairs Committee, and thank you for finding some time to give evidence to our inquiry into banking supervision and regulation. This is the fifth public hearing of the inquiry and members have already declared their relevant interest in previous hearings. Feel free to answer each question, but do not feel you are obliged. If you agree with either one of your colleagues, just nod assent and that will be helpful for us in getting through the questions that we want to ask in a reasonable time. Do you want to make any introductory remarks or shall we move straight on to questions?
Mr Hitchins: No.

Q294 ***Chairman:*** In which case, let me start. Auditors clearly have a unique access to the engine room, if I can put it that way, of banks and, given that unique access, should the accounting firms not have identified liquidity and capitalisation problems at the banks in the period leading up to the financial crisis?
Mr Hitchins: I think you have to start by looking at what we are trying to do. Auditors are expressing a true and fair opinion on historical information. In arriving at that historical information, the directors of the banks have to make an assumption as to whether the bank is a going concern and we have to look at whether that assumption is reasonable. In doing that, we, therefore, have to take account of the amount of capital the banks have and what the liquidity forecasts are, but, unlike a corporate, banks have a permanent funding gap. On a corporate, when you are doing a going concern review, you look at the amount of funding needed for the year, you look at the amount of bank facilities they have got and see whether the two equate. On a bank, they never do because the nature of banking means that they borrow short and lend long and always have a funding gap, so, when you are reviewing liquidity, you are actually looking at current market conditions, the way the banks are funding in the market, what the management's funding plan is and deciding whether it is reasonable to assume that that funding plan will continue. Similarly, on the capital, you are looking at the FSA's requirements and whether the banks are forecast to meet the FSA's requirements over the period you are looking at. It is not a guarantee, it is merely an assessment of whether it is an appropriate assumption to use for the accounts. Clearly, what we have seen in the past year is events unfolding in the following 12 months after accounts were issued which were unforeseen by anybody at the time that the accounts were issued.

Q295 ***Chairman:*** I understand the formal position, that you are dealing with historic data and you are there at the end of the day to say whether it is a true and fair view in the company's accounts, but there is an informal relationship as well, is there not? There is a relationship both with the executives of the company and, very specifically, with the audit committee of the company and, in spite of the formalities, would you not have thought that your auditing partners would have picked up that perhaps things were going slightly awry, and would it not have been natural under those circumstances to tip the wink to the audit committee?
Mr Nelson: There was an issue, and again you have to go back into history when this thing started, but during the second half of 2007 things started where you could see problems emerging in the marketplace which clearly started to raise concerns about liquidity, particularly with respect to certain financial instruments. Everybody was on notice from about August 2007 that the markets were starting to look slightly different from what people had traditionally expected, so that sort of paved the way right up to the year end when people started to focus around liquidity and capital and the shape of some of the risks that banks had on their balance sheets. Nevertheless, we went through the 2007 reporting season and the biggest issue then was more around the valuation of these financial instruments rather than the liquidity of them because there still were liquid markets and these instruments were still being traded and, therefore, there was still an element of price transparency in the marketplace, so, in a sense, the accounts were reflecting the shrinking of liquidity rather than the absence of liquidity at that point in time. When you looked forward to 2008, again the expectation and all the signals were that, although liquidity seemed to be getting tighter for certain financial instruments, there was enough liquidity in the marketplace for banks to be comfortable and these instruments could continue to trade, albeit at much lower levels. The other important thing to bear in mind at the end of 2007 was that, for the first time, banks had to disclose in their financial statements more information about the way in which they managed liquidity risk because there was a new standard introduced, IFRS7, which required banks to give much greater disclosure around their management of liquidity risk and market risk as well as the traditional credit risk. Those disclosures were subject to audit, so they were covered by the audit opinion, but the level of disclosures was mandated by the standard and, therefore, it was slightly elective for banks to decide whether they disclosed

what was required by the standard or whether they gave additional disclosures, but subsequently there have been revisions to IFRS7 and more disclosures will come through in the 2008 financial statements of banks.

Q296 ***Chairman:*** Is there room for revision of the standard?
Mr Nelson: Well, I certainly would not look at IFRS7 on its own. I think there is a broader issue in terms of financial statements of banks, what information is actually given in them and how relevant that information is to the people that use financial statements. Traditionally, financial statements are prepared on a look-back basis rather than a look-forward basis, although there is some element of forward-looking information in there, but it is not subject to audit. Similarly, there is other regulatory-type information put in bank financial statements, such as the regulatory capital ratio which again is a mixed bag of information, some of which is covered and some of which is not.

Q297 ***Chairman:*** Do you think that the regulatory capital ratio should be audited? Would that be a sensible thing to do?
Mr Nelson: Yes, I do because I think it is the ratio that people look to first of all to determine the health or strength of a bank and it is the one that banks use to reassure the market that they have sufficient capital to meet their current and future needs and, although we audit the composition of regulatory capital, we do not actually audit the ratio itself because it is a function of that relative to the risk-weighted assets which are not audited.

Q298 ***Chairman:*** And each of you takes the same view?
Mr Grundy: Yes. It was the case up until quite recently, certainly for investment banks, that all of their capital requirements were audited, but those requirements were withdrawn at the beginning of 2007 largely because of being seen to be equivalent to what was happening in the rest of Europe.

Q299 ***Baroness Kingsmill:*** What is the relationship between a bank's auditors and the regulator?
Mr Hitchins: Well, we have certain duties under the financial services legislation whereby, if we believe that a bank is in danger of breaching one of the threshold conditions for its authorisation, we have to report that information to the regulator. The regulator can also approach us for information, but that is up to the regulator to exercise that.

Q300 ***Baroness Kingsmill:*** So do you have regular meetings with the regulator?
Mr Hitchins: It varies enormously from bank to bank. There is no mechanism which requires a meeting between the auditor and the regulator.

Q301 ***Baroness Kingsmill:*** What would trigger one then in that case? Would it be some disaster, some problem?
Mr Hitchins: We can only trigger it if there is a problem.

Q302 ***Baroness Kingsmill:*** You cannot see them under any other circumstances on a normal, regular basis?
Mr Hitchins: I think it would be an extremely good idea if we did have regular meetings with them on all banks, which we used to.
Mr Grundy: Again, that used to be something that was part of the supervisory agenda of the regulator to have bilateral meetings between ourselves alone with the regulator and trilateral meetings with the bank present.

Q303 ***Baroness Kingsmill:*** When did that stop?
Mr Grundy: Rather than it stopped, it just simply began to fade away, I would say, and there were less meetings asked for by supervisors.
Mr Hitchins: Effectively, the mechanism that the meetings used to occur under was changed when the Financial Services and Markets Act was introduced.

Q304 ***Chairman:*** It was not that the banks did not want it? What you are saying is that the supervisors did not ask for it?
Mr Hitchins: The supervisors did not ask for it.

Q305 ***Chairman:*** So there was no resistance from the banks themselves?
Mr Hitchins: No.
Mr Grundy: No.

Q306 ***Baroness Kingsmill:*** As a supplementary question, have any of you had the need to contact the regulator in relation to any of the banks which you may have audited?
Mr Grundy: Yes, in the past.
Mr Hitchins: Yes.
Mr Nelson: But we also sought a meeting with the regulator. Towards the end of 2007 when we realised that the markets were changing, we approached the FSA and said that we thought it would be a good idea if there were a meeting with the FSA because we wanted to understand how they were seeing the issues that were affecting the market from the entities that they were regulating, so we sought this meeting. What the FSA then did was they called a meeting where the major firms of accountants were invited and then they invited the Bank of England, they had the Financial Reporting Council there and, as part of

the Financial Reporting Council, the Financial Reporting Review Panel plus a number of people from the FSA. It was a very high-level meeting where the FSA basically talked in general terms about some work they had done on market risk, the FRC highlighted going concern, as a potential issue for 2007, although it was not really, and then there was just a very high-level discussion around what we saw as some of the issues impacting that year end's audits, which was basically around valuation.

Q307 ***Baroness Kingsmill:*** I just want to clarify a few things. Who sought that meeting?
Mr Nelson: We, the accounting firms, sought that meeting.

Q308 ***Baroness Kingsmill:*** Because of your concerns about what you were seeing?
Mr Nelson: Because we felt we needed to have a dialogue with the FSA.
Mr Grundy: We realised by the end of 2007 that we were in a different environment from anything that we had seen before and, as I remember it, they were concerned that there would be consistency of approach by the accounting firms to the audits and consistency of approach to valuation as well.
Mr Nelson: The other reason we sought it is that the legislation, as John says, imposed a statutory obligation on us to bring anything to the regulator's attention where we thought that the entity was failing to meet the regulatory requirements. There is no corresponding obligation on the FSA to bring anything to our attention. They are encouraged to inform us, but there is no corresponding legal obligation on them to tell us of anything that they know about that could actually impact our position as auditors, so the only way we could deal with that was for us to approach the FSA and say, "Is there anything that you are aware of that would affect us in our role as the statutory auditors?" but that was not a very constructive or particularly conclusive discussion with them.

Q309 ***Baroness Kingsmill:*** Did you exchange information between yourselves in any formal way, obviously protecting client confidentiality and all the rest of it, but was there any exchange of information between yourselves?
Mr Hitchins: There is a forum at the Institute of Chartered Accountants within the Financial Services Faculty where the big firms meet along with representatives of the bank and discuss generic topics. We obviously cannot talk about specific institutions in that forum.

Q310 ***Baroness Kingsmill:*** And you were beginning to get seriously worried around about the end of 2007?
Mr Hitchins: At the end of 2007, the issue was the valuations and how you could get consistency of valuation across institutions. As we moved through 2008, the issue became liquidity.
Mr Grundy: It is fair to say that at the end of 2007, with the exception, I think, of Northern Rock which had by then sought lender of last resort protection, most banks could secure funding in the markets, albeit at a greater cost and not on the same terms as they had before, but that was not any problem to them.

Q311 ***Lord Eatwell:*** I am intrigued by your emphasis on 2007 and valuations and then liquidity concerns only appearing in 2008. It seems to me that risk in an institution is often associated with very rapid change in the capital structure of that institution. Now, the capital structure of British banks started changing in 2000. In 2000, roughly in aggregate, British banks lent their deposits. By 2004, they lent £350 billion more than their deposits. By 2008, they had lent £700 billion more than their deposits, £350 billion of which was from abroad. You missed that, did you not? You missed the implications of that.
Mr Hitchins: It is not up to us to determine what the appropriate level of capital is.

Q312 ***Lord Eatwell:*** But that is a change, an entire change in the funding of the British banking system.
Mr Hitchins: It is a change in the model, yes.
Mr Grundy: It is also a macro change. The auditor was looking at only one institution in isolation.

Q313 ***Lord Eatwell:*** But, if there is £750 billion around, each of the institutions must have been changing quite a bit.
Mr Nelson: And it is disclosed in the financial statements. It is not hidden. It is disclosed in the financial statements as the source of funding.

Q314 ***Lord Eatwell:*** That is true, but here we are and we have a dramatic change in the funding of the British banking system. A dramatic change like that might suggest a change in the risk and, as we know now, it was a dramatic change in the risk. You missed that.
Mr Hitchins: It is not a black-and-white thing. Yes, risk was rising. What we did not foresee was that the risk would change so fast in 2008. If you look at the end of 2006, all the banks were funding successfully in the market. Yes, they were much more highly leveraged than they had been before, but they were funding successfully in the market.

Q315 ***Lord Eatwell:*** The other point that you made, forgive me, I forget which person made it, but you were saying that in 2007 the market was still relatively liquid in the sense that new instruments, securitised

instruments, whatever they might be, were trading, but 70% of securitised instruments are OTC and are not traded at all and they are mark-to-model, they are not mark-to-market. What was your estimate of the risks associated with those instruments, which were a very important part of the balance sheets of the banks, as we now know?
Mr Hitchins: Well, at the end of 2007, the securitisation market was largely dead. That is what brought Northern Rock down. Most other banks were not dependent on it. Securitisation was a source of funding, it was one source, and they had switched to other sources of funding by that stage.

Q316 ***Lord Tugendhat:*** Mr Grundy, when you answered Lord Eatwell a moment ago, you said you looked at the banks in isolation. I do not quite understand that because I agree that Deloitte's audited whatever banks it was, but audited more than one and I do not know how many you did audit, but you certainly audited more than one.
Mr Grundy: Certainly.

Q317 ***Lord Tugendhat:*** So you would have been in a position to see that there was a trend and you would have been in a position to say that bank X, bank Y and bank Z were either moving in the same direction or a different direction.
Mr Grundy: Across the banks that we audit, yes, you would see a trend and I think you would see a relatively short-term trend. What we have been talking about is quite a long-term, big, macro trend over the last decade in the model of banks and it is more the province, I think, of the regulators and central banks to look at trends like that.

Q318 ***Lord Tugendhat:*** Yes, that is a slightly Pontius Pilate reply, if I may say so! I agree with you of course and Pontius Pilate was quite right too, but, nonetheless, here was a significant change, as Lord Eatwell has pointed out, and presumably you noticed it, you might have conversed about it, you might have wondered whether it had an implication, or did you merely file it away like a test match score, as it were?
Mr Nelson: You have to go back, I am afraid, to what our responsibility is as auditors, and it does not impair our opinion on the financial statements, provided that it is properly disclosed in accordance with the Companies Act and accounting standards. Again, the role that we perform is very much this snapshot in time in terms of the financial statements as of the year end and it is a look back in terms of what the institution has done and how the balance sheet is set up at 31 December, if that is the year end, and our job is to make sure that those financial statements present a true and fair view. If the institution has decided to leverage itself more than it has done in the past, then that will be reflected in the balance sheet of the institution as presented to the shareholders.

Q319 ***Chairman:*** Can I come back just for a moment to the informal point that I made earlier on, and I take the formality, but was this major change in the leverage of banks something that you would draw the attention of an audit committee to? Was that ever something that you brought up?
Mr Grundy: We certainly raise with clients increasing levels, say, of illiquid assets, primarily focused on the disclosures that were required around them and the difficulties of valuation.

Q320 ***Chairman:*** Is it something that came up with each of you? Is it something that you would expect to draw to their attention?
Mr Nelson: It is all relevant to your own client experience, I suppose, and it just depends on which clients you work with, but, maybe to look at it from a slightly broader perspective, what we look at in the context of the governance model is the way in which the audit committee informs itself of what is happening with the institution. When you get to areas like risk management, there is no consistent model in the UK as to how risk management should be addressed from a corporate governance perspective, and perhaps that is something that may need to be looked at because in some organisations the audit committee would take responsibility for risk management, so there would be an audit and a risk committee. In other organisations, the audit committee would not take responsibility for risk management and there may not be any other governance body outside of the board itself that would take that responsibility and, therefore, in the audit committee you could find yourself dealing solely with matters pertaining to the financial statements and not necessarily matters pertaining to the risk profile of the organisation and how that was changing. The other important thing is that all banks were required to document their risk appetite in terms of actually clearly setting out what the appetite of the institution was in terms of the various risks that they were willing to undertake, and that was shared with the regulator, so the regulatory process captured that dimension of the banks' activities.

Q321 ***Lord MacGregor of Pulham Market:*** Audit committees always have these private meetings without the executives present with the auditors where, quite frequently, issues which are not strictly related to the audit are raised and questions asked. Presumably, that happened with some of the banking institutions.
Mr Nelson: Did those sorts of meetings happen? Absolutely.

Q322 ***Lord MacGregor of Pulham Market:*** But were those questions raised?
Mr Hitchins: Lots of questions were raised and usually around controls. That was the most common topic that we would have had private conversations on. I do not know with how many institutions the question of the spread of funding sources was discussed.

Q323 ***Lord Forsyth of Drumlean:*** Could I just ask a sort of daft question here. I cannot get my head around how it could be that, when you were having a meeting of the kind that Lord MacGregor describes, alarm bells would not be ringing and there would not be a discussion about the risks that the banks were facing. Now, there must have been a point at some point along this continuum where you became very alarmed by what was going to happen to the banks. After all, we have almost shovelled our entire GDP into the banks in the last few months. When did that happen and how did you react to it?
Mr Grundy: I think it depends on the particular client. Just to give you one example, for a non-bank financial institution involved in securitisation, when the securitisation markets shut in, sort of, August and September, we raised that with them in September that this would have a significant impact on their going concern, but up until that point, and those markets shut very quickly, they were able to securitise the assets they had originated.

Q324 ***Lord Forsyth of Drumlean:*** So after the horse had bolted?
Mr Grundy: As soon as their funding market dried up, yes, because up until that time there was no sign that the funding was going to dry up.
Mr Nelson: It is also the case that at the end of 2006 the world was seen then as a very different place from what it is now and there was plenty of liquidity in the marketplace, there were no issues around valuation, all these instruments were trading either on official exchanges or unofficial exchanges or indexes were set up and you could see price transparency. Through 2007, that started to change. Although we talked about valuation as a year end accounting issue, liquidity was a concern for institutions and they began to see that liquidity for certain instruments was beginning to dry up, so there were discussions around this, but there was no dramatic contraction of the inter-bank market where a lot of these banks were funding.

Q325 ***Lord Paul:*** With all of this happening in 2007, did you have any contact with the rating agencies to ask them to look at it?
Mr Grundy: We have no contact with the rating agencies at all.

Q326 ***Lord Paul:*** So you were not surprised that the credit rating agencies were going ahead with all their ratings without making any changes whatsoever, in spite of all these ratios changing in the banks?
Mr Hitchins: We have no contact with the rating agencies.

Q327 ***Lord Paul:*** No, but a concern that they are merrily going ahead?
Mr Hitchins: Well, the issue with the ratings, I think, from our perspective, was that a lot of the products that were being rated had never been tested in a downturn, so you had that concern that they had never been through a downturn, so would the models stand up.

Q328 ***Lord Paul:*** But, especially in the banks, apart from depending on the accounts, people do depend a lot on the rating agencies, so you are sharing that responsibility, as far as the public is concerned.
Mr Hitchins: It depends on the bank. The less sophisticated banks are more dependent on the rating agencies. The large banks have their own risk departments which are quite capable of making their own rating judgments and use their own internal rating systems.

Q329 ***Lord Paul:*** Turning to the risk management, in some of our meetings we have found that a lot of board members really did not understand the risk management of the banks and the risks existing. Do you have sufficient people in your firms when they are auditing it who understand risk management?
Mr Hitchins: Yes, we do, we have specialist teams and we use them on the audits as well.

Q330 ***Lord Paul:*** Did you come up with some of those questions to the audit committees or any other committee of the boards?
Mr Hitchins: Yes, where we have found deficiencies in risk management controls or processes, we would report those to the audit committee.

Q331 ***Lord MacGregor of Pulham Market:*** I just want to come back to the very brief reference in the previous discussion, which I do not think we have fully explored, and that is the question of mark to market, and the accounting regimes are based on that. We have had some evidence that it could be inappropriate in markets where trading is infrequent and where really it is actually a model. I wondered if you had any views on that issue, what the alternatives would be and whether the profession is really seriously looking at it.
Mr Hitchins: I am not sure you are going to get a consensus here! Mark-to-market or fair-value accounting is entirely appropriate for portfolios where banks are holding them for short-term gain, even if the market is thin and relatively illiquid. You

can get some problems where you have assets that are actually held for the long term, but, for other reasons, are fair-valued in markets in which you get a huge liquidity discount. At the moment, if you take corporate bonds, the huge explosion in spreads on corporate bonds has both a repricing of risk element, which is perfectly validly reflected in the value of those bonds, and an illiquidity element. If you have the liquidity and, therefore, the capacity and intent to hold to maturity, then I can see the argument of, "Why are you reporting these losses when you'll get that money back by simply holding to maturity?" It is quite difficult to split the component and to do it in any other way, and there are some actuaries who will do modelling for you, but it is not the practical way on an individual instrument to do it. The accounting profession is looking at that, and the reclassification amendment to IAS39 that was passed last autumn does actually provide a measure of relief for banks to take assets out of categories in which they were fair-valued and put them back into loans and advances where they are now being managed as a loan and meet the criteria for loans, so there has been a response to that, but I imagine the debate will continue.

Mr Nelson: There are discussions with the US as to whether there should be a temporary suspension of fair-value accounting when markets become so dislocated that you cannot get a fair value. The problem with that is what you replace it with, and that is the real conundrum. Then you lose transparency if you go back to historic cost numbers and then whose interests are best being served then? The best you could do is actually describe the assumptions that you have used in arriving at some of these values and maybe provide some sensitivity to show the sensitivity of certain assumptions to those values. The other thing for some banks is that there is a concern over mark-to-model where you do not have any price transparency at all, but the actual percentage of assets that are mark-to-model is actually a relatively small percentage of total assets that are marked to these models. The other thing to bear in mind with these mark-to-models is that banks do not take the profits arising from mark-to-model because, if the prices are unobservable, then they defer the recognition of those profits so that they are not feeding the P&L account with what people might regard as unsupportable profits.

Mr Grundy: I would simply add to that that the amount of the balance sheet that relates to what the layman would call "mark-to-model" has had to be disclosed in the last couple of years, and part of our job has been to ensure those disclosures were there and correctly shown.

Q332 ***Lord Tugendhat:*** If I can ask you a question that particularly interests me, and I have asked related questions in previous sessions, do bank audit committees, do you think, need to be redesigned in the wake of the financial crisis? Do you think their role needs to be altered and do they have the right sort of members? We all have the benefit of hindsight, so I am asking you the question with the benefit of hindsight.

Mr Nelson: In my own experience, first of all, I think bank audit committees have done a very difficult job extremely well over the last 18 months. These have been extraordinarily testing times for financial institutions in terms of understanding how the crisis in the market was impacting members' organisations and how to respond appropriately to that. There is absolutely no doubt that the world of financial services is extremely complex both in terms of the types of risks that traditionally were being taken and the nature of some of these products, and implicit in that was an element of complexity that challenged everybody in terms of really getting to understand it. When you look at audit committee responsibilities, looking at the adequacy of controls within an organisation to ensure that there is an effective control environment dealing with the external reporting issues around financial statements, and that is a very complex area as well because accounting standards are not easy in terms of the application of some of these complex instruments, clearly there are serious challenges for audit committees and obviously audit committees would benefit, I suppose, from a simpler environment, as we all would, but it is difficult to see how you change the role and responsibility of the audit committee. I would come back to the point I made earlier on. I think what drifts into the audit committee agenda is risk management and it is an issue around whether there is enough time spent at a governance level on risk management, and maybe that is a better avenue to pursue in terms of how does the risk governance process within an organisation work and is enough time being spent on that.

Q333 ***Lord Tugendhat:*** Years ago, when I was Chairman of Abbey National, the Bank of England, who were then the regulator, put forward a proposal that they should have a direct relationship with the chairmen of the audit committees, not just of ours, but everybody's, and we all, the bank chairmen that is, resisted this because we said it would divide the boards. When I look back, I think perhaps we were wrong and the Bank of England was right, but do you think, again with the benefit of hindsight, that, if the regulator did have a direct relationship with the chairman of the audit committee and, thus, with the audit committee, this would be a helpful development?

Mr Nelson: But they do.

Mr Hitchins: They do now.

Mr Grundy: They absolutely do.

Q334 ***Lord Tugendhat:*** Secondly, it has occurred to me that, when you meet with the audit committee privately, would it be helpful if you were in touch with

the regulator on an ongoing basis and that the regulator asked you to put a certain number of questions to the audit committee which members of the audit committee would then have to sign off so that there would be the regulator, yourselves and the audit committee all focusing on whatever issues were of particular concern at that time? Would that be a practical or helpful way forward?
Mr Nelson: We certainly believe there is scope for a better and more formal relationship with the regulator in the sense that the audit firms and the audit process can support the regulatory process better than it has been used in the past. It is not through lack of will on our part, it is just that the way that regulation was performed in the United Kingdom following the introduction of the Financial Services and Markets Act changed, and the auditor had a very limited role to play in that, extremely limited. We would welcome, and we have made it very clear publicly, a constructive dialogue with the regulator to explore ways in which we can support the regulatory process, and that may be an example of one of the things that we could do. We are not recommending that we go back to the pre-Financial Services and Markets Act regime of section 39 under the Banking Act or section 55 under the Building Societies Act, but there could be scope where the auditor can actually contribute more to the regulatory process than historically has been the case certainly over the last nine years.

Q335 ***Lord Forsyth of Drumlean:*** On that last point, Chairman, I am sure it would be helpful to have a note on the specific detailed things that could be done on that.
Mr Grundy: Yes, through the Institute of Chartered Accountants, we have already made, I think, about five particular suggestions.
Mr Hitchins: The Institute gave written evidence to the Treasury Select Committee, so we can certainly send you the same evidence.

Q336 ***Lord Forsyth of Drumlean:*** Perhaps I may raise a different, and perhaps more sensitive, issue and that is whether the governance auditing should be carried out by a different firm from the one that audits the accounts?
Mr Nelson: I do not think we would have a strong opinion on that if the people that were supporting the regulatory process were separate from the people who were actually auditing the financial statements.

Q337 ***Lord Forsyth of Drumlean:*** No, I mean, for example, where, let us say, there is an issue about governance or where there has been a whistleblower, is it appropriate to have that carried out by governance—
Mr Grundy: That quite often happens by another firm. The way that the FSA deals with this, if it is something sufficiently serious, is to commission a report by what is called a "skilled person", and a skilled person may well be a firm of chartered accountants and generally they tend to employ somebody else other than the auditor for that.

Q338 ***Lord Forsyth of Drumlean:*** Yes, but, as a matter of practice, do you think that it should always be the case that a different firm does that?
Mr Hitchins: Well, there is no inherent conflict between doing a financial audit and auditing governance in a normal environment. When there has been a problem, you might well want a new pair of eyes to come in and look at that.
Mr Nelson: I would not advocate mandating it, I think, because we do not commission it, but it is up to the commissioner of the work to decide who would be the best person to do the work, having regard to the benefit of the knowledge of the institution versus the benefit of a perceived greater independence.

Q339 ***Lord Forsyth of Drumlean:*** I do not want to embarrass you, but one example that comes to mind is the HBOS example and the complaints that were made by Paul Moore where, I think, KPMG actually were the auditors for HBOS and they also investigated and subsequently there was some criticism about the impartiality. I do not say that that criticism was fair or unfair, but I am just saying, as a matter of good practice, should it not always be the case? Clearly, if you have a client relationship and there is criticism of the client, it is very difficult, I would have thought, not to feel some kind of conflict of interest.
Mr Hitchins: That particular situation was some time ago. That type of investigation is usually these days driven by the FSA under section 166 of the current legislation. In that situation, the FSA makes the choice as to who does the investigation.

Q340 ***Lord Forsyth of Drumlean:*** I appreciate that.
Mr Hitchins: It is more often than not, in that situation, somebody who is not the auditor. Clearly, if you are investigating an area which the auditor has looked at, you should use somebody new, but I would not advocate having a hard rule on it because it should be addressed by an independent regulator in the circumstances, and I think the FSA should make that decision.

Q341 ***Lord Forsyth of Drumlean:*** Well, I do not want to pursue that particular example, but in this particular case the independent regulator also had someone who was involved in the board of the company concerned, so it is a bit of a circular argument, which is why I am trying to keep it on the

principle level, which is: should the principle not be that they are different?
Mr Grundy: I think you have got to allow the commissioners of the work, which is probably an audit committee, some flexibility with this.

Q342 ***Chairman:*** On a similar point, should governance audits be made a statutory requirement for banks?
Mr Nelson: Again, I think this is an area that is perhaps worth looking at in terms of, in a way, an audit can actually add more value than the current very limited role, in a sense, that we have just purely on the statutory financial statements, and that is something we would welcome.
Mr Grundy: Under the previous Banking Act, such reports were often commissioned of auditors to look at the high-level controls or governance in a bank, and I think that is something where we still think there is a place for, not necessarily every year, but a place for that sort of approach.
Mr Hitchins: I think the consideration that needs to be given though is whether those are more valuable done privately through the FSA or whether they should be in a public format, bearing in mind that public reporting of that type of thing then tends to follow a rigid template.

Q343 ***Lord Currie of Marylebone:*** Could you explain how you, in these very difficult conditions, make these going concern judgments about banks, given that it depends on regulator interventions and indeed government interventions? How on earth do you go about making such judgments?
Mr Nelson: It has been extremely difficult. The primary responsibility obviously rests with the board because they have the responsibility to prepare the accounts on a going concern basis or not, depending on their view of whether they have the necessary access to funds and capital going forward, but it has been extremely difficult. Obviously, it has involved a significant amount of understanding and an element of dialogue with the Government to make sure that there was sufficient clarity around the various government schemes and support initiatives to be able to draw a safe conclusion.

Q344 ***Lord Currie of Marylebone:*** Do you get that clarity or are you getting that clarity in the present circumstances?
Mr Nelson: Yes.
Mr Hitchins: We always have the option to have a private discussion with one of the tripartite authorities on an individual institution if we have a particular concern.
Mr Grundy: But it has been important, these statements and the actions of the authorities, in the going concern assessment. Without those, I think we would be in a very different position around our audit reports, undoubtedly.

Q345 ***Lord Best:*** In terms of your income from the banks, what is the proportion that comes from consulting and what from good old auditing, and is there a possible conflict of interest in that division inherently?
Mr Hitchins: In 2007, taking the six largest banks in the UK and just on their published data to give you a flavour, the proportion of non-audit fees to audit fees and fees closely related to the audit varied from 34% to nine, and that is on a snapshot basis. An awful lot of that non-audit fee is actually not consulting work per se, it is tax advisory work or it is often other work around controls, so, for example, one of the banks concerned includes the element of Sarbanes-Oxley reporting in its non-audit fees, and others include it in the audit fee, but it is there, so that is there. The independence of the auditor is something that all the major firms take really seriously and, therefore, any non-audit work we do has to be very carefully checked as to whether it threatens our objectivity, and we have a whole series of rules and processes that we go through, and that involves almost invariably also an audit committee pre-approval process, ie, before we can do the work, the audit committee must have said it is okay.

Q346 ***Chairman:*** I believe that the FSA are looking again at the quality of some of their staff and whether they need people with greater intellectual capability in getting their minds around some of the credit derivatives and so on. Is this a problem that also affects the accounting firms? Do you have sufficient people of the knowledge and capability to get their minds around these instruments and how they are managed?
Mr Grundy: I think we all feel we do. We have plenty of people who are highly specialist and can value and understand complex instruments. Many of those people, who do not actually want to work in a bank, do enjoy the variety of work in a professional services firm, and we have never really had difficulties in getting people with the right intellect to deal with that challenge.

Q347 ***Chairman:*** One gets the sense that in the banks the people with that intellect and that kind of motivation tended to be in, what I call, the "engine room", way down there, and that perhaps at higher levels, maybe at director level, there was not quite the same kind of capability. By the same token, do the partners who are involved in the accounting firms have the ability to get their minds around these issues or the specifics of the modelling that is involved?

Mr Hitchins: I think you would expect us to say yes! Perhaps to flesh that out a bit, these days audit partners are becoming highly specialised so that you get people who have spent their careers looking at this stuff. Also, no audit opinions are taken by a single partner these days and we have quality review partners. On the larger banks, we tend to have a review committee looking at all the key judgments, so there is an awful lot of intellectual power that is applied to whether or not the audit opinion can be signed.
Mr Grundy: It is very much a collective set of judgments and, yes, it is made by a number of partners.
Mr Nelson: And we all have to go through mandatory training on numerous occasions throughout each year.

Q348 ***Chairman:*** This would include modelling, would it?
Mr Nelson: No, we would not do modelling. We rely on experts to provide us with expert input, but we would define what we wanted in terms of what level of comfort we needed and the procedures that we wanted people to actually go and check.

Q349 ***Chairman:*** I think one of the things which is coming across in the evidence to us is how you apply judgment to the output of models and how you know where their limitations lie. There may be a risk that there are people who are very clever at modelling at one level in an organisation and there are people elsewhere who have judgment, but bringing the two together effectively is a difficult thing to do, but it is not something that you sense?
Mr Nelson: But, when you have liquid markets, you have quite significant price transparency, so, even though you have model-derived values, you are able to look to the market rather than look to the model to see if the model is producing the right result, so it was not only understanding the controls and processes around the model, but you were able to look to the market and see price transparency. Also, to go back to a point we discussed earlier, because we act for quite a large number of institutions, each firm, you are able to sort of benchmark across institutions, so we do not look at each client in isolation, but we actually have the ability to look across, and it is the same specialists that are looking at each institution, so they are building up a portfolio of knowledge around the marketplace in terms of what things should look like.

Q350 ***Lord Currie of Marylebone:*** We know that the markets work very well on the whole, but from time to time liquidity dries up, and that is a historical fact and it gets repeated quite frequently. Is not your point that, when markets are liquid, you can assess risks very well actually missing that point?
Mr Nelson: Historically, when you had liquidity issues with a product because there was no price transparency, what you used to do was to make financial provisions against the valuation to take account of the liquidity risk, so you reduced the amount of profit that was being recognised from that instrument if there was a liquidity issue associated with it at that point in time.
Mr Hitchins: What is happening in the current market is that the range of values you are getting out of models has broadened a lot, so there are very few instruments out there where there is only one model and you have got no means of checking the calibration of it as to whether there is any outside benchmark. The problem you are faced with now, as an auditor, is that the client has often done quite a lot of work to calibrate its model against outside data, but has come up with the fact that that outside data has a significant variation in it and you are deciding where in that variation you should fix the number to go in the accounts. There is now a disclosure requirement that, where you have an assumption where a reasonably possible alternative could produce a materially different number, you have to disclose that in the accounts.
Chairman: Well, thank you very much indeed for spending some time with us this afternoon; it has been very helpful.

TUESDAY 10 MARCH 2009

Present	Best, L	Levene of Portsoken, L
	Eatwell, L	MacGregor of Pulham Market, L
	Forsyth of Drumlean, L	Moonie, L
	Griffiths of Fforestfach, L	Paul, L
	Hamwee, B	Tugendhat, L
	Kingsmill, B	Vallance of Tummel, L (Chairman)

Examination of Witness

Witness: Mr Jacques de Larosière, Chairman of the EU High Level Group on Financial Supervision, examined.

Q351 ***Chairman:*** This is the sixth public meeting of our inquiry into banking supervision and regulation and members have already declared their relevant interests at earlier hearings. Mr de Larosière, welcome to the Economic Affairs Committee. We are very grateful that you are here in London today and I think this is your second Select Committee appearance today. We have all read the report of the EU High Level Group on Financial Supervision of which you were the distinguished chairman. Do you want to say anything by way of introduction or shall we move straight on to questions?
Mr de Larosière: No, thank you. I will answer questions.

Q352 ***Chairman:*** The first question I wanted to ask was whether you might tell us what you feel was the main underlying cause of the current economic and financial crisis and where you think the main blame lies.
Mr de Larosière: The main fundamental cause of what happened was the piling up over 10 or 15 years of easy—too easy—monetary policies, very large current account imbalances in the United States in particular, matched by large structural surpluses in a number of emerging countries which pegged their currencies to the dollar more or less and therefore injected very large amounts of liquidity into the system. This easy money, easy credit condition propagated a search for higher yields than those that were offered by very low interest rates which were associated with this easy monetary policy; financial institutions' investors engaged in search of higher yields, therefore paying less attention to the quality of credits, accepting relatively low spreads for high risks, therefore undermining the fundamental prudence of the banking system. This was the basic set of circumstances that led to the present crisis. So it is an accumulation of international imbalances and what I would call loose monetary policies. Inflation of course was not an immediate concern for central banks because price inflation, CPI, remained relatively tame during the period because of a number of factors of which you are aware, innovation and also low cost of imports from emerging countries which had very low labour costs. Inflation was not of immediate concern to central bankers who geared their policies to inflation targeting. But where inflation appeared was in the assets. Assets went up and up and up in all segments of the market: real estate; equity; bonds. I think that was the cause. Of course, some innovations in the financial instruments contributed to the over-extension of the system, thinking in particular of the abuse of securitisation which allowed banks to get off their balance sheet a lot of assets which were perhaps not of the highest quality and which were then sold out to the market, to the investors, with very handsome ratings from rating agencies which were paid by the originators of these products which I think is a major conflict of interest. All these things accumulated and explain the crisis of today. If you add the herd instinct, the greed and all that, you get the picture today. It is not just the bankers: it is more importantly the general conditions which I have explained and which stem in great part from official authorities.

Q353 ***Chairman:*** From that loose monetary policy.
Mr de Larosière: Yes.

Q354 ***Baroness Kingsmill:*** Your group suggested EU-level oversight of macro prudential supervision should be provided by the European Central Bank and the European System of Central Banks as part of a new European Systemic Risk Council. Is it possible to separate out macro prudential regulation from the broader questions of economic policy? That is the first part of it. The second is: how would you resolve conflicts as between state governments and a proposed European Systemic Risk Council?
Mr de Larosière: Let me take both questions in succession. When you exercise macro prudential regulation you are bound to ask yourself questions of economic policy. Let us not hide ourselves from that reality. Often, as I have explained, official policies,

fiscal policies can be part of the systemic risk. What we have been careful to avoid in this report is giving this body which you have mentioned, the European Systemic Risk Council, decision-making powers which could have, in the case you have just indicated, impinged on the sovereignty of nations in terms of their general macro economic policy. We did not do that. What we said was that what was lacking in the current system was a body of independent central bankers who would look into the emerging problems of a systemic nature which could be contagious and affect the whole system; an independent body of central banks who would meet, not very often, in my view they would meet perhaps two or three times a year at the highest level, at the level of governors and discuss, under the aegis of the European System of Central Banks, because I think that is the best place to do it, a bit like the BIS is probably the best place to host meetings of the Basel Committee. With the technical assistance and the help of the European System of Central Banks, the central bankers would meet and would try, with the Level 3 committees, (to be upgraded) and a representative of the Commission, to detect nascent problems. These people are not going to make decisions, they are going to make warnings and these warnings, in the process that has been laid out in the report, would seep down into the authorities concerned. Suppose you have a problem of excessive borrowing in some European countries, borrowings denominated in foreign currencies; it is a major systemic problem nowadays on our borders towards the East. Suppose that had been detected in such a meeting, there would have been a warning, the central banks in question would have had to respond, either they would have abided by this recommendation to curtail these types of mismatching operations or they would not. If they had not, if they decided not to move, the matter would have been transferred to the political level, which is entirely correct, that is the Council of Ministers. So that is the way it works. If I may say so, it is a soft decision-making process because there is no decision. It is a warning system, but a warning system that goes beyond and that is the novelty which I would like to be understood. Instead of having reports that pile up on shelves and get buried in dust, instead of having general warnings like we have had over the years: that risk premia are too thin, that the system is too much extended; that there is too much (extended) leverage, which was said but then evaporated into thin air, what we are trying to do here is create a strong wired system whereby you have to go through a process which does not entail decision making from this committee but you do have to go through a process where you either apply the recommendation or you do not. Then the system has to be politically conscious that something is going wrong. It is probably the best we could do. Some people said "No, you need more teeth in the system". I was amongst those who felt that you had to have a softer process precisely for the reason you said which is that this macro economic surveillance treads on other boundaries. The second question was: how would conflicts between member state governments and the European Systemic Risk Council be resolved? I do not think there would be conflicts. There might be advice, recommendations, if the country's national authorities think they are right and that the Systemic Risk Council is wrong so be it. This system is rather solid and the Bank of England would be a full part of this which is indeed under the aegis of the European System of Central Banks which features the Bank of England in a very prominent part.

Q355 ***Lord Moonie:*** Your Group proposes a European System of Financial Supervision, the ESFS. This would involve consistency of rules and sanctions across the EU. We know from our experience of the Basel Committee that international coordination is difficult and slow. Is there a danger that under an ESFS regulations would evolve too slowly and that cross-border standardisation would inhibit innovation in regulation?
Mr de Larosière: Personally I do not think so. If you read the report carefully, you see that these enhanced Level 3 committees basically will help harmonise—although this is not a word I like very much—make more consistent the interpretations of rules which are, as you know, very diversely interpreted at present in Europe. This is something that we all want. It will have some limited powers to do that. For instance, if you have a difference of views in a college between a host and a home regulator, this matter, if it persists, can go up to the Level 3 committee, enhanced in its authority, part of the European System of Financial Supervision. There are limited actions that these authorities could take and which would be consistent with the principle of letting the national authorities do what they do best. Would regulations evolve too slowly? It all depends on the way this is implemented. What we have proposed was to take stock of all the major differences which at present exist in the European rules, these national exemptions, these differences of interpretation, and to wipe out the most unnecessary or harmful divergences. That is the first thing. The second thing is for the future not to engage in such a fragmentation. Will it be slow? Will it be quick? I do not know. In the past it has been slow, that is for sure. If you have more independent, more visible, more established authorities, I think this could change things for the better.

Q356 ***Lord Paul:*** In answer to the Chairman's question you have said that perhaps one of the things was wanting to create higher yields by the bankers

because of the lower interest rates. That seems a bit too simple. Do you suspect some sense of greed, almost bordering on fraud, which drove them to come to such kinds of decisions which neither the credit agencies nor the auditors want to own? Where could these things have gone wrong? Such a large number of people all over the world have suffered from this and neither the bankers nor the accountants nor the credit agencies seem to have a sense of responsibility.
Mr de Larosière: You have put your finger on the problem. What we say in the report is that these practices of abusing securitisation, that is turning a blind eye to the inherent quality of the credit which lies behind these sophisticated products, is something which should be corrected. We think that securitisation should be simpler, should be related to understandable risks and that the issuing banks, the originators, should keep on their books part of what they have issued for the long period, that is until maturity, and without hedging those positions. Those are some of the measures which could curb the excesses to which you were alluding.

Q357 ***Lord Eatwell:*** Your report places very strong stress on notions of consistency rather than harmonisation, which is the word you do not like. I wonder whether I could just press you on two aspects of consistency. First of all, you plan to build on the three Level 3 committees and, given the disintermediation in the financial system and the way in which crises for the banks have occurred in investment banks or even in the insurance companies, does it make sense to keep those three committees separate any more? Should there not just be a committee overlooking the financial services industry as a whole rather than what are now old-fashioned institutional boundaries? The second consistency question involves consistency as between national regulators and the fact that you seem to be suggesting there should not be innovation in regulation or distinct proposals. As we all know, the Spanish regulators behaved in a different way to everybody else—or at least the main countries—over the last 15 to 20 years to their ultimate benefit. Would they have been inhibited from doing that in the search for consistency?
Mr de Larosière: Let me tackle the second question first. If we had applied the principles that are contained in our report, not only would our Spanish colleagues not have been criticised for this dynamic provisioning which they put in place, they would have been applauded. Indeed the gist of this report, in terms of regulation, is to say that if anything the Basel Committee has been too pro-cyclical in its rules and has aggravated the pro-cyclicality in a way of the accounting rules. The combination of Basel and the IFRS has enormously aggravated the pro-cyclicality.

Q358 ***Lord Eatwell:*** I thought that was a tactic.
Mr de Larosière: On the contrary, this system would not have broken that down. On the question of harmonisation, it is absolutely clear to me that we need better and more consistent rules. We need to have a rule book that is understandable and that is consistent, if not we would get all sorts of drawbacks. There are leakages, rushing to more lax systems, competitive distortions, regulatory arbitrage, all these things we have known in the past. I think we need to get into that and to change it. Maybe I did not answer your first question properly.

Q359 ***Lord Eatwell:*** It was just that it seemed to me that building on all three Level 3 committees—
Mr de Larosière: You are absolutely right, I forgot that. I can say that personally I have some sympathy with what you have just said. We do actually say in the report that after an initial period where we do keep the three committees, there would be an evolution towards a twin-peak system where you would have insurance and banks on the one side and markets and market practices on the other side. So it does not go as far as one institution but certainly not more than two.

Q360 ***Lord Tugendhat:*** In your report you say " . . . consideration should be given to the ways in which the formulation of ratings could be completely separated from the advice given to the issuers on the engineering of complex products". When we had the ratings agencies here a week ago, rather to my surprise, they all denied categorically that they provide ratings consultancy. Would you be kind enough to give me the answer to two questions? How big a problem do you think this is? How would you like to see the whole business of ratings structured in the future and who pays for them?
Mr de Larosière: You have provided the leads to the proper answer. No, there is in my view a conflict of interest when you are a rating agency and not only do you rate some of the products but you participate in the manufacturing and engineering of the products. Of course it is an iterative process: the issuer calls on the credit rating agencies and asks whether that would call for Triple A and the rating agency says no you have to restructure it in another way and you get into that sort of relationship where the agency is paid for two parts of its intervention. That is wrong and we say it, not mincing our words, in the report. You are right that we should be looking into the business economic model of those agencies. We have lived through the last 30 or 40 years in a system where it is

the issuer who pays the rating agency. There have been periods when it was the investors who paid for the gradings. You can imagine a small fee that would be levied on the transactions. It is a question which has to be asked because there has been so much harm in this sector that it is worth looking into it.

Q361 ***Baroness Hamwee:*** You suggest withdrawing the licence from rating agencies. How could their performance be evaluated if the licence was withdrawn? Would that not in fact have the consequence of damaging confidence? So is a threat to withdraw the licence a credible threat?
Mr de Larosière: I do not know whether confidence has come out of the recent events when Triple As suddenly in July 2007 became Triple Cs. That I will leave to your own judgment. It is normal that if these agencies are registered, they are submitted at least to a comparative check on the way they perform their duties and if something reveals that methodology has been faulty, results have been not consistent with what the rest of the profession had done, it is perfectly normal, not necessarily to withdraw the licence, that is a last resort and you should not focus on that, but at least to look into the sectors where the credit rating agency perhaps did not act so carefully and to act on that part. Then, after one year, you could look at it again. That is an idea. I do not say that is going to change the world, but it is an idea which has been expressed.

Q362 ***Lord Griffiths of Fforestfach:*** It is an excellent report and, if I may say so, it comes to us from an Anglo-Saxon tradition as very much out of the continental European tradition. You talk a lot about coordination and harmonisation, a common global approach, you see the European System of Financial Supervision ensuring that national supervisors perform. You talk about a common global approach to remuneration schemes. Let us assume this was adopted by the Eurozone members, it seems to me that other regulatory regions, particularly the US and possibly the UK, might have different views to yourself or to the European view and the question then is, if I were a banker doing business in the European zone, would I not really want to relocate outside of it? While your approach may harmonise things within Europe, the danger is that you lose out really to the rest of the world because you cannot impose this globally.
Mr de Larosière: I am afraid I do not follow you at all on that point; I am sorry to say that. This is a mistaken view.

Q363 ***Lord Griffiths of Fforestfach:*** When you say you do not follow it, what do you mean? I am sure you understand it.
Mr de Larosière: I understand you, but I do not agree with you and I am going to say why because this is perhaps the most important part of the report. We are not laying down new rules in this paper, we are saying that some of the existing rules have been misleading and inappropriate, for instance some of the Basel rules, some of the accounting rules. We do not say that we, the Europeans, are going to change this alone. Of course it would not even be possible. You cannot change the Basel rules without having the agreement of all the others, including the Americans and those who participate in the Basel Committee. What we tried to do is reflect on what went wrong and to make a number of proposals which are of course destined for the global system. I do not think we are foolish enough to believe that we can have a nice, well-harmonised, rule-based system in Europe and turn a blind eye to what is going on elsewhere. This could indeed be a recipe for what you said, that is turning towards places where regulation might be lighter. What we think is that it is in the interest of the United States—I am not here to judge whether it is in the interest of the United Kingdom; that is for you to choose—it is in the interest of the global system to have a system of regulation that is consistent overall, that does not propagate these circumventing actions of regulatory arbitrage, that does not allow a parallel banking system to do all sorts of things which are very close to the basic functions of banks without having any deposits, any capital requirements, any regulations. These things should be mended. If we do not think they should be mended, then I do not understand why we have been asked to do the report and I do not understand why we read in the press every day that the system is collapsing. We should be looking at that on an international global plane, absolutely right. I participated in the Volcker report in the United States which came out in the first week of January 2009. If you read the two reports, you would see that there is a great convergence of views, including on things like the principles for corporate governance and remuneration. Of course remuneration is a global problem; you cannot tighten the system in one country or one region and then let the party go on elsewhere. But I think the Americans are very desirous of putting some order in this and if you look at the Institute for International Finance paper that goes back to the autumn of 2007 you will see things which are absolutely on the same wave length as those we have said. I would really like to avoid a presentation of this report which would say "This is the old Gallic thing, they are doing their *dirigiste* system in Europe and then they are not even looking at the rest of the world". Not at all. This is a paper which is a global paper and I must say that I have been congratulated more by American friends who took pains to read it than by some of my European friends.

Q364 ***Chairman:*** We would have loved to have had you here for much longer this afternoon but we did promise to get you away in time to catch your Eurostar. Thank you very much indeed for your very helpful contribution.
Mr de Larosière: Not at all; it was a pleasure.

Supplementary memorandum by Jacques de Larosière

Q. *The three new European System of Financial Supervision (ESFS) Authorities should ensure that national supervisors perform adequately, according to your Group's report. It also refers to "graduated sanctions" that will be applied if national supervisors fail to respond to rulings from the Authorities. It concludes that, in exceptional circumstances, the Authorities should be able to acquire the duties that the national supervisor is failing to discharge. If the ESFS had existed 18 months ago, would it have exercised this power? What would be the systemic consequences of such a severe penalty?*

Given that the report proposes that national authorities remain responsible for micro supervision, it only seems reasonable to check whether those national supervisors meet the standards of professionalism and performance that (as experience has recently shown) are so important for financial stability.

Therefore the report proposes that the European "Authorities" should have the duty to ensure that all national supervisors meet the required standards (by rulings destined to ask national supervisors to correct weaknesses and, if needed, to apply "graduated sanctions"). Barring such powers, the European system of supervision would run the risk of being inefficient.

It is very difficult to "redo" history after the facts and to decide whether the proposed system would have avoided the observed failures. But if one looks at certain examples (see Iceland) of foreign branches having mushroomed in a number of European countries with a very weak group supervision, I would tend to believe that the extreme proposition contained in the report (or the threat to have recourse to it) would have helped prevent and contain the contagion. The U.K. is very insistent on this point.

Q. *What should be done to ensure that supervisory staff have sufficient expertise?*

Supervisory staff should be trained, receive adequate remuneration and use the private financial sector as a source of recruitments. All this requires, as the report stresses, sufficient budgetary resources. The aim is to create a strong European supervisory culture.

Q. *Your Group's report discusses crisis management and resolution, and it argues that a lack of consistent crisis management and resolution tools across the Single Market places Europe at a disadvantage relative to the United States. How should this lack of consistency be addressed?*

This lack of consistency should be addressed by the following measures :

— the Authorities should receive information from competent supervisors and from central banks ;

— they should act as mediators if needed.

Furthermore, while national authorities will always (as long as there is no European federal budget to this effect) be responsible for public funds in case of financial bail-outs, and therefore, while no burden sharing can be determined between states in advance of a cross-border crisis, more has to be done in terms of reinforcing and clarifying the framework that should preside over crisis resolutions (see n° 139–143 of the report).

Q. *How closely should bank risk management practices be supervised in the future?*

Bank risk management should be better regulated (see the part of the report that criticizes the Basle approach to risk management, VAR…). Once regulation has been corrected, supervisors will focus on internal risk systems and check their adequacy, as well as the quality of "risk governance" called upon in the report.

10 March 2009

Memorandum by the British Bankers Association

1. The British Bankers Association (BBA) is the leading association for the UK banking and financial services sector, speaking for over 200 banking members from 60 countries on the full range of UK and international banking issues. In addition, 37 professional firms are also associated with us. Our members, whilst predominately banks, engage in activities which range widely across the financial spectrum, encompassing services and products as diverse as primary and secondary securities trading, insurance, investment advice and wealth management, custody, as well as conventional and non conventional forms of banking.

Can the regulatory authorities effectively control the risks taken by banks, especially in today's globalised markets? How can the international dimension be addressed?

Colleges of Supervisors

2. We believe the answer to the effective supervision of individual global banks lies in colleges of supervisors. That is, a forum to bring together the supervisors from each of the jurisdictions in which a firm operates, to discuss and agree the supervisory approach for the group. A number of large globally active banks already have colleges in place but this must be extended to all large, systemic, cross-border entities as was suggested by the Financial Stability Forum in its April 2008 recommendations.

3. We believe colleges are the best mechanisms to coordinate and harmonise the implementation of decisions taken by national supervisors. They not only allow more efficient and effective supervision but also permit supervisors to take a holistic view of the risks faced by firms and, further, the risks they pose to the financial system.

4. Colleges also help to foster trust and confidence between supervisors, which is so important in crisis situations. In our view, it is no coincidence that the colleges which have operated most successfully during the current crisis are the longest established.

Global Regulatory Framework

5. In addition to the action taken by the UK authorities, international regulatory bodies and standard setters—under the aegis of the Financial Stability Forum and more recently the G20—have set in train an action plan aiming to address coherently the shortcomings in the international regulatory framework for financial institutions. These measures are comprehensive in nature and are supported by the UK Government which rightly sees the need for problems associated with a global industry to be addressed on a global basis.

6. Urgent steps are also being taken within financial markets to progress far-reaching measures on an international level over the short-to-medium term in seven key areas:

- Strengthening transparency and accountability
- Regulatory regimes
- Prudential oversight
- Risk management
- Promoting integrity in financial markets
- Reinforcing international cooperation
- Reforming international financial institutions

7. Within these broad areas some 50 regulatory initiatives are being pursued. Each initiative is being developed on the basis of international cooperation and the expectation is that solid progress will be reported by the time of the April 2009 G20 Summit. This constitutes a diverse reform programme and the British Bankers' Association is engaged on each of these initiatives at an international level.

Has the supervision of individual banks been handled effectively under the Tripartite System of the Treasury, the Financial Services Authority and the Bank of England? Should banking supervision remain with the FSA or be returned to the Bank of England?

8. We believe that the current Tripartite Arrangements in the UK remain valid, but, in relation to Northern Rock, what was at fault was their execution. The 1997 Memorandum of Understanding between the Bank of England, the Financial Services Authority and HM Treasury, as amended in 2005, will no doubt be further changed as a result of recent experiences. We would hope that the authorities will put these changes out to consultation. The authorities learned their lesson with Northern Rock, and the subsequent problems

associated with Bradford & Bingley, the Icelandic banks, and London Scottish Bank were handled much more expediently and efficiently.

9. On balance, our members have no desire to see banking supervision returned to the Bank of England. They see continued merit in a properly focused, resourced and integrated financial supervisor, which enables them to conduct a single set of regulatory relationships.

How is responsibility for stability of the financial system divided in the Tripartite System? Has oversight of the banking system been lost due to a focus on individual banks? What has been the nature of coordination between the different regulators before, and since, the Northern Rock crisis in the summer of last year?

10. As noted above, this co-ordination has improved in the wake of Northern Rock. That was a consequence of, notably, an insufficient amount of information exchange between the Bank of England and the FSA. There was also a misunderstanding that general market liquidity enhancement would be promptly corrected by the Bank. The information gap is now being addressed with a provision in the Banking Bill enabling the Bank of England to obtain additional information from the FSA. We would also encourage the Bank and the FSA to exchange more systematically information about "names" in the market. The Bank needs to display less timidity in communicating market observations to the FSA, and the FSA in cross-checking its prudential concerns about a particular institution with the Bank. While the Bank remains responsible for the stability of the financial system as whole, and the FSA for the prudential supervision of individual firms, both should not be averse to communicating views about each other's sets of responsibility: in other words, overlap of responsibilities is better than underlap.

How can regulators employ people of the right calibre to regulate the banking system effectively?

11. This is a worldwide phenomenon. Regulators, in normal economic circumstances, can rarely employ a sufficient number (or quality) of supervisors, as the best of these tend to be poached by firms. In present market conditions, the attractions of a position with a regulatory authority are self-evident. In the FSA's case, they are addressing these issues by recruiting a significant number of additional line supervisors, as well as enhancing their line supervisory training programme. These are both lessons arising out of Northern Rock. The FSA also has a very broad remit and finite human resources: this suggests a much more prioritized focus on those supervisory targets that really matter. The answer is not to continue significantly increasing the FSA's budget.

Could the regulatory authorities have foreseen the banking crisis? What changes might help the authorities predict such a crisis in future? What could then be done to avoid a repeat?

12. The FSA issued a "Dear CEO" letter at the end of 2006, highlighting the pricing of risk and the need for stress testing. In addition, the Bank for International Settlements and the International Monetary Fund had warned against the mispricing of risk, and the debts being accumulated by governments and consumers.

13. The current crisis has its origins in the Basel I environment. The revised framework will better equip regulators to supervise financial institutions. The three pillars associated with Basel II, and the steps taken since August 2007, should enable regulators, and, with regard to Pillar 3, investors, to better assess capital adequacy and risk management.

14. A global approach to regulation, including cooperation and reform of international institutions, increased transparency and accountability for both regulators and regulated firms, better rather than more regulation, and the promotion of integrity would go a long way. In addition, shareholders, especially pension funds, and non-executive directors should be more active in ensuring proper corporate governance and the preservation of shareholder value.

What changes should be made to banking regulations?

15. Prudential monitoring of financial institutions by the FSA necessarily focused on individual company solvency rather than systemic stability, for which the Bank of England has responsibility, but the co-ordination of supervisory, financial and statistical information has been lacking. Regulation of institutions and a formulation of stability indicators require better sharing and joint assessment of data, particularly in respect of group structures and business models. The clause in the Banking Reform Bill to facilitate the further sharing of information between the Bank and the FSA is most welcome. However, the authorities should make better use of information already gathered before requiring additional data.

16. As stated in paragraph 6, a broad range of steps are being taken at both national and international level. These cover areas where supervision fell short.

17. In particular, the following should be addressed among the prudential soundness and liquidity measures:

Regulatory Capital

18. Banks' own risk models for tradable assets and the underlying assumptions have not delivered appropriate amounts of capital, with losses very significantly exceeding model-predicted capital requirements. Changes to the trading book regime should aim to restore confidence in derivatives and securitisation (which have brought benefits to consumers and businesses alike) and avoid unintended consequences that would hinder future innovation. In reviewing Basel II it is already accepted that its pro-cyclicality is an issue that requires further investigation.

Collateral for Central Banks' Operations

19. As central banks' experience has developed, they have recognised that case-by-case solutions are not appropriate and that a coordinated market-wide and globally-synchronised approach is required. We support further moves to widen and harmonise the range of collateral eligible for central banks' liquidity support schemes and the de-stigmatisation of their use by market participants.

For example, should capital adequacy regulations be tightened? Should they take account of the quality and liquidity of the assets held by the banks? If so, how? Do regulators need to create different sets of rules for different assets held by banks? Should fair value accounting rules be adjusted?

20. We do not feel that a tightening of rules is needed.

21. The EU Directive implementing Basel II, the internationally agreed capital adequacy framework, came into force at the beginning of 2008, whereas the bubble that created the credit crunch had been building for a decade. So the revised and tighter Basel II rules—in relation for instance to securitisation—did not have time to permeate deeper into the financial supervision of banks.

22. Basel II's shortcomings were recognised as the 1988 Basel Accord was revised and bankers and regulators achieved a framework that balanced practical applicability with theoretical thoroughness, recognising that evolutionary amendment would be required—in for instance the application of the framework to the trading book and liquidity risk.

23. It is important that Basel's weaknesses are addressed and amendments made but there is no need for a root and branch re-examination of the Basel II framework. The Basel Committee has already released proposals, currently out for consultation, in relation to resecuritisation and market risk. It is also examining ways of building capital buffers during the good times and considering the introduction of a leverage ratio, although the industry remains unconvinced that a leverage ratio is an appropriate regulatory tool—it seems to have little effect in the US where a leverage ratio has been a requirement for some time.

Liquidity and Asset Quality

24. The FSA—somewhat ahead of other regulators—is currently consulting on tough rules that will require banks to hold more, higher quality liquid assets and place more of a reliance on retail deposits and subject their liquidity assumptions to rigorous stress testing in order to enhance their liquidity. Whilst understandable given the stress on some UK banks caused by the recent shortage of liquidity we are concerned that some of the requirements if applied over zealously to UK branches of foreign banks could impact on the attractiveness of the City of London as an international financial centre.

25. The Basel II framework already takes account of asset quality, either by using credit ratings as a proxy for credit quality (for banks using the standardised Basel II approach), or a bank's own assessment of the riskiness of its assets as permitted by the Internal Ratings Based approach, which is used by large internationally active UK banks.

26. However the approach to setting the amount of capital to be held against an asset can differ depending on whether it is held in a bank's banking book or its trading book. Assumptions about a trading book asset's inherent liquidity have been shown to have been flawed and the Basel Committee is currently consulting on capital requirements for trading book assets, as noted above. When implemented these are expected to require multiples of extra capital to be held against trading book assets.

27. As noted above there is already a bifurcated approach to assets held either in the trading book or the banking book and this is being re-examined to reduce the heretofore preferential capital treatment for trading book assets.

28. The banking industry remains convinced however that capital should be determined by the key characteristics of an asset's riskiness—eg Probability of Default, Loss Given Default and Exposure at Default—rather than by its type *per se*.

Fair Value

29. The turmoil has demonstrated the difficulties associated with applying fair value measurement requirements in the absence of deep and liquid markets. We therefore welcomed the publication of guidance by the International Accounting Standards Board and its US equivalent—the FASB—(at the request of the Financial Stability Forum) clarifying how their valuation standards should be applied in illiquid markets.

30. Whilst guidance is welcome, however, it does not alter the fact that IAS 39: *Financial Instruments: Recognition and Measurement* has very real shortcomings. In this regard, we welcomed the IASB's decision to amend IAS 39 to permit, in rare circumstances and on a fully disclosed basis, certain financial instruments to be reclassified out of the fair value through profit or loss category. Following this amendment, the IASB and FASB announced the creation of a new Financial Crisis Advisory Group to consider further the financial reporting issues arising from the global financial crisis. This is a welcome development.

31. In our view, this new group should take into account the significance of the effect on valuation resulting from the loss of market liquidity, which is proving to be sustained and has shown up the frailty of assumptions made previously. This is not only a question of refining standards through guidance, but must also read across into:

- The scope of fair value, including the appropriate dividing line between classifying instruments as held on a trading or available for sale basis and their classification as being held over the longer term
- The calculation of fair value and the concerns expressed by many of the mechanical nature of "exit price" and the assumption it makes about the existence of deep and liquid markets
- The case for permitting further reclassification (in all cases at fair value and on a fully disclosed basis) in light of dramatically changed market circumstances
- Whether measurement shortcomings can be addressed through refinement and better understanding of the principal categories for financial instruments or whether a more fundamental revision can be justified.

Do Basel banking standards and guidelines need to be changed? Did the FSA ensure that banks followed the Basel standards and guidelines?

32. Basel banking standards and guidelines, as implemented by the EU's Capital Requirements Directive (CRD) in early 2008, are being amended. Significant steps have been and are being taken to improve prudential soundness. Those areas currently under consideration are:

- Tightening up of quality (Tier 1) capital
- Higher capital requirements
- Enhancement of risk management, particularly liquidity risk
- More and better stress-testing
- Mitigating pro-cyclicality, and provisioning in "good times"
- Tightening up of retention of securitisation tranches, and off-balance sheet vehicles in general
- Circumscribing the effect of remuneration practices and incentives against excessive risk-taking.

33. Taking each of these in turn:

Capital

34. The Basel requirements are being revised in terms of both the Tier 1 capital requirements and the expectations of supervisors with regard to Pillar 2, especially the use of stress testing and its application to internationally active groups. Prudential standards and their interaction with liquidity, as well as liquidity were addressed by the supervisory architecture in Europe well before the credit crunch and liquidity squeeze made

these priorities. We accept that there will be a greater focus on these themes, but believe that better, focussed and coordinated regulation is the way forward, not just more regulation.

35. It is important to note that there are many local variations both in the application of Basel II/CRD and in determining what instruments qualify for inclusion as Tier 1 capital. Whilst accepting that there will often be a need for local discretions, the nature and extent of these requires review with the intention of bringing about more equivalence in this area.

36. We note also that whilst many regulators both in the EU and elsewhere have used powers to increase the minimum Tier 1 capital, there appears to be different reasons given for these actions and in turn have prompted the market to assume that a higher minimum Tier 1 capital threshold has been mandated rather than a larger capital cushion for the purposes of absorbing losses as a result of the unprecedented credit crunch. This serves to highlight the need for clarity and co-ordination in this and in other areas, and that the EU should remain consistent with development of global standards.

37. The present crisis has also brought to the fore the part that dynamic capital provisioning has to play in minimising the pro-cyclical affects of the current CRD/Basel II requirement.

38. Furthermore, as it is important that not only is a prudential framework sound, but that institutions and regulators are confident that risks are being measured in the right way, that aspects continue to be reviewed on a regular basis and not just left to be "shocked" by an unprecedented event.

Liquidity

39. A significant aspect of mitigating systemic risk is the management of liquidity, especially in times of global macro economic shocks and contagion. An obstacle for global liquidity risk management is the inconsistent nature of national liquidity standards. As banks become more internationally active, the rationale behind domestic focussed liquidity requirements may need to be reconsidered and weighed against the fact that the viability of global banks depends on timely flows of liquidity across jurisdictions.

40. It is our contention that regulators, by way of colleges, should improve coordination in this field, matching the needs of the firms they supervise to regulatory practice.

41. The immediate focus of such colleges should be the elimination of practices that hinder intra-group funding and result in excessive locally-maintained pools of liquidity. The BBA recognises however the concerns of individual countries and their need to protect depositors and investors, and particularly when part or parts of their retail banking industry is operated as a subsidiary or a branch of a major entity headquartered elsewhere.

42. However it needs also to be recognised that greater harmonisation of liquidity standards, as well as those applied at the global rather than the individual local legal entity level, coupled with the elimination of obstacles to funding will have the beneficial effect of enhancing liquidity risk management and make for more efficient financial markets. In this area, colleges of regulators have a strong part to play.

Stress-testing

43. It has an important role to play. It is a critical modelling and risk-management technique, which our members use to check estimates and parameters, but it remains only an instrument of self-assessment, to be used with judgment and accompanied with qualitative evidence, and not a validation procedure as such. The governance and qualitative aspects of such validation are as important as the quantitative element. There are many good practices in this field on which to build enhanced stress testing models.

Remuneration

44. Through regulatory tools such as Pillar 2, supervisors should encourage banks to ensure that they understand the potential for inappropriate incentivisation of their remuneration policies without being prescriptive. This is a sensitive issue and the BBA has put together a working party composed of senior practitioners from within a cross section of banks for the purposes of developing a remuneration framework that has the effect of promoting good practices within member banks. Remuneration is not separable from good risk control and should reinforce the risk appetite of the financial entity. Framed in this form it can also be included as part of the holistic regulation of the entity and play a role in the regulatory capital assessment process.

45. Broadly, we believe that the current prudential initiatives underway, at the global, EU and national levels, constitute a number of welcome steps towards renewing the prudential soundness of banks. These initiatives, together with recapitalisation and other measures, will leave the banking system in a stronger position in the long run.

46. In the short-term, as the authorities consider and implement the new framework they must also be fully mindful of the international context as a global industry requires global rules whilst also being vigilant about any further emerging deficiencies in the prudential framework, filling these gaps where necessary.

FSA

47. One should not forget that the EU's Capital Requirements Directive, implementing the internationally agreed Basel II capital adequacy framework, came into force at the beginning of 2008, whereas the bubble that created the credit crunch and liquidity squeeze had been building for a decade. As such, the sources of the crisis lay in the 1988 Basel I environment. Therefore, the revised and tighter Basel II rules—in relation for instance to securitisation—did not have time to permeate deeper into the financial supervision of banks.

48. At the end of 2008, the FSA issued consultations on stress testing, building on the work that it did as part of the Basel Committee, and liquidity, trading book capital and market risk. As can be seen within the context of the various consultation exercises on the part of the tripartite authorities—the Treasury, Bank of England and Financial Services Authority—during the course of 2008 there is acknowledgement that UK market oversight and banking supervision specifically have fallen short of an acceptable standard. The banking reform programme, as trailed in various consultation exercises during the course of 2008 and partly encapsulated in the Banking Bill, involves significant revision to UK institutional arrangements and brings with it the promise of a sharper focus for regulatory execution.

Is better testing and regulation needed of new financial products, especially complex securities? If so, how? Should complex financial instruments, such as credit default swaps, be traded through clearing houses?

49. Stress and scenario testing, including for new and complex products, should be enhanced and better integrated with strategy, capital planning and risk management, becoming part of the culture, especially when assessing risk appetite. Scenarios should include those likely to cause business models to become unviable, but remain plausible, ie get management to think outside their usual. Testing should not be seen as a perfect, single metric solution. Results should be taken into account in decision-making, but such output should be used thoughtfully and not made automatic.

50. The use of clearing houses for complex instruments would result in savings for banks on their capital requirements as banks will know their net rather than their gross positions. However, participants will have to post significant amounts of money to the clearing house's default fund. Should there be multiple clearing systems, each will require a separate fund. When instruments are netted, banks have not removed the risk. They are instead pooling the risk of default with other banks involved with the clearing house. In addition to the default fund, participants will have margining requirements (based on the amount that is cleared). Firms will need time to build links to with the clearing system. In turn, the clearing house needs to connect to the settlement systems and regulators.

Should there be tighter regulation of off-balance sheet vehicles in which some banks held "toxic" assets associated with US sub-prime mortgages? Is there a case for requiring greater public disclosure of banks' balance sheets?

51. We believe that IAS 27: Consolidated and Separate Financial Statements and SIC-12: Consolidation—Special Purpose Entities strike broadly the right balance between which entities should be consolidated onto a group's financial statements and those which should remain "off-balance sheet". That is, if the reporting entity has the ability to control the vehicle or has the right to the benefits that arise from it, then it should be consolidated onto the balance sheet.

52. The IASB is currently consulting on proposals—prepared at the request of the Financial Stability Forum—to incorporate both SIC-12 and IAS 27 into a new standard. This includes a revised definition of control which focuses on the ability to exercise control rather than whether or not control actually exists and changes the focus on "benefits" to "returns", which can be either positive or negative. The proposed standard also includes enhanced disclosures about consolidated and unconsolidated entities.

53. We welcome the publication of these proposals. We note, however, that the work being conducted by the US FASB appears to be proceeding at a different pace to that of the IASB. Whilst we accept that there were arrangements permitted under US GAAP that did not exist within IFRS and which required immediate attention (for example "Qualified Special Purpose Entities") we would wish to see the IASB and FASB move forward at the same pace.

Are bank directors, especially the independent non-executives, in a position to exercise effective oversight? In particular, do they have sufficient understanding of the complex assets held by banks? If not, can any changes be made which will ensure effective oversight? Do any other governance issues need to be addressed?

54. The crisis has flagged up aspects of corporate governance which need addressing, for example the role of non-executive directors and shareholders, and the need to better embed risk management into the senior management decision-making process.

55. It is fair to observe that some non-independent directors lacked the expertise to challenge the strategy of executive directors and had served on boards for perhaps too long, thus being deprived of a more detached perspective. For example, the long-serving chairman of the audit and risk committee of one overseas firm had left the industry three decades before becoming a non-executive director of the company.

56. Supervisors and shareholders should be more active when performing the "due diligence" required to approve a non-executive director.

57. The internal enquiry of one overseas global giant revealed that its chief risk officer, tasked with monitoring a complex overseas operation, had never worked overseas and in that particular field. As such, he was unable to grasp the risks associated with the activities undertaken by the subsidiary which was actually bigger than the home state business.

58. Therefore, risk management should be elevated in the company hierarchy and embedded in front line processes. It is not for supervisors to determine how firms should organise themselves, but a proportionate and principles-based approach would assist.

To what extent has the financial crisis been caused by the failure of banks' business models rather than by that of banking supervision? Did the remuneration structure of banks contribute to the crisis and, if so, how should remuneration structures be changed?

59. Some firms did rely on wholesale rather than deposit funding and when liquidity, a sign of market confidence in a participant, dried up, these firms were caught short and unable to meet certain obligations. In addition to a model depending mainly on one form of funding rather than diversified sources, stress testing to scenario of liquidity evaporating and counterparties losing confidence was not enough.

60. However, supervisors did not fully understand the workings of such models, the implications should the sources of funding dry up and the impact the model had on competitors, including the systemic risks inherent in such a model and peer group.

61. Prudential monitoring of institutions by the FSA necessarily focused on individual company solvency rather than systemic stability, for which the Bank of England has responsibility, but the co-ordination of supervisory, financial and statistical information was lacking. Regulation of institutions and a formulation of stability indicators required better sharing and joint assessment of data, particularly in respect of group structures and business models.

62. While there is a need to appreciate the fact that the UK operates within a global marketplace and will continue to need to provide competitive terms for financial service professionals, it is nevertheless accepted that there is a need to ensure that risk and remuneration are appropriately aligned.

63. The Financial Services Authority has provided initial guidance around the principles of risk management and remuneration policies in financial services firms. In particular, this identifies using a measure of risk-adjusted return or return on economic capital in remuneration policy, taking into account a range of risks including liquidity risk. It also sees virtue in performance assessment being based on a moving average of results, though the answer may lie in a combination of single and multi-year performance requirements. It also considers the composition of remuneration, with a balance to be had between a fixed component and a bonus element designed to align the interests of the employee and the firm, including through deferral. It also sets out observations on the governance around remuneration policies and the need for independent process, valuation and risk assessment. These initial thoughts are based on the FSA's observations on the distinction between good and bad or poor practice and constitute a valuable reference point for the review of remuneration structures, both at an industry level and within individual financial services firms.

64. The Institute of International Finance has produced a report on Market Best Practices which developed some principles of conduct for remuneration. Specifically these principles are:

- Compensation incentives should be based on performance and should be aligned with shareholder interest and long-term, firm-wide profitability, taking into account overall risk and cost of capital
- Compensation incentives should not induce risk-taking in excess of the firms risk appetite
- Payout of compensation incentives should be based on risk-adjusted and cost of capital adjusted profit and phased, where possible, to coincide with the risk time horizon of such profit
- Incentive compensation should have a component reflecting the impact of business units' returns on the overall value of related business groups and the organisation as a whole
- Incentive compensation should have a component reflecting the firms overall results and achievement of risk management and other general goals
- Severance pay should take into account realised performance for shareholders over time
- The approach, principles, and objectives of compensation incentives should be transparent to stakeholders.

How should the regulatory system take account of the Government's position as a majority shareholder in a number of banks?

65. On the understanding that State ownership of certain banks is temporary, then no special measures should be contemplated beyond those introduced by the UKFI. Otherwise, the commitments entered into by Northern Rock, in relation to competition issues, are the appropriate ones.

Where should the boundary be drawn between the institutions that are covered by banking regulations and those that are not? For example, does there need to be a clear division between commercial banks, with relatively strict supervision, and investment banks? Should banking regulations address the role of credit rating agencies?

Shadow Banking Sector

66. Over a number of years, the boundaries between different types of institution, for instance banks, securities firms and insurance companies has become blurred, both as to the business model employed by these entities and the products they sell. In simple terms, insurance products can look like bank savings products (eg annuities, credit insurance), and some banking products may look more like securities products (eg types of securitisation, such as Mortgage-Backed Securities). A further aspect is the interconnectivity between these different types of institution and product, as particularly seen with sub-prime debt and in credit default swaps. The key aspect is being able to identify the credit transfer effect: in other words who is actually holding the debt or the exposure, and who will benefit from positive returns, and be encumbered with negative ones (including liquidation). The global financial services industry is also increasingly concentrated, so for some Over-The-Counter instruments such as credit default swaps, there are probably only about 20 institutions that are active in trading them.

67. The very significant accumulation of private wealth in the last 20 years or so, and the ability of capital to move freely, together with the low historical returns on conventional instruments, has resulted in a search for alternative investment opportunities. This is one reason for the success of the hedge fund industry, and with wealthy private investors also being prepared to take greater risks in supporting private equity deals. The key point here is that these entities exist as part of the conventional financial system, since, for instance, they are dependent on routine finance from, eg banks. This then becomes an activity (for instance "prime brokerage"), just like any other, and becomes a question of the management of those risks. During the recent financial and economic downturn, hedge funds have incurred losses in much the same way as other investors. When financial markets re-open, it will be important for supervisors to identify once again the way in which business is being done and to mitigate any risks.

Commercial banking and investment banking

68. Banking services are essential to the financial well-being of the public and priority should be given to their continued provision in the event of a financial failure. However, we would not agree with the notion that banks should be viewed as a utility and see within this term connotations of standardisation that would stifle innovation that in the past has served consumers well. We also see no grounds for an enforced separation of investment banking and insurance services given the synergies that can exist between different financial services.

Credit Rating Agencies

69. They are an integral part of the banking crisis. Following the implementation of the Basel requirements, credit rating agencies were drawn much more formally into the financial structure but without any corresponding regulatory requirements. Conflicts were evident in a number of areas including the product provider paying for the rating; a charging structure which was weighted heavily towards the initial rating rather than maintaining the rate; issues surrounding seniority of staffing; unclear methods of rating; lack of clarity between the rating of a company and the rating of a product. Some regulation is required along the lines of that proposed within the IOSCO Code of Conduct. Specifically, structures need to be in place to avoid conflicts, there needs to be clarity and transparency of how the rating is assessed and significantly greater emphasis based upon maintaining the rate than at present.

How far can banks circumvent UK regulations by, for example, setting up offshore operations? How far should changes be made at the UK-level and how far through international agreements? What is the impact of EU banking regulations and how do they interact with UK regulations?

70. It is not clear that banks can, or do, circumvent UK regulations by setting up off-shore operations. Arrangements are often made to make transactions more tax-efficient, but these are within frameworks negotiated by governments and legislation approved by parliaments.

71. A coordinated global approach would be sensible, given the broader global moves currently place to improve financial stability. Responses to the financial turmoil should be based on international consensus as consistency in approach will aid the effectiveness of any measures taken. A European solution would not lead to an optimal outcome for any regulatory objective associated with capital movement. Regulatory intervention would need to be implemented at global level. Otherwise, we could see competitive inequalities emerging, with capital simply moving from Europe to other regions, making transactions less transparent and difficult to police, and making it more difficult for supervisors to react to trends and their associated risks.

Are there lessons Britain can learn from the experience of other countries' banking systems during the financial crisis, such as Spain and the US?

72. Britain is obviously by no means alone in being impacted by what is a global financial crisis and it is therefore important to examine how different national regulatory systems have performed during the crisis and then to understand what, if any, lessons can be drawn from them.

73. The Bank of Spain's "dynamic provisioning" model is currently being considered as one of a number of options to address concern about the pro-cyclicality of the capital and accounting regimes. The Financial Stability Forum is giving active consideration to recommending the adoption of a dynamic provisioning approach to capital whereby pro-cyclicality would be countered by raising an impairment provision on lending in healthy economic times for releasing as and when recession hits—in effect a rainy day fund. The BBA believes that there may be a place for a dynamic provisioning approach providing it can be introduced in such a way that it does not inadvertently add to capital requirements if we head into recession in a deeper and more precipitous way than forecast (and providing the buffer can in fact be released).

74. But we do not subscribe to the view that this approach can be said to fit within the incurred loss model on which IFRS is struck and believe that it would be inappropriate to try and shoehorn a dynamic provisioning approach into current IFRS. Should progress be made on this the question is whether it should be introduced purely through the regulatory capital regime or reflected in IFRS (and US GAAP). And, if the latter, should this be through specific amendment to IAS 39, bearing in mind that this may then require equivalent consideration to be made of insurance and contingent liabilities, or through some form of earmarked reserve in equity that would enable balance sheet transparency within the financial statements.

75. The US banking system has long been required to meet a leverage ratio based on the gross assets of a bank, rather than its risk adjusted assets à la Basel II. Failure to meet progressively lower leverage ratios triggers an increasingly interventionist set of Prompt Corrective Actions that impact the ways in which a bank is required to run its business and can ultimately result in its closure. The leverage ratio's blindness to asset quality, thus penalising low risk assets such as government bonds, has lead to industry opposition to the introduction of such a blunt regulatory tool outside the US, particularly as it does not seem that the existence of a leverage ration in the US prevented the failure of a wide range of US banks.

Should other aspects of the system of banking regulation be changed?

76. The broad range of measures being undertaken will address the areas where regulation and risk management appear to have fallen short. With regard to capital, Basel II, when fully implemented, will deliver the capital buffers that will enable banks to survive stress.

77. For many years, regulation has focused on protecting consumers, but there hasn't been an equivalent focus on market stability or insuring against systemic corporate risk. However, with the new measures in place and planned, the supervisors will be in a position to adequately respond to any further disruption. The balance of regulation is therefore now addressing the issues correctly.

78. A trap to be avoided is the belief that a heavily-policed rulebook provides greater assurance against failure. It has long been understood that the Sarbanes-Oxley Act introduced in the aftermath of Enron and other US corporate failures of the day has been hugely detrimental to the commercial interests of the United States; moreover the regime it introduced can hardly be said to have insulated the US from catastrophic market failure. Better regulation, rather than more regulation, and a global, coordinated approach are required.

January 2009

Memorandum by the Building Societies Association

Introduction

1. The Building Societies Association (BSA) welcomes the opportunity to submit written evidence to the Committee's Inquiry. The BSA represents all 55 building societies in the United Kingdom. Building societies have total assets of £395 billion and, together with their subsidiaries, hold residential mortgages of £250 billion, more than 20% of the total outstanding in the UK. Societies hold over £235 billion of retail deposits, accounting for more than 20% of all such deposits in the UK. Building societies also account for about 37% of all cash ISA balances. Building societies employ over 51,500 full and part-time staff and operate through more than 2,000 branches.

2. Building societies are essentially domestic institutions, concentrating (as required by statute) on the residential mortgage and personal savings markets. We have therefore concentrated our submission on those parts of the Committee's terms of reference (ToR) that are most relevant to building societies and their business.

How is British banking regulated and what improvements are needed? Has the supervision of banks been handled effectively under the Tripartite system? Should banking supervision remain with the FSA or be returned to the Bank of England?

3. We recapitulate briefly the development of the prudential regulation of building societies, within the broader context of the regulation of British banking, as we think this offers certain lessons for the future. Building societies have never been regulated by the Bank of England. Modern prudential regulation of building societies dates back to 1986, with the Building Societies Act of that year establishing a separate statutory regulator, the Building Societies Commission, superseding the very limited role and powers of the Chief Registrar of Friendly Societies, particularly in the light of weaknesses at some small building societies detected in the 1970s and early 1980s.

4. The BSC rapidly acquired a reputation for tough but intelligent supervision, and the building society sector survived the deep housing recession of 1990–92 in good shape, with a few weaker societies merging with stronger partners. The 1986 Act had also established for the first time a statutory compensation scheme for building societies, the Building Societies Investor Protection Scheme, but this never needed to be activated. Before 1986, this Association had ensured, in the rare cases of a society facing insolvency, that—if necessary—

contributions from other societies would maintain the record—unbroken since at least 1945—that no-one has lost any savings held with a building society.

5. From the 1980s onwards, building societies were progressively covered by European banking directives, such as the First and Second Banking Coordination Directives and, amongst others, the Own Funds, Solvency Ratio and Large Exposures Directives (now replaced by the Capital Requirements Directive, CRD). Apart from one or two minor derogations, this meant that building societies were required to meet, and met, the same minimum standards of prudential regulation in these areas as the banks, notwithstanding their separate supervision by the BSC.

6. The process of merging financial regulators begun in 1997 led to the FSA formally succeeding to the Building Societies Commission at the end of November 2001. The substance of prudential policy for building societies continued relatively unchanged for another five years, as the FSA's Interim Prudential Sourcebook for Building Societies essentially consolidated and rebadged the Commission's Prudential Notes. Since late 2006, this legacy prudential regime has almost entirely been superseded by the CRD-based General Prudential Sourcebook, the Prudential Sourcebook for Banks, Building Societies and Investment Firms and the Senior Management Arrangements, Systems and Controls Sourcebook.

7. The BSC had a clear, simple statutory duty to promote the protection of the savings held with every society and, as evidenced by the experience of 1990-1992, ran a zero-failure regime. The Association submits that, for significant retail deposit-takers, the regulatory regime needs to move, quite explicitly, closer to a zero-failure target than the FSA initially recognized—the damage to public confidence from deposit-taking failures is otherwise too great (as also is the damage to other, sound deposit-takers from the enormous levies now imposed to fund intervention in collapsing banks through the Financial Services Compensation Scheme). We appreciate that the FSA's comprehensive coverage of financial markets involved regulation of a large number of very small firms—typically various kinds of brokers—for which a zero failure regime was both unnecessary and unsuitable. But some of the arguments advanced in FSA's September 2003 paper *Reasonable expectations: regulation in a non zero failure world* now look pretty threadbare when applied to banks. Moreover, the FSA appears—at least in day to day supervision of banks and building societies—implicitly to have adopted a zero-failure regime for the time being. The Association's overall view on various banking reform measures, including the Banking Act, that constitute the policy response to the banking crisis, is that *prevention* (of bank failure, by sound, effective prudential supervision) *is better than cure* (clearing up the results of failure through special resolution regimes etc.)

8. We would also argue that the diversion of both deposit-takers', and the regulator's, attention through the proliferation of "fairness" initiatives contributed to a de-prioritising of financial soundness. The FSA's Treating Customers Fairly initiative, while praiseworthy in principle, unfortunately—in its execution—fell into exactly this trap. There was a failure to realize that, for a deposit-taker, the highest expression of treating customers fairly, and the single element of over-riding importance to the customers themselves, is to safeguard their deposits and ensure they are repaid in full when due. If this cannot be achieved (and in a business based on maturity transformation it does not happen automatically), everything else is almost irrelevant.

9. Clearly there have been weaknesses in the supervision of individual firms. But we doubt that it would serve any useful purpose to "return" the supervision of banks to the Bank of England, and as pointed out above, building societies never fell within the Bank's remit in the first place. Moreover, in an environment in which banks own insurance companies and vice versa, it would be odd to have some elements of a firm regulated in one place, and other elements regulated elsewhere. The upheaval and loss of focus during any such transition would in itself add a new dimension of risk. A better course would be to ensure that each member of the Tripartite carries out its own functions effectively, and that there is consistency and joined-up thinking in policy areas—such as sterling liquidity—where both FSA and the Bank are involved.

Could regulators have foreseen the current banking crises?

10. No-one reasonably expects regulators to foresee whether and when a particular crisis may happen. But regulators were in a position to know several key risk factors that turned out to contribute to the actual crises:

- Some banks' excessive reliance on short-term wholesale funding, and holding treasury assets of doubtful, unproven liquidity;
- Perverse incentives for banks and others to originate and distribute mortgage and other assets of low quality;
- The release of capital that flowed from the implementation of Basel 2/CRD, fuelling imprudent lending and asset bubbles;
- The complexity of financial engineering leading, effectively, to a concealment of risk.

Interestingly, some of these issues were discussed in the FSA's Financial Risk Outlook document published in January 2007. The question then is whether the knowledge of these risk factors in respect of the market as a whole led to timely and relevant action in respect of individual institutions. The FSA internal audit report on the way it supervised Northern Rock, suggests not, at least in the case of that institution.

Can national regulators effectively control risks?

11. Yes, in respect of domestically owned and operated institutions, if they are sufficiently determined on tough regulation, rather than laissez-faire, in ostensibly good times, and face down the inevitable chorus of protest from banks when they "take away the punch-bowl". However, difficulties emerge where institutions are based overseas, in the case of Lehman Brothers, and operate in other jurisdictions. In these cases, home country national regulators can expose host countries to risks that those countries cannot control.

Should capital adequacy regulations be tightened? Should they take account of the quality and liquidity of banks' assets? Do Basel banking standards need to be changed? Did the FSA do enough to ensure that Basel standards were followed?

12. Within the field of prudential regulation, there are serious questions to be asked of the immensely labour-intensive Basel 2/CRD edifice—has it, in fact, failed its first serious test?

13. This Association was concerned from the outset that these negotiations, and the outcome, were driven by the big banks' agenda, and—in some areas—generated self-defeating complexity, so that participants could hardly see the wood for the trees. At the same time, the massive time and resource demand led to a relative neglect of funding and liquidity issues by the regulator—although funding and liquidity risks are by their nature fast-burn, while credit and other risks covered by adequacy of capital are often relatively slow-burn.

14. Adequacy of both capital and liquidity is extremely important for all banks and building societies. While capital adequacy has received the lion's share of regulatory attention in recent years, through the long drawn out and complex Basel 2/CRD negotiations and implementation, it was the crystallisation of latent funding and liquidity risks, not a shortage of capital, that triggered the current crisis. The Prime Minister himself referred to this recently, saying (in response to a question about regulatory failures on 18 February):

There were problems about dealing with issues of liquidity, so for example Northern Rock ran out of money before it became insolvent and regulators were used to dealing with insolvency.

But liquidity risk had received little attention, indeed in the UK, banks and building societies were still operating on pre-FSA liquidity regimes. There has been, as we suggested above, some mis-allocation of resources, both by the regulator, and consequently by firms, between these two topics.

15. The Basel 2/CRD process had some laudable objectives, including taking explicit account of asset quality in a way that responded better (than did the crude coefficients in Basel 1 / Solvency Ratio Directive) to the variations in credit risk encountered in banking assets. So Basel 2/CRD already does exactly what the ToR suggest—it takes account of the quality of banks' assets. Nor do we see any evidence that in the UK FSA has not satisfactorily implemented Basel 2/CRD standards (which are anyway minima—and in some areas FSA has gone further than the bare minimum).

16. Our main criticism of Basel 2/CRD is that it has encouraged, and rewarded, a step-change in complexity (or "sophistication") based on intricate and costly models favoured by big banks, which were supposedly the panacea (and, as a result, disadvantaged smaller and specialised deposit-takers such as most building societies, with possibly an overall anti-competitive effect). With hindsight we can also see that one effect of Basel 2/CRD implementation was first to release capital at just the point where it accentuated the credit boom, and then—once the credit crunch started—its pro-cyclical features operated to constrain new lending: that is, exactly the wrong outcome on both occasions.

17. In this context, we would refer also to some recent observations by the FSA. In an excellent speech entitled "Model Myopia" given on 8 December 2008, Dr Thomas Huertas, Director, Banking Sector, FSA, remarked as follows:

> "Banks and to some extent their supervisors suffer from what might be called model myopia—a belief that their models fully capture the risks to which the bank is exposed.
>
> The broad assumption underlying the Basel Capital Accord—that regulators around the world could rely on firms' own risk models as the basis for capital requirements—has not turned out to be correct, at least for the trading book."

18. The Association is not opposed to further reforms of capital adequacy requirements, if these prove justified, but we are wary of the resource demands of yet another major upheaval. Before setting out down that route, we need to be clear—as Dr Huertas explores—what didn't work, and how to avoid repeating the mistake and becoming the turkeys of tomorrow. Was Basel 2/CRD just far too complicated, leading to regulators, and firms, getting bogged down in the complexity and not seeing the wood for the trees? Are the pro-cyclical features in Basel 2/CRD now unwelcome? Since the current regime is now set in EU law by the CRD, it would appear that the UK has in any case little latitude for independent action—beyond saying "use the same methodology, but just hold more capital"—essentially what the Government did in its October announcement. In the short term, of course, any general hike in capital requirements could make the credit crunch worse. Building societies tend to hold high levels of capital, but have fewer options to raise or generate new capital. So any further uplift in required capital levels would need careful phasing (although, of course, if building societies' existing holdings of capital remain well above the new minima a further uplift may have no particular consequences).

19. In this context, we also note, and welcome, the readiness to question the past—including FSA's own theories and practices—evident in Lord Turner's speech on 21st January, and subsequent utterances. In building the future of regulation, there should be neither uncritical acceptance, nor wholesale rejection, of past policy, but a principled, intelligent review. We look forward to the publication of Lord Turner's review and to offering a constructive response on behalf of this Association.

20. We are currently considering the FSA's December consultation paper CP08/22 on liquidity. As mentioned above, the current regimes which date back to well before FSA clearly need replacing. The tougher policy signalled by the FSA may be needed in order to reduce the propensity for banks to fail. We particularly welcome the recognition by FSA that building societies' simpler retail-funded business deserves a simplified model within a unified liquidity regime, though we think some of the detailed quantitative and reporting requirements look onerous (and we will be pressing this case in discussions with FSA). And a hike in the level of liquidity banks and building societies hold may also prolong the effects of the credit crunch.

Should there be tighter regulation of off balance sheet vehicles in which some banks held toxic assets associated with sub-prime mortgages? Should there be greater public disclosure of bank balance sheets? Should fair value accounting rules be adjusted?

21. The banking crisis has revealed that complex, opaque financial products, whose risks are not individually well understood, can pose a systemic risk in wholesale markets. Before deciding how further to regulate such products, it may be fruitful to consider whether the development and promotion of these products—essentially, what is known as the "originate and distribute" model—result from perverse incentives created by existing regulation—for instance, in relation to securities based on sub-prime mortgages. Building societies themselves do not undertake the structuring or promotion of such products, though a few societies have used securitisation on a modest scale to diversify their sources of funding. Their use of derivatives is moreover restricted by statute to managing their own interest rate and other risks.

22. The traditional building society model of lending may, by contrast, be described as "originate and hold", aiming for a long-term relationship with the mortgage borrower (who becomes a member of the society with a vote at general meetings etc). This arguably leads to more prudent lending in the first place and works better where borrowers encounter payment difficulties and fall into arrears. Building societies do also acquire and sell portfolios of mortgages, but their core business adheres to the "originate and hold" model.

23. Bank and building society balance sheets are already subject to extensive disclosure under the EU Bank Accounts Directive and (as applicable) IFRS or UK GAAP. Rather than more disclosure, we suggest that existing disclosures should be made in a way that is more relevant and accessible to the general public—who typically are bank depositors but not bank shareholders, and so currently receive nothing. We commend a practice that building societies are required by statute to follow. Once a year, every saver with more than a nominal amount of savings with a building society is sent, free of charge, simple, clear information about the financial position of their society. The document is called the Summary Financial Statement and it is required under section 76 of the Building Societies Act. It contains a summary derived from the audited annual accounts, the annual business statement, and the directors' report, including specified key ratios covering lending, funding, liquidity, profitability and capital. Surely bank depositors too deserve a similar summary?

24. On fair value accounting, before adjusting anything, we should be asking this prior question : did fair value rules fail to deliver the outcome that was intended, or did they deliver that outcome, but in changed circumstances in which we now find that outcome unpalatable ? We see little benefit, and some detriment, to societies from fair value rules, and if they are now felt to contribute to instability then perhaps they should be changed. All sacred cows may be challenged.

25. While on the subject of accounting, we consider that the failure of the accountants and the relevant regulators to come up with a single authoritative view on how to account for the FSCS levies, even four to five months after those levies became a reality, is extremely regrettable.

The Role of Independent Directors, Remuneration Structures

26. The experience of building societies in both these areas is quite different to that of most banks. Building society boards have a clear majority of independent non-executive directors, including the chairman: executive chairmen or combined chairman/chief executive are not acceptable. Societies have a single core business, with a prudent, low-risk business model. NEDs are fully able to understand this business, and to oversee and challenge the society's risk management. In technical areas such as treasury, this Association has for many years run regular workshops, conducted by experienced City practitioners, that are targeted at society NEDs and assume no prior technical knowledge. These are extremely popular, demonstrating that both societies and their NEDs take seriously their responsibilities, and need for training.

27. Given that building societies are in their own right substantial businesses (as the figures in our introductory paragraph illustrate), remuneration levels are relatively modest. Societies generally follow an adapted version of the Combined Code, and remuneration policies are put to a vote of ordinary members (one member, one vote) at the AGM and approved. Typically over 90% of the 20% of members who vote, vote in favour of the remuneration report. Building societies are not involved in investment banking or securities or derivatives trading, where breathtaking bonuses are, or were, apparently customary. Nor does the constitutional structure of building societies allow the use of share options.

A clear separation between commercial and investment banks?

28. Building societies' locus in this matter is that they are exposed to the risky business or behaviour of banks through the FSCS (as they have now experienced for real), which ultimately functions as a tax or levy on their individual saving or borrowing members. As argued elsewhere, it is imperative to reduce the propensity of banks to fail. If it is not possible to make all banks sufficiently less risky, then at least retail banks—who take retail deposits covered by the FSCS—must be made a lot safer, and wholesale and investment banks—if they are to stay risky—had better be kept quite separate.

How should the regulatory system take account of the Government's position as a majority shareholder in a number of banks?

29. The most important challenge posed by the Government's presence in the banking industry relates not to prudential regulation, but to competitive distortion. At a time when both wholesale and retail depositors are unduly motivated to prefer Government–backed institutions, the presence of several major wholly or partly nationalised banks as well as a resurgent National Savings, all enjoying this competitive advantage, remains a major concern to our members.

Are there lessons the UK can learn from the experience of other countries' banking systems during the financial crises?

30. We caution against the temptation to view the grass as greener on the other side. There are some examples which we would certainly not want the UK authorities to emulate—eg Iceland. And local conditions—particularly the structure and concentration or diversity of the banking industry—in overseas countries may differ considerably. More important than following foreign fashions is for the Authorities, whilst remaining realistic and principled, to take tough pre-emptive action in situations where the behaviour, or failures, of foreign banks transmit risks, or costs, to domestic institutions through the operation of the FSCS.

24 February 2009

Examination of Witnesses

Witnesses: Ms Angela Knight, British Bankers' Association and Mr Adrian Coles, Building Societies Association, examined.

Q365 ***Chairman:*** Good afternoon and welcome to the Economic Affairs Committee. Thank you for making time to be with us today and thank you both for the written evidence you gave in advance. Most of our questions will be addressed to you both and we look forward to hearing both views. If one of you agrees entirely with the other, then a nod of assent will do and will help us get through all the questions. Do either of you want to make any introductory remarks or shall we go straight to questions?
Ms Knight: May I just make one? I would like, if I may, to declare an interest in case it is relevant to some of the questions you may come to. I am a non-executive director of Brewin Dolphin PLC which is a private client stockbroking firm in the UK.

Q366 ***Chairman:*** The de Larosière High-Level Group on Financial Supervision in the European Union argues for the creation of a European System of Financial Supervision, the ESFS. That would involve consistency of regulatory rules and supervisory sanctions across Europe. Do you, from your point of view, support those proposals? What do you think the impact of those proposals might be upon the City of London?
Ms Knight: The BBA would agree that there does need to be some clear and careful reflection of the current system and that there needs to be an examination of what can be improved. We actually put forward to the de Larosière committee some options which would give a greater degree of powers to what we currently refer to as the Level 3 committees, namely CEBs for the banking industry, CEIOPS for the insurance and CESR for the securities trading. The reason we did that was because there are very considerable differences in regulations across the EU and because there are different applications of the rules which does not fit particularly well with multi-jurisdictional operating banks. We believe that possibly one of the main things which needs to be done first is to bring together properly operating colleges of regulators for the major financial institutions of the EU. Some are working well at the moment, others are not properly established and there is everything in between. This is part of what de Larosière is proposing. As far as what are going to be the responsibilities of the current Level 3 committees in future is concerned, we would also agree that they have to have some more teeth; some ability to bring about agreements where agreements have not necessarily been achieved. We then have a bit of hesitancy about the next steps. There is talk within the report and indeed more widely about, for example, harmonised rules and common rulebooks, yet the actual legal basis across Europe in different countries is very different. We think that greater attention needs to be paid, for example to common outcomes rather than arguments about the actual rules themselves which can get tied up in legal differences. We think that there is something about standards and principles which needs to be addressed as well. We believe perhaps that needs to be heightened emphasis on regulations rather than more rules. As our major financial institutions in Europe also in the main operate internationally, we would like to see that better reflected within any new stability supervision arrangements that are put forward. Whilst the international context is actually addressed within the report, it does not fit very well with what is proposed and we do have to ensure that whatever we do in the EU—in Europe—has that international context firmly in mind and particularly important for these large financial institutions because of how and where they operate.

Q367 ***Chairman:*** From the evidence Monsieur de Larosière has just given us, I think he would take the same view.
Mr Coles: May I add two points to that as the representative of a body of institutions which generally operate in the UK only. Some fund raising is done in the international capital markets and a little bit of lending is done in Ireland and Spain in euros but generally they are UK-based institutions and it is very important, if we do have pan-European rules or greater concentration on those, that the requirements of those institutions that operate within single jurisdictions are maintained, that we do not have a set of harmonised rules which damage those institutions which do not operate cross-border. One paragraph to which I was particularly attracted in the de Larosière report, paragraph 42, has a sentence in it which should be italicised, underlined and emboldened. It says "The enforcement of existing regulation, when adequate, or improving it where necessary and better supervision can be as important as creating new regulation". There is a huge search for new regulation at the moment and for a rearranging of the deckchairs, giving different responsibilities to the FSA, the Bank of England and the Treasury where, if we did better with what was there already, as the FSA report on Northern Rock drew attention to, we could well achieve the same objectives.

Q368 ***Lord MacGregor of Pulham Market:*** I have two questions which perhaps follow on from the ones suggesting further changes and they are based on previous witnesses' views. Some of our witnesses

favoured a more macro-oriented, counter-cyclical approach to capital regulation. Do you think that capital adequacy regulation is correctly focused, particularly with that comment in mind? Secondly, some felt that some form of liquidity regulation would have avoided some of the excesses of recent years. What would be your view on liquidity regulation and how it would affect your members' businesses?

Ms Knight: The answer to both those is yes, if you really want a quick answer. To take it a little slower, the capital rules were decided at Basel II, as you know. They have been very differentially applied across Europe and they were not applied in the US. The rules were designed in times of peace and goodwill and as soon as they were applied in the very difficult circumstance we have today, they have been proved to be somewhat flawed. Is it necessary to re-address them and find some counter-cyclical capital measures? The answer to that is yes. We have to have another arrangement. But if we are going to agree this, then let everybody agree it. It is no good agreeing around the table but crossing your fingers and sitting on your hands and just not implementing it when you get back home. On liquidity, again all the attention was paid on capital and not on liquidity. What happens first? The answer is that liquidity disappears. The FSA has put out a consultation on liquidity and it has a lot of good sense in it. Again, it is something the BBA believes has to be addressed. I suppose though we would have two concerns. The first is that liquidity is being discussed for longer in international fora than capital and there has never been an agreement on what is needed and where it is needed. Second is that whilst it is absolutely correct that now authorities have to try to effect a better set of arrangements for liquidity, if they are going to do this, the UK needs to go at the same speed as others, otherwise an early implementation of change here in the UK—and I think we are the only country who has put out proposals for discussions on liquidity—would simply result in us losing some of our international business. The answers to your questions are yes, but it is often how one does things that is as important as what one does. That really feeds into what Adrian said earlier, in that we have rules aplenty, but the enforcement of rules is not necessarily anything like as good as it should have been.

Mr Coles: In the past the capital rules were far too complex, there was a huge absorption of regulatory effort in assessing the complexity of the Basel II rules. There was a very good speech given by Thomas Huertas and again I will quote you just one sentence from this, if I may. "The broad assumption underlying the Basel Capital Accord that regulators around the world could rely on firms' own risk models as the basis for capital requirements has not turned out to be correct, as least for the trading book". The complexity did not capture the eventual complexity of the world and there was that overemphasis on that complexity which took people's eyes away from everything else. On liquidity, the danger is we go too far in the liquidity direction as we realise that we ignored it too much in the past. Certainly as far as building societies are concerned, the regulatory attention now being given to the amount and nature of liquidity is, in the view of many building societies, preventing them lending into the home loans market, reducing the supply of funds for mortgage at a time when it is government policy to try to increase it and also at the same time, because returns on liquid assets are now so poor, it is damaging profitability and therefore damaging their ability to build up capital. So we have to make sure we do not over-react on the liquidity side, encourage firms to hold too much liquidity and encourage them to hold liquidity of such a high standard that they cannot get any return on it.

Ms Knight: May I just add one last thing and that is that you cannot change the capital requirements and make them more counter-cyclical without also changing the accounting rules. Whilst I appreciate that Spain did make some changes, it actually disapplied the international accounting standards and, whilst clearly they got away with it, I think that we cannot separate out the interaction of accounting with capital; they do go together.

Mr Coles: One of the great attractions of the Spanish model was that the central bank was responsible both for capital adequacy regulation and accounting regulation of the banks.

Q369 ***Lord Best:*** My question is directed particularly at Mr Coles. I just wanted to tease out whether you thought there were fundamental differences in the way in which regulation, governance, even the reward of chief executives differs in the sector for which you have responsibility, the mutual building societies, as compared to the banks which are the subject of so much of our discussion. Could you just explain how you see the difference in the models you are working through?

Mr Coles: There are legal differences. The building society legislation prevents building societies from taking more than 50% of their funds from the wholesale markets. Northern Rock as an outlier took 75% of its funds from the wholesale markets and the average for building societies is 30%. On the other side of the balance sheet they have to invest predominantly in residential mortgage assets and it is illegal for them to invest more than 25% outside the residential mortgage market. Secondly of course, they are owned by their customers. There are no external shareholders and that gives them a different focus. They seek to serve customers because

customers are their owners. For example, they are seeking—today not so much—to minimise their margins because that maximises the utility of their mortgage borrowers and the savers. Where as in a bank, if you are trying to maximise profits, you are trying to widen margins. That gives a different approach to the business. As far as executive remuneration is concerned, there is no doubt that executive remuneration in building societies has risen over the last 10 years. It has not risen to the extent it has in the banking sector and it is notable, as you may have seen in the Sunday newspaper report just this weekend, that a significant proportion of chief executives of large building societies were not paid bonuses last year, for example.

Q370 ***Lord Best:*** Am I right in thinking that the performance indicators for chief executives in building societies are very often based on customer satisfaction? Not a measure that is so well known in the banking industry.
Mr Coles: The independent research shows that while in balanced score cards it is typical in the PLC sector and not only in the banking sector for shareholder return, profitability and cost control to be the key drivers of salaries in the PLC sector, in the building society sector independent research shows a wider range of indicators to be equally important, including customer satisfaction, staff satisfaction and other softer indicators. Absolutely.

Q371 ***Lord Forsyth of Drumlean:*** Do you not think this point about ownership which you stressed is rather overdone? I cannot help thinking that if we take the collapse of Lehman for example, Lehman was an institution where the ownership of the business was very much in the hands of the people who presided over its collapse, of the employees.
Mr Coles: What is important is that we have a biodiversity in the economic system in the UK, that we do not put all our eggs in one basket, we do not only have the PLC structure, we have alternatives. Mutuality has been a very viable alternative and it is sensible to have customer-owned institutions in the marketplace which give people a choice.

Q372 ***Lord Forsyth of Drumlean:*** May I ask both of you about corporate governance? We have had quite a lot of evidence which has placed a lot of stress particularly on the role of the non-executives; some people even suggest non-execs should have some kind of independent staff of their own challenging the concept of the unitary board and some have suggested that perhaps the idea of having limited terms for non-executive directors should be abandoned so that you have people who have experience across the economic cycle. Could you comment on those thoughts?
Mr Coles: In the building society sector, especially for the smaller institutions, it would be an unnecessary cost to provide independent staff for the non-executive directors. Building society boards are typically constituted of about eight or nine people, typically two executives, perhaps three, typically five or six independents. The chairman is always independent and a non-executive. An interesting point about length of service is that in the building society sector the average length of service of non-executives is eight years: in the FTSE100 it is four years; this is not just banks it is all of the FTSE100. Personally—and this is not a BSA view, I think there is an over-emphasis on turning over directors rapidly. I think there is a lot to be said for directors serving for a longer period of time because that enables them to see the consequences of their actions. I think that a short term on a board encourages short-termism in the outlook because those board members who make decisions do not necessarily stick around to see the consequences of those decisions. In the building society sector we have boards who have a six-year maximum term, boards who have a nine or 12-year maximum term; the longest serving director in the building society sector is 85 and has been on the board for 35 years. That may be going a bit too far in the other direction. My own view is that six years is too short; nine years or 12 years is sensible, but, especially for small local building societies where it is not easy to get well-qualified talent, to kick someone off a board just because he reaches 12 years' service is inappropriate. The reason I believe time limits were introduced was that boards were reluctant to take the appropriate action to get rid of people who were no longer giving consistent good service to their boards.
Ms Knight: I have served as a non-executive director on a number of boards and of different sizes of companies. The first thing is that a small company is very different to a large company and a complex company is different again to one that is fairly monochromatic. There is no one universal answer to your question. Secondly, whilst I think that if you are a board member of a mutual you are giving a very valuable service, you are certainly not exposed to shareholders, to investors, to analysts, in anything like the same way as you are to a listed company. Again I am afraid you cannot really compare the two. As far as who should be there, how long they should be there for and whether they need some independent advice, it is correct that if someone is there for a long time, they are saying the same thing and are viewing things in the same way. They are captured in part by the organisation on which they serve and by the market which that organisation itself serves. I do not mean that in any way as a critical point; it is an inevitability that time means you will tend to see things in the same way as others. That can be helpful, but it certainly is not something a company wants to

have from all its non-executive directors. If you say, for example, that you want NEDs to stay—or at least have some who have stayed—through an economic cycle, at the moment you would have had to have been a NED for an extremely long time. If you had come out of university in 1992, for example, and gone into work then, this is the first time that you would have actually seen a recession and you are 40. If you have a non-executive director, you are going to have to keep him on a very long time indeed for him to have seen properly through the last recession and therefore be able to contribute through this. Economic cycles are movable feasts. They are not necessarily short, they are not necessarily long; you do not know how long they are. I think that a company needs to have a reasonable amount of new blood coming through.

Q373 ***Lord Forsyth of Drumlean:*** I am sorry to interrupt. Perhaps the questions were too specific or literal. Behind this question and behind the evidence we have received it is perfectly apparent that the non-execs in some institutions really did not have a clue what was going on and they allowed things to happen which should not have happened. We have had evidence which has suggested that is because they did not have enough training or enough knowledge; they were disadvantaged and that is the argument for having background support. The argument about the economic cycle is that there appear to be non-execs who just assume that every year would get better than the last and have not actually had experience or did not seem to anticipate that there would be a crisis and that is what is behind this question.
Ms Knight: On that basis, there is absolutely no structure which can make somebody who is a bad non-executive director a good non-executive director and there is no structure which can actually make somebody who is not going to ask the right question ask the right question. I think we have to accept that individuals have to take a lot of personal responsibility on themselves if they are going to perform properly as a non-exec. I too am surprised at what seems to be an absence in some instances of asking the right questions and assumptions that maybe were made which should not have been made. There is already the ability to take outside assistance and help if you wish. At one time I chaired a with-profits committee of a major life company. I employed some outside help and as a non-executive director you need to be able to do that. We have to structure things better, so I entirely agree with you on that, and that it is made absolutely clear that there is additional assistance if it is necessary, particularly for the major PLCs. I am not going to go into the small ones but I say again that non-executive directors do have to take responsibilities upon themselves to ask, to enquire, to find out and to understand.

Q374 ***Lord Forsyth of Drumlean:*** When you say we have to structure things better, without getting into specific examples it is apparent that the non-executive system completely failed in respect of some of the large banks who are members of your association. It has been suggested that perhaps they should have had advice or whatever. If neither of these things is appropriate, what should we do in order to ensure that we have non-execs who actually carry out the functions which are expected of them? Manifestly that has not happened in respect of these institutions for which the taxpayer has now had to shell out very considerable sums of money.
Ms Knight: As you know, I cannot answer as to what happened in a particular board of a member of the BBA at which I was not present. I cannot do that.

Q375 ***Lord Forsyth of Drumlean:*** I am not asking you to do that.
Ms Knight: What I have said to you in response is that you can, right now, take independent advice. If that needs to be formulated better: let us formulate it better. Sir David Walker is already starting to look at these matters and I believe he will be reporting at the end of the year. The Financial Services Authority have put in place a set of principles which are now flowing through some broader aspects of the way that some of these issues are picked up within a bank and within other financial institutions. Yes, you have an absolutely valid point. There does need to be something more so that the game is improved considerably by some of those non-executive directors, though by no means all; as you cannot say that all non-executive directors of all financial institutions or all banks are performing badly. They manifestly are not, nor can you say that there is just a problem with a couple of banks in the UK, when we have a global financial system problem. Also, I do not think it is right to say either that individuals do not have a responsibility to act properly themselves, to ask, to enquire and to question. Of course they have. In the end you get the right results if you have the right people in the right place at the right time.
Mr Coles: At the BSA we do organise a series of training seminars for non-executive directors of building societies, a seminar for newly appointed directors, we do treasury management seminars for the non-executive directors and we have a seminar for chairmen of building societies so they are aware of policy developments. Training is important and we think it is important that we play a role in that area.
Ms Knight: It is a fair point. The accounting firms are providing that widely across the PLC spectrum as well as for the financial services industry.

Q376 ***Lord Paul:*** Looking at what has happened, so many new products have been put forward by the banks that I am not sure even the executive directors

understood the consequences or what can happen and what cannot happen. They were just driven by greed or whatever you want to call it. Is it really possible for a non-executive director to be able to discover anything by just asking questions of people who do not understand the answers themselves?
Ms Knight: A non-executive director is not there to second-guess the executive team nor to sit on the shoulder of the chief executive and run the organisation in any company. They are there to ask questions and you can certainly ask questions about the risk, the complexities. You can certainly ask about bringing forward examples of how something may or may not perform. On the question of complexity of products, you are entirely correct that what has in effect happened is that products which were anticipated to perform in one way simply have not. Equally, I do not know of anybody who really anticipated quite such a set of circumstances which resulted in the global financial system freezing to such an extent that none of the previous standards and assessments worked properly. That is not just a view from the banks: regulators did not expect it; central bankers did not expect it; finance ministers did not expect it; nor did economists; observers and others. This has been a huge extraordinary set of events in which many people played a part and many people hold a responsibility as well as the banks themselves.

Q377 ***Lord Paul:*** Have you figured out who are the people responsible then or did everybody get carried away with the great profits they were making?
Ms Knight: As far as the complexity of product aspect is concerned, I frankly think that we are now moving into an environment where products will be extremely simple. There is nothing quite like having something happen of this sort of magnitude for change to occur. It is better than any regulation and complexity is something that we have to leave behind. But you cannot have no innovation because no innovation brings with it its own downsize. Certainly we will be shifting and rapidly, as you can see. Right across the financial services industry generally the movement is to simpler, more transparent, more well-understood products. There is a flight to safety, to conservatism, to extra capital, to holding more liquidity and that has brought with it some of the other issues of finance or absence of finance which are now starting to be questioned.

Q378 ***Lord Levene of Portsoken:*** You have been talking about the competence of boards and their membership. There are really two interlinked questions. Do you think there should be more regulatory intervention on corporate governance generally in these institutions? At the same time, what has been an even more hot topic recently, should there be some kind of regulatory maybe not intervention but oversight on the question of compensation which seems to have played a big part. Do you feel this would be productive or counterproductive if the regulator actually had specific responsibility to look at those two issues?
Ms Knight: We are probably going to have both anyway. Taking remuneration first, changed remuneration proposals or structures have been put forward by the FSA and they have said that those will be assessed as part of what they call their ARROW visit and if they do not believe that the remuneration structure is operating appropriately, by which is meant, broadly speaking, reinforcing good behaviour but not reinforcing excessive risk-taking, then they will take steps regarding the amount of capital that the entity has to hold. There is an indirect grip of remuneration by the FSA in this way. Frankly it is actually a very good grip because it is going to cost you more money to do your business unless you get remuneration right. So we are there with that. As far as corporate governance and oversights are concerned, one aspect that has been most noticeable over these last few years in the way regulators have regulated, is that they have looked to the execution of the rules rather than supervision of the entities. That is something which has to change and is changing. For a non-executive director to be appointed you have had to provide certain information in the past and that is now coming under much greater scrutiny. Whilst the questions are correct ones, the answers are that we are already getting there with both issues.
Mr Coles: On the building society side, building societies adhere to a special version of the combined code which takes account of their mutual status. You will see in every building society annual report a report on how they discharge the responsibilities under that code. We sent the FSA note on remuneration out to our members on the day it was published. There was one area of it which was not appropriate to building societies, where it said the key financial indicator was profit. We do not always see that in building societies as the key financial indicator, although in current circumstances we tend to. We are very keen to adopt the higher standards in these areas.
Ms Knight: There is one thing about remuneration as well which it is important to recognise and that is that remuneration committees often have external advisers. The way that remuneration was structured for senior teams tended to move as a pack, not just banks but right across the PLC world, and was voted upon by shareholders, or not, as the case may be, at AGMs. There has been that interaction on remuneration which has not been only within the organisation but has also had external shareholders involved. That is something that clearly is not going to stay as it is, which is why the point is correct that there is a role for the regulator in remuneration and structures within the industry.

Q379 ***Chairman:*** The institutional shareholders are driven by very similar remuneration arrangements, are they not?
Ms Knight: Absolutely.

Q380 ***Chairman:*** They too are highly geared and highly bonused. If you are trying to align the interests of the management of the bank with that of the institutional shareholders, do you not also have to tackle the other end of that, namely the way in which fund managers are paid?
Ms Knight: That is an immensely valid point as well. You cannot actually keep this as a narrow discussion. If we go back on the complexity of the financial instrument question, there was a lot of pressure on those institutions who were not taking the more adventurous steps in financial innovation from some investors who asked "Why is your share price not going up so quickly? It is because you are being too cautious". This is the circle and it goes round and round. It is absolutely correct that you cannot just take one bit of the remuneration piece and forget that there is a broader range of entities out there who all have to look at their own remuneration structures, their own risk models and the way in which they reward within their organisation.
Mr Coles: In the building society sector it is of course the ordinary members of the building society—the depositors and the mortgage holders—who vote on remuneration. That is a voluntary system by the building societies. In a mischievous moment I did wonder whether Angela would support the idea that bank customers should vote on bank chief executives' remuneration. That would seem to be a useful idea that the banks could borrow from the building societies.
Ms Knight: And of course, with some of the banks being demutualised building societies, they have a vast shareholder register as a result and still the remuneration proposals went through.

Q381 ***Lord Levene of Portsoken:*** I am sure, as you say, that if the regulator is going to look more closely at the qualifications of non-executives who are appointed and not just given a ritual tick in the box, it must be a good thing. Do you really think that in an ARROW visit the officials of the FSA who go there are going to say that they are looking at this remuneration, the chief executive earns £500,000 a year or £5 million a year and they think that is right or wrong? Are they really going to be able to do that?
Ms Knight: No; that is not what they are there to do. In the ARROW visit they are not looking at the senior team, as I understand it at the moment and this new process is being developed as we speak here. The ARROW visit will be looking at the remuneration structure below the board level and of course their particular concern relates to the very large bonus that, for example, some traders have been able, under certain circumstances, to earn. So the kind of structure they are looking at is much more about that balance between the bonus and the standard pay and what sort of response the structure is going to have on certain types of activities.

Q382 ***Lord MacGregor of Pulham Market:*** I am not sure that the FSA's visits do cover the question Lord Forsyth of Drumlean was asking. If you look at the position of directors or senior executives who have been paid short-term bonuses for particular performance, I do not think the ARROW visit would pick that up, would it? That is much wider than that.
Ms Knight: No; that is right. There are a number of different structures here, a number of different slices, if you like. The remuneration within an organisation, certainly the middle and lower rank and up to some point presumably below the board level, is where the ARROW visit focuses. Then for the senior teams and the board and the way that that is going to be looked at is for Sir David Walker's review. In the international context there are a couple of entities that come out and say they are also going to look at that part of remuneration. There has already been an agreement between those banks which have a shareholding from Government in them on remuneration in that area. But this is a moveable feast and where it will be in three or four months' time is a different place to now. The intention though is for remuneration to be addressed by one way or another right the way through, not just banks but into broader financial institutions of other types as well.

Q383 ***Lord Griffiths of Fforestfach:*** Over recent years we have seen the growth of the shadow banking sector which I suppose was not regulated in the way the banking system was regulated. We have seen institutions such as hedge funds which have had a much lighter regulation than the banks. However, those institutions have provided credit and provided financial services which people paid for and I assume therefore you had to say would be valuable. If you look to the future, we have a banking system which is regulated. To what extent would you see, alongside that, another part of the financial system which was highly innovative and much less regulated but which was also providing credit as a service to the economy?
Ms Knight: The questions can be asked but the answers are much less clear. First shadow banking. I think I would define a shadow bank as one which does a similar activity to the core function of a bank, which is maturity transformation, but is outside the similar type of regulation. If one says shadow banking is maturity transformation, then I would say it does need to have some form of prudential supervision; I am not quite sure how much, I am not quite sure how it is agreed, but it cannot be without

prudential supervision. On hedge funds, the question is more one of whether they have a systemic effect than any other. If they do have a systemic effect, and collectively they certainly appear to—I do not necessarily mean in the spotlight of short-selling but I mean in the way in which they have been heavily geared and have been selling down equities steadily now for six to eight months or more—then because they have a systemic effect like that and although they are within the regulatory environment, they should be within the regulatory environment a bit more than they are at the moment. Next there is something about regulatory boundaries as well. SIVs and conduits are outside and yet when they had to come back on bank balance sheets they had a great impact. The fact is that one can ask the questions and say that something does need to be looked at, but this does not, I am afraid, mean I can come up with an absolute answer. There is a balance between getting a bit more regulation in this area, which is probably right, and not suddenly finding that there is a lot of liquidity in cash which has formerly been provided into the whole financial system beneficially that suddenly goes away. After all, if I go off to a garage now to buy a car and the car seller asks me if I want finance and I say yes, that finance will come in most instances from an entity which is not a bank, and not a deposit taker, but an independent finance organisation which had access to the wholesale market and used the securitisation route and as both are now closed to them so that finance is not available. So we have to recognise that there is a benefit in these shadow entities and getting that balance of what should be regulated whilst not removing the benefit is going to be a very difficult thing to do, but it does need to be addressed.

Mr Coles: I would broadly agree with Angela. If I may just give an example from the mortgage market, it is interesting that some of the innovation in the mortgage market, in particular servicing the sub-prime sector, came from what you might call shadow mortgage lenders, that is non-deposit-taking lenders which were regulated less lightly than the deposit-takers, banks and building societies and it is perhaps no surprise that those institutions took bigger risks than the banks and building societies did.

Ms Knight: Absolutely right.

Chairman: I think you meant "more lightly".

Q384 ***Baroness Hamwee:*** May I ask you about the role of audit committees? Should they have more formal involvement in the validation and testing of risk management systems?

Mr Coles: A fairly easy question for me to answer. Many building society audit committees are changing their names to audit and risk committees and many building society boards would precisely agree with the point which is behind your question.

Q385 ***Baroness Hamwee:*** Are they doing more than changing the name?

Mr Coles: Yes, I think they are also changing their agendas, they are changing what they are talking about, they are changing the focus of the attention of the conversation within the committee. Building societies, even though they are simple institutions, do recognise the risks involved in maturity transformation, the risks involved in liquidity management. Where do you put your liquidity these days that you are being asked to hold more of by the FSA? Which institutions do you trust? How do you work out, given the discrediting of the credit rating agencies, which institutions are worthy of holding your money? These are all issues on the liquidity side coming within audit committees in building societies. On the mortgage side, what types of customers are you lending to, how far up the risk curve should you travel, should you go at all into sub-prime, should you be lending on buy-to-let, does buy-to-let really mean more risk or is it a different form of risk. These are all questions I have heard building society audit committees now consider.

Ms Knight: You can either have an audit and risk committee or you set up a separate risk committee and that is possibly an appropriate step to take the more complex the organisation is. You also have to make sure that the actual risk function within a financial entity has the right attention paid to it, so it is a senior position within that organisation, certainly at the senior executive committee level. You find that some financial institutions have separate risk committees which they then coordinate with audit; the chairman of risk sits on audit and vice-versa. Also if one spotlights the whole area of risk, the structure falls into place underneath it. But it is not just a case of having a committee, you have to give the attention right the way through, the staffing, the reporting lines and so on, within the bank or other organisation.

Q386 ***Baroness Hamwee:*** Are you saying that there might be rather different skills to apply and therefore separating them out is useful or just simply the workload.

Ms Knight: Probably a mixture of both actually; probably a mixture of both.

Q387 ***Lord Griffiths of Fforestfach:*** Let me ask you in connection with this, if an audit committee, which would be a sub-committee of a board of directors of, let us say, a bank or a risk committee, had on it, let us say, three non-executive directors, which may be typical, those three non-executive directors, if that committee had a formal involvement in the testing and validation of risk management systems, would have to deal directly with management within the organisation who were designing these risk models, monitoring risk, measuring risk and ultimately

managing risk. Would that not really go some way to the question which Lord Forsyth of Drumlean raised about competence in corporate governance? If you actually had committees working like that, non-executives who sat on those committees would have basically to do their homework in order to deal with the officials and ask appropriate questions.
Ms Knight: Yes, but some did and a risk committee is an arduous committee and if a risk report comes to a main board, as a non-executive director you have to understand what the risk report is telling you, not just look to see whether there are reds, oranges and greens. The points you make are entirely correct; I do not disagree at all. All I was trying to convey to Lord Forsyth of Drumlean was that it is a mixture of structure but also the efforts that the individual puts in the competency of the individual, and that you can have a first-class structure, but if you do not have the right people, you are not necessarily going to get the right answer. It is a mixture of the two.

Q388 ***Lord MacGregor of Pulham Market:*** Do you think that has actually been happening in a number of banks and institutions? Do you think that there really have been the risk executives who understand the whole process of risk and the non-executives, particularly with some of these very complex mathematical models which have obviously proved to be faulty? Do you think also that sufficient attention is given at the board level to the reports from the risk committees?
Ms Knight: There must be every variation available because we have every different type of result. One of the great mistakes is to say that because things have worked out badly for some banks, therefore all banks, have made mistakes, all banks have not had the right people and all banks have not looked at their risks properly. The majority have done this right. Where mistakes have been made, mistakes have not solely been centred on one or two people either. I am not trying to pretend, by any manner of means, that everything is perfect; of course I am not. What I am saying though is that the attention to risk and the attention to audit is key to whatever has happened in the past and are clearly absolutely at the forefront, but in many institutions attention was paid appropriately.

Q389 ***Lord Eatwell:*** I was very struck during discussions of the Banking Bill, now the Banking Act, that the BBA was critical of the notion of the partial acquisition of assets by the state or by the Bank of England from a failing institution on the grounds of property rights, defence of property rights, the same institutions, which when they screw up want to turn to a lender of last resort or for the state to bail them out. I do not see how you can argue for a classic definition of property rights, when you expect the state to stand behind you when you mess things up.
Ms Knight: Well we did not actually. Our main concern, as the Bill was going through the parliamentary process related to netting agreements and the legal aspects of netting agreements. In fact that was picked up and re-addressed through some of the provisions in secondary legislation in a way which we believe provides the necessary degree of certainty. Certainty is actually something which is essential because there are good times as well as bad times. Without having that certainty on netting, there were consequences, both through to the customers of the bank—I do not mean retail customers particularly in this instance I mean on the wholesale side—and also some major problems which relate to business as usual as far as netting of regulatory capital was concerned. Those were the main areas. I do not think that to say we were particularly critical is quite the right thing. What I do think it was right for us to do was to put up where some of the problems lay within the technical areas and indeed with the draftsmen and in the various discussions which have taken place those have broadly been resolved. I believe there are one or two issues left where lawyers are having some discussions right now.

Q390 ***Lord Eatwell:*** Do you think that institutions which ultimately have the state standing behind them, as we know they do, have a different relationship to society than simply represented by private property rights as you would expect in, say, a car company?
Ms Knight: There is self-evidently a different relationship. The circumstances which we have at the moment have shown that the state involvement with certain of the institutions has been essential to bring about stability. Of course that transforms and changes the relationship.

Q391 ***Lord Eatwell:*** For all institutions? Not just the ones which have been intervened upon but all institutions, because the state ultimately stands behind them too if things go wrong for them.
Ms Knight: Yes, that is how we see it.

Q392 ***Lord Paul:*** The Financial Services Compensation Scheme as presently constituted results in a cross-subsidy by low-risk deposit-taking institutions of high-risk institutions? Should it be re-designed?
Mr Coles: Inevitably a compensation scheme is going to result in the transfer of funds from those institutions which did not take excessive risks to the depositors of those institutions which did take excessive risks and then could not handle them. That is an inevitability of an insurance scheme. From my members' point of view, they are fully in favour of a

compensation scheme, they recognise that in some conceivable circumstances we could have building society depositors being paid out through such a scheme, but in general terms they are upset at having to pay significant sums into the compensation scheme to bail out those institutions which did not act as prudently and as carefully with depositors' money as they themselves did. Indeed there was a debate exploring these issues in the other place this morning.
Ms Knight: This has been a long-held debate though, because the compensation scheme was last reviewed a couple of years ago in 2007. Then there was also a long debate as to whether there should be any sort of cross-subsidy. Ultimately the default mechanism on the entire compensation scheme is actually just a few of the major institutions who already pay into a variety of the different types of categories. While the building societies pay only into two categories in the main. The questions have arisen before. There is no easy answer to cross-subsidy actually; there is no easy answer at all. We have lived with an uncomfortable situation for many years and I suspect we will continue to do so. The main issue we have to address, if it is a large financial institution, is not to get to the Compensation Scheme position in the first instance.

Q393 ***Lord Forsyth of Drumlean:*** We do not hear about moral hazard any more; moral hazard was fashionable about six months ago and seems to have disappeared under the weight of billions of taxpayers' money. Is this not the ultimate moral hazard? Here you have building societies who have behaved perfectly responsibly, who have lent on the basis of their deposits and who are now being asked to find money to support institutions which were not behaving responsibly. When it is suggested that that is in the nature of an insurance scheme, I could think of how you could devise a scheme which had required prior contributions in a way which would insulate people from that kind of difficulty. If you are sitting on the board of a building society and you have just got an enormous bill and you have run your affairs prudently, it must be more than a little galling and it is certainly very unfair. We are not talking about boards or companies here. The people who are having to pay are the people who are now getting nothing on their savings because the building societies cannot provide that return. Surely we have to think of a better system?
Ms Knight: I am sure you right. May I just say that I did not run a bank. Okay? I represent a trade association after all! Let us get to the compensation scheme itself. The major calls on the compensation scheme are the Bradford and Bingley, the Icelandic banks and then there has been a small addition. Certainly as far as the industry is concerned, we were very surprised that the Bradford and Bingley was dealt with in that way. We were also quite surprised at the way the Icelandic authorities behaved. It is actually a very big bill; the predominant amount will of course be picked up by the banks themselves. In the building society world, if I may say, because you are a mutual, you are not exposed in the same way as you are as a PLC. So it is often possible for a merger and acquisition to take place without triggering this type of involvement. Where I think that there is absolutely legitimate concern is at the proportionate pick-up of an adverse consequence. The proportionate pick-up of the largest part easily and any way one wishes to carve it, of the deposit protection falls to the banks, whether it is a bank or whether it is a building society which gets into difficulty. What I do think needs to take place in future is that we do need to address some of the cross-border situations because the Icelandic responsibility has fallen significantly to the UK to pick up. I also think, and it comes back to a point made earlier, that early intervention is much better than waiting to a point where a compensation scheme is triggered and particularly, if a rights issue has already taken place and where the same banks have been asked to underpin that rights issue.
Mr Coles: I would only add that I agree entirely with Lord Forsyth of Drumlean's question.

Q394 ***Lord Forsyth of Drumlean:*** What is the answer?
Mr Coles: The answer could be to go to more risk related contributions towards a compensation scheme but the measurement of risk is extremely complicated and we at the BSA do not know the answer to that. The answer could be sub-schemes for banks and building societies, but if we ever did have a building society claiming, and I did say that was conceivable, then you are cutting off your access to the 80% of deposits that the banks look after. There is no easy answer; nevertheless you are quite right to record the strong degree of unfairness that building society directors feel about the current situation. We are currently formulating a blue-skies paper on how we think this should go forward but the issues are extremely complicated.

Q395 ***Lord Eatwell:*** May I ask whether the compensation scheme has ever been drawn on as a result of a building society failure?
Mr Coles: The answer to that is no.

Q396 ***Lord Moonie:*** Some commentators have suggested that in recent years supervisors have over-emphasised fairness in financial intermediation at the expense of financial stability. Is this criticism valid? Is there really a trade-off? If so, how do you think it would be most effectively resolved?

Mr Coles: I personally think that financial stability is at the heart of fairness. The fundamentally fair thing that depositors want is to have their money back when it falls due and that institutions do not take excessive risks with the money when it is under their control. Financial stability is a fairness issue. Having said that, there probably has been over-emphasis on treating customers fairly; certainly within institutions it has resulted in huge investments in management information systems, in diverting possibly management attention from prudential soundness to conduct of business approach. We obviously must take steps to make sure that boards and management of building societies do not misrepresent products to their members and do not sell them products that are not appropriate, that they do not target products to the wrong type of customer. All that is very important but it does pale into insignificance and importance compared to giving people their money back when it falls due and not taking inappropriate risks when you control their money. Broadly speaking I have sympathy with the point behind the question.
Ms Knight: Yes, there has been quite a long-held view that the balance has not been right and in a number of areas. I said earlier that too much attention has been paid to the execution of the rules rather than supervision of the organisation and that has meant that the way that the regulators have looked at the different aspects of a financial institution has been compartmentalised. There are perhaps two things which need to be done. The first is that I am not sure that being a regulator is actually seen as the career it should be and the FSA has said that it will bring into that organisation a cadre of higher quality practitioners to look at regulating not just banks but the major entities in particular. We think that is right. On the treating-customers-fairly project, which was an FSA project, that in fact resulted in a diversion of very significant attention by organisations, by management and indeed by the FSA itself. There are ways in which one can actually address some of that and that is by looking at what is meant by, for example, "fair" or "unfair" in those areas to a greater degree. We do not have rules in subjective areas, we only have rules in objective areas, but that very subjectivity is giving a lack of clarity both to customer and to the product provider. Maybe that issue has been forgotten and clarity and the need for clarity have been forgotten—just maybe getting greater clarity what is fairness would be helpful for all and enable regulators to get their eyes up to the bigger picture, which is clearly essential.
Mr Coles: What is important is the culture of the organisation. It is very difficult to adapt a tick-box mentality from a regulator to assessing the culture, ethics, the DNA of the organisation—to use the modern terminology. A supervisor has to form a judgment on that and the supervisor needs to be almost as skilled as the non executive director in asking the appropriate questions and making the right judgments and not taking a regulatory box-ticking attitude that they have done all of these things. You can do all of the things on the treating-customers-fairly project and still be rather unpleasant to your customers.
Ms Knight: That box-ticking culture has been one of the areas which all different types of financial firms have been concerned about because it does not get to the core of the issues.
Mr Coles: Absolutely.

Q397 ***Lord Paul:*** I just wanted to know. With all this talk of regulations, better regulations is it really possible to stop the kind of things which happened with any regulation and would any regulator dare control what has happened?
Mr Coles: My own view is that markets will always innovate more rapidly than regulators can pass regulations.
Ms Knight: Yes and mistakes will always happen and wrong judgments will always be made.

Q398 ***Baroness Kingsmill:*** I was very taken by your comments about the need for biodiversity in the financial services sector. I wondered whether you would both let me have your views on whether you think, when all of this crisis is over, that the day of the big bank is over or should be over and whether or not we should not perhaps be diversifying in a way which meets the need of the different kinds of customers of banks in a more appropriate way.
Mr Coles: Far be it for me to say the day of the big banks is over. I do not think I'd assert that. There is a danger in the way that mergers have gone ahead that we have banks which are both too big to fail and too big to save and of course we have had a huge merger which has created the new Lloyds Banking Group. If that in the next financial recession faces difficulties which are even a proportion of the size they currently face then that is a big set of questions we need to ask. The Financial Services Compensation Scheme is based on insurance of a large number of small institutions. It is impossible to see how the compensation scheme can bail out the big institutions in the current environment and the whole idea of insurance cannot work when you have half a dozen huge financial institutions which dominate the markets. I do think that the term "economies of scale" is over-used; there are significant diseconomies of scale which have not been recognised in the upswing. You can have institutions which are too large. What matters from my point of view, running a financial institution, is not how big you are but whether you have an appropriate strategy, whether you can actually implement it and whether you have an appropriate management. Size is far less

important on all those factors than is frequently suggested.

Q399 ***Chairman:*** I wonder whether the BBA response might include economies or diseconomies of scope as well.
Ms Knight: With any business, the broader range of customers you have and the broader range of suppliers you have the more likely you are to be able to handle the ebbs and flows of economies. It is exactly the same in the banking industry as it is in any other sort of industry. The question which arises is one of how you control it, how you manage it and whether the risks are properly addressed, which has been the subject of much of the questioning today. Personally I think that some errors have been made in some of the commentaries. For example "Give us back narrow banks" has been one. Yet of course, if you are going to have anything from a fixed interest mortgage onwards, then you require something in the way of a derivative in order to enable that to take place. Financing of corporate Britain is not just a case of taking in deposits and then lending out. We would not be able to finance corporate Britain like that. What you have to have is a range of activities which a bank undertakes and it has to be able to operate in different types of markets.

Q400 ***Baroness Kingsmill:*** All within the same institution is necessary for that.
Ms Knight: Yes, I think it is, but that does not mean that you do not address some of the risks through capital rather better. As is well known, the amount of capital that you have to hold in the trading book was much less than in the banking book and that resulted in a growth of instruments held in the trading book whereas in previous years the bank would have put them into the banking book. That was one of the consequences of Basel II actually which resulted in those capital allocations which were rather different to that which one might have expected. That is therefore where I would look. I would go into the areas of control in the different types of activities rather than try to split some activities off. We have after all seen perhaps the residual consequence of the Glass-Steagall Act in the US, in the sense that the independent American investment banks, the Wall Street investment banks, remained as Wall Street investment banks until now. Now of course none of them have remained as independent Wall Street investment banks. In the narrow banking field, a lot of the mortgage and savings and loans banks have got into very real difficulty. Bradford and Bingley was a narrow bank. Northern Rock was a narrow bank. The questions are about control, proper application, capital, risk and liquidity. We need some of the broader-based institutions, we need some small ones, we need some specialists, we need some in between and we need that range.
Lord Forsyth of Drumlean: You left out Citibank.

Q401 ***Lord MacGregor of Pulham Market:*** Can I come in on that one because it raises issues we have not really properly explored, although it was touched on earlier with reference to hedge funds. When you are talking about some of the new instruments which were created in response to Basel or whatever, there is also the issue of all these structured investment products et cetera, created for a number of reasons but one of them was to have them off balance sheet. I wonder whether you feel that there is not a lot more that should be done about transparency.
Ms Knight: And the regulatory boundary as well, which is why I mentioned the SIVs and conduits point before. There is already transparency, though I tend not to use that word so much as comprehensibility. Some of these financial instruments are immensely transparent, 400 pages of transparency, but people could not work out what it meant.

Q402 ***Lord MacGregor of Pulham Market:*** You need both actually.
Ms Knight: Absolutely. You are absolutely right: where is the regulatory boundary as well? It is part of the debate and it is part of the things which have to be addressed and shifted.
Mr Coles: And regulatory arbitrage. Basel I certainly encouraged institutions to take things off balance sheet if they possibly could.
Ms Knight: Absolutely.
Mr Coles: The capital treatment was far more favourable if you took it off the balance sheet than if you left it on.
Ms Knight: Which is why it is said that this crisis is a Basel I crisis not a Basel II one. It started in the US and that off balance sheet was promoted.

Q403 ***Lord Forsyth of Drumlean:*** We were talking, in answer to Baroness Kingsmill's question, which is a very important question, about this issue of whether they have become too large and whether it is necessary to have the one-stop-shop model. You gave the examples of the Bradford and Bingley and Northern Rock. Well actually the problem was not that they were not a multi-purpose bank but that their business model relied on the wholesale market. You left out Citibank, which is an example of a multi-function bank which has not actually turned out to be an enormous success. It is a question. Generally I am disinclined to be interventionist, but Baroness Kingsmill's question is a question which somewhat haunts me. If you have these very large institutions, by the way, they are not always using their diverse business interests to act in the interests of the

customer. Some of it is "If you want this loan, you have to take these products" and some of that has created some of the difficulties for some businesses. I am not sure you really addressed this fundamental issue, which is too big to fail and the deal the customer gets, because the multi-function all-singing all-dancing model does not actually seem in the end to have served the customer terribly well.

Ms Knight: We are at the start of the discussion, certainly not at the end of the discussion on this; it is a point which is going to carry on coming up. You can find examples of a bank which has not worked in all shapes and sizes, in large, in medium-sized, in narrow and so on. We can either use the failures as an example and we have to use them, but we also have to use the successes as well. Why is it that some of the larger entities are actually managing rather better? Why are some of the narrower entities managing rather better? Some of the answers are obvious and some of the answers are not as obvious as all that. Two more points if I may. If we are going to say in the UK that we do not believe in a broad-based bank, then we do need to think what that is actually going to do to the UK, its economy, financial services sector, competition and all those other things. The second thing is: are we really saying that you can have a multinational in any other type of industry, or a multi-faceted type of company, but you cannot have one in banking? I am not sure that people have thought of it like that. There are a lot of points in there which you rightly raise but we are a long way before we come to a conclusion.

Chairman: That is a good time to bring it to a conclusion. May I thank you both very much indeed for spending some time with us this afternoon? It has been very helpful. Thank you.

TUESDAY 17 MARCH 2009

Present	Best, L	Levene of Portsoken, L
	Eatwell, L	MacGregor of Pulham Market, L
	Forsyth of Drumlean, L	Paul, L
	Griffiths of Fforestfach, L	Tugendhat, L
	Kingsmill, B	Vallance of Tummel, L (Chairman)

Memorandum by Barclays

Barclays welcomes the opportunity to submit written evidence to the House of Lords Economic Affairs Committee's Inquiry into Banking Supervision and Regulation. John Varley, Barclays Group Chief Executive looks forward to providing oral evidence to the Committee on 17 March 2009.

Barclays is a major universal bank, headquartered in the UK and doing business in nearly 60 countries around the world. We provide a wide range of banking and asset management services to individual consumers, businesses and institutional clients with our UK home market accounting for around half of our total business.

We deeply regret the part played by the banking sector in causing the financial crisis. There are valuable lessons to be learnt. Barclays stands ready to play its part in helping to build a more robust framework for regulating the financial system and individual financial institutions at UK, EU and international levels. It is in everyone's interest that confidence in the system can be rebuilt and trust restored on a sustainable basis.

Recent experience has shown that a number of reforms to the regulatory system are needed if we are to strengthen financial stability and improve the identification and management of risk going forward. The points below outline our thoughts on some key issues.

Systemic Risk

It is clear from recent events that there is a significant regulatory gap in relation to systemic risk—not just in the UK but also in the US and at EU and international levels. Mechanisms do not exist to identify and ensure action is taken on system wide or "macro—prudential" risks as they develop (eg market wide liquidity problems, asset price bubbles, excessive leveraging).

This is now widely recognised. Within the EU the de Larosiere report recommends a new European Systemic Risk Council comprising of governors of EU central banks, Chairs of Level 3 Committees and the Commission, to provide an early warning system on macro prudential risks. Within the UK Lord Turner has said that the Bank of England and the FSA need to work to ensure macro economic and macro prudential analysis is brought together, system wide risks identified, and the findings harnessed into both macro economic and monetary policy and also micro prudential regulation at firm level. We look forward to the FSA's Regulatory Review, to be published on 18 March.

We see advantages in the Bank of England being given formal responsibility for monitoring macro prudential as well as macro economic risk, and for there to be some formalised process to require the Bank to alert the FSA to emerging risks and for the FSA to respond, with this exchange being in the public domain. Clearly we also need mechanisms to monitor systemic risk at EU and international level and the capacity to press for coordinated action. We hope that action at international level will be progressed at the forthcoming London Summit.

The Tripartite Authorities

We support the current tripartite arrangements in the UK. While alternative models could be considered, each will have advantages and disadvantages and we do not believe there is an unambiguously better arrangement. We consider the broad division of responsibilities between the FSA, Bank of England and Treasury, as refined by the Banking Act 2009, to be fit for purpose. As with any regulatory system, however, there is room for further improvement.

As outlined earlier, we would like to see the Bank's role extended to include macro prudential responsibilities. The Bank needs to find a way to bring together its monetary policy and macro prudential functions in order to fully understand market developments, and its dialogue with both market participants and the FSA could be further strengthened.

By international standards of comparison, the FSA has done a difficult job reasonably well over the past few years and needs support and encouragement to improve further. There is a risk that FSA morale could deteriorate in the current environment just at a time when recruiting talent and motivating staff is crucial. The FSA needs to attract more good people from the market. It would be unfortunate if it became more process oriented and risk averse rather than equipped to make quality judgements on complex issues. The FSA may need to review its internal structure so there is a clearer focus on prudential supervision.

The Treasury is a key member of the Tripartite and needs to have sufficient resource with the requisite skills and experience to ensure effective oversight of the financial services sector in the UK and to enable the UK to play its full part in the development of EU supervisory and regulatory policy.

Capital Requirements

Since the start of the credit crunch there has been significant focus on the capital adequacy regime for banks, both at national, EU and international levels. It has become clear that some elements of the current frameworks have—inadvertently—exacerbated the financial crisis, and helped amplify the economic cycle.

The Basel capital adequacy regime is procyclical in respect of both capital requirements and capital resources. Because it requires banks to hold capital in inverse proportion to the value of assets on the books, when markets are exuberant and assets are highly priced, less capital is required; when markets are depressed and assets prices fall, more capital has to be held. This exacerbates the peaks and troughs of the economic cycle. We would like to see a regime that encouraged counter cyclicality in capital provision, not pro cyclicality. Four particular changes would help in this regard.

First, the capital provisioning regime should require greater provisioning in good times, which can then be called upon during times of stress. That would help ensure stability and sustain banking operations throughout the cycle.

Second, the application of external credit ratings to specific assets—for example, the holding of securitised positions—should be adjusted to a "through the cycle" basis. AAA assets have very low capital requirements within the Basel framework; lower rated assets have exponentially increasing requirements. Because external credit ratings signal the attractiveness of underlying assets to investors, the ratings understandably shift down during a stress. This increases capital requirements exponentially. A "through the cycle" approach would ameliorate this effect.

Third, probability of default (PD) estimates should be "through the cycle". Risk weighted assets under Basel are derived by modelling the probability of an asset defaulting, the severity of loss given such a default and the exposure at the time of default. Point in time PD estimates increase significantly in a stress. By scaling these to a through the cycle basis, the pro-cyclical nature of this element would be removed.

Finally, loss given default (LGD) estimates should be set with reference to minimums, or smoothed. LGDs are linked to the price of collateral used to support loans. As the price of assets (particularly property) declines, the risk weighted assets will increase. Minimum LGD estimates could be used in good times to build sufficient capital resources to provide a buffer for a period of stress; and, in times of stress, smoothing or limiting the impact of LGD will reduce pro-cyclicality.

Accounting Standards

Banks are required to follow the accounting rules set by the International Accounting Standards Board, with a few adjustments to enable them to handle cash flow. These rules include significant use of fair value accounting, or "mark to market" principles, particularly for financial instruments that are held for trading purposes. While fundamentally sound, this accounting practice tends to be pro-cyclical, as trading profits are boosted when asset prices expand and decimated when asset prices collapse. This leads to corresponding over and under-investment during peaks and troughs of the economic cycle.

The negative impact of this was particularly visible through the current crisis. In the first instance, the lack of market liquidity and increase in the perceived risk associated with some asset classes significantly reduced asset prices. In many cases that decrease undershot long-term trends in asset prices. As institutions suffered losses linked to the marking of such assets to market, many were forced to dispose of assets to restore their liquidity

and capital ratios. This exacerbated the deterioration in asset prices, increased losses and led to a further loss of confidence—a vicious downward spiral.

We agree with de Larosiere that a wider reflection on the application of the mark to market principle is required. For example, items held for trading or otherwise managed on a fair value basis should be booked at fair value, but this should reflect the business's intent with respect to the financial instrument. Whilst this intent should be declared up-front, the business should have the freedom to change intent and reclassify the assets. In particular, if an asset is held for trading purposes (and held at fair value) and it is no longer possible to sell it or to manage it on a fair value basis, the institution should be able, subject to specific stipulations, to transfer the asset to an amortised cost category, provided there is full and transparent disclosure. This will ensure institutions can value financial instruments at an appropriate economic value at all times.

The difference in accounting standards between standard setting bodies, principally US Generally Accepted Accounting Principles (US GAAP) and the International Accounting Standards Board's framework (IFRS), helped contribute to the recent crisis of confidence. For instance, banks' leverage ratios have been widely misunderstood by the market because of differences in treatment between IFRS and US GAAP. The different treatments of netting / off balance sheet consolidation and other matters has also confused investors and added to market uncertainty.

Barclays strongly supports efforts to harmonise international accounting standards through convergence on a single set of high quality standards. In particular, we support the US moving towards IFRS with certainty and on a timely basis. We are also in favour of consistency of accounting treatment.

Debt Rating Agencies

Both the EU and the US are pursuing separate regulatory initiatives with regard to external credit rating agencies. Whilst the concerns are common (conflicts of interest, lack of transparency of risk assessment systems, governance) the approaches are different. There needs to be consistency in the approach taken, as ratings are used globally.

In addition we agree with de Larosiere that the use of ratings in financial regulations should be significantly reduced over time.

Risk Management

A robust risk function within banks is clearly of critical importance to prudent decision making. The risk function needs to have the status and resource to challenge commercial decisions and the power to escalate issues to the group CEO and/or Board as required. In Barclays we have a NED constituted Board Risk Committee, which receives reports from the Risk Director on a regular basis.

Risk management systems should be forward looking and use a range of techniques including models and stress tests. Annual stress testing exercises on significant issues can be helpful. There should be clear accountability at Board level for risk management, and regular engagement with the regulator and the body responsible for macro prudential supervision.

Competition

While we understand the reasons for special measures and public intervention during a period of financial crisis, these have developed in an ad hoc way without the benefit of a common framework of principles for such interventions. There is a risk that ad hoc measures may cause market distortions (for example: differential terms for central bank liquidity; differences in capital guarantee and asset protection arrangements; differential terms for capital support to troubled banks; changes in consumer behaviour if some banks are perceived to be "safer" and there is significant market consolidation; forced lending impacting market pricing).

There needs to be an agreed roadmap at EU level and more widely for unwinding state support of the banking sector and a full return of normal competition policy as soon as markets return to normal. We also would like to see a framework of principles established at G20 level as well as within the EU to help ensure that future interventions do not distort markets or have anti competitive effects.

4 March 2009

Memorandum by Lloyds Banking Group

1. Introduction

1.1 We welcome the opportunity to submit evidence to the Committee's inquiry into banking supervision and regulation. Our comments relate primarily on the position of Lloyds TSB as the acquisition of HBOS was only completed on 19 January 2009, however, we refer to the Lloyds Banking Group when we look to the future.

2. Why did the financial crisis happen?

2.1 In looking at the current crisis and what needs to be done, we believe it would be helpful for the committee to split the crisis into two parts—the financial markets crisis and the deteriorating global economy.

2.2 By the start of 2008, the UK economy had enjoyed 60 consecutive quarters of sustained expansion. Average inflation rates remained very low globally and in the UK household incomes had grown strongly and asset markets—especially housing—had boomed. This booming economy meant that demand for borrowing had outpaced the growth of savings for quite some time. To meet this demand, banks increased their borrowing from the financial markets from 2000 onwards. Throughout this period investors continued to search the markets for instruments that would give them higher returns in what was essentially a global low yield environment. The result was a surge in a number of complex structured credit products.

2.3 The current banking crisis resulted from a collapse of confidence causing the money and capital markets to seize up. In a world suddenly very risk-averse, banks and other investors became very reluctant to lend to each other. All banks, including stronger ones, have therefore faced increased difficulty sourcing funding, affecting their ability to lend in turn to their customers.

2.4 The crisis has most affected the banks which have borrowed most from the markets.

2.5 The withdrawal of foreign and non bank institutions from the market has caused a UK lending gap. Over the last 10 years, they accounted for almost 50% of new corporate loans and approximately 45% of mortgages.

3. Accountability

3.1 At a global level, risk was mis-priced and the new instruments' sophistication out-paced banks' ability to manage and understand their long term implications particularly in a less benign economic environment. This lack of understanding by banks, regulators and Central Banks around the world who did not always grasp the inter-dependencies in the financial system and the true nature and scale of the risk being taken by some banks. This knowledge gap was compounded by a general failure to recognise the dependency of the major economies on non-bank financing. Though to be fair, this was always likely due to the sheer complexity of the global financial system.

3.2 The priority now is to address the systemic risks and for everyone, including the banks, to work together to restore confidence in the financial system and the economy. We are working hard to that end.

4. Position of Lloyds TSB

4.1 Lloyds TSB entered the financial crisis in a strong position due to our relationship banking strategy; strong business model; prudent risk approach and "through-the-cycle" approach. The company anticipated the benign economic environment would not last and so positioned our business to avoid riskier parts of the lending market.

4.2 Relationship banking is at the heart of Lloyds TSB's strategy—working with and understanding the financial and non-financial needs of its customers, building a relationship with them to help them grow and prosper. Lloyds TSB had a "through the economic cycle" approach to credit policy, helping and working with customers through the good times and the bad.

4.3 One test of Lloyds TSB's relationship model is whether it is able to quickly respond to the short term borrowing needs of its customers. Because of the strength of its financial position, Lloyds TSB remained "open for business" throughout 2008 and committed to maintaining a broad range of products and actively marketing them to customers. As a result of its financial strength, in September 2008 it was one of the very few institutions who were in a position to be able to acquire HBOS, when it became affected by the global problems in the banking system.

4.4 By early October 2008, confidence in the sector was at a low point worldwide and the most important issue was restoring confidence and stability. In the context of the unprecedented turbulence in global financial markets and as part of the Government's action to stabilise the UK banking system, HM Treasury had discussions with Lloyds TSB on the additional capital it would be required to hold, to have access to the Government backed provision of liquidity. Based on these discussions the Boards of both of Lloyds TSB and HBOS agreed to raise £17bn of capital across both banks, through a combination of ordinary shares, which were underwritten by the Government, and preference shares. We welcomed the investment by the Government as it represented certainty of capital availability and relatively attractive pricing—compared to a traditional rights issue approach

4.5 In March 2009, The Lloyds Banking group announced its participation in the Asset Protection Scheme which will increase the Group's capital position making it an even stronger bank. In making the Group a more strongly capitalised bank, it also puts it in a better position to weather a severe recession should the economy deteriorate further. The Group's Core Tier 1 ratio will increase to well in excess of regulatory requirements. We believe that it will also help to stabilise the financial sector and through the continued lending to personal customers and businesses, will help to support the economy.

5. Other Government measures

5.1 We have been fully supportive of the measures the Government has taken to restore confidence to the banking sector. As we mention above, in October last year, confidence in the sector was at a low point worldwide and the most important issue was restoring confidence and stability. The Government took a number of steps to address these problems which we believed were necessary. The Government showed leadership in the UK and this formed part of a globally co-ordinated approach to addressing the systemic market issues.

5.2 However, despite the efforts of banks and the government, there will still remain a gap in lending capacity which has been created by the withdrawal of foreign banks and non-bank institutions. In order to fill this gap, which represents 50% of capacity, the British banks that remain in the market would have to more than double their lending. It is absolutely in line with Lloyds Banking Group's strategy of relationship banking to support our customers and we will continue to help our customers during these difficult times and we will make funds available to customers that meet our lending criteria.

6. Conclusion

6.1 We have experienced unprecedented market dislocation across the world in the last 12 months. Failure by banks, regulators and governments to recognise early enough the implications of complex global interdependencies as led to a long and deep crisis in financial services.

6.2 There is no one cause for the current crisis. Instead there were a series of "jigsaw pieces" each of which had its part to play but each of which could have been coped with in isolation. The coming together of all these "pieces"—risk mis-pricing, complex products and so on—at the same time was both unforeseen and unprecedented.

6.3 As a result the UK Government and governments around the world have had to take unprecedented steps to address the crisis. We support the Government in these steps taken to restore capital and funding levels both as they apply directly to the Lloyds Banking Group and in the wider drive to restore confidence and financial stability in the economy as a whole.

6.4 Historically, Lloyds TSB was able to maintain its support to customers, in particular mortgage customers and SMEs, through its strategy of maintaining customer relationships throughout the economic cycle—good times and bad.

6.5 As we enter a more challenging period for the economy and after its recent recapitalisation, Lloyds Banking Group will continue to support its customers during this difficult time, ensuring that they have access to the finance, products, advice and relationships that they require.

12 March 2009

Examination of Witnesses

Witnesses: Mr John Varley, Chief Executive, Barclays, Mr Eric Daniels, Chief Executive, Lloyds and Mr Douglas Flint, Group Finance Director, HSBC, gave evidence.

Q404 ***Chairman:*** Good afternoon everyone and to Mr Daniels, Mr Varley and Mr Flint. Welcome to the Economic Affairs Committee. Thank you for finding the time to attend today and thank you also to Barclays and Lloyds for your written evidence which we have read. I am always asked to ask you if you can speak reasonably slowly and clearly for the benefit both of the stenographer and indeed for members. Perhaps you could introduce yourselves briefly when you first speak, that is particularly for the benefit of the web broadcasters. I believe you do not wish to make any introductory remarks so we will move straight onto questions. If you agree in your answers with an earlier speaker, there is no need to repeat it; a nod of assent will be fine and then we can probably cover slightly more ground. Banks are clearly one of the most regulated sectors of business and the regulations are there ostensibly to promote sensible behaviour in the market or to head off potentially harmful or over-risky behaviour in the market. To what extent are bank strategies actually shaped by those regulations? Or are the regulations viewed more as hurdles to be circumvented or got over as required? Specifically, do you think that better or more astute bank regulation or supervision could have headed off the current financial crisis? Perhaps I can start with Mr Flint from HSBC on that one.

Mr Flint: I am Douglas Flint; I am the Group Finance Director of HSBC. I do not agree that bank strategies are shaped by regulation; I believe that bank strategies are shaped by the economic environment and the needs of customers. However, I think the framework within which the services are provided are governed by the governance of our own institutions and by the regulatory frameworks in which we serve customers around the world. We ourselves respond to over 500 regulators and to have strategies shaped by 500 different regulatory systems would be a challenge. The strategies are economically focused and the regulators provide a backdrop to how we apply those strategies in practice. I think that it is simplistic to think that there is a silver bullet of better regulation or supervision that could have prevented the current financial crisis because I think a large number of the inputs to the current crisis were macro economic in terms of excess liquidity, low interest rates and a search for a yield over a number of years. However, having said that, I think there are elements of fragmented regulation that are now being addressed. There were also elements of lack of transparency as to where the end risk within the broadest definition of the financial system resided. There are areas where the regulatory framework did not catch all of those elements. The number and the type of entities that were captured and the way that they were regulated around the world were not consistent. Again that is an area that contributed to elements of regulatory overlap and regulatory under-scrutiny of certain activities in certain parts of the world. One of the areas where a lot of attention is now being given and talked about is that perhaps there was not a framework regionally or, probably more importantly, globally that looked at the possible areas of systemic risk that were emerging from the combination of macro economic events and the way the financial framework was evolving, the way the regulatory framework was evolving, the interplay with accounting and other rules and simply the behaviour of market participants. Putting all that together in a way that would sit within a framework that addressed the systemic implications from all of these contributory factors was something that did not exist and I suspect a lot of attention will be focussed on that in the coming months and years.

Q405 ***Chairman:*** Do either of you want to add to that?

Mr Varley: I am John Varley, Group Chief Executive of Barclays. I agree very much with what Douglas said. The regulations define the corridors down which banks can walk as they pursue strategy but they do not define the strategy itself. I would add two further things. First of all I think Douglas is right in referring to the principal failure in the space of regulation, as one looks back at the events of the last two years, as being a failure to spot the macro prudential systemic risk. I think that governments, regulators and banks could have spotted that and failed to. When I say could have, should have, and failed to. There are two obvious areas where I think, as we look forward, we could be better served as an industry by regulation. One would be in the area of provisioning and reserving where the requirements of Basel II (which, as you know, have required banks to increase their capital provision in the downturn) have exacerbated the issue with which the world is now struggling. The second example I would point you to would be the subject of mark-to-market accounting. In just the same way as financial institutions' profits were boosted by the mark-to-market accounting included in international financial reporting standards, so too have they been reduced dramatically on the downturn. I think that the volatility of financial performance and indeed a risk management task for banks and regulators has been exacerbated by mark-to-market accounting.

Q406 ***Chairman:*** Mr Daniels, do you want to say anything?
Mr Daniels: No, I think that covers it very well, thank you.

Q407 ***Chairman:*** Can I ask you, amongst the players, who is in the best position to pick up systemic risk? Is it yourselves because you are close to the coal face, as it were? Is it regulators or supervisors? Who is in the best position to do it?
Mr Flint: I think it has to be a combination of all of these. I think there needs to be input from within the industry. I think there needs to be input from the micro supervision of individual institutions. I think there needs to be input from those who look at segments within the financial industry whether it is banks, insurance companies, hedge funds, money managers or whatever. I think there needs to be input from treasuries, there needs to be input from the Bank of England, the Fed, those who look at money supply and the large movements of capital around the world. I think all of these have input to the debate and indeed without all parties participating I think there are likely to be gaps in the understanding of the drivers of behaviour and of the impacts of that behaviour that mean that systemic risk will not be fully captured.

Q408 ***Lord Griffiths of Fforestfach:*** For those of us who have been involved in banking the crisis has been quite horrendous. People who are bankers—regulators, Treasury officials, Bank of England officials—are very intelligent people but in a way the scale of what might happen was totally missed. Why do you think that was?
Mr Varley: Douglas made the point a moment ago about the macro prudential risk. To me it matters in a sense less who has responsibility for monitoring that in the system; what matters is that somebody has responsibility for monitoring it in the system and that that entity is fixed with a clear regulatory or statutory responsibility. I think as we look back that particular responsibility somewhat fell through the cracks. I am not pointing a finger at government or regulators because I think that the banks themselves should have spotted this risk. To me the most important safeguard for the future in this area is that within the tripartite authorities, for example, it matters not which member of the tripartite authorities had that obligation, but somebody must be fixed with that obligation.

Q409 ***Lord Paul:*** Is there any possibility of the regulator being able to spot all these kinds of issues?
Mr Varley: The optimist in me says yes. It does seem to me that we should take advantage of the calamity of the last two years and ensure that we do learn and that we have in place a structure of supervision that does enable people to spot those risks. It will rely fundamentally on there being more active collaboration between the international regulators, more concerted action and it will require some quite tough mechanisms which I suspect we will all find rather indigestible but nonetheless I think that is required.
Mr Flint: I agree with what John says. One of the aspects for further consideration is the balance between regulation and supervision. Part of the issue over the last several years is that a lot of attention was given to the framework of regulation but the actual supervision by experienced professionals talking to experienced professionals discerning what was happening in the market place and what that might mean was perhaps less than it might be optimally. In response to the question why was it missed, I think there are three elements here which are quite important. One is that our industry, for right or for wrong, over the last five years became intensely complex and part of that complexity drove considerable attention within the industry and within the regulatory framework to risk models that sought to capture all the elements of things that could go right and wrong and produce a result that guided management to risk appetite and so on and so forth. With the benefit of hindsight I think people took too much comfort from the sophistication, complexity and regulatory endorsement of what were best in class, best practice models but which failed to capture all the elements of liquidity risk and the tail events that could go wrong.

Q410 ***Lord Paul:*** Banks have very intelligent people. If they cannot find out some of these issues how can you expect the regulator to be able to find them? What makes them different to be able to find out when the banks themselves cannot find out? I need to declare my interest. Two of you are very close business partners of mine and very good ones.
Mr Varley: In answer to your question, Lord Paul, it is possible for these issues to be identified. It may need more formal mechanisms in the system of regulation or legislation. I will give you an example. One of the things I think we all failed to identify was the fact that the debt fuelled financial economy had got out of balance with the real economy. I think it would be possible in this country and in other countries around the world for there to be a statutory obligation that imposed on a member of the tripartite authorities in this country to signal a point in time when the amount of debt in an economy had become too big. With that signal would go some consequences for banks, for example the requirement to hold more capital at that time; for example a management of monetary policy or interest rate policy that would identify that risk and seek to

combat that risk. I think it will require some elements of formalisation.

Q411 ***Lord Forsyth of Drumlean:*** I am sure that is right and I am sure the general point is being made, but I am trying to think of an example that does not involve any of you but I am afraid I can only think of one which now involves you, Mr Daniels, but it does seem extraordinary that a bank like the Bank of Scotland, HBOS, could have so much of its portfolio in housing and as late as January of last year still be investing very heavily in housing. It is hard to see how one could rely on a regulator in that respect. If we take another example, the Royal Bank of Scotland, which was paying a very silly price for ABN Amro at the time. You had a lucky escape there but it is hard to see how having a regulator in place will avoid people making these catastrophic business decisions.
Mr Varley: I am certainly not suggesting that the regulator should bear unique responsibility because the primary responsibility is of course with the boards of banks, the makers of the commercial decisions, the takers of the risks. If, in my remarks, you read some suggestion that bank boards should side-step their responsibility I do not believe that at all. Theirs is the primary responsibility.

Q412 ***Lord Tugendhat:*** Coming back to a question Mr Varley answered when you were talking about what you should have spotted. I have heard the chief economist of an investment bank say that he did warn the management of the dangers to which you are referring and the mood of the bank and the mood of the time and everything else was such that nobody was actually paying attention. I know him well and I believe what he told me to be true. When you look back with the wisdom of hindsight do you think that actually within your organisations you did have economists or others who were warning about the imbalances and the dangers inherent in them, but that the mood of the bank and the mood of the time and competitive pressures blinded you to what you were being told?
Mr Varley: I can only speak about Barclays but let me give you some examples. We have, as a sub-committee of our board, a risk committee populated by non-executive directors, chaired by somebody whose professional background is banking. That committee called for a review of sub-prime exposure in Barclays at the end of 2006. It was prescient of it to do so looking back on it because we certainly were very active in the first part of 2007 in reducing our exposure as a result of that governance structure. Similarly I think within the sort of banks that are giving evidence to you today there are risk systems which spend a lot of time looking at trends. In our own experience base we have a very clear pattern that within seven quarters of gearing rise in British companies we have all seen an increase in impairment. We started seeing gearing rise in our corporate base here in the United Kingdom at the beginning of 2006 and that caused us to do an extensive review of risk concentration in the United Kingdom and reduced sectoral exposure to those parts of the economy where we thought there would be a downturn. What I would say is that banks should not be fatalistic about this; they should have—and I think mostly do have—risk systems that enable specialists to be able to say, "You need to be paying attention to this". You also need to have governance structures in organisations which mean that people can do that without fear.
Chairman: Certainly the latter. Lord Best?

Q413 ***Lord Best:*** The scale and the scope of banks have expanded dramatically over recent years. Do you think it has really led to serious efficiency gains and possibly other economic benefits or has this simply meant that the banks have become too big to fail and thereby encouraged to greater risk taking?
Mr Daniels: I am Eric Daniels, Chief Executive, Lloyds Banking Group. In the case of Lloyds what we have done is seek to expand by serving more needs for our customers. A couple of decades ago, for example, it was almost inconceivable that a mid-market customer would hedge interest rate risk or foreign exchange risk even though they had those risks. What we have done over the past several years is in fact expand our product offerings to serve our customers better. What I fundamentally believe is that a customer centric strategy is the right one and it has to be built on a strategy which looks to sustain itself over the economic cycle. In the case of Lloyds we do not believe that we can accurately call each one of the cycles. Certainly if we look back to the 1970s with the developing world having debt problems with the recycling of petrodollars, the over concentration of leverage buyouts in commercial real estate in the States were the most recent crises. I do not believe that the majority of banks accurately called that so I think there is a huge benefit to thinking about a strategy that runs through the cycle. Then I think size is somewhat less relevant if you build a business proposition that is customer centred and one that seeks to serve customers through the economic cycle.

Q414 ***Lord Forsyth of Drumlean:*** I wonder if I could ask each of you how important you think the extent of the difficulties we now face was influenced by the decision to allow Lehmans to collapse.
Mr Varley: I think it was a seminal point in the crisis because the credit markets froze and something happened which had not been allowed to happen in the recent history of the financial services industry, which was that a very big institution was allowed to go to the wall. It coincided with aggressive inflation

in consumer prices and therefore very active interest rate policy management. I think that confluence of the failure of Lehmans with the extraordinary spike in consumer costs that was occurring—for example as a result of the movement in the oil price which took several years to go from $40 to $70 and then took about two months to go from $70 to $140—that cocktail proved to be extremely poisonous. If you ask me why is it that we have seen this extraordinary synchronised reduction in economic activity during the fourth quarter of the year and since then, I think the combination of those two things and Lehmans played a major part.

Q415 ***Lord Forsyth of Drumlean:*** Is it true that you were all set to take over Lehmans and were prevented from doing so by the FSA at the last minute?
Mr Varley: We were very clear in saying that if we were going to buy we, Barclays, were going to buy all of Lehmans and we needed certain guarantees from the American Government. Those guarantees were not put on the table—for reasons that I respect, I am not complaining about that—we were never in a position where we had made a decision as a board that we should go forward. That trigger with the board would have caused us formally to request consent from the UK Financial Services Authority as our regulator.

Q416 ***Lord Forsyth of Drumlean:*** So it is not true that the FSA intervened and stopped you doing it.
Mr Varley: The FSA was involved throughout the weekend in question, but I say again that there was a sequence of events and we would have formally requested consent to proceed had we had the guarantees that we were looking for from the American Government but those were never put on the table. We asked but they were not put on the table.
Mr Flint: I would add just a little about Lehmans and say that I think there were three events very close together. One was the failure of Lehmans. Second was the way in which Washington Mutual was taken into public ownership and moved out again with senior debt holders losing money, which again was a very unusual event and caused significant pain to money market firms because they were put in danger of "breaking the buck" because they had invested in bank paper. The final piece at the same time was the failure of AIG where significant attention was drawn to risk mitigation that could fail because one of the most significant providers of risk mitigation had proved that it was not competent to provide the scale of mitigation that the banking industry was allowing for. Those three events put at risk enormously bank capital and indeed encouraged investors in the capital structure of banks to worry very forcibly that not just the equity but the subordinated debt—or even the senior debt—could become part of a capital structure in banks in an unintended way and this made the bank funding market dry up almost totally.

Q417 ***Lord Forsyth of Drumlean:*** Was it a mistake?
Mr Flint: I believe history will judge it to be so.
Mr Daniels: I would agree.

Q418 ***Lord Griffiths of Fforestfach:*** I want to ask a question about the management of risk. I am sure that each of your institutions has very sophisticated ways of managing risk; you have statistical models and so on and you make a judgment which looks at history and you somehow bring everything together. However, as you look at what has happened, in which ways are you changing the way you manage risk going forward as a result of the crisis?
Mr Flint: I think one of the changes that is taking place is that historically people developed product propositions that were based around customer needs and then did a full analysis of whether we understand the risks, can we measure them, can we capture them, can we account for them, do they fit within a regulatory framework, is the profitability of the product commensurate, and so on and so forth. I actually think that one of the changes taking place is that rather than start with a product and measure all the risks we need to be much more disciplined in setting a risk appetite—what are we in business to do?—and therefore even if the risks are remunerative and everything else is compliant, are those the sorts of risks that we take—so much more focussed on the policy of risk appetite. The other thing, going back to models, is it is important to use all the techniques within modelling and so on, but at the same time have an override for judgment. At one time that was dismissed as somewhat old fashioned and hocus-pocus; in reality there is a comforting factor to the sophistication of modelling that needs to be put into the real world of somebody saying, "I don't care if the model says this is a good risk, I just don't like the look of this"; so putting more judgment around it.
Mr Varley: I would give you two specifics, Lord Griffiths. One is that that I think we will find that those who are engaged in securitisation will be required to retain more risk than historically they have done. That is important because I think the normalisation of securitisation markets is going to be one the key ingredients to the normalisation of economic activity. The second example I would give you—I can see this practice rising across the industry as we speak—is the use of stress testing where regulators and banks both in dialogue and independent of each other stress test the banking balance sheets to ensure that they are resilient to various levels of severe economic downturn.

Q419 ***Lord Eatwell:*** I would like to ask about securitisation and risk taking. Given the growth of securitisation and the relocation of risk moving it out of the banking system, do you think that the banks took greater risks than they would have done if they had not been able to mitigate their risk, to sell it on to somebody else?

Mr Varley: Yes. The orthodoxy was that the originate to distribute model would have a significantly beneficial effect on risk diversification but the orthodoxy depended on the risk diversification being outside the financial system and in fact what happened, as you know, a lot of the securitisation ended up within the financial system itself. Is the model correct and can it help with risk diversification? I am quite sure that the answer to that is yes, it can, but we need to ensure that there is genuine diversification rather than partial diversification. The second point I would make is that I believe that there is not enough on balance sheet capacity in banks in the world to allow the world to grow at four per cent or five per cent per annum in the way that it needs to and therefore the importance of securitisation is that it is a means of enabling citizens, businesses, governments to take risk. That is absolutely fundamental to economic growth in the world.

Q420 ***Lord Eatwell:*** I think that is a very important point and I would like to follow up on it. In 2000 the amount the British banks lent was equal to the value of their deposits. By 2008 the amount they lent was £750 billion greater than their deposits and £350 billion of that came from abroad. Is it correct that that £750 billion has disappeared, in other words that market has frozen or substantially frozen? If so, what is the impact on the quantum of your lending? Thirdly, how do you expect it to look in five years' time?

Mr Daniels: I think that approximately 50% of the corporate lending capacity has been withdrawn from the market either from players that no longer exist or from foreign players who have chosen to withdraw. It is about 45% on the individual side; 50% on the corporate side. Very clearly that is having somewhat of an impact. While demand for lending is down, the capacity is down more than the demand and that is one of the reasons why I think government is so concerned about putting in new measures to encourage lending. What the position will be in five years from now it is very hard to say of course but I hope we will have something where we see a demographic shift. There will be probably less household debt and greater household savings. That is a very healthy trend. I think we will reach a better equilibrium than we have today.

Q421 ***Lord Eatwell:*** My point is that if you continue to rely—and Mr Varley suggested that perhaps you have to—on wholesale funding, that tends to be relatively short term and therefore the issue of the maturity match between your assets and liabilities becomes an important issue which apparently has been neglected by yourselves—question mark and by the regulators—for sure—over recent time.

Mr Varley: As we look back over the past two years did, for example, the Basel II regulations pay sufficient attention to liquidity? I think the reality is that they did not. Again that seems to be an important learning point and we should take advantage of that learning point. I think that the phenomenon to which you refer, which is the short term nature of liquidity, is really a consequence of risk appetite. You are absolutely right to say that there was an asymmetrical growth of assets versus liabilities over the course of the last years. Historically that gap between asset growth and liability growth has been filled by the money market funds, comfortable takers of that risk, comfortable takers of bank paper. However, risk aversion in the money market funds, partly just intrinsic risk aversion, partly concern that they were going to suffer redemptions, created a much more short term structure to the provision of liquidity to fill that gap. I would say that at the edges, Lord Eatwell, that situation is improving. I would not overstate the extent of the improvement, but I do think that one sees some move towards a greater turning out of those money market structures and that risk, and that of course is an absolutely critical ingredient of normalisation too.

Q422 ***Lord Levene of Portsoken:*** This Committee has spent quite a lot of time looking at how boards of directors can monitor the activities of the organisations which they serve which are very large and complex enterprises. What procedures exist for your non-executive directors to have enough information to challenge executive decisions? In other words, when you go to a board meeting there is a whole stack of papers; executives will be well-versed in this, the non-executives see these for a little while. How are they going to be able to plough though these and ask the sort of challenging questions one would want? How do you do that?

Mr Daniels: Speaking in the case of the Lloyds Banking Group we involve the board heavily when we set our risk appetite. The board is very explicitly involved in determining how much risk we want to take and then depending on the moment whether we should adjust that risk appetite up or down. We have a sub-committee of the board, as does Barclays, that is composed of non-executives. They are given a very extensive briefing on the state of the portfolio and where we stand versus our risk appetite on a periodic

basis. That allows them to guide the board in terms of questioning whether this is a prudent policy, questioning whether this is appropriate for the moment.

Q423 ***Lord Levene of Portsoken:*** When you were going about buying HBOS, which clearly was a very major acquisition and you have said publicly elsewhere you were obviously up against time to do it quickly, to what extent were your non-executives then able to have sufficient visibility of the whole transaction to form a view as to whether this was something they wanted to do?
Mr Daniels: I am very glad to clarify the issue; I think there have been some misunderstandings in my previous testimony. We did very extensive due diligence before purchasing HBOS. We spent approximately 5,000 man days of diligence. There are rules regarding the takeover of a public company, how much information you can access and so on and we went as far as we were permitted by the law to understand HBOS. I think we had a very good understanding; the board had a very cogent understanding of the risk model and the amount of risk inherent in the HBOS portfolio. We understood that it was subject to volatility in the economic environment. The board was fully informed; we made a prudent decision based on the information that we obtained. Our estimate of the losses that we would take during 2008 was mostly correct. We missed a bit in the fourth quarter downturn in the economy which was much more severe than anyone had forecast. The board had full access to the diligence; we conducted very thorough diligence.

Q424 ***Lord Levene of Portsoken:*** Do you all make sure your non-executives are independent?
Mr Flint: We have a recurring programme of risk awareness presentations to the board taking them through the hot spots within our industry across the world including presenting, for example, on lessons that may have been learned from fraudulent trader incidents elsewhere, to the extent that we can get public information. We have a programme of going through the hot buttons within our industry presenting where we stand against them and the audit committee has a free rein to set its own agenda as well as receiving standard risk presentations and can set an agenda or ask for a special report or presentation on aspects that may have concerned them in relation to areas they have read about other institutions getting into difficulty.

Q425 ***Baroness Kingsmill:*** I would like to follow through on that point in the sense that Northern Rock had an excellent, well-qualified board of non-executives and yet they failed to recognise the liquidity risk that the bank was facing at the time. Do you think it is all possible for a non-executive to be able to truly appreciate the risks that the banks may be exposed to?
Mr Varley: Yes, I emphatically do. I think there are practical things we can do to make that possible and to make that a reality. I do not think that the non-executives of a bank should comprise uniquely people who have banking experience but it is very helpful to have on our non-executive cadre, as we do—the same would be true to left and to right I know—to have people who are banking specialists. It is not coincidence that in our case the chairman of Barclays has a banking career behind him and we have a number of people who have their deepest professional suit in financial services and banking. That is one practical thing you can do. A second practical thing, I think, is to ensure that the committees that we have been referring to are both chaired by and populated by people who can do some of the heavy lifting on behalf of the board with more time at their disposal and with the ability to engage in greater forensic inquiry. A further thing which is an obvious thing but it is clear that the obligation of a company is to ensure that there is an induction programme in a way that Douglas referred to. All non-executives when they join the board, whether they have banking experience or whether they do not, are schooled in a way that enables them to challenge.

Q426 ***Baroness Kingsmill:*** Being a non-executive of a bank is a rather different proposition from being a non-executive of any other kind of plc if only because of the systemic nature of banking and the systemic risks to the economy as a whole that a failure can cause. I was wondering whether or not you thought it might be a good idea, for example, for the non-executives of a bank to have a standing committee of advisors rather like the members of the MPC have to help them appreciate and understand this sort of thing. It is a different scale of non-executive directorship one seems to think.
Mr Varley: What I would say, just drawing on our use of that, is that the external auditors are there in exactly that capacity, to advise the audit committee and to advise the board. That would be one very good example. If I look at our remunerations committee as an example, again populated by non-executive directors, they do have independent advice and they call on that very frequently to ensure that they form their own views about policies and practices in the area of compensation. I would agree with what you say; I think it can be a very useful source of third party input to reinforce independence.

Q427 ***Lord Eatwell:*** We have had the auditors up in front of us already and they all owned up to the fact that they missed it completely, so that does not help very much. The issue I would like to address is that

over the last three years have you had a senior non-executive on your board who has actively disagreed with your strategy?
Mr Varley: Certainly. If I speak for Barclays, the conversations around the board table are vigorous. They are intended to be constructive not dysfunctional, but they are challenging. As an executive director of a bank I benefit from that; I hope they feel they have a significant impact on the decisions that are taken.
Mr Flint: From our perspective I do not think there has ever been any dramatic disagreement on strategy because the strategy is fairly broad, but within the application of the strategy there has always been a vigorous debate on how it is applied, the timing and the methodology of application. Indeed we welcome that.
Mr Daniels: I would echo the same sentiment. Our board meetings are characterised by vigorous challenge and debate but I am very pleased that they end in consensus. I think we have a very well governed board.

Q428 ***Lord Griffiths of Fforestfach:*** May I say that the more this meeting goes on, the more mystified I become. You are clearly three very talented people to start with; the members of your board—some of whom I know—are also very talented people. It is not just Barclays or Lloyds or HSBC, it is in North America, commercial banks, investment banks, again with very talented people on the boards. Yet somehow we have got this horrendous banking crisis. With all the talent you have at the top of these institutions, something went wrong. You give very good answers to questions, but given that you have this vigorous debate, given that you have good training programmes and all of that, in that case what actually went wrong?
Mr Flint: I think one of the things looking back is the speed of transmission. Going back to the complexity, the speed of transmission of fault lines that suddenly were uncovered and the gap that appeared between valuations day one and valuations day two, instead of moving in a gradual pattern there was an enormous gap coupled with a loss of liquidity. That was an experience that no-one had seen before and I think part of that may be, on reflection, a reaction to the last 10 years when the banking industry had come through multiple crises that at the time were seen as dramatic: LTCM, South American debt crisis, Argentina's pesification of its currency, Russia defaulting on its debt. All these crises had been seen as absolutely significant and cataclysmic and yet within a very short period of time they were simply seen as buying opportunities because the financial system had rebounded and healed itself. There was perhaps a sense of over-confidence in the system's ability to reconstruct itself after what were seen as critical events.

Q429 ***Lord Tugendhat:*** I realise that you cannot answer for banks other than your own, but with hindsight do you feel that your banks and indeed the industry as a whole has been well or not so well served by the auditors in terms of drawing attention to the implications of approving the accounts of some of the positions held and some of the risks taken? Do you feel, looking at the industry, that perhaps the auditors did not warn sufficiently or perhaps understand sufficiently the implications of some of what they were confronted with?
Mr Varley: I think Douglas's analysis in response to the last question was very accurate and that failure to understand the impact of the confluence of events and that misplaced confidence in the ability of the industry to manage through the cycle because of its sophistication, because of a view about risk diversification, I think we all made that mistake. The bankers, its auditors, its regulators, its governors; I think we all made that mistake to be honest. We should own up to that and we do. If you then ask me about auditors as such, I believe that for all the fact that we missed some things we have been well served by the intensification of the relationship with auditors. Gone are the days when the auditors appeared once or twice a year. The reality of all three of us I suspect, but certainly speaking for ourselves, is that there is a pretty much continuous dialogue with the auditors as they review what we do. That challenge is genuine and it is substantive. Would the audit firms have to put their hand up and say, "Yes, we missed this?" Indeed it was said a moment ago that they said just that. I think they would have to do that, but do I feel that our ability to manage risk well and understand the implications of it is helped by the relationship that we have with external auditors. Are they genuinely independent? My unequivocal answer to those questions would be yes.

Q430 ***Lord Tugendhat:*** There is a question I would like to put to Mr Daniels. Your group was, let us say, more cautious than HBOS and RBS in the height of the excitement. To what extent did you feel pressure from your shareholders to be less conservative and more adventurous and emulate the two Scottish banks? To what extent did you feel both to your share price and to what the analysts were saying and what the shareholders were saying that you were under pressure to be less conservative?
Mr Daniels: Clearly when I took over as CEO in 2003 the newspapers were carrying headlines about the lame horse, the horse being a donkey and so on. As you know, the symbol of Lloyds TSB is the black horse. The debate at the time was would be able to compete with some of the racier strategies and some

of the racier institutions. We were not quite intelligent enough to make progress. When we set the strategy with the board at that time we said that we would set a through the cycle strategy, we would do the basics extremely well of serving our customers. We decided we would stay with the strategy that served real customers, people who would need to borrow to buy a house or corporations that needed to finance expansions of plans and so on. We decided we would set a strategy that dealt with real customers, that we would build a strategy that would serve customers through the cycle because we thought that cycles were very hard to predict. As a result of putting in piece by piece that strategy I think we served our shareholders extremely well. In the first two and three years there was substantial unrest as to whether we would in fact be able to build the proposition as I had outlined it. After that initial period the shareholders became more and more comfortable that a through the cycle approach, a customer driven approach was actually a prudent one.

Q431 ***Lord Paul:*** There is a lot of talk about compensation for big bankers. Does bank compensation policy need to be reformed? Should reforms be imposed legally?

Mr Varley: I think there will be some reforms. As you know, the Financial Services Authority here has published a code of practice relating to remuneration. That is in draft form at the moment so it is the subject of discussion between the FSA and practitioners. There will be a final form code of practice in due course and the sanction from that will be that those who do not conform will have greater capital requirements imposed on them by the Financial Services Authority. That will be an example, I think, of change coming. I hope, notwithstanding the changes that are introduced through time, that a pay for performance philosophy will be maintained and provided that the interests of shareholders are served by compensation policy, provided there is very strong alignment between the interests of employees and the interests of institutional shareholders, for example, then having variability in compensation—which I know is a hot topic at the moment—is very helpful because it does enable a bank or indeed any other organisation in a downturn to reduce its costs. To me an absolutely critical ingredient of our ability to manage business risk is having a highly variable cost base. I would want to see that apply in the area of compensation. Generally what I expect is for there to be some changes: increase in deferral of compensation, increase in utilisation of equity or the equity equivalent, the ability to look back to ensure that over time risk is properly reflected in reward. I think all those things should be ingredients of the policy of the future.

Q432 ***Lord Paul:*** The general feeling is that the rewards became so high it drove the bankers to take risks which they would not have taken in the normal course. It has to be controlled by some kind of regulation. It is not something which the bankers accept that this is the best thing to do.

Mr Daniels: I am somewhat fearful. I agree with what John has said but I am somewhat fearful if we have a one size fits all arbitrary view of remuneration. I think remuneration has to follow strategy. As I talked about when we built a through the cycle model, one that was customer focussed and so on, the way that we set our remuneration was to measure people on what we call a balance scorecard: how do you do on financials which are clearly important? Is the franchise being built? Are we acquiring new customers, deepening relationships? Are we serving our customers well? So we measure our customer service. Are we taking prudent risk? Are we managing people well? For a manager in Lloyds Banking Group to do well and to get a bonus they would have to do well on all five of those pieces. That is a much different strategy than John or Douglas would have and so their remuneration policies would probably be different from mine. I think that diversity is okay because if your REM follows your strategy and passes a reasonableness test of course, then I think that is a better way to operate.

Q433 ***Lord Paul:*** I have no problem with that. I think that everybody appreciates that you reward the people who produce the service. The problem is that it has driven people to do things which they normally would not have done, like the idea of getting those very high remuneration. How are you going to control that?

Mr Flint: Speaking for HSBC, in relation to the governance of how the rewards are allocated, I think there are no circumstances in our organisation where there is a direct linkage between a compensation amount and a profit and loss line that somebody has contributed to. Nobody can take a percentage of a line and say, "That is mine"; there is governance over how a compensation pool should be allocated. The structural changes that John and Eric have referred to, which the industry has now embarked upon—in terms of longer deferral and claw back of potential awards should the circumstances that gave occasion to the award turn out to be misplaced—ie profits that were made no longer exist because there has been a bad debt or the strategy with the position no longer works—I think are benefiting our industry in terms of structure. I think these are changes taking place and the greater transparency that the current environment is demanding is also welcome in terms of being able to articulate why it is necessary to have the policies we have and to be able to justify that they are linked to success and not to failure.

Q434 ***Lord Forsyth of Drumlean:*** I very much agree with the view you are taking on compensation, but I do have one worry. Lord Paul asked whether there should be some sort of statutory involvement which I would be against, but is there not an issue which is that you at Barclays might take the view that you were going to have a compensation scheme structured sensibly along the lines that you have outlined, but what happens if one of your competitors takes a different view which is more advantageous? Given that you are operating in a global market place, how do you then ensure that we maintain the prominence of the City of London and attract good talent? There is a balance here. When I was at JP Morgan we used to struggle with this. The argument that if we do something, our competitors will do something else. Is there a way of trying to deal with it other than the FSA saying you have to put more capital which would actually resolve it? Rather like your point on mark-to-market I can see the problem but I cannot see what the solution might be. Finally, is it not a nonsense to suggest that we got into this position because of bankers and their bonus schemes when actually in the case of Lehman, which was not a bank, the staff actually had huge shareholdings and made huge losses as a result of it going? The other institution which has been central to this, AIG, is not a bank either. Although I can understand why it makes great headlines, is this not a little bit of a red herring? How do you deal with this issue which Lord Paul hinted at, which is suggesting that there should be statutory controls which I would be opposed to?
Mr Varley: I think it comes down to risk really. What one wants is a compensation structure, just as my colleagues have said, which is aligned to risk adjusted strategy. That is why I think that looking through the lens of capital, prudential capital is quite a good way of addressing the point that you are raising. If I put it at its most extreme, if a bank has a set of remuneration policies that are indifferent to risk taking and the response to that from the regulator is, "In which case that bank will carry more capital", that goes straight to the heart of its ability to compete efficiently. That seems to me to be a very sensible way of moderating the risk that you are referring to and it is of course ubiquitous in those circumstances, so the risk that somebody else will do something different is, I think, well managed by that particular point.
Mr Flint: We have had a simple policy over many years that if someone wished to be paid in a Wall Street type of arrangement then they should go and work on Wall Street. It is as simple as that. I think you set your framework and if people buy into that framework they get remunerated in accordance with that framework. If they want to have a more exciting opportunity they should go and take that risk somewhere else. I would agree with you on legislation. I think the risk of legislation is the unintended consequence of shifting economic activity to somewhere where it is unregulated rather than actually changing practices.

Q435 ***Lord Eatwell:*** I think I have heard just about all of you agreeing that part of the origins of this crisis was excessive liquidity and very low returns associated with that liquidity and therefore a search for higher return. You have also all said that your strategies are customer based. Those two things cannot both be true. If your strategy was driven by the availability of funding it was not customer based. If it was customer based, it was not driven by the availability of funding. I am a bit puzzled by that but I just want to move on a bit. There have been a lot of discussions in regulatory terms about restricting the activities of commercial banks, the extreme form is the Volcker Lawson appeal to Glass-Steagall. Paul Volcker is always saying that commercial banking should be like water coming out of a tap; it should be like a utility, it should not do anything else. We know what Lord Lawson's opinion is; it was in the *Financial Times* the other day. There is a sort of restriction light which has been proposed by the financial stability forum which is essentially that the assets in which commercial banks deal should all be assets which are trading on markets that clear which would take you out of a lot the securitisation market. Do you agree with that?
Mr Flint: I think that one of the systemic improvements that could be considered is a greater concentration of risk through regulated exchanges with central counterparties. I think one of the reflections over the last five years is the extraordinary growth in the credit derivatives market with no central clearing, no central counterparty and no transparency as to where ultimate risk rests. I think that one of the systemic improvements that could be made is a greater concentration of standardised products through regulated exchanges with central counterparties.

Q436 ***Lord Eatwell:*** Less OTC; less customer based.
Mr Flint: Yes because on the one hand you have tailoring of products, sophistication, innovation and higher profitability. On the other hand you have lower profitability, more utilitarian products and less systemic risk. I think these are two extremes of a continuum and there probably does need to be a debate on where on that continuum you want to be. If the cost of the high degree of tailoring and sophistication (I am not talking about the products that John and Eric were talking about, which are simple products well delivered to existing customers but at the more exotic end of securitisation) is where we have got to, it was probably a price far too high.

Q437 ***Chairman:*** Is that view something you both share?
Mr Varley: Yes.
Mr Daniels: Yes.

Q438 ***Baroness Kingsmill:*** There has been a lot of talk in the papers about whistle-blowing and I think at least two of you have had experience of whistle-blowers. What do you think about that and should whistle-blowing, within the context of a bank, be actively encouraged, even rewarded, in a formal way by regulation? What do you think should be done about whistle-blowing and how do you handle it?
Mr Daniels: Whistle-blowing serves as a very valuable check on what is going on within any organisation. We have within our policy manual a whistle-blowing procedure. We ensure that each one of our managers informs our staff about the whistle-blowing procedures. We have a third party anonymous line that employees can call if they do not feel they can speak to their manager. Our group executive committee—that is the senior committee of the bank—reviews the whistle-blowing cases on a periodic basis. This is something we believe in. We believe it is a very worthwhile source of information to find out what is going on in the corporation if we have missed something.
Mr Varley: The sort of practices that Eric refers to in Lloyds we also adopt. The simple point is that you have to make it safe and convenient for people to blow a whistle. They have to be able to do it without fear of retribution and they have to know that they have the appropriate access.

Q439 ***Baroness Kingsmill:*** What about the recent whistle-blowing revelations about tax avoidance? How do you feel about those?
Mr Varley: I do not see it as specific to any particular activity; I see it simply as having a policy that enables people, wheresoever they are within the organisation, to blow the whistle in the knowledge they can do so safely and in the knowledge that people will react. That means that the executive, in the way that Eric describes, needs to have line of sight but also the non-executives. For example, at each meeting of the board audit committee there is a review of whistle-blowing activity so that it is known within the organisation that independent directors are reviewing whistle-blowing.

Q440 ***Baroness Kingsmill:*** And taking action on some of the events that have been reported.
Mr Varley: Yes, of course.

Q441 ***Baroness Kingsmill:*** Let us just concentrate on the tax avoidance issue at the moment. Do you feel that institutions who do it receiving state support on the one hand should be avoiding tax, albeit legally, on the other hand
Mr Varley: I suspect you are referring to Barclays so I will be grown-up and say that if you are talking about Barclays, Baroness Kingsmill, I am happy to talk about Barclays.

Q442 ***Baroness Kingsmill:*** There were other banks as well, but you are here so I might as well focus on you.
Mr Varley: The first thing I would say is that it is wrong to suggest that we have some tax avoidance specialism or dedicated activity. We have financing activities within Barclays and a regular component of financing is tax. It is our fiduciary obligation to our shareholders and it is the fiduciary obligation of a lot of our clients to their shareholders to manage their tax in an efficient way. Do we have to be absolutely punctilious about obeying tax regulation and legislation? Of course we do. Do we have to make sure that the relationship that we have both in this country and elsewhere with revenue authorities around the world is transparent so that transaction by transaction revenue authorities are aware of what we are doing? Of course we do; we make that our practice. Ultimately I would say, judge us by the amount of tax that we pay. If I look at the amount of tax that Barclays has paid in the United Kingdom over the last five years it is £10 billion. If I look at the amount of tax that we have paid in the last two years in this country and outside the United Kingdom, again it is a £10 billion number. We are not shy about paying tax.

Q443 ***Lord MacGregor of Pulham Market:*** I must apologise that I was not able to be here at the very beginning but I think the question I want to ask has not yet been asked and it follows on more widely from Baroness Kingsmill's last question. There have been suggestions from the media pundits—politicians even—that financial institutions that have a lot of substantial state support should either face restrictions on the businesses in which they can engage or should follow certain directions as to how they conduct their business and how much lending they should do, for example. How do you respond to this?
Mr Varley: My view would be that with the involvement of taxpayers' money, whether it is in this country or in another country, of course goes a taxpayer's agenda of some sort. In other words, I can understand why governments want to have some influence over a bank that they are investing in . That seems to me to be perfectly understandable and perfectly reasonable. Is it a natural state of affairs in a normalised environment for the shares of a bank to be owned by the government? No, I do not believe so. I think the shares of banks are best owned by the private sector. Do I understand why around the

world we have seen this as a phenomenon of the crisis? I think it is perfectly understandable.
Mr Flint: I agree with that but I would add that it would entirely appropriate for there to be clear accountability to the taxpayers who have put money at risk, put money up for the capital of banks. I think it is however very important that the business model is not too narrow so that those banks can return to the private sector in as robust a state as they can, at some point and as early a point in the future. I think it would be disappointing to the sector as a whole, albeit competitively potentially advantageous, if the banks do not have as full a service proposition when they return as they can have, because a fully functioning banking system relies upon risk distribution and therefore the broadest range of activities for us to engage in counterparty activities is very important. I hope that there can be breadth so that the value within the franchise, that may be narrower for a while, can be retained for ultimate transmission back into the private sector.

Q444 ***Lord MacGregor of Pulham Market:*** Is there a conflict between avoiding risk and accepting a lending target that is given by the government in response to the state investment?
Mr Daniels: I think it is my turn to be an adult! We have accepted a lending commitment to the government of £14 billion through accepting the APS programme. What we all agree is that this has to be done on a commercial basis and within our normal credit standards so we do not see a conflict. We believe that we are in the business of serving our customers, including lending. We think that this is a commitment that we can make within those parameters that I mentioned.

Q445 ***Lord MacGregor of Pulham Market:*** With that caveat.
Mr Daniels: With the caveat that it is done on a commercial basis and within our normal credit standards, yes.

Q446 ***Lord Griffiths of Fforestfach:*** I have a quick question to do with the Volcker Lawson issue of Glass-Steagall and so on. Let us assume the government is totally out of it and we are back to business as normal, there will be some people who want to say that you should not be doing commercial banking and investment banking side by side. Presumably you would oppose that, but what would be your defence of what you would like to do?
Mr Flint: I think getting the definition between commercial banking and wholesale banking and then, in the far extreme, proprietary risk taking, is a difficult one. In relation to the combination of commercial and wholesale banking, allowing customers to hedge interest rates, foreign exchange, deal with their financing needs, these are part of a natural, commercial wholesale operation. I would take a great deal of care to ensure that any change in the business model did not in fact restrict companies getting the breadth of services that enable them to compete effectively around the world.
Mr Varley: I completely agree.
Mr Daniels: I agree.

Q447 ***Chairman:*** I have one final question. What would the impact upon your business be, and upon the capital markets as whole, of a significant increase in the capital requirements for bank trading books?
Mr Daniels: For the Lloyds Banking Group the impact would not be high. We do not have much trading activity. Again our business proposition is very customer centric, but what it would mean, even for us with a relatively limited amount of activity, if we in fact weighed more capital there we would have less capital for our other activities, including lending.
Mr Varley: I would say that with greater capital would go wider spreads, greater cost to clients of risk management and financing activity. The consequence of greater capital within the system is not trivial.
Mr Flint: It would shrink elements of the trading operation which is what, of course, it would be designed to do. In our case the capital allocated to trading again is a very small proportion of the capital but it would undoubtedly shrink those elements that were now taking on a much higher capital charge because the return on that capital allocated would be uneconomic.

Q448 ***Chairman:*** So for the capital market as a whole you would agree with Mr Varley, not trivial.
Mr Flint: For the capital markets as a whole, not trivial.
Chairman: Thank you very much indeed for spending so much time with us, rather longer than you were anticipating, but that is because we were very interested in your answers.

Memorandum by Nationwide Building Society

INQUIRY INTO BANKING SUPERVISION AND REGULATION

Nationwide welcomes the opportunity to provide evidence to this inquiry. We are the UK's third largest mortgage lender and second largest retail savings provider, with almost £200 billion in assets. As the UK's largest building society, we are different to many of our competitors. Unlike firms run for the benefit of their shareholders and to maximise profit, we are owned by and run for the benefit of our circa 15 million members.

1. *Can the regulatory authorities effectively control the risks taken by banks, especially in today's globalised markets? How can the international dimension be addressed?*

1. The drive for profit maximisation to provide the greatest return to shareholders led to some banks taking excessive risks. It is worth comparing this with the building societies model. Societies are different from banks, owned by and run for their members, with a business model of profit optimisation rather than maximisation.

2. Unlike banks, building societies also face a limit on the proportion of funds they can raise from the wholesale money markets. A building society may not raise more than 50% of its funds from this source, with the average proportion raised being 30%. This funding limit, however, is subject to change by the Building Societies (Funding) and Mutual Societies (Transfers) Act 2007 (the "Butterfill" Act).

3. While these different models ensure that our risks are well managed, we look forward to the FSA's report into the future of banking regulation in the UK, which will include measures to address the risk management of banks. Regarding building societies, any institution that has been at risk of failing has been taken over by a larger Society at no cost to the public and with no loss to members.

4. Regarding the international dimension, effective supervision of individual global banks may lie in colleges of supervisors, as was suggested by the Financial Stability Forum in its April 2008 recommendations. Each global institution would have a national supervisor within its jurisdictions who could coordinate the implementation of changes and take a holistic view. This level of harmonisation is likely to reduce the risk of contagion and systemic failure.

5. We support the UK and G20 in their work to improve international financial stability and cross-border crisis management. London is the largest financial centre in Europe and it is essential that this coordination is well managed. Ahead of the G20, the emphasis must be on proactive prevention measures to prevent further crises.

2. *Has the supervision of individual banks been handled effectively under the Tripartite System of the Treasury, the Financial Services Authority and the Bank of England? Should banking supervision remain with the FSA or be returned to the Bank of England?*

6. The While the current Tripartite arrangements in the UK remain appropriate, in the case of Northern Rock it was their execution that was at fault. It has become clear that upon recognition of the start of crisis, the Tripartite Authorities should have moved more swiftly to prevent further contagion. It is vital that the authorities work closely together, with open communication channels and a spirit of cooperation. The recent handlings of Bradford & Bingley, the Icelandic banks and London Scottish Bank were far more efficient.

7. The Nationwide does not believe that banking supervision should be returned to the Bank of England. Building Societies have never, in fact, been regulated by the Bank of England and we believe that the current arrangements are adequate assuming that the responsibilities of the tripartite are understood by all parties and are effectively executed.

3. *How is responsibility for stability of the financial system divided in the Tripartite System? Has oversight of the banking system been lost due to a focus on individual banks? What has been the nature of coordination between the different regulators before, and since, the Northern Rock crisis in the summer of last year?*

8. The Bank of England is responsible for the stability of the financial system as a whole, while the FSA is responsible for the prudential supervision of individual banks. Both oversight and individual focus on banks are needed. The problems in dealing with the Northern Rock crisis were to be found in execution of responsibilities rather than being wholly attributable to design.

9. Before the Northern Rock crisis, there was insufficient coordination and communication between the Bank and the FSA. Since the crisis, the problems with Bradford & Bingley, the Icelandic Banks and London Scottish Bank have been handled effectively by the tripartite without endangering consumer confidence in the financial system.

10. The earlier difficulties have also been addressed through the Banking Act, as the Bank is now able to obtain additional information from the FSA. In putting the Act in to practice, Nationwide would argue that the Bank—in its capacity as a monitor of systemic risk—should be more forthcoming in communicating its observations to the FSA. Likewise, the FSA should share and corroborate any concerns about individual institutions with the Bank.

4. *How can regulators employ people of the right calibre to regulate the banking system effectively?*

11. The FSA are seeking to ensure that they recruit the right mix of staff and that their training is adequate going forward. Nationwide would support this in light of the FSA's own admission of their failings.

12. We would support the FSA's efforts to recruit more supervisors, though would argue that their supervisory efforts should be focussed on the priority areas where the lessons of the Northern Rock crisis can be learnt. This should go some way to preventing further failings.

5. *Could the regulatory authorities have foreseen the banking crisis? What changes might help the authorities predict such a crisis in future? What could then be done to avoid a repeat?*

13. The FSA recognized some of the risks in their *Financial Risk Outlook* of January 2007. The previous month they had also written to institutions highlighting the need for more stress testing.

14. The risks were evident, but the FSA did not act on their assessments. It is one thing to identify risks, it is another to then have sufficient resource, authority and confidence to advocate widespread change.

15. Nevertheless, the risk factors in the banking system were irrefutable and change was vitally needed. The excessive reliance on short-term wholesale funding, the incentive to create and distribute mortgage assets of low quality, and the use of complex financial instruments in the unbridled pursuit of profit were proven to be unsustainable.

16. Policy makers must also share some responsibility. The fundamental economic de-stabilisers of unfettered credit and unconstrained house price inflation are economic aspects that government can exercise some direct influence over. Boom and bust is an inevitable feature of markets, the role of government is to try to mitigate the excesses of these cycles.

17. This failure of policy, alongside the recognition of the failure by the FSA to implement its supervisory responsibilities and the acknowledgement by the banking sector of their excessive risk-taking, have all meant that change is required. To avoid a repeat, the authorities would also be wise to learn lessons from the building societies model, where prudent management and low risk has avoided the worst excesses of the current crisis.

6. *What changes should be made to banking regulations?*

18. The key areas of change to banking regulations have already been identified by the G20. These include strengthening transparency and accountability, a focus on regulatory regimes, prudential oversight, risk management, promoting integrity in financial markets, reinforcing international cooperation and reforming international financial institutions.

19. In implementing the changes, the FSA and Bank of England will need to coordinate and communicate more effectively. Better sharing of data and assessment of stability measures within and between the authorities is crucial.

20. Nationwide also welcomes the coordinated global approach by Central Banks. In particular, the concentration on a better understanding of pro-cyclicality alongside ongoing Central Bank intervention to provide liquidity support will go a long way to help prevent further crises.

7. *For example, should capital adequacy regulations be tightened? Should they take account of the quality and liquidity of the assets held by the banks? If so, how? Do regulators need to create different sets of rules for different assets held by banks? Should fair value accounting rules be adjusted?*

Capital Adequacy Regulations

21. Capital adequacy rules are currently the subject of consultation. At this stage, we feel that the international rules that came in to force in 2008 as part of the Basel II framework are still relevant and that the changes being proposed, such as a leverage ratio and the creation of capital buffers during a benign economic environment, require careful and more detailed consideration. It must be remembered that it was liquidity risk rather than a shortage of capital that triggered the current crisis. Nationwide have a prudent funding model and our total capital ratio, as stated in our half year accounts in September last year, was 12.7%.

Quality and liquidity of assets; differing sets of rules for different assets

22. The requirement to hold more, high quality liquid assets and rigorous stress testing is understandable in the current environment. The Basel II framework already takes account of asset quality and further change requires careful thought. Nationwide believes that there is scope, however, to consider expanding the reclassification of fair value assets, looking at derivative netting, and modifying the rules on hedge accounting for risk.

Fair Value Accounting

23. Nationwide welcomes the information provided by the International Accounting Standards Board in relation to how valuations are applied in illiquid markets. We also regard the creation of the Financial Crisis Advisory Group to consider financial reporting issues in light of the credit crisis as an important and necessary step. Care must also be taken to ensure that simpler, retail funded building societies are not subject, however, to onerous and detailed reporting requirements.

8. *Do Basel banking standards and guidelines need to be changed? Did the FSA ensure that banks followed the Basel standards and guidelines?*

24. The regulatory framework is being reviewed in respect of increasing and tightening capital requirements, enhanced risk management, improved stress-testing, reduced pro-cyclicality and remuneration and risk-taking practices. While we believe that a focus on these areas is important, we would argue that better regulation is more of a priority than increased regulation, particularly since Basel II only came in to force at the beginning of 2008. As banking reform continues, it will be important for the FSA to execute its powers more effectively in light of its previous failings.

25. From the point of view of Nationwide and other building societies, increases in capital requirements may in fact make the credit crisis worse, as it reduces our ability to lend. This is more pronounced for new lending. For example, a loan with an 80% loan-to-value (LTV) consumes more than three times the Pillar 1 capital of a 60% LTV loan. While the FSA have recently made improvements to capital-raising, building societies have less flexibility to raise or generate capital compared to the banks under the Building Societies Act Section 9, creating specific difficulties for the sector compared to the banking sector.

9. *Is better testing and regulation needed of new financial products, especially complex securities? If so, how? Should complex financial instruments, such as credit default swaps, be traded through clearing houses?*

26. We agree that testing should be improved for products. In addition, stress scenarios should be an integral part of capital planning and risk management. New and complex products should be tested effectively, especially in relation to their possible contribution to systemic risk. Clearing houses would not remove all of the risk, however, as this would instead be pooled with other institutions.

10. *Should there be tighter regulation of off-balance sheet vehicles in which some banks held "toxic" assets associated with US sub-prime mortgages? Is there a case for requiring greater public disclosure of banks' balance sheets?*

27. The Financial Stability Forum has asked the International Accounting Standards Board to consult on regulatory issues and we support this activity. Nationwide, along with other building societies, manage our accounts prudently and do not engage in the extensive use of complex financial instruments. Within our internal risk management, off balance sheet vehicles remain consolidated within calculations of credit and funding risk.

28. As a member owned organization, we are also transparent in our engagement with the public. For example, members are sent a summary financial statement each year outlining key ratios in relation to liquidity, capital and other measures.

11. *Are bank directors, especially the independent non-executives, in a position to exercise effective oversight? In particular, do they have sufficient understanding of the complex assets held by banks? If not, can any changes be made which will ensure effective oversight? Do any other governance issues need to be addressed?*

29. This issue is being addressed by the G20 and by David Walker's independent review of corporate governance. This is because it has come to light that some non-executives have not had sufficient scrutiny over the strategic direction and senior management decision-making process within their organisations. As a prudently managed building society, we believe that risk management should be embedded at all levels of the organisation.

30. Within building societies, there are clear board structures in which the non-executive directors are able to challenge the direction of the organisation and become familiar with the workings of a model that is low-risk, simpler and perhaps easier to understand compared to the complexities found within the banking model.

12. *To what extent has the financial crisis been caused by the failure of banks' business models rather than by that of banking supervision? Did the remuneration structure of banks contribute to the crisis and, if so, how should remuneration structures be changed?*

31. There is a clear difference in the prudent building society model compared with the banking model. Indeed, all of the societies that demutualised have either failed or been taken over. While a reliance on wholesale funding within the banking model was pivotal to the credit crisis, building societies have been more reliant on the security provided by retail deposits. It is also true, however, that the Bank of England and FSA did not act on the risks evident within the banking sector and so a failure of banking supervision is also evident.

32. There is now a recognised need to ensure that risk and remuneration are aligned within the banking model. Within building societies, remuneration policies are approved by ordinary members at the AGM and are modest in comparison to bank bonuses. This is because Building Societies do not engage in the complex trading activities of investment banks where the remuneration structure has been based on high risk, high reward. Additionally, building societies do not have shareholders and therefore share options are not included in remuneration packages.

13. *How should the regulatory system take account of the Government's position as a majority shareholder in a number of banks?*

33. The distortion to the market of nationalised and semi-nationalised institutions is a concern for the building societies sector. In particular, the recent growth of National Savings and Northern Rock in the savings market has resulted in an unfair competitive advantage. In the three months to October last year, for example, NS&I accounted for 56% of the balance growth in the household savings market. This growth means that building societies have fewer funds to make mortgage loans.

34. Moreover, while prudently managed building societies pay a disproportionate levy to the financial services compensation scheme to protect members up to £50,000, the failed banks have received substantial support from the government despite their risky activities and failure to adequately protect their depositors. We feel that the inherent inequities of the FSCS levy system should be urgently addressed.

14. *Where should the boundary be drawn between the institutions that are covered by banking regulations and those that are not? For example, does there need to be a clear division between commercial banks, with relatively strict supervision, and investment banks? Should banking regulations address the role of credit rating agencies?*

35. The excessive risk taking within the banking sector has resulted in an increased cost to our members, in the form of the FSCS levy, to bail out these institutions. We would advocate measures to reduce the risk taking of firms contributing to the FSCS, or to charge a higher levy for those institutions that continue to take higher risk.

36. The role of the credit rating agencies in the banking crisis has been recognised and we would welcome the implementation of any changes to improve the assessment of risk.

15. *How far can banks circumvent UK regulations by, for example, setting up offshore operations? How far should changes be made at the UK-level and how far through international agreements? What is the impact of EU banking regulations and how do they interact with UK regulations?*

37. As a domestic organisation, we are affected less by these issues. We would suggest, however, that it would be sensible to improve international coordination to ensure that capital movements can be effectively policed and that risks are managed appropriately across different countries.

16. *Are there lessons Britain can learn from the experience of other countries' banking systems during the financial crisis, such as Spain and the US?*

38. It is important to recognise the success or otherwise of other countries in responding effectively through their regulatory systems to the banking crisis. For example, Spain's dynamic provisioning model could be a useful tool to address pro-cyclicality and we are supportive of the efforts of the G20 to improve collaboration and coordination.

17. *Should other aspects of the system of banking regulation be changed?*

39. Nationwide welcomes the recent and ongoing activity to improve regulation and financial stability. However, the priority must remain better rather than more regulation. We are also supportive of the G20's global, integrated approach to regulatory change given the continued risk of contagion across economies.

March 2009

Examination of Witnesses

Witnesses: Mr Graham Beale, Chief Executive, Nationwide and Mr Matthew Bullock, Chief Executive, Norwich and Peterborough, gave evidence.

Q449 ***Chairman:*** Mr Beale, Mr Bullock, welcome to both of you and thank you for spending the time with us today. I am sorry we kept you waiting for a bit but you can probably understand why. Thank you also to Nationwide for your written evidence which we have read. I am always asked to ask you to speak reasonably slowly and clearly for the benefit of the stenographer and the members. When you first say something perhaps you could briefly introduce yourselves as that will help with the web broadcasting. I understand that neither of you wish to make any introductory remarks so we will move straight onto questions. Building societies' losses have been less dramatic than those of banks and you appear to be in a better position to weather the storm. Why is this?

Mr Beale: I am Graham Beale, the Chief Executive of Nationwide Building Society. It is interesting having just followed on from the banking model that you have been exploring, I think we need to understand that building societies are structured quite differently to banks and I would say, because the structures, are inherently less risky than banks. The items I would point to are the much higher levels of capital that building societies traditionally hold; the much lower leveraging that is on the balance sheets so we are predominantly retail funded, so the typical level of wholesale funding is around about 30% for the industry and indeed there is a statutory limit of 50% so there are some regulatory restrictions that would prevent us from becoming over geared. We carry high levels of liquidity and I would say as well that the business model recognises the capital structure of the society. I will explain that to you because it is a very important point. The capital that resides on our balance sheets is really accumulated profits from previous years; there is no risk capital or equity capital that sits on the balance sheet. Therefore we need to manage the business accordingly because our ability to raise capital from outside of our business model is restricted and because there is no risk capital, we are not motivated to the same extent to generate high levels of profit, to give a return to a shareholder, because there are no shareholders expecting a return on an equity basis. Our shareholders are in fact the retail depositors and for somebody who deposits £10,000 with Nationwide, for example, their full expectation is that they will get that back as and when they want it, together with the prevailing interest that sits on it. So we have to manage the business very much on the basis of risk aversion, to really honour the obligations that we have to our members, who are indeed our shareholders, without the drive to create profits to make dividend payments, which is where the banking model sits.

Q450 ***Chairman:*** I should have mentioned earlier on that if either of you take the same view as your colleague, just nod in assent; do not feel obliged to

answer in the same way. Mr Bullock, do you take the same line?

Mr Bullock: My name is Matthew Bullock; I am the Chief Executive of Norwich and Peterborough Building Society. I agree with much of what Graham has said and I would add a couple of points. First of all, we have a much simpler customer base than banks, they are less risky, and by and large, therefore our business will be less risky. A second important point about building societies is that we have a "hold-to-maturity" ethos. If I were to say one thing which I think has changed the banking industry fundamentally in the last 15 years it has been the erosion of the "hold-to-maturity" ethos with a view that you could find somebody in the debt capital markets who would hold the debt for you. By contrast, building societies tend to think about assets, when we bring them onto a balance sheet, as something we are going to be looking after for a long time and not something that we can pass to somebody else. Thirdly, I would underscore, the point about risk capital. The cost of capital in a mutual is theoretically zero. Effectively we run ourselves at a pre-tax return on capital required after risk of 11 per cent. That is some seven or eight per cent lower than would be typical of a bank. It means therefore that typically we get driven into much less of a search for returns than the banks.

Q451 ***Lord Tugendhat:*** In the light of that rather comforting response, I wonder if either of you could tell me how many building societies have sought refuge with larger building societies since the summer of 2007 and why you think a number of building societies seem to have needed to seek refuge as an alternative to going down if things work in quite the comforting way that you describe.

Mr Beale: From my knowledge there are five building societies that, since the start of the financial crisis, have had to be rescued by larger societies.

Q452 ***Lord Tugendhat:*** Which are they?

Mr Beale: Nationwide merged with the Derbyshire and Cheshire; Skipton has merged with Scarborough, Scarborough being the weaker player; the Catholic was merged into Chelsea, Catholic being the weaker player; and Barnsley is in the process of going into the Yorkshire.

Q453 ***Lord Tugendhat:*** You also took over the Portman, did you not?

Mr Beale: Yes, we took over the Portman. That was driven by a strategic combination of two strong organisations; it was not done in any way because the Portman or Nationwide required to do it for health reasons.

Q454 ***Lord Best:*** Are we likely to see after years of demutualisation and the contraction of your industry, whether we are now at the point where we might see a growth again, let alone more people sheltering under the big boys' wings? Are we now in an era, having watched the banks fail us so badly, when we might be seeing a revival of interest in mutuals, social enterprises and the rest of it, something between the state run things and market forces being left to do it?

Mr Bullock: I think there is a great deal of political interest in it and I think that there have been a number of reviews of the governance of mutuality and the benefits it brings. It has been developed more in areas of social enterprise rather than necessarily within the financial services. The only re-mutualisation that has so far taken place has been the purchase of the branches of Bristol and West by the Britannia Building Society. Clearly the Butterfill Bill does throw open the opportunity for more corporate action within the mutual envelope that has been seen before. The formation of a building society under the act requires one million pounds' worth of capital to be borne by initial membership subscription and the nature of building societies is that the owners are individuals and there is no concentration of voting power; it is one member, one vote. I think it would be difficult, but not impossible, to create a new building society and indeed there was discussion a while back as to whether a Muslim sort of building society mutual could be formed although obviously it would have to comply with Sharia law. It is not easy but I think there is certainly quite a lot of discussion about whether this particular form of governance suits certain kinds of activities. If you look at the taxonomy of corporate forms you find mutuals basically where there is a requirement for long term personal capital services. I am sure we will get a question later on about efficiency, but one point about mutuals is that because they do not have to pay external shareholders within the business they are extremely efficient on a compounded basis for people who have services from those organisations. There have been studies carried out of the returns, for example, in mutual life companies where it is clear that the returns from mutual policies have, over the long term, been stronger than those from proprietaries. I think people are starting to come back to realise what an effective form this is in certain areas of our economic life. It is not anything like as dynamic or whippy as the proprietary system.

Q455 ***Baroness Kingsmill:*** In the current housing crisis do you think there has been any evidence of mis-selling? As part of that same question, do you think there is any argument around regulation in relation to loan-to-value loans?

Mr Beale: I am not aware of any evidence of mis-selling. Mortgage Conduct of Business rules were introduced in 2004, so the process of selling mortgage products is a regulated process and you have to be authorised to do so. In addition, I would say that Mortgage Conduct of Business has been supplemented by the treating customers fairly principles that the FSA have been driving for the last two or three years.

Q456 ***Baroness Kingsmill:*** We heard something from Shelter about self-certification; do you think that constitutes mis-selling?
Mr Beale: Again if you undertake self-certified lending, provided it is done properly it does not mean that the income is not verified. What is means is that the income comes from self-employment or whatever so you can still verify the borrowers' ability to service the loan that is being contemplated. As with any form of underwriting, if it is done properly you can cater for different types of borrower. If there is a compromise in the underwriting, whether it is self-certified or not, then that is an issue that we must safeguard against. We are back to one of Matthew's earlier points that if you originate to hold you are very careful about the loans that you write because you live with the consequence. If you originate to distribute you are originating in the knowledge that at some point that risk will be passed onto other third parties. I think that that difference in attitude does influence the diligence with which you undertake the underwriting activity.

Q457 ***Baroness Kingsmill:*** And the loan-to-value ratios?
Mr Beale: I think there is a lot of discussion around regulating loan-to-value and also the income multiples. We need to be very careful because there are certain borrowers—first time buyers—who we require to stimulate the market, that typically will come in at a very high loan-to-value. I think to regulate just by very crude measures that you cannot have a loan-to-value in excess of Y or an income multiple in excess of Z is a little bit crude and is failing to understand that as part of the underwriting process we need to look at the absolute level of affordability. You can have two borrowers in front of you both earning £50,000 and if one of them has children to support, a car loan to repay and some other form of debt, and the other individual is entirely unencumbered I would be very happy to lend an awful lot more to the second borrower than the first borrower, but at face value the parameters look the same. I think we need much more sophistication in measuring and understanding affordability and that will ultimately determine the amount of risk that you are bringing onto the balance sheet.

Mr Bullock: I think it would be very surprising if, through this cycle, there had been no mis-selling of mortgages anywhere. I would just pick up a point about this hold to maturity ethos. One of the things which is not well-recognised outside the industry is that there has been a growth of another series of parties who are also less interested in the eventual loan outcome, the broker community. Their share in originating mortgages went from 30% to 70% within this last cycle. If you combine that with the originate to distribute model you have two sets of parties, one of whom is dealing with a customer, the other one is dealing with investors. The care with which you would review a credit could be different from what it was before. I think we have to look at those two systemic changes. The point that Graham makes about affordability is absolutely central. We do not lend on LTVs now; we lend entirely on affordability. If you wanted to bring in something that was going to constrict, for example, covered bond issues which might be the way in which regulation goes, you would probably look at something like a debt to income ratio because that actually would pick up affordability in one form or another. I am resigned to the fact, going back to the Volcker question earlier on, that this kind of banking is probably something people want to be very unexciting, to turn it into something like a utility and that is probably one of the ways in which it should be approached.

Q458 ***Lord MacGregor of Pulham Market:*** What would be the consequence if the regulator did introduce a cap on loan-to-value?
Mr Bullock: I think people would try to observe it; it would have a very large effect on the market but in a sense that is entirely what it would be designed to achieve. It would slow the market up because first time buyers would not be able to come to the market very easily. There would be a transitional pain and the market would have to adjust to whatever the rules were.

Q459 ***Lord Eatwell:*** I am intrigued by Mr Beale's willingness to lend to the unencumbered playboy and not to the struggling family man.
Mr Beale: I did not actually say that.

Q460 ***Lord Eatwell:*** I want to push a little bit further on this originate to hold and the hold to maturity issue and the role of securitisation of wholesale funding. Wholesale funding can go up to 50%. We have seen already that banks have been severely hit by the freeze of credit markets, the freeze of wholesale funding. Has that affected you? How do you fund your wholesale money? How does the liquidity or the length of maturity of your wholesale funding match your asset side on the balance sheet with respect to your mortgages?

Mr Beale: There are quite a few points there. First of all, we are predominantly retail funded and in the price list what we have done is to moderate our new lending to make sure that it will be covered by the retail funds that we bring in. So we have moved away from what would traditionally be a market share model, where you would say you want to take 10% of the market or whatever, to a model whereby we would determine how much cash we could bring into the business and in the current market it is from retail sources. That would then determine the lending appetite in terms of our lending activities. However, even if you do that, you do not stand still because clearly the wholesale funding exists on the balance sheet and we are 30% which is constantly maturing and needs to be re-financed. We have made use of the guarantee scheme and activities like that. Pre the crisis we did not securitize. We have never issued any form of securitised mortgage assets. What we have done is to operate the covered bond as a way of secured funding. The difference between a covered bond and any form of securitised asset is that with securitisation, the risk and the ownership of the loan passes to the third party; with a covered bond the risk remains with Nationwide and is effectively just collateral and to the extent that it underperforms we have to substitute it with performing collateral. So the risk remains entirely with Nationwide and it is therefore consistent with the philosophy that we have about originating for the long term. We are not immune. I think the pressures on re-financing the balance sheet have hit every player in the market that has any form of wholesale funding. We are highly respected within the investment community and that is why our reputation is very precious to us in maintaining that confidence in Nationwide. We have not had any problems in re-financing the balance sheet but it has got shorter and shorter because it is impossible to get any form of term financing without a government guarantee to support it. We have started to be much more active in the retail market place. Last year in our full financial year we took in about £9.1 billion and we lent £8.9 billion so that is the matching that I spoke about.

Q461 ***Lord Eatwell:*** Essentially on your wholesale funding you are becoming more exposed to a mismatch.

Mr Beale: There is a mismatch and it is much more volatile, so to the extent that there is a major disruption to the market place and the markets freeze again—another Lehman type of event—it would start to cause some enormous strain. I was very much against the Bank of England removing the special liquidity scheme, because I regard that not as a means of funding the business on a day to day basis but it is a safety net, so that in the event of a shock to the system—which is impossible to do anything about, you just have to respond to that situation—we need to have these safety nets in place.

Mr Bullock: We, like Nationwide, fund ourselves. Our mortgage book is entirely funded by our retail deposits. We are required to be in the wholesale market in order to manage the liquidity portfolio we are required to hold by regulation. As far as we are concerned, like Nationwide, we have found ourselves getting shorter and shorter maturities because of the wholesale market being jammed up. But a bigger impact is that the clearing banks who, for a long time got out of the retail deposit market, have now gone back in and are paying extraordinarily high rates in order to raise retail funding to service their obligations and that is causing a real problem in the retail market. I think that, if anything, is probably the largest disruption to the building society sector because it means that the cost of our basic raw material is being driven up by the banks coming back into that market in this very rapid way.

Q462 ***Lord Paul:*** Your association claims that the Basel II gives very large financial institutions a leverage because they are better placed to take advantage of the opportunities to reduce capital adequacy requirements through complex securitisation and similar transactions. If this is the case, the Basel II Accord could have the effect of reducing the number of small building societies. It also stresses the importance of a level playing field. Do you think that it ensures a level playing field between building societies and banks?

Mr Bullock: Since my society was the first financial institution in the West to get approved for IRB advanced ranking under Basel II ahead of any bank I have to say that it is not necessarily something that can only be done by large institutions. I think that as far as the credit side of things is concerned largely building societies can do what we have done; it is possible for them to play on a level playing field. In fact it is an advantage to us because it equalises the amount of capital we will put to loans and then, because we have a lower return on capital requirement, we in fact can always undercut the proprietary banks on price. I think the major difference that I would cite as being inadequate in the present arrangements is the issue of capital to trading books: this is an area in which the banks, both on and off their balance sheets, have substantially leveraged their businesses in a way that societies cannot, because they are not allowed by regulation to engage in trading activity. Therefore they have very large activities which have very low capital allocations from which they try to earn substantial profits and of course have had substantial losses. That is something that we are not engaged in. I think it would be very painful for the capital markets, to answer an earlier question, for capital to be put back against trading

books; it would, I think, be one of the ways in which any disequilibrium in the playing field could be sorted out.

Mr Beale: In terms of the level playing field, there is one major difference between what is available to a building society and what is available to a bank in terms of managing your capital base. There is no possible way for a building society to increase its core tier one but you can supplement your total tier one by permanent interest bearing shares. There is a legal restriction which minimises the permanent interest bearing shares to being no more than 50% of your total tier one, so you cannot unduly skew the capital base. However, most permanent interest bearing shares that are in issuance have some form of call rights at five or 10 years into the term and that is classed as being innovative tier one. There is a proposal coming out of the EU that will restrict innovative tier one to 15%. For some societies this will restrict their ability to grow and will cause complications because a number of societies, including Nationwide, are already through the 15% limit. We would find it very difficult to replace and sustain that level of capital because of these restrictions if it is introduced. We are not massively through; we are about 17%, so in the great scheme of things we could equalise, but I do think in terms of a level playing field, enabling societies to grow and to expand their business in requiring capital, it is very difficult and is therefore not on a level playing field with the banks, which have much greater access to capital.

Q463 ***Lord Tugendhat:*** I was going to ask you about whether you felt that large scale government ownership of the banks would lead to a distortion of competition but I think you answered that question earlier so let me ask you a related question which is whether you feel that there is a case for establishing separate depositor protection schemes for depositors in banks and building societies given the relative risk of depositing in the one is greater or lesser than depositing in the other.

Mr Beale: Can I just start with the point about distortion arising from state ownership, because I think there are some important points there and in a way it will lead onto the financial service compensation scheme. What has been quite clear, particularly in the last several months—I would say probably since Lehman—is that consumers have looked through the level of compensation afforded by the financial service compensation scheme and have effectively attached a greater level of comfort from organisations which are either fully or part state owned, on the basis that they are on state support, which will exceed the level of the FSCS compensation. In the last few months, a very large proportion of retail deposits that are in the system have flown to institutions such as Northern Rock and to National Savings and Investment, so it is effectively sucking retail receipts out of the building society sector into the institutions and when you talk to savers who have moved to Northern Rock—we can all visualise the queues that were outside Northern Rock when investors were taking money out—it is not because they suddenly feel that the Rock has gone through a revolution, it is rather because they feel that they have got a government underpin at a hundred per cent, whereas all I can offer is £50,000 through the compensation scheme. There is some quite significant distortion going on which has had a serious disruption for institutions such as ourselves, who are very traditionally retail funded so there is quite enormous distortion. In terms of the compensation scheme, we feel very aggrieved at having to pay the lion's share of the failure of Bradford and Bingley and some of the Icelandic banks. If you look at the proportion of costs to the building society sector compared with the banking plcs it is quite dramatic. The argument is that because we have more retail shareholders we are therefore enjoying more protection. I think that is missing the point which is behind the question, which is that our risk appetite and our risk model is much, much lower in terms of the risk that we have than a banking model. I feel that that should be recognised in the cost of the FSCS in terms of the levy on the industry and we have lobbied very hard for a revision to the costs that we had to incur for the failed institutions so far and we have suggested schemes whereby there are different contributor groups—building societies being one group, for example—whereby if there was a failure within the building society sector we take the lion's share of the pain but with contributions from other groups and vice versa, so if there was a failure in the banking sector the banks take the pain and we take less. That, to us, seems to be much fairer. The cost to Nationwide of these failures so far is going to be around about a quarter of a billion pounds, that is quarter of a billion pounds of costs that our membership is having to bear for the failure of Bradford and Bingley and the Icelandic banks. That is not right.

Q464 ***Lord Forsyth of Drumlean:*** This is a point we explored when the Building Societies Association gave evidence; we did not have time to follow through on it. I am amazed that you are so calm about this. I do not know what the opposite of moral hazard is but it seems that you are the good guys and you are getting the rough end of the stick. The Building Societies Association said, "We can see the problem but it is difficult to find a solution". You, Nationwide, are so large relative to the others (I am not suggesting for a moment that Nationwide is going to collapse in a heap) and if you are a small building society the idea

that you might be taking on the liability for Nationwide which is a big elephant in the room makes it difficult to devise a scheme. Have you got a worked out scheme? Have you discussed this with the FSA? It seems to me that what is happening is absolutely iniquitous. That is my first point. I did not realise that the sums were so large, but is it not getting worse because, as I understand it at the moment that is a loan from the government and at some stage this is going to have to be repaid. Are the building societies going to get hit with an enormous great liability just at the point when the banks are back on their feet? Is that not desperately unfair?

Mr Beale: It is desperately unfair. I may appear calm, but it is not without very, extensive lobbying through all channels—the FSA, HM Treasury, there was an early day motion with 157 MPs signing, there was a lobby in Westminster last week. There is a huge amount of activity. We have had the likes of Lord Turner in front of the Treasury Select Committee taking questions on this. They have undertaken to review the way the FSCS is operated going forward but we have been told very, very clearly that in terms of what has happened, it has happened and I do not think there is any desire or appetite to change the position. We are not calm, but I guess it is a resignation that we have tried every which way to point out the iniquitous situation that we find ourselves in. I think there is an issue in your comments about size. I do not know where it is, but there comes a point where no compensation scheme can really operate effectively given the size of an institution. We have an asset size of £200 billion and I cannot really see that the construct of any scheme is really going to operate so that you could get to such value that would really cover for a failure of Nationwide (which, for the record, is not going to happen). There comes a point where some form of government intervention or some forced amalgamation is an alternative recovery becomes the only option available at a certain size and scale. For the small and medium sized institutions I think the compensation scheme has the potential to work very, very well but we need to have a fair system that does not unduly penalise, because I have absolutely no doubt that there will be building societies who are going through their financial results for the December 2008 year end and during the current financial year it will be the difference between making a profit and a loss in terms of their contribution to the compensation scheme for the failure of the banks.

Q465 ***Lord Forsyth of Drumlean:*** It does seem to me that we need clarity because when the trade association gave evidence they suggested that there was not a scheme that everyone had agreed to. Are you saying that the Building Society as a whole had a proposal which they would all sign up to and which the FSA or the Treasury could actually achieve?

Mr Beale: The Building Societies Association has made recommendations as part of the consultative process for the compensation scheme, one of which was to have different contributor groups. We are in consultation. I think we have tried to make some very sensible suggestions. To the extent of saying that everyone will sign up to it, we have not gone through that strict process but I think the fact that it is being sponsored by the Building Societies Association and the council which represents a cross-section of the players within the sector—

Q466 ***Lord Forsyth of Drumlean:*** A failure to agree this when eventually the money is paid will presumably mean that some small societies may have to run to the arms of others or it will mean that the deal which the savers have put their money in the building societies is reduced because they are having to compensate people who chose the banks.

Mr Bullock: In our case over 50% of last year's profit went to pay the FSCS. In my members' meetings in East Anglia people are "gob smacked", to use an East Anglian expression. They cannot believe that the building societies are having to pay this kind of money to someone who de-mutualised and left the building society camp and took their business elsewhere. I would echo what Graham says that we are not going to be able to push the water back under the bridge, but the much bigger "rapids" we have facing us is if there are capital losses in Bradford and Bingley's portfolio and we are asked to pay for those. The sums involved will come down, just as they did, in a single line e-mail from the FSA saying, "Your contribution is this". I think we are very concerned that that form of being "doshed out with a ticket" that you have to pay is reviewed. As far as the FSCS scheme is concerned, I think it had a place when you had single institution failure for some fraud or some kind of issue when the rest of the industry was in a reasonable state and could pay for it. It is not designed for systemic failure and frankly its use by the Treasury to deal with Bradford and Bingley was, in my view, very strange given that the rest of the rescues they did were paid for entirely by the tax payer. From that point of view one questions why it was that just in that one particular instance they chose to use that system and yet when they dealt with the other institutions they did not. My own view is that I would prefer to have an FSCS scheme which relates to the building societies. I watch my peers extraordinary closely and I think I would have an idea what I would be paying for. I think I knew that Bradford and Bingley had problems; I could not say anything about it and yet I end up paying for it.

Q467 ***Lord Levene of Portsoken:*** There has been a lot of talk recently about compensation levels. How are senior executives in your organisations compensated and how do you ensure that those levels of compensation are aligned with the interests of your members?
Mr Bullock: In my case we have, just as Mr Daniels described earlier on, a balanced score card which includes four elements. There is one for financial, one for the customer, one is our staff and one is efficiency and processes. I think it is worthwhile saying that every financial measure in my society is risk adjusted over risk adjusted capital and that the stress we apply to the return is a "through the cycle" adjustment. None of our people are able to write mortgages without having a full capital cost for every single mortgage they write, based on what it might look like at the bottom of the cycle (not just the next 12 months) booked against their revenues. Our remuneration levels for basic salaries are based upon the market. We also have bonuses; our bonus levels at their maximum will pay an executive 38% of his basic salary. My salary is £303,000 and I get my bonus on top of that. That is a whole order of magnitude different from the banks.
Mr Beale: The situation in Nationwide is that the compensation arrangements are set by a remuneration committee, which is chaired by non-executives and indeed comprises non-executives; no management sit on that committee. We use Hay Consultants to help us with the benchmarking activity. The Nationwide is very significantly larger than the Norwich and Peterborough, so we have different considerations in making sure that we can recruit and bring the right people into the organisation. The way we set the basic salary is to take the median of the market based on the view from Hay. As to the bonus arrangements, we have an annual bonus, which again is driven by a balance score card containing 12 measures across the piece with appropriate risk adjustment where that is relevant. We have a medium term bonus which looks at the amount of value that we give back to our membership because we measure our pricing of our principal products and compare it with our peer group to make sure we give sustained value back and that is what is used to determine the medium term bonus arrangement.
Chairman: I think you have actually answered en passant most of the other questions we were going to ask, but there may be other questions. Lord Eatwell?

Q468 ***Lord Eatwell:*** I was just wondering whether you envisage the possibility of re-mutualisation. We have had demutualisation. I cannot see Abbey/Santander suddenly declaring themselves a mutual, but it is likely that building societies would buy the mortgage book of banks who wanted to move out of the mortgage business?
Mr Bullock: I think there is an issue about where would you raise the capital. The inherent nature of a society is its organic capital base. We would find it very hard to make a very major acquisition of a large book of risk.

Q469 ***Lord Eatwell:*** If there is to be a re-mutualisation of the housing finance sector it will happen organically by you chaps growing faster than the banks.
Mr Beale: Yes, we would have the capacity to undertake some small acquisitions, depending on the scale of the venture. You do get portfolios being acquired either in part or in whole. We are back, though, to extreme caution in doing that because you are effectively buying assets that have been originated by somebody else and we are back to the fact that we are very precious about understanding the risk that resides on the balance sheet. If you go and acquire the mortgage portfolio for Bradford and Bingley, for example, without having seen any form of due diligence, that it is something that we would not want because it would be outside of our risk appetite. I think there are other restrictions that would come into play and the likelihood is that if there is a plc that is seeking some alternative business model, it is because it will have major problems and those are not problems that a building society would wish to inherit.

Q470 ***Lord Eatwell:*** The point that both of you have made all along is the sensitivity that you have to the quality of the risks you are taking. There was one warning bell sounded when you referred to the role of brokers. It sounded as if brokers were pursuing something which sounded like an originate and relocate model which has contained severe risks within the banking sector, is it creating similar risks within the building society sector?
Mr Bullock: In America you will have found at the peak of the cycle emergence of organisations that were originally brokers, that had very strong flows from other sub-brokers and that turned themselves into "originate and distribute" banks because they could get banking loans from banks which would then fund those assets. Certainly I visited a group in California who basically would originate and distribute a whole portfolio once a month and their returns on capital were simply fantastic, as you can imagine, because if you turn your capital over 12 times a year rather than once it becomes very profitable. I do not think we have yet seen that happen here although there were signs of people like Edens and some of the other later cycle entrants who were starting to play in that way. It is certainly a possibility. I would not want to suggest that all

brokers are mis-selling, they are not, but I do think that what we are seeing now is a consolidation in the broker market into about five or six bigger groups. Their structures are strange. Legal and General Insurance Company runs one of the largest and is actually responsible for the compliance of several thousand brokers. I think that is a complicated model and I am not sure how it would work under pressure. There is no question that the consumer has had his eyes opened to choice and if choice means that he can get a little bit more by shopping around he will not stop doing that! I do not think we are going to have a market society where there are not brokers.

Q471 ***Lord Eatwell:*** Do brokers worry you, Mr Beale?
Mr Beale: They do not worry me but you need to be very careful when you operate. I think we need to be clear on two points, first of all the brokers are subject to the Mortgage Conduct of Business Rules, so there is regulation given to what they do. The second point is that when they are originating business through Nationwide, it is to our underwriting criteria. They have to abide by the rules that we set and we do check carefully that we are happy with the quality of the application and that it meets our criteria. I think there are safeguards that can be put in place to deal with them in a reasonable way.

Q472 ***Lord Tugendhat:*** When one looks across the piece at the mortgages which are in arrears, is there any pattern at all that emerges as between the instance of mortgages in arrears held by the building societies and held by the banks, and that is including Bradford and Bingley and Northern Rock and so forth? Secondly, in the light of your responses about brokers, is there any correlation between arrears in broker originated mortgages and those which did not go through independent brokers?
Mr Beale: The first thing to say is that in terms of the industry statistics on arrears they are done at a national level, so I am never in a position to compare our arrears performance with a named bank. You can pick up information from the performance of securitisations where you can see very specifically arrears performance and we have had some disclosures from the likes of Northern Rock and Bradford and Bingley because of the state that they find themselves in. You see very, very marked differences in the level of their arrears compared with the arrears for the building society sector. In terms of broker originated transactions within our own institution, we do not really have any correlation in terms of a weaker performance arising from broker introduced business; you just cannot see that at all. Again, there is a lot of evidence in play for institutions that have acquired portfolios from some of the packages who effectively created large portfolios and then sold them on, some absolutely appalling arrears performance. There is a really marked difference between what we are experiencing and what they are experiencing.
Mr Bullock: Our own intermediary originated mortgages perform at the same level as our direct book but I think if you are not a sound institution, brokers will offer you loans which could be bad, particularly if one looks at those books that were traded by packagers. Those are the areas where you would say "So and so has bought a book from a well known packager, they're going to have a problem": and they do.

Q473 ***Lord Forsyth of Drumlean:*** At least some of the brokers that I have spoken to are complaining in terms of getting the housing market moving about the very large fees that are now being charged by building societies for new mortgages. Some of them are very substantial, not hundreds of pounds but thousands of pounds. What is driving this? On the face of it it does actually seem to be making it much more difficult for first time buyers and people to get back into the housing market and therefore making the recovery more difficult.
Mr Bullock: The issue is that there is no money to lend so people will price products that basically are pricing out the demand. At the moment the effect of the closure of the wholesale markets and the effect of the raising of prices in retail markets means that it is exceptionally expensive to do more than just cover your liquidity.

Q474 ***Lord Forsyth of Drumlean:*** So it is a rationing thing then.
Mr Bullock: Yes.

Q475 ***Lord Best:*** The housing associations have borrowed £50 billion so far from the building societies and from banks. They are now finding it extremely difficult to borrow any more. This of course is holding up major building programmes. Sometimes the land is acquired, the grants available from government but the mortgage loan is not there and when people ask for more money from the lenders that they have been accustomed to borrowing from they are told, "We are going to re-price your book now and it is back to square one". Do you feel that the building societies have a better record and are likely to be more amenable lenders for the non-profit housing associations than the banks, or are you just competitors, side by side, nothing to choose between you?
Mr Beale: We are one of the largest, if not the largest, lenders to the Registered Social Landlords sector. It is true that where we are looking at re-financing proposals we need to look at the whole of the loan that is outstanding to Nationwide and this is because,

in terms of our ability to now raise funding and the cost of the funding for Nationwide, it is very, very substantially different to the cost of funding to us when the loans were originated. One of the complications of loans to the RSL sector is that they tend to have very, very long terms. A 25 year term and even longer is not unusual in that sector. You cannot get 25 year money at any point in the cycle in terms of drawing cash flow into Nationwide and so the loans that we wrote two, three, four, five years ago where your margins were just a few basis points over LIBOR, you cannot replace that funding in a month of Sundays at the same sort of levels. So you have got to recalibrate the cost. We are still lending to the sector and we have recently completed a very large transaction that was in excess of a hundred million just to one institution, so it is still going on but they have to be realistic about the cost of funding and the cost of funding has gone through an exponential increase. We are a commercial entity and it has to be in the interests of my members that we make a margin on the lending activity that sits on the balance sheet. I am afraid it is a bit like everybody, they have to understand that the cost of funding, the cost of risk and the cost of credit has moved. They have to either adjust their business model to accommodate it or they will not get funding.

Mr Bullock: We also have an RSL book. There is a problem; it is not "Baseled" because the government does not "Basel" housing associations in the same way as commercial lending. Therefore it actually sits outside some of our critical ratios. We have certainly maintained our relationships with the smaller housing associations with whom we have had very long relationships. However I would say that the degree of consolidation within the housing association market has meant that many housing associations we did deal with have been folded into larger associations who have been happy to go to capital markets and commercial banks for their funding. When they come back bleating we just say, "We haven't seen you for the last five years". I think relationships flow both ways.

Chairman: There are no more questions. Thank you very much Mr Beale and Mr Bullock for spending time with us; that was very helpful indeed.

TUESDAY 24 MARCH 2009

Present	Best, L	Kingsmill, B
	Currie of Marylebone, L	Moonie, L
	Eatwell, L	Paul, L
	Forsyth of Drumlean, L	Tugendhat, L
	Griffiths of Fforestfach, L	Vallance of Tummel, L (Chairman)
	Hamwee, B	

Examination of Witnesses

Witnesses: MERVYN KING, Governor, PAUL TUCKER, Deputy Governor Financial Stability and SPENCER DALE, Chief Economist and Executive Director, Bank of England, examined.

Q476 ***Chairman:*** This afternoon's hearing will be in large part about the Committee's inquiry into banking supervision and regulation. Members of the Committee have already declared relevant interests in previous hearings. First of all may I welcome you and your colleagues, Governor, to the Economic Affairs Committee; thank you for taking time to be here this afternoon. We have read with interest your speech at the Mansion House last Tuesday which is very germane to our inquiry.
Mr King: Shall I introduce my team now?

Q477 ***Chairman:*** By all means.
Mr King: I am Mervyn King, Governor of the Bank of England. On my right is Spencer Dale the Executive Director for Monetary Policy and on my left is Paul Tucker the Deputy Governor for Financial Stability.

Q478 ***Chairman:*** Excellent. Do you want to make any introductory remarks?
Mr King: No, I think we should go straight to the business.

Q479 ***Chairman:*** Let me kick off then. Jacques de Larosière gave evidence here two weeks ago. When we asked him what the main underlying cause of the current financial and economic crisis was, whether it was the banks or whatever, he replied that it was " . . . the piling up over 10 of 15 years of easy—too easy—monetary policies". He thought that was the underlying cause. He was not, of course, just talking about the UK at the time but I wonder whether you would like to comment on his comment and tell us whether you think that firmer monetary policy, possibly with added objectives or instruments, might have avoided or mitigated the current crisis?
Mr King: I would put a different emphasis on it than Jacques de Larosière. I would start by focusing on the imbalances in the world economy. They made it inevitable that some countries would have to go through a period of large current account deficits. The countries with large current account deficits wanted to maintain a balance between demand and supply; that was the objective of monetary policy, to maintain a balance between overall demand and total supply to maintain stable inflation. Most countries were actually successful in doing that, but in order to maintain a balance between overall demand and supply in a situation with a large drag on demand from a large current account deficit, domestic demand in the deficit countries had to be high enough, in fact in excess of the supply potential of the economy so that overall demand would be in balance. That was a product of the imbalances in the world economy and not the monetary policy decisions of each individual country. Of course the deficit countries could have run policies which had tighter monetary policy in the developed world, but only at the cost of having high and rising unemployment and falling inflation. I do not think there would have been much support for that. The support for the inflation target for an independent central bank is very much based on the idea that our job is to maintain stable inflation not to create deliberately falling inflation to offset someone else's current account surplus. I think the big lesson for me from this at the monetary policy level is the need to rework the international monetary system, to go back to the objective which was discussed widely at the time of Bretton Woods, which was to try to find a way of imposing symmetric obligations on the surplus countries as on the deficit countries. The most striking fact about the last 10 years or so is that most of the developed countries with deficits did not have rising inflation; they had pretty stable inflation right through this period. We had an inflation rate within nought point one percentage points of our targets on average over the past eleven years and we did have a higher interest rate than most other countries; in fact since the MPC was set up in 1997, from then on, apart from two very brief periods in which the United States had slightly higher interest rates, actually interest rates were higher in the United Kingdom than anywhere else.

Wherever monetary policy was loose, it certainly was not in the UK, indeed our bank rate averaged virtually five per cent over the period. Most of the G7 countries other than Japan, which had basically zero interest rates, were in the three to three and a half per cent range on average over that period. So we did have tighter monetary policy, we did play our part but the only way monetary policy on its own could have contributed more to preventing the build-up of imbalances was for the UK unilaterally to try to make a sacrifice by having high unemployment and frankly that would have made no noticeable difference at all to the imbalances in the world economy. The conclusion is that we actually need more instruments; I have talked about this before. I do think that, rather than sacrifice what is a very sensible macroeconomic policy objective of matching demand and supply in the economy and maintaining stable inflation, we need to create new instruments to enable the authorities to have some power to prevent a build-up of credit expansion within the financial sector.

Q480 ***Chairman:*** What do you think the instrument should be?
Mr King: There is a lot of work to be done. People talk about counter-cyclical capital requirements; there is quite a good case for that. They refer also to the Spanish experience of dynamic provisioning of accounts whereby banks put to one side larger reserves in good times so that they have those reserves to draw down on when experiencing losses in bad times. All of these ideas are sensible at the level of principle, but there is an awful lot of detailed work to be done to turn them into concrete practical propositions; that work has not yet been done and it needs to be done over the next year. I think that is what we ought to be focusing on. There are international issues; how you deal with an international bank when you are trying to impose a counter-cyclical capital requirement, where the cycle is in one country and the bank is dealing with many other countries. There is a lot of detail which has not been thought through yet, but we need to because there are very important potential instruments.

Q481 ***Chairman:*** Would you also want to look at the CPI as a measure of inflation, given that it does not include the effect of house prices?
Mr King: When we switched from RPIX to CPIX I expressed some reservations about the move on the grounds that, although CPI has many advantages over RPIX, it has one very big disadvantage which is that RPIX includes house prices and CPI does not. I expressed some concern about the move at that point. I would like to see us have a price index which does include house prices; I have made no bones about that but we are where we are and it does not make sense to chop and change the target too often.

Q482 ***Baroness Kingsmill:*** It would appear that the use of interest rates is not for controlling inflation alone; it is not an adequate basis for the Bank's ongoing role. I would highlight the fact that the inflation target seems to have resulted in too low interest rates which have created excessive mortgage debt and a house price bubble. Furthermore, the Bank has had to resort to quantitative easing and the quantitative easing requires Treasury approval, so it would seem that the Bank has lost some of its independence. Furthermore the tripartite agreement does not appear to have worked. Would you like to comment on those concerns?
Mr King: There are several quite different issues all wrapped into one.

Q483 ***Baroness Kingsmill:*** I thought I might as well get them all out.
Mr King: Let us start with the most basic one which is obviously similar to the question the Chairman asked. I believe that an inflation target is a necessary but not a sufficient part of our policy framework to achieve stability overall. It is a necessary part because to set monetary policy on any basis other than trying to achieve low and stable inflation is a recipe for really making mistakes. Every single time that I have come across people who wanted the Bank to pursue something other than an inflation target in the last 15 years, on every single occasion, it has been in the cause of lower interest rates, never higher. Whatever people say in abstract about the benefits of having a different objective, for monetary policy to have higher interest rates, in practice I have never come under pressure or seen people either off or on the Committee really argue for these other motives in order to have higher interest rates only for lower. One of the great merits of an inflation target is that it holds the feet of the Committee to the fire in saying "You may be unpopular. Don't go for popularity just go for what is necessary to meet the inflation target". I think that is fundamental, otherwise we would be lost in monetary policy. However, an inflation target is not sufficient, we have seen that, because you can still get build-up of credit within the financial sector. What is most extraordinary about the last decade is that two thirds of the increase in credit was within the financial sector, not credit extended to the non-financial sector, companies or households, but within the financial sector and it was that expansion of credit which, if anything, needed to be controlled. Bank rate is not the weapon to do that because if we had raised bank rate to a level which might have slowed that growth rate of credit within the financial sector, we would undoubtedly have slowed the real economy to a point where inflation would have been falling below

the target on average and we would have seen rising unemployment. We just need additional instruments to do that, but you are right in saying we do need additional instruments. I am conscious that I have not tackled all the other parts of your question.

Q484 ***Baroness Kingsmill:*** There was the point about quantitative easing and the impact that has on the Bank's independence because it requires Treasury approval. The final bit was a comment on the tripartite agreement.
Mr King: Quantitative easing is not a question of getting Treasury approval. What it has to do in order to work is that it must be carried out in tandem with debt management, which is the Treasury's mandate. We are independent. The decisions on quantitative easing are our own decisions. We remain an independent central bank. However, no central bank can engage in what I prefer to call unconventional operations without having agreement with the Debt Management Office that they themselves will not then engage in debt management operations which would offset the operations we want to carry out. That is just as true going into this as it will be for the exit route. Any kind of operation of that sort which involves buying and selling assets has to be done in conjunction with the Debt Management Office just to make sure we do not get in each other's way, but it is not a question of affecting the independence of the central bank.

Q485 ***Baroness Kingsmill:*** I wondered whether the sharp cut in interest rates over the last four months had actually been because of the inflation targets.
Mr King: It certainly has. Every decision we have taken has been discussed in the Committee at great length and explained outside and our decisions have been based solely on our wish to meet the inflation target. The great virtue of the target is that within the Committee diversity of view and expression and debate are important but that can never work if people feel that around the Committee are people with different objectives. That open discussion and debate can only work if people know and believe that everyone else is trying to hit the same target, but they may have a different view about how the economy works, which is something we should take into account in debate. It is very hard to have that atmosphere of trust in the Committee, to enable us to have an open debate, if you feel that somebody is pursuing a different target. I think the target is fundamental to the dynamics of the way the MPC works.

Q486 ***Lord Forsyth of Drumlean:*** I just wanted to pick up on the question which the Chairman raised to which you gave a very complicated answer in terms of international aspects of it. The evidence we have had, and certainly the report points to it, is that you were setting interest rates looking at a very narrow measure of inflation whilst house prices were going through the roof and other asset classes were going through the roof. I understand the point that if you put up interest rates you might not have met your narrow definition of inflation target and it might have meant that there were fewer building workers employed building flats which turned out subsequently to be almost worthless. But is there not merit in the argument which says that part of the problem has been holding interest rates down too low, so people went out and borrowed and bid up the price of assets like houses? Now, as a result, we are having to pay the price with very high unemployment which is going to go over three million. Did we not actually try to play the game of golf with one tool to the very considerable disadvantage of people in this country, which had nothing whatever to do with international factors but was entirely a result of the way we chose to handle our monetary policy?
Mr King: No. I certainly accept that we did go into this with only one instrument for the Bank of England, which was the bank rate, and that in itself was not sufficient to guarantee stability. I totally accept that; the point I made to the Chairman. However, we do work and live in an international capital market. Rightly or wrongly we have abolished capital controls and the level of long-term interest rates in our economy is determined in the world capital market and what happened with a very large expansion of the volume of savings in Asia was that world real interest rates were bid down to very low levels. Those are the interest rates which determine asset prices and that is why all asset prices went up, not just here but in other countries too. That is something which no one country had much control over and that is why we do need some action at the international level.

Q487 ***Lord Forsyth of Drumlean:*** But if you had had housing in the measure of the increase in inflation and you had set interest rates to take account of the increase in house prices, then people would have been less able to borrow to the extent that they have and there would have been less pressure on house prices.
Mr King: Certainly in the last two or three years, before the crisis began in 2007, it is fair to say that the change of the target probably made it more difficult for us to achieve that balance. After all, our job is to follow the remit given to us by Parliament. It is not our job to say we do not care if Parliament have made a mistake, we will do something else. There is a system which gives us a very clear remit and our job is to follow that. I have said before that I think it would have been preferable had we stayed with an index in which house prices were still included. I have said that several times before.

Q488 ***Lord Eatwell:*** In his evidence to the US House of Representatives in the autumn Alan Greenspan made two quite striking statements. One was that he thought that firms would manage the risks to which they were exposed and their shareholders were exposed. He also said that the entire intellectual framework of risk management had collapsed; presumably the intellectual framework he had used. Was that your position as well at the time?

Mr King: No. I interpreted his comment to be the following. He was absolutely right in saying that the firms themselves had every incentive to manage their risk properly. He was also right to imply that regulators would find it very difficult to second guess the details of risk management that the firms were engaged in. The problem was—something you had written about many years before—when you get big swings in sentiment, change in a view about the conventional valuation of assets, as Keynes described it, then you will get a very big change in risk premia and the values of many assets will seem to disappear. The world in which we moved was one in which there was extraordinary complexity in the range of financial instruments, that the assumptions which were being made to value those instruments were not good assumptions, they were based on massive mathematical and statistical detail but not based on an appreciation that things could change quite radically outside the experience even of the post-war period. That was a mistaken judgment where people did not give enough weight to history and they made assumptions about what might happen. In some cases—and the Executive Director for Financial Stability in the Bank, Andy Haldane, talked about this—when we talked to some of the firms more recently, it was clear that some of them had taken the view "OK, let's suppose our assumptions are not that good, let's suppose the world really does come to an end, the authorities would bail us out". So they took less care in managing those extreme risks because they took the view that if it did happen, they would in fact be bailed out. That poses the dilemma facing the authorities when creating a regulatory structure to put in place a framework for financial stability.

Q489 ***Lord Eatwell:*** Mr Greenspan seems to have said that the intellectual framework he had used had collapsed. That is a view which is echoed in Lord Turner's report, that the intellectual framework has collapsed. I am really looking for your reaction to that. I was wondering in particular, with respect to the responsibilities of the Bank whether the Monetary Policy Committee really took much account of what was happening to the balance sheets of financial institutions. After all, that is part of the monetary transmission mechanism and that is in effect part of the risk management process which was going on.

Mr King: I think what Alan Greenspan was talking about was the idea that the people making decisions about risk had a view of the world which is very accurately described in the quotation from Keynes which I put into my speech last week: as long as everyone else is doing the same thing, why should we hold out differently? It is a safe position to be in, if other people feel the same. Everyone gets sucked into that. We felt—and maybe this was a problem with the framework—that our job in the Monetary Policy Committee was to meet our remit, which was to hit the inflation target, and we did achieve that. The difficulty was that the link between the top-down view of the balance sheets and the bottom-up view of regulation of individual institutions was not matched. In part—and I say this for the Bank—we did talk about this quite a bit in our financial stability reports and our speeches. In 2003 I spoke about the reason that the nice decade was coming to an end was because it would not be so smooth in the future, there would be rebalancing of balance sheets. In 2005 I gave a speech on the housing market, about house prices. In 2007 I talked about the dangers of liquidity in markets for complex instruments drying up, about the dangers of excessive leverage, about the dangers of not learning from history. We spoke about it but the fact was that the Bank of England had no policy instrument other than words and the danger with that, in my view, is that, if the only policy instrument you have is talking about it, you have to be very careful with what you say for fear of being accused of exaggerating or being a scaremonger. I hope in the future that whoever is given the responsibility for financial stability will indeed spend much more time looking at the balance sheets of institutions and of the sector as a whole but be given some policy instruments to enable them to take decisions about it which will force them to think deeply about it and to be careful in their decisions and in their words as well. I can understand why people were rather sceptical about the Bank. They said that we had our financial stability report, we did not have to do anything, we were not supervising the institutions, it did not really matter what we said. It was frustrating for us but we did not have a policy instrument. Looking forward, I do think that is a question which has to be answered. If you are going to give a central bank a responsibility for financial stability, what is the instrument you expect the central bank to use in order to achieve financial stability? I do not think that question has been answered.

Q490 ***Chairman:*** I am sure it has not. Just going back into the past for a moment, apart from speeches and reports, were these things that you discussed directly with the FSA in a forceful way or not?

Mr King: They were discussed primarily at the level of the deputies' committee; that is the level at which the tripartite committee met regularly before 1997. The Bank made these points. For example, take regulation of liquidity. This was a point we had been making quite forcefully for many years, in fact it was a point the Bank of England made at the very first meeting of the Basel Committee, suggesting that the Basel framework included liquidity as well as capital, which sadly it does not. This is something the Bank has been very conscious of for a very long time. Perhaps it goes back to the question about the tripartite. The tripartite committee is a vehicle for communication and exchange of views; it does not take decisions in itself. Maybe it should, but as it has been set up it is there as a vehicle of communication. Each individual member of it has very clear responsibilities. There is no ambiguity about them at all and they are decisions on regulation for FSA, on anything to do with the use of public money for the Treasury and the Bank's monetary policy and its liquidity operations for the Bank. There has never been any misunderstanding about that amongst the three members of it but precisely because we have specific responsibilities—

Q491 ***Chairman:*** Are you saying there is underlap?
Mr King: You say "underlap" but there was a very clear delineation of responsibilities. One thing which I noticed after 1997 was the enormous improvement in the relationship between the Treasury and the Bank. Why? Because the overlap which had existed on debt management and monetary policy came to an end. The two institutions had camps. They had the best people they could find camped on either side of the frontier, on monetary policy and on debt management. There would be skirmishes and there would be debates to see who could get the most influence. That was wholly counter-productive. I was entirely in favour of having very clear delineation of responsibility. I do not think that was a mistake in the way the arrangements were set up in 1997. If anything the problem was not with the arrangements which were set up but what was not set up, which was this range of macroprudential policy instruments to deal with something. Spain did not have dynamic provisioning as a tool of counter-cyclical policy. It was put in by the central bank to protect their own banks. As far as I know, no country had actually got to the point of saying they needed to have an additional set of instruments for policy in the macroprudential area. Now everyone is saying we need to have it. That is fine in principle but there is a lot of detailed work to be carried out.

Q492 ***Lord Moonie:*** You referred to the "paradox of policy"—reducing interest rates when they are already at an historic low, increasing fiscal deficits, government debt when both are already very high using unconventional monetary measures. Would you explain why you think policy should ignore convention in this way and whether you are confident that you can actually reverse policy at the right time to avoid an unsustainable fiscal position and excessive inflation?
Mr King: The "paradox of policy" comes directly from the "paradox of thrift", which is that in present circumstances, if everyone were to save more, which might look sensible from a long-run point of view, that actually we would all end up spending less and the economy is worse off. It is a coordination problem. We cannot find a way to coordinate our decisions about investment for the future. In the short run, given what is happening, if you look at what is happening to the fall in trade around the world, five per cent down in the last quarter of last year, a bigger fall probably in the first quarter of this, exports from Japan down a third since last October, these are extraordinary figures which we have not seen before. There needs to be a coordinated effort to ensure that we do maintain spending in the short run. You are right, the reason why it is a paradox is that once we have adjusted to that and the world economy has recovered, then some countries, particularly ourselves and the United States, will need to move to a point in which our national savings rate will need to rise and other countries, like China and some of the Asian economies, will need to move to a point where their national saving rate will probably fall. Then we will have a more balanced world economy and we will be back in a sustainable position.

Q493 ***Lord Paul:*** The Bank's first response to the financial crisis was to emphasise the dangers of moral hazard rather than the systemic failure. Subsequent events suggest that this diagnosis was unhelpful and delayed the Bank in taking appropriate action. What has the Bank learned from this and what procedures need to be in place for the future?
Mr King: I do not accept the suggestion that it delayed our action. In fact a very interesting chart appeared in last week's *Economist* which showed the balance sheet of each major central bank in the world relative to GDP. You can see that after the financial turmoil started in August 2007 the Bank of England's balance sheet relative to GDP actually rose earlier and faster than that of the ECB and the Federal Reserve. I do not accept the proposition that we delayed action. We had deliberately put in place—and Paul was instrumental in doing that—a new system of money market operations which did not require us to make a great announcement about the fact that we were allowing banks to increase their reserves and that the liquidity we would provide to the banking system would rise. That was something which they could choose themselves and indeed they

did. We made a conscious decision in August 2007 that we would not lower interest rates, overnight rates for the first two weeks until the end of what was called the maintenance period, until we got to the September MPC meeting, to allow banks to make their own decisions. We have provided a very large amount of liquidity since. I do not accept that we were slow in that sense. In terms of moral hazard, you will find that most of the debate about schemes to resolve the banking system at present is all about moral hazard. Perhaps it is unfortunate that the words have come into common currency. All that it means is that when the Government engage in an intervention the Government should think through what the consequences of that intervention might be, both intended and possibly unintended. If you are going to engage in some intervention you need to anticipate how the private sector would react. That is exactly what everyone is having to do now when thinking about schemes to find a way to stabilise the banking system. Actually moral hazard, though that may not be the most fortunate name for the concept, is fundamental to everything the Government are now trying to do to solve the problems of the banking system.

Q494 ***Lord Tugendhat:*** May I ask you a slightly personal question? You speak with exceptional clarity and authority on these issues, both when you come in front of parliamentary committees and when you make speeches. Yet here we are, we have been through and indeed are still going through, an exceptionally torrid time, a time when the general public has great, great difficulty in understanding what the causes of the problem are, what the parameters of possible policy decisions might be and yet you very, very rarely speak other than when you present your monthly reports. When I look at successful governors of other independent central banks—of course there are not very many to choose from—if you look at Tietmeyer and you look at Perl, at Trichet, if you look at Greenspan and indeed if you look at your own distinguished predecessor, they all seem to take more seriously than you do the public education and public information role. It seems to me that one of the roles of the governor of the independent central bank is to spread what I might term knowledge, reassurance and understanding. I wonder why you do not do more of that, if I might ask.

Mr King: In a sense I am surprised you ask that in that over the last 18 months I have given a live televised broadcast on average once a month. I think these parliamentary appearances are rather important. I think many people actually, rather than just listen to what they might think of as a dull speech being read out in a monotone to some audience they cannot see, would prefer to see their representative putting questions directly to the Governor. This is my thirteenth appearance before a parliamentary committee in 18 months. I do not think any minister can easily match that; certainly none of my predecessors can. All my speeches are now usually broadcast live on one television channel or another and they are all available. The quarterly press conferences are too and, again, people can put questions to me. I set great store by our role in educating the public. Maybe we have not been very successful at it. I make a regional visit almost every month for two days; I am making one to the North West this week, at which I will give three or four off-the-record talks to groups of business people, again where I speak and they will put questions. There will be other occasions where I will be talking to smaller groups. I do not think that any governor has ever spoken to as many groups around the country as I have before. We do put enormous weight on that. What I think is the real difficulty here, and I do not see any easy way out of this, is that there has been an extraordinary event in the UK economy. For 20 years most people, most ordinary businesses were told that if they adopted the disciplines of a market economy they would all be better off in the long run, prosperity would be the reward for the application of market discipline to employees and to others, if people did not work hard enough or asked to be paid too much, they might lose their jobs; that was market discipline. If businesses were not productive enough, they would not sell their goods and they would go out of business. So we have applied market discipline. Now people find that, having accepted that, out of a clear blue sky comes an extraordinary crisis which has absolutely nothing to do with the real economy in any sense and is not created by the efforts or excessive expansion or over-investment of the business sector in the UK or most households. If anything it is caused by excessive credit expansion within the financial sector, by people who, when the turbulence hit them, said actually market discipline may be pretty good for the workers, but it is not such a good idea for the bankers, so can we have a bailout please? It is very hard to explain to people that a market economy is meant to mean discipline for one group but not for another. There is a big educational job to explain—I explained this all the way through my previous appearances—that the reason we are trying to find a solution to the banking problems is not to help the banks themselves but to help the wider economy. That is the only reason we are doing it: to help the wider economy but these are not easy issues to understand and they are not easy points to get across. We are trying hard. Maybe we can find better ways of doing it and maybe I should make fewer parliamentary appearances and more appearances somewhere else, though I am not quite sure where that would be. We are willing to consider all

possibilities but we are certainly out and about all the time explaining what we are doing.

Q495 ***Baroness Hamwee:*** May I follow that up by thanking you for the very intelligible, commonsense synonym for "moral hazard" which I take to be "What if?". What are the banks asking you to do now? I assume it is not a generalised "Ah" because they have a range of problems. What are they asking of you?

Mr King: It is what they are asking of the UK Government as a whole. The strategy which has been set out is pretty clear now. I think the banks are asking, and it would be sensible for the Government to do this, that the Government say that for any major bank of any serious importance to the economy the creditors of that bank should be wholly reassured that the Government will underwrite those obligations. To do that the Government have to underpin the equity capital of those major banks. That is the first point: capital. The second point is that even with a reasonable capital position the banks need funding to be able to lend on to the UK economy. A lot of that funding in the last seven or eight years has come from borrowing in short-term wholesale markets rather than using retail deposits. Some of that has come from overseas; a significant chunk of the wholesale deposits has come from overseas. That source of funding has dried up. So there has to be a new source of funding. That will not come quickly or easily. The credit guarantee scheme which has been introduced is a scheme under which banks can search out sources of finance, knowing that the Government will underwrite their credit. That is a very helpful source of funding to banks. Those are the two major things. In addition, they are also concerned about short-term liquidity support from the Bank of England but we have put that in place and we have a new system, a discount window in which banks can come to us when they need short-term liquidity. People have now come to recognise that the central bank cannot be the source of long-term funding. We are there as short-term liquidity insurance not as a substitute for retail deposits or other sources of long-term funding. That has to come from savers in the economy.

Q496 ***Lord Griffiths of Fforestfach:*** May I come back to the question of quantitative easing? It is perfectly understandable, at a time when output in the UK is falling, unemployment is rising and world trade is going down, that you should be very concerned with deflation. However, before quantitative easing was announced, the monetary base or high-powered money, notes and coins plus bank reserves, had really increased very considerably. If you now look at what is happening with quantitative easing, in my judgment it is increasing at an extraordinary rate. I am sure you would say the argument is that there has been a big increase in liquidity preference and therefore no-one is critical of what you are doing at the moment. However, if you look back over the last 50 years, the increase in the monetary base at present is quite extraordinary. The problem that you are now building up in terms of the exit is that we will see an upturn from this cycle and as we see the upturn there will be an enormous amount of high powered money in the system. The banks will want to lend it, people will want to borrow, for you to counteract that you will have to be selling stock, the price goes down, interest rates go up and the politicians will not want it. The question is: are you enough concerned about future inflation in what you are doing now?

Mr King: I can assure you that we are focused solely on one thing which is meeting the inflation target in the medium term. That is my sole criterion for success at the Bank. You are right that we know the monetary base is expanding. We are more concerned at present by the fact that the broad money held by the non-financial sector has not been growing, the nominal demand, which had been growing at pretty healthy rates has just stopped growing at all; if anything there has been a fall in the level of total nominal demand at the end of last year. This is a short-term problem, we will come out of this and we will need to reverse the actions we have taken. That is where I think the inflation target is so important because we will have to take very seriously the need to follow the exit route and to raise interest rates, for example, quickly and sharply where necessary. I promise you we will make those judgments in order to try to hit the inflation target. This is clearly an issue. We need to be very conscious of the exit route for all the policies we are pursuing now. It goes back to the question about the "paradox of policy". If you are going to take measures to stimulate the economy now, you have to be ready to have an exit route or to think through the exit route before you start down the path, but you need to be careful and judge the timing of that.

Q497 ***Lord Forsyth of Drumlean:*** The 2009 Banking Act creates the renewed Financial Stability Forum to which you referred. I am a little bit confused as to how this committee will work. It appears to be advisory and not to have an executive role. Do you think it should have an executive role? I am also a bit confused as to how this relates to the FSA. I keep asking the question, which I am sure you have heard 100 times: who is actually in charge? One of the suggestions in the Turner review is that the idea is that the FSC should be designated as a joint committee of the Bank and the FSA. Could you try to clarify for me what you think about this? My own view is very simple: it should be executive and it should be the responsibility of the Bank. I do not know where the Bank is on this.

Mr King: The trouble is that there are as many different views on what the ideal Financial Stability Committee would be as there are people. You could have many different concepts for the Financial Stability Committee. As you say, Lord Turner of Ecchinswell has aired one. That is clearly not the committee we have; that is a completely new idea. There may be arguments for it, there may be arguments against it but it certainly is not what we have now. Parliament has now decided what the Financial Stability Committee is, that is clear: it is a sub-committee of the Court. Its role is to provide a source of advice and discussion between the executives of the Bank and the non-executive directors of Court. The executive responsibility for those decisions remains with the executive of the Bank. We will be held accountable by you and other committees for our decisions, not the non-executive members of Court. It is not an executive committee, it is a non-executive committee and it would help prepare the way for the Court of the Bank as a whole to hold the Bank accountable, not for its policy judgments but for the way it went about organising its financial stability work. I think what we have is clear. Whether it is desirable is a different question, but we know what we have and we have to make it work.

Q498 ***Lord Forsyth of Drumlean:*** My question was whether you thought it should have an executive role.
Mr King: It is difficult to have an executive role if the other members of it are the non-executive directors of the Bank who cannot devote the time which is really necessary to make the judgments you need in the midst of a financial crisis and where—this is even more important—there is this terrible difficulty of knowing whether you should allow people who maybe have very recent experience in the field of financial services to be members of a committee which might generate conflicts of interest. It is clear they could not have someone on that committee who is currently occupying a senior position of either an executive or non-executive nature in the banking community. We have seen recent events, that it is quite dangerous to have people who have had very recent experience serve on such a body too if they are meant to be a regulator or serve some independent role when their past may come back to haunt them.

Q499 ***Lord Currie of Marylebone:*** Given the difficulty of pricing the toxic assets and the rather expensive recapitalisation of the banks which has not led to a return of lending to the private sector, is there a risk in all of this that the way we rescue the banks means that the taxpayer picks up the costs if those toxic assets turn out to be really toxic and the banks get the benefit if they are less toxic? Would it not be much cleaner to nationalise the banks fully?
Mr King: The cost would still fall on the taxpayer.

Q500 ***Lord Currie of Marylebone:*** If the assets turned out to be more attractive, then it would not fall on the taxpayer and they would be able to get the upside.
Mr King: Indeed but that does not go to the heart of the question of whether you nationalise banks but the question of what you take in return for offering a guarantee to the balance sheet of the bank. I take the main principle to be one in which governments say "Given where we are, in the midst of this financial crisis, no important bank will be allowed to fail, we will underwrite the balance sheet". I interpret that as being essentially—and I prefer to see it this way in many ways—a statement that if the equity capital of a bank falls to some critical minimum then the Government would inject equity capital into it from the Government. That means that the public sector would then own shares in the bank. If you adopt that principle and that is what you intend to do, to underwrite the capital of the banks, which in essence is what Government have to do now and are doing, you cannot run away from the fact that if the losses are big enough, you may end up owning more than 50% of the shares. That is a dilemma which every government round the world is facing, which is that the logic of the position drives you to accept that, but you are not very keen to sound enthusiastic about it and indeed no-one is enthusiastic about it and for good reason. I do not think you need to frame this in terms of a proactive nationalisation. What you need to do is to recognise that in order to underpin the balance sheet of the banks two things are necessary: one is to make that guarantee, make it unambiguously clear and that means being prepared to take the equity if necessary. The second thing you need to do is to embark on a process of proper audit of the balance sheets of all the major banks. The US has embarked on that road; we have done it now; well the Government have done a first stage of that for RBS and Lloyds and is embarking on the further stages of the audits that are necessary. We need to do it for all banks just to clear the air. I have no reason to express any concern about our banks at all, but I just think that the uncertainty is still there and will be there until people can just go right through the balance sheets and sort them out.

Q501 ***Chairman:*** This might be an appropriate time, as you mentioned the US, to ask whether you have any reactions to Tim Geithner's plan for the US. Are there lessons for us to learn here?

Mr King: It has been very warmly welcomed. There are many different ways you could do this. We will see how well the scheme of asking the private sector to value assets and then buy them actually works. The difficulty with these assets is that people cannot easily price them and that is why the market itself has not generated these kinds of transactions. I very much hope that the scheme will be successful in doing that. In their own ways different governments are all doing the same thing, which is, following the principle I enunciated, underpinning the balance sheet of the bank. What we have done here with the asset protection scheme is essentially to offer insurance explicitly, not to the whole of the balance sheet, which is one way you could so it, but to a large sub-set of assets, the assets where the risks really lie. Both for RBS and Lloyds, the size of the asset pool which is being insured is sufficiently large that that should give a very high degree of comfort to the market. What matters most on this is the reaction of creditors of banks and whether they really feel it is safe to extend credit to a bank which the Bank can then use to on lend. That is a challenge because the shock to confidence, which occurred ever since last September when Lehman Brothers failed, has been so enormous and it has come as such a surprise to people who had not seen anything remotely like this in their lifetime, is not easily repaired. It is very easily destroyed and quickly destroyed but not easily put back together.

Q502 ***Lord Best:*** In the future regime, how will the Bank communicate with Treasury on questions of financial stability? Is that going to be formalised in some way? Will the public know if there are disagreements between the two of you? Will they come out? In the past, with the meetings of the tripartite principals, how often were you meeting in the decade leading up to the current situation?
Mr King: Before August 2007 and after 1997, that decade, there was a handful of meetings only at principal level. We all engaged in crisis management exercises, war games if you like, where we tried to simulate the effect of various serious problems in the financial sector. One of them we did jointly with the United States. We were really keen to do that because many of the issues are cross-border in scope. Domestically we carried out several and in those exercises we identified exactly the problem that arose with Northern Rock, namely that there was not a proper legal framework for resolving a failing bank. That was why in the end the Government had little choice but to take Northern Rock into public ownership. There was no formal framework as an alternative: now there is with the Banking Act 2009. The way in which we communicate with the Treasury is through endless meetings. The one thing this country is not short of is meetings. I know that many people recommend new committees and processes with the best of motives. All I would say is that the one thing we are not short of is process. We are short on policy instruments but not the number of meetings. We will communicate and it is right that the views of the Treasury and the Bank and the FSA when they are talking to each other should be in private. If we are to express an honest view and opinion, then we must be able to do that in private.

Q503 ***Chairman:*** I have two linked questions for you. One is whether the Bank has sufficient access to information at the level of the individual institution to fulfil its responsibilities with respect to financial stability. The other is that, given you have responsibility for that stability, do you think the Bank should have the power, as the FSA does, to trigger the Special Resolution Regime?
Mr King: Two distinct questions there: one on information. Yes, I am fairly confident that after what we have been through the FSA will share with us all the data that they have. More relevant to us is, if we think it is data we should have and the FSA for its own purposes, for good reason, has not collected, how do we get those data? FSA have made commitments that they will engage in their best endeavours to supply us with that information but I am still a bit surprised to find that a Banking Act which gives the Bank of England the explicit statutory responsibility for financial stability has not seen fit to include in it the Bank of England's statutory right to obtain information and data that it thinks it needs. I cannot see any objection to that myself if we are given the responsibility. That is not in any sense a reflection on the FSA, it is just that if you are designing it, it would seem very odd not to give us that right, but we do not have it. On the trigger, yes, I said before that I felt that ideally the Bank of England would have, together with FSA. I certainly do not want to take away FSA's own trigger to trigger the Special Resolution Regime for a failing bank, but I do think it would have been sensible for the Bank to have had that trigger too. I made that point. I made it in public, I made it clearly with the Chancellor, I lost the argument, I accept that, we move on.

Q504 ***Lord Forsyth of Drumlean:*** What was the argument on the other side?
Mr King: You will have to ask them really. This was a period in which the tripartite committee was coming under somewhat unfair attack because tripartite arrangements were built up by some to mean more than they could possibly handle. The tripartite arrangements are a method of communication between three bodies with distinctive responsibilities. There is no separate

decision-making role for the tripartite committee as such. In an environment in which the tripartite arrangements were coming under a lot of attack, it was felt that to somehow put into a legal framework responsibilities which might be interpreted by some as suggesting that one member of the tripartite would not want to share information with another did not seem to make a lot of sense. The spirit of the tripartite arrangement is that we have very clear responsibilities and there is no ambiguity about them and from that point of view it would have been better had we had that power but we do not have it.

Q505 ***Lord Eatwell:*** It does seem to me that in the legislation governing the Bank's responsibility under the new Banking Act and the Financial Services and Markets Act both institutions are responsible for financial stability. That certainly was claimed by Lord Myners in the House of Lords. He claimed that the market efficiency objective under FSMA was a financial stability objective. So there is an ambiguity; you both have responsibility for financial stability. The issue then is, if we are going to have this macroprudential regulation, with all the extra tools that you are looking for, that it does involve looking both ways. You need detailed information on how markets are developing and you need the macro view that the Bank has. How are those two going to mesh together? There does not seem to be an effective mechanism for bringing together the detailed knowledge of individual institutions and market structures and the macro view that the Bank would be taking.

Mr King: I will ask Paul to comment in a minute because he is going to be taking this forward. In our financial stability wing it is very clear now, and this was something I learnt from the experience after Northern Rock, that even if the legislation says that you do not have responsibility for supervision, people out there, including in Parliament, obviously feel the Bank of England must have something to do with banks and therefore they hold us accountable. In our financial stability role, we will need to ensure that we are taking an adequate look at the data and the position of individual institutions, but with the objective of making judgments about the stability of the system as a whole. We are not going to be concerned with the regular day-to-day supervision of individual institutions, but we will need to combine knowledge of data and information about individual institutions, together with the work that we have been doing a great deal of in the last decade, which is the macroprudential view. The challenge for us is that when we have got that we can form a view about where the risks are, but we do not actually have any policy instrument that will enable us to do anything about it.

Mr Tucker: Two things to add. The first thing is that this is more than just bringing together macroeconomic analysis with information about individual institutions. There is the question of being close to markets; what is going on in the plumbing, the payment system and settlement system. I feel comfortable that the Bank is okay on the macroscene, being close to markets and the plumbing. So the issue is around access to individual institution information. On that, it is tremendously important that we should have access to the contingency plans which firms either do have or if they do not they should certainly have in future as to how they would handle liquidity crisis or a capital crisis of some kind. The second thing is underlining the burden of the Governor's message in that we need to ensure in the way things are set up that we are not a shadow supervisor for individual institutions. Being a supervisor for individual institutions means taking robust judgments which, if necessary, you impose on the firm concerned and that is not the role we have or are set up to take as things stand. At the moment, while avoiding that, we will need to look more closely than in the past at patterns across institutions and you cannot do that solely from the aggregate data that we have in the Bank. The way things are set up at the moment we have to find a way through; using bottom-up information on individual firms without placing ourselves in the position of second-guessing what the FSA do as regulators or, for that matter, creating double jeopardy for the regulated firms. With one exception, which is that if they head towards distress and it becomes reasonably likely that they are going to have to go through the Special Resolution Regime, then we absolutely have to be able to get close to them in those circumstances. One of the painful lessons of Northern Rock was that the Bank was not able to engage directly with Northern Rock about lender of last resort until very late in the day, and then they were surprised about the granularity of the information that the Bank wanted because that is what you need. If you like, there are three levels, there is what you need as a macroprudential supervisor, there is what you need as a microregulator in normal circumstances, and then as the Resolution authority you need very granular information indeed. This is something we will have to find our way through.

Mr King: One of the things which was most striking about the past 18 months was that when a bank needed liquidity support—and several did—we had to be so intimately involved that we ended up knowing far more about the bank than FSA. We really had to get to grips with every detail of that bank.

Mr Tucker: In a sense we were helped in that—no more than helped, but helped—by the fact that we run our own balance sheet and therefore were used

to dealing with granular information in running our balance sheet and the collateral that we hold, which is very extensive at the moment.

Q506 ***Chairman:*** Just to be clear on this, you do not hanker in any way for banking supervision to be returned to the Bank from the FSA, do you?
Mr King: I do not hanker for any extra jobs to be given to me. I have more than enough to cope with. What I would say is the basic point that if Parliament expects us to be responsible in some way for financial stability, I do want it to be very clear that all we can do is to use the instruments which are given to us. If the only instrument given to us is that of voice, then it is wrong to hold us accountable for anything other than how we use that voice. If you want us to play a wider role, then you have to spell out what that role is. The big debate which is needed in the macroprudential area now is less who does what; that is down the road. What matters is not who does what but what it is that whoever it is that does it actually constitutes. We have had a very helpful review from Lord Turner of Ecchinswell in setting out the issues and the choices, but in the macroprudential area there is an awful lot of hard work and hard thinking to be done about precisely what is meant by macroprudential regulation. Once you have done that and worked out what instruments it is that we think somebody should be using, then it will be appropriate at that point to ask the question "To whom do we give those instruments to deploy?".

Q507 ***Baroness Kingsmill:*** Do you think that financial stability would be increased if bank size or bank scope were limited by statute? We have had a number of witnesses before us who have said that the banks can be too complex to manage, too big to fail and too big to rescue. We have also had a witness, Professor Enrico Perotti, who said that bank expansion achieves very few efficiency gains but introduces significant systemic costs. Others have even gone further to suggest that there should be a separation between investment and commercial banking. Would you care to comment on this, particularly in relation to financial stability?
Mr King: Those are very important questions. I do not want to give a definitive answer because I want to think it through carefully and I would like to be guided by a careful examination of the arguments for and against some of these questions. I remember very clearly five years ago Paul and I and some others from the Bank went on a Bank team visit to New York and we went to visit all the major banks in New York. At that point the big question confronting all banks was whether we could really follow the Citibank route. This is clearly the model of banking that is sweeping the world, to be as big as possible, to have access to as large a source of funds at as low a cost as possible, that made it possible to drive the business, grow and become the most important and biggest bank in the world. That was the model which was the basis that people were looking at, no restrictions at all, encouragement to size. Now of course we are looking at the opposite with people seeing very clearly the costs of complexity. If you look at the senior management of Citibank, look at the top four or five people there, these are some of the brightest and best people you could imagine: Bob Rubin, former Treasury Secretary, chief executive of Goldman Sachs; Sandy Weill, very savvy Street trader in Manhattan; one of the best macroeconomists in the world, Stan Fischer; other people there with tremendous expertise. If we had been asked as a group round this table to choose the best people to manage the biggest bank in the world we would have been hard put to come up with a better group of people. These organisations did become too big and too complex for people to manage easily. I do not want to say that in the current climate it would be right to conclude definitively now that we should therefore inevitably move to the opposite extreme and say all banks should be small and there should be forcible separation between investment banking and commercial banking but these are very good questions to ask. There are some very powerful arguments which go in favour of both limiting the scope of financial institutions and go to the heart of the investment; commercial banking distinction and indeed their size. We ended up in the UK with a very highly concentrated banking sector. I do not think that has been easy to manage, particularly in the crisis. I do not want to give judgment right now but what I would encourage everyone to do, this Committee and other committees, is to take some time now to think our way through these issues. They are immensely important, we will not get another opportunity to restructure our banking and financial system in a hurry and it is very important that we take this opportunity. We have time now. These banks are not going to rush out and take wild risks for quite a while. We can take our time to think this through and we must do so, both in terms of the regulatory aspects and in terms of the structure of banking which we commit to have.

Q508 ***Baroness Kingsmill:*** There seems to be a good argument for a diversity of institutions in terms of banking.
Mr King: Yes and there is no doubt that in the context of financial stability diversity has enormous benefits. Equally, as ever, there are arguments on the other side that a very small institution may prove fragile and prone to failure because of one or two specific loans. The arguments do not go entirely one

way but they are very, very important arguments. We have not really had a proper debate on this since the time of the great depression and this is a debate we ideally would have had at the time of Big Bang, except that it was very difficult to anticipate the consequences of Big Bang. While the last 20 years have shown us very clearly what has come out of it, now we need to rethink what we think the appropriate structure of the financial sector is. I do not want to pretend that the answers are easy and maybe even after a year's deliberation they will not be clear-cut either. At least we should take the time for that deliberation.

Q509 ***Baroness Kingsmill:*** And you do not think we will be rebuilding it in the shape that it has already been.
Mr King: I have an open mind. We should examine these questions very carefully and then come to conclusions in due course.

Q510 ***Lord Griffiths of Fforestfach:*** I come back to your answer regarding the Special Resolution Regime. Given the Turner Report, clearly the FSA is going to have a much more intrusive form of regulation. That means they are going to be all over the banks in a way they have not been, because even if they put a capital control on, which is much higher than present, they will really need to know what those assets are like. From what you have just said a few minutes ago, when you see an institution which looks as though it is getting into trouble and when it is even near the edge and it is now your responsibility, you will also want to get to know exactly what those assets are like and the culture of that institution and that is absolutely right. As a country, are we not then in danger of duplicating banking supervision? Would it not be better if it were given to one institution?
Mr King: I do not want to give answers on the architecture of who does what. I really do think that the first thing we should do now is to work out what, if any, additional instruments we need, what powers the authorities ought to have, how supervision should be exercised and once we have a complete description of all that, which I do not think we have yet, that would be the point to ask how they should be divided up and who should do what.
Chairman: Thank you very much Governor and your colleagues for spending time with us this afternoon. Inevitably this was going to be largely about banking supervision and regulation and that was very helpful. I hope that at some later stage we resume our periodic meetings on the wider economic scene. Thank you very much.

Memorandum by the Financial Services Authority (FSA)

1. This memorandum is submitted to the Committee as part of its "Banking Supervision and Regulation Inquiry" and in advance of Lord Turner's evidence session on 24 March. It covers:

— the origins of the financial crisis; and

— the required regulatory response to the crisis across the world.

2. In response to the Chancellor of the Exchequer's invitation to Lord Turner to conduct a review of banking regulation, we have published the *Turner Review*, which we attach. This analyses the root causes of the crisis and addresses the fundamental and long-term policy questions on what needs to be done to reduce the probability and severity of future financial crises. It also sets the direction and defines the changes we believe are required in international regulation, and which we will be proposing in the EU and internationally. At the same time we published a more detailed FSA Discussion Paper which sets out our initial thinking on how the issues addressed in the *Turner Review* can be translated into practical policy proposals. We will be hosting a conference on 27 March which will discuss the Review and consider the way forward. Speakers at that conference include Lord Turner, the Chancellor of the Exchequer and Mario Draghi, Chair of the Financial Stability Forum (FSF).

3. Some changes to the international regulatory and supervisory framework have already been made and further work is in train. However, final conclusions as to the scope of the fundamental reforms that are clearly needed have yet to be reached. Work is currently under way to this end within the G20, the FSF and the three main global regulatory standard setting bodies—the Basel Committee on Banking Supervision (BCBS), the International Organisation of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS). In addition, similar work is in train in various fora within the EU. This has included the recent publication of the de Larosière Group's report to strengthen European supervisory arrangements covering all financial sectors.

A. Origins of the Financial Crisis

4. Over the last 18 months, and with increasing intensity over the last six months, the global financial system has suffered its greatest crisis in over 70 years. The origins of the crisis can be explained by a number of factors. They include:

— *Growth of significant global imbalances over the last decade:* Large current account surpluses accumulated in the oil-exporting countries, China, Japan and some other east Asian developing nations, while fiscal and current account deficits grew in the US, UK and some members of the Eurozone.

— *Increasing complexity of the securitised credit model:* Lower risk-free interest rates produced an intense search for higher yield at low risk. This demand was met by an increase in volume and complexity of the securitised model of credit intermediation.

— *Rapid extension of credit and falling credit standards:* Between 2000 and 2007, credit extension in the US, the UK and some other countries grew quickly. This credit extension was partly driven by the rapid development of securitisation, with an increasing proportion of UK mortgages credit packaged and sold as residential mortgage-backed securities, thus not appearing on the originator bank's balance sheet. In addition, lending on balance sheet grew rapidly, as banks competed for market share, often funding their rapid growth with easily available wholesale funding. This rapid expansion of credit was accompanied by declining credit standards both in the household and corporate markets.

— *Property price booms:* The rapid extension of mortgage credit and of commercial real estate loans developed into a boom where rising property prices drove the demand and supply of mortgage credit, resulting in even higher property prices. Continuously rising prices convinced both borrowers and lenders that high loan-to-income ratios or high loan-to-value were acceptable given the potential for future capital appreciation. The widespread extension of credit on terms that could only be justified on the assumption of future house price appreciation was particularly symptomatic of the US sub-prime market.

— *Increasing leverage in the banking and shadow banking system:* The increasing scale and size of securitised markets and their mounting complexity were accompanied by a significant escalation in the leverage of banks, investment banks and off-balance sheet vehicles, and the growing role of hedge funds. Large positions in securitised credit and related derivatives were increasingly held by banks, near banks, and shadow banks, rather than passed through to traditional, hold-to-maturity investors. Hence, the new model of securitised credit intermediation was not one of "originate and distribute". Rather, credit intermediation meant passing through multiple trading books in banks, leading to a proliferation of relationships within the financial sector. This "acquire and arbitrage" model resulted in the majority of incurred losses falling not on investors outside the banking system, but on banks and investment banks themselves involved in risky maturity transformation activities. The explosion of claims within the financial system resulted in financial sector balance sheets becoming of greater consequence for the economy, with financial sector assets and liabilities in the UK and the US growing far more rapidly as a proportion of gross domestic product than those of corporates and households.

— *Underestimation of bank and market liquidity risk:* The growth of the securitised credit market and bank leverage and the multiplicity of inter-bank claims were also accompanied by changing patterns of maturity transformation and in many cases by serious underestimation of bank and market liquidity risk. Maturity transformation—holding longer term assets than liabilities—was increasingly performed not only by banks, but also investment banks, off-balance sheet vehicles and, in the US, by mutual funds. This made the financial system overall increasingly reliant on liquidity through marketability—the ability to meet liabilities through the rapid sale of an increasingly wide range and much increased value of long-term credit instruments. When the crisis struck, the assumption that the markets for these instruments would remain liquid was proven wrong as concerns spread about the quality of such instruments.

5. These interrelated effects and relationships resulted in a self-reinforcing cycle of irrational exuberance in pricing of both credit and volatility risk over the last 10-15 years. Credit spreads on a range of securities and loans fell steadily from 2002 to 2006 to reach very low levels relative to historical norms. In addition, the price charged for the absorption of volatility risk fell, since volatility itself appeared to have declined to very low levels. This cycle turned in 2007 and gave rise to the crisis we are now facing.

B. The Required Regulatory Response to the Crisis Across the World

6. The *Turner Review* outlines the fundamental changes in regulatory approaches required in relation to capital, liquidity, accounting, shadow banking, remuneration policy, credit rating agencies, derivatives trading, cross-border banks and EU supervision and regulation.

— *Capital:* The crisis has revealed the importance of focusing on the implications of bank capital structure for the behaviour of banks and the implications of that behaviour for the whole economy. Important issues for the international capital framework include; the level of capital that we expect banks to hold, the quality of capital and whether risk-based capital needs to be supplemented by a non risk-sensitive measure (such as a leverage ratio). In addition to this, any new system should include an overt counter-cyclical element of capital requirements to ensure institutions build up a buffer in good times which they can draw on in downturns. These views will feed into the Basel Committee on Banking Supervision and the Financial Stability Forum's consideration of new approaches to the regulation of the capital adequacy of banks. In addition, more capital will be required against trading books and the taking of market risk.

— *Liquidity:* New approaches to the management and regulation of liquidity are equally important. The lack of a defined international standard has reflected the extreme complexity of liquidity risk. As such, the regulation of liquidity should be restored to a position of central importance. This should focus on individual guidance, stress-testing and cross-system analytical trends—not through a quantitative ratio regime. In December 2008, we issued a Consultation Paper proposing a tighter surveillance regime for liquidity along these lines.

— *Accounting:* The current system of reflecting the "facts" of the situation as at the balance sheet dates adds to systemic pro-cyclicality. It is important that the counter-cyclical approach to bank capital is reflected in a significant way in published account figures, such as by anticipating future losses before they are evident in trading book values or loan repayment problems.

— *Hedge funds and shadow banking:* In their performance of the macro-prudential analysis role, regulators and central banks need to gather much more extensive information on hedge fund or other activities outside the banking sector. They also need to consider the implications of this information for overall macro-prudential risks. Off balance sheet vehicles which create substantive economic risk, either to an individual bank or to total system stability, must be treated as on balance sheet for regulatory purposes. Regulators should also be given the power to apply appropriate prudential regulation to hedge funds, or any other category of investment intermediary, if their activities have become bank-like in nature or of systemic importance.

— *Executive remuneration:* Remuneration structures played a contributory role in the origins of the crisis by helping to create incentives for harmful risk-taking. We will need to include a strong focus on the risk consequences of remuneration policies within our overall risk assessment of firms, and we will enforce a set of principles which will better align remuneration policies with appropriate risk management. On 26 February, we published a draft Code of Practice which sets out these principles and issued a Consultation Paper on 18 March 2009.

— *Credit ratings agencies:* The embedding, by institutions, of ratings based rules in operating procedures and the increase in the role of securitised credit increased the dangers of pro-cyclicality within the system. In addition, ratings for structured credit proved far less robust predictors of future developments. The resulting instability of ratings not only produced a pro-cyclical effect but also undermined confidence in the future stability of credit ratings. Questions were also raised regarding the governance of rating agencies and issues relating to conflict of interest. Regulation can and should address these issues, both through registration and supervision of rating agencies, and clearer understanding on the purpose of ratings and the requirements for institutions to hold securities of a specific rating. We continue to support the new European registration regime for credit ratings agencies and we will prepare for subsequent implementation. Given the global nature of capital markets, it is important that the European legislation is matched by agreement of compatible global standards, and the FSA is working through IOSCO to achieve this.

— *Derivatives trading and counterparty risk:* The size and complexity of the derivatives market, and the fact that most of it is almost entirely traded in an over-the-counter fashion, creates a danger that the failure of one party could produce market disruption. The FSA strongly supports the objective of achieving central counterparty clearing arrangements for credit default swaps trades. We will work with our international regulatory counterparts, market participants and infrastructure providers to make trading and operational arrangements for over-the-counter derivatives, including credit default swaps more robust.

— *Cross-border banks:* The financial crisis has revealed major fault lines in existing approaches to the regulation and supervision of cross-border financial institutions. The FSA's past approach placed significant reliance on the home country regulator. The failure of Lehmans highlighted that national legal entities and national bankruptcy laws have a major impact on the relative position of different creditors, and the decision to allow Lehmans to fail clearly had huge global economic implications. In light of this, we support a further strengthening of co-operation between regulators (eg through colleges of regulators for all major cross-border banks). However, this is not the basis for a fully integrated approach to the supervision of cross-border groups. In addition, host regulators should be able to ring-fence, where necessary, more local capital and liquidity in the local branches, which would improve the position of local creditors and result in higher levels of capital and more liquid balance sheets.

— *EU supervision and regulation:* The underlying philosophy for the existing arrangements for banking supervision and regulation in the EU has been shown to be inadequate and unsustainable for the future. This was highlighted particularly in the case of Landsbanki which, as Iceland is a member of the European Economic Area, could operate in the UK as a branch over which the FSA had only limited powers. The *Turner Review* sets out the arguments for both a "less Europe" and "more Europe" approach, and highlights that the EU must now consider the appropriate way forward. The FSA Discussion Paper proposes for debate; the creation of a new EU institutional structure, which would replace the Lamfalussy committees; and the reinforcement of host country supervisory powers over liquidity and the right of the host country supervisors to demand subsidiarisation and impose capital requirements if appropriate deposit insurance arrangements are not in place.

C. Wider Issues—Open Questions

7. The *Turner Review* also sets out a number of wider policy changes which may also be appropriate, but where debate on principles is required. These include product regulation, the use of other counter-cyclical tools, and balancing liquidity benefits against stability concerns.

18 March 2009

Examination of Witness

Witness: Lord Turner of Ecchinswell, a Member of the House, Chairman of the Financial Services Authority, examined.

Q511 ***Chairman:*** Welcome back to the other side of the table as a former member of this Committee. Thank you for spending time here. We have all read your impressive review and thank you for the FSA's memorandum. Do you want to make any introductory remarks or shall we go straight in?
Lord Turner of Ecchinswell: No, I am quite happy to go straight into questions.

Q512 ***Chairman:*** Let me start with a general question. Banking regulators and supervisors have historically always been behind the curve, playing a game of catch-up with what has been going on in the market. Hence, perhaps the periodic crises in what is after all the most heavily supervised and regulated business sector. What makes you believe that your recent review represents more than another round of catch-up, of dealing with yesterday's issues, whose lessons have probably been learned already and painfully by the banks? Is it really radically different from what has gone on before or is it simply a shifting of constraints? If so, what is the core of this radical difference?
Lord Turner of Ecchinswell: You are right to raise the question as to whether we will ever manage and manage permanently to guard against the tendency in banking systems for periodic irrational exuberance and whether we can create robust enough mechanisms against it. History tells us in the famous Galbraith analysis that broadly speaking you tend to be able to do it for as long as there are people around who can remember the last crisis and that when memories fade that disappears. I think the fundamental challenge of defining a regulatory system is to try not to make it dependent simply on memory but to embed robust enough approaches that you still have constraints on that irrational exuberance when memories have faded. What my review tries to set out is to identify what those constraints are most likely to be. It is not surprising that the core and most important ones are about capital and about liquidity because that is the absolute core of the risks that banks run. If we had had higher capital in the past, higher capital against trading books in particular and counter-cyclical capital, it would have made it less likely that we would have had the crisis that we have had over the last 10 years. In particular if we had had much tighter control of liquidity and there is an issue of whether you do that by a highly specific regulation of individual institutions or by the re-introduction of some of the across-the-board rules like core funding ratios that we

had decades ago but moved away from; there is a debate to be had about that, which I set out in the review. I think if we had those we will very significantly reduce the probability and severity of future events like we have had provided there are also two things. Provided there is continual analysis of whether new risks are emerging which will not be captured by those constraints and that is why you need a continual process of analysing what has occurred and whether something is different and we fundamentally failed to do that with the securitised credit model. We fundamentally failed to realise that something had happened which needed a new approach that we did not have before. Secondly, you need a robust willingness to resist lobbying for it to be loosened over time. Whatever regime we put in place now, in 10 years' time, if things are better, you will have business lobby groups saying they needed that at the time but these are really constraints on innovation and rapid growth et cetera and there will be pressure gradually to undo what we had in place at the time, as indeed happened to elements of the regulatory regime in the past. It is highly likely that the sort of things I am proposing, which are also very similar to those being proposed by the Financial Stability Forum and do reflect an international consensus, are the appropriate things to make the system robust. However, we do need to combine it with the willingness to stick to that in the face of lobbying and the willingness to keep continually analysing what is happening to the financial system to understand whether something new has occurred which is not caught by the proposals which I am putting here which reflect an analysis of the situation as it is at the moment and as it has been in the run-up to this crisis.

Q513 ***Chairman:*** Your review also talks about a new philosophy of regulation, one which is outcome based, which is more intrusive or systemic. I think your chief executive Hector Sants also said that it involved the FSA making judgments on the judgments of senior managers of banks. Could you expand a bit more on this change of philosophy? I cannot quite get a clear idea of what it means.

Lord Turner of Ecchinswell: Let me try to be very specific about it. I will talk about a particular case because I think I can. If you look at the case of HBOS, at the time where there were discussions from the person who described himself as a whistleblower, Paul Moore I think it was, in relation to events four or five years ago. Not surprisingly I read all the way through the FSA file on HBOS. What I found—and it is a fair reflection of much of what happened at the time—was that in this case it was a perfectly professional file, it did not have the faults which the FSA internal audit report on Northern Rock had revealed of a failure to keep good records, failure to have enough visits. It was a perfectly acceptable implementation of the then existing philosophy and the then existing philosophy was that markets are self-correcting, the boards of companies and the management of companies are best placed to understand the risks that they are running and that the fundamental role of a regulator like the FSA is to focus on systems, processes, structures, whether the reporting lines are right, the information flow effective. One of the reports which then go through what is called an FSA ARROW review, which is simply an acronym we have for a risk analysis and the risk mitigation programmes, had 32 points and 28 or 29 of those points were fundamentally about categories of systems, process, structures and only two touched on whether the whole business model of HBOS at that time was developing risks and whether those risks were even bigger when you considered everybody else. In future what we would want to do, and this does relate to the issue of who does macroprudential analysis, which we have just been discussing with the Governor, but somewhere between us and the Bank of England we need an analysis which says we have a number of rapidly growing mortgage banks, Bradford & Bingley, Northern Rock, HBOS, Alliance & Leicester. They are all running similar strategies which involve rapid growth and significant reliance on wholesale funding. Those create very significant risks which exist at the level of the whole strategy and they are even more risky because several of them are simultaneously following it. One of the points about reliance on wholesale funding is that it can be a strategy which works perfectly well as long as only one of you is doing it. It becomes more risky precisely because a whole number of people across the market are following that strategy. In future we need a greater ability to put together that overall picture, both to make judgments as to whether the overall strategy of a firm involves over rapid growth, over reliance on wholesale funding but also to make that judgment within the context of what all the other firms are doing because sometimes, quite often, the most important risks in banking are risks which you can only see if you are looking at the system level rather than at the operation of the one individual firm within a system.

Q514 ***Chairman:*** We probably heard from earlier witnesses that there is this major distinction between systemic risk and idiosyncratic risk but the regulator is in the best position to look at systemic risk which is possibly where the failure of FSA regulation lay over the last crisis. I come back for just a bit more of Hector Sants' point about the FSA passing judgment on the judgments of the individual banks. If the FSA does take that line and, as it were, imposes its own perception of risk across the banks as a whole, does that not of itself introduce a new systemic risk should the FSA's judgment prove, as sometime it might, heaven forefend but it might, to be faulty?

Lord Turner of Ecchinswell: It obviously creates a greater burden on the regulator if we are expecting them to understand those systemic risks and take judgments about it. By the way, again to refer to the macroprudential issue, that will overlap with the discussion of issues which reside between us and the Bank of England and if we are in future going to pull levers such as counter-cyclical capital, obviously that is a much more powerful and judgmental lever than we have been pulling in the past and we need to get those judgments right. We also need to approach that in the realisation that sometimes even clever people looking at a macroprudential level can get judgments wrong. The fact is—and I quote in my report—there are statements by the IMF of only two years ago arguing that the development of securitised credit, far from creating risks, has actually reduced the risks in the system. You are quite right to flag that there is nothing about the fact that risks are often at the systemic level rather than the idiosyncratic level and that therefore we need a role for a regulator to look at the systemic risk. There is nothing about that need which will equip us with a failsafe regulator who is bound to make perfect judgments. I do not see a way round that. Given that we do recognise, and it is a fundamental understanding now, that many of the most important risks in banking are systemic not idiosyncratic, you have to have regulators making systemic judgments and they are simply going to have to make them to the best extent possible. That, by the way, raises issues again on the macroprudential area of analysis as to how we get real intellectual challenge into the points of view that are being developed and make sure that there are not just conventional wisdoms. On the whole the risk would more be that we might be somewhat constraining rather than that we could actually add risks but clearly that is a risk and that I am sure is what will be argued. I would doubt whether the nature of us making judgments would introduce new risks. There is a danger that it might unnecessarily constrain activities which did not absolutely need to be constrained. That would undoubtedly be a danger.

Q515 ***Lord Forsyth of Drumlean:*** Following up on the example you gave of HBOS, I am just a little bit bewildered because it was the talk of the City; everybody knew that HBOS was investing very heavily and paying a very high price for property businesses. As late as January of last year HBOS bought 25% of Miller and paid a very high price for the shares. They have taken housing business after housing business after housing business; a large part of their loan portfolio was in housing businesses in which they had taken equity. It was an accident waiting to happen and everybody in the City knew that it was an accident waiting to happen. What I find extraordinary is why an organisation like the FSA, which costs whatever it costs, £320 million a year, with all its resources and when you read the file why on earth did no-one have the commonsense to query whether these guys were not getting a bit over-extended in property at a time when everybody knew that the property market was about to go phut?
Lord Turner of Ecchinswell: You have quoted from January last year. I can tell you that by the time you get to the file, at that point then that is reflected in the file. I specifically said that I was referring to the file back in 2004-2005-2006 and that is where I would say it was much more focused on systems and processes. By the time you get to last year it is changing in its tone, not surprisingly. Partly that is because by then Northern Rock has run into trouble but even though the particular time that you quote is last year rather than three or four years ago, I think it is our challenge in the future to spot emerging problems even before they are the talk of the rest of the City. I suspect that if you went back to 2005–06, quite a lot of the talk of the City would be about what very clever strategy they were pursuing. Certainly let us remember that if we take the collective judgment of the City as being expressed through the share price and the CDS spread, all of the signals from those, right up to May, June, July 2007, were telling the British banking system that they were doing very sensible things and that they were doing low risk things. The composite CDS spread gets to its lowest in spring 2007. If you think the market price is the collective judgment of the City, it was not sending that message until really it was pretty obvious to everybody else.

Q516 ***Lord Forsyth of Drumlean:*** Indeed that is the case but then the reason we have the FSA is because they are in there looking at the books and looking at what is happening. I just find it a little bit difficult to see how an organisation which failed in that particular example which you have chosen, and you were quite open about the failures with respect to Northern Rock, how it can suddenly be transformed so that it can then second-guess the decisions of executives in the way the Chairman was suggesting.
Lord Turner of Ecchinswell: We will have to change it in some ways quite fundamentally and we are going through a fundamental change through what is called the supervisory enhancement programme which, for instance, has included the hiring of 280 people who were not there before who have different sets of skills; it involves different approaches. My point would simply be though that if the approach is right we have got to do it somewhere. We may get on to the issue of whether it should be done in the Bank of England or the FSA, but if it were done in the Bank of England, you would either have to hire 700 or 800 new people for prudential supervision at the Bank or you would have to take these 700 or 800 people from the FSA and put them back into the Bank, remembering that

pretty much all of them came from the Bank in the first place. There is sometimes an odd belief here that in the Bank of England there is a shadow supervisory department waiting to go which, if we only handed it back, would do a perfect job. The supervisory department of the Bank of England moved to the FSA; that is where the FSA came from in its bank supervisory department.

Q517 ***Lord Best:*** Hector Sants in a speech a couple of weeks ago said that the financial institutions should be frightened of the FSA and in fact he said "People should be very frightened of the FSA". A lot of bankers have responded that at least in the past there is no reason to believe the FSA would have seen the financial problems coming any better than they would have done and you have been answering that in terms of the future. They have also made the point that no senior UK banker has actually been found to be breaking the law; at least that was the position prevailing until recently. How do you respond? Do you think that the financial institutions should be frightened of the FSA?

Lord Turner of Ecchinswell: It is very important that people who are acting in a way which is fraudulent or breaking rules or wilfully risk taking or falling short of the competence level which is expected and required of people at particular levels, the attention to detail, failing in their responsibilities, they should be frightened because we will take appropriate enforcement action. You then have to realise that does not necessarily mean that a senior banker will be found guilty of a particular offence as a result of this. The thing you have to distinguish is people make misjudgments and misjudgments are not breaches of the rules and we have to keep that as a separate thing. The sanction for misjudgement is losing your job, losing the value of your shares, being sacked by your shareholders. The sanction for misbehaviour is enforcement action from the FSA. We do have to keep that distinction clearly and not leap over into because something is wrong people actually committed offences. It is possible that they did and possible that they did not and we will certainly look carefully if there is any *prima facie* evidence that there are breaches of our rules. We cannot take enforcement action against people who did not breach rules but simply made business decisions which turned out in retrospect to be bad business decisions. You have to draw that distinction.

Q518 ***Lord Currie of Marylebone:*** Did the FSA over-emphasise conduct-of-business regulation at the expense of prudential regulation in the lead-up to the financial crisis? If there is some truth in that proposition, is there an argument for going back to the idea which was thought about before the creation of the FSA, a twin-peak approach? We went for a more unified approach with the FSA but a separation might suggest two organisations which work upon both aspects with equal vigour.

Lord Turner of Ecchinswell: It is broadly speaking true to say that in retrospect we focused too much on the conduct of business and not enough on prudential. That is not entirely the case because, for instance, the FSA did some very good work on the prudential regulation of insurance companies back in the 2002–04 period where there were quite major changes for the capital regime for insurance companies which did put the insurance companies, particularly those in relation to with-profit funds, in a stronger position now than they would otherwise have been. That was a clear focus on an important area of prudential which we are not focusing on now because we are focusing on banks. It is reasonable to say that there was not as strong a focus as there should have been on the prudential regulation of banks and that the institutional focus of the FSA probably was too much focused towards conduct of business. Of course that also reflects the external environment to which they were subject. I do not know whether it is true of this Committee, but certainly if you go back through the Treasury Select Committee of the House of Commons you will find that what they were primarily quizzing the FSA on from 2001-2002-2003-2004, et cetera, was Equitable Life, split capital trusts, mis-selling of endowments, mis-selling of mortgages and organisations do tend to respond to the external pressures of the press and politicians and they go in a way which deals with it. So it would not be surprising if the tendency of the focus of the organisation was to think the external world is really worried as to whether they have a grip on conduct of business so that is what they do. I think there was a danger of that. The question then is whether that says we should have institutional separation (twin peaks versus a single unified regulator). In my review I set out some arguments for and against each of these. There are arguments for and against each of these; in fact since I am a new chairman of the FSA I am completely open-minded on these issues. If you had asked me to be chairman of something which was different from the FSA at the present moment I might have ended up as chairman of that rather than the FSA. I certainly do not sit there saying "We've got it absolutely right; it's got to stay like this". Having said that, there are some significant advantages, or can be, in having prudential and conduct together. It does give a unified supervisory interface to the firms and there are some efficiencies in that and there are some areas, particularly in relation to wholesale firms, where issues of conduct and prudence can significantly overlap and there are some issues which are on the table for the future which could actually create a greater overlap. Let me give you an example. In this report I raise the issue as to whether we should

be involved in the future in tighter regulation of the mortgage market than we have been in the past. We said that we will come back with a paper in September which discusses that. It is not for us in a sense to be definitive about that. It is so wide-ranging an issue that it has to be debated politically as well. The more we go down the regulation of the mortgage market, the more that you would really have to think about whether you do it by conduct regulation, that is a greater focus on what is appropriate selling of a mortgage to different categories of people, or by product regulation, whether we limit loan to value or loan to income ratios. There we could get some of the things we want to do for prudential purposes; you might actually pursue them by tighter conduct regulation in the way that we sell mortgages. There are many of these issues where there is overlap. The final point, which I do flag in the review, is that if we are to proceed—and I think there is a lot of value in proceeding—with the organisational boxes we have at the moment, because whenever you have a crisis there is a dangerous tendency to believe that things will be magically better if you simply rejuggle the organisational boxes and every time you do that you put a lot of effort into people finding new premises and finding new jobs rather than getting on with the job, if we are to stick with the existing organisational structure, we need to look at the internal organisation of the FSA about how we more clearly distinguish expertise on prudential and expertise on conduct to make sure there are people within the FSA who are exclusively owning a focus on prudential and therefore will not be diverted by a focus on conduct. So there may be things we can do through internal organisation that get the best of both worlds.

Q519 ***Lord Forsyth of Drumlean:*** According to your review, which incidentally I thought was absolutely excellent and I enjoyed reading, Citibank has more than 30 supervisors on site at any one time. Even after the planned expansion, the FSA will have 10 to 20 people on site in a major UK bank. Notwithstanding the significant number of supervisors at Citibank, it is now reliant upon government support. In the light of this, how can we be sure that simply increasing the number of supervisors will have an impact in that it will actually make any difference or generate value for money? When I asked you earlier you told me you were going to add yet more people to the FSA, whereas in my mind is the question which I appreciate sounds very unfair which is: what on earth were they all doing? The idea that there should be more people when clearly, as is acknowledged, there has been a failure, is worrying. Should the emphasis not be more on outputs than inputs?

Lord Turner of Ecchinswell: I take that point and it is something we had tried to look at in this review and in the discussion paper which backs it up. We tried to do an exercise on the different approaches of supervisory authorities around the world. It is not an easy exercise to do because these things are always difficult to get clear comparators on. We looked at the Canadians, the Spanish, the Americans, ourselves. We just happened to take those four. A number of points came out of it. First of all—and it is quite noteworthy—the degree of success in dealing with this crisis or avoiding this crisis seems, as best one can tell, uncorrelated to either a discernible difference in the supervisory approach or a discernible difference in the way they organised the boxes. So broadly speaking, people say Spain has done somewhat better: dynamic provisioning, major macroeconomic downturn but fewer problems in its major banks, at least so far. In Spain banking supervision is with the Bank of Spain, does that not prove it should be put back with the Bank of Spain? That is true. Then you go to Canada. Canada has an organisational structure pretty similar to us and people believe that Canada has also been relatively successful in avoiding these problems. Again then you say what about the amount of people that you have? Spain comes out with more people than us, more close to what is called the bank examiner model, but so undoubtedly does the US and the fact is the 30 in the US from the Office of the Comptroller of the Currency is probably the tip of the iceberg, because you also have people from the FDIC, you also have people from the Fed. American banks have very large numbers of regulators crawling over them but it has not stopped the problem. What we believe is that we were doing the core supervision of our major institutions, very light in terms of the number of people who were literally focused on that particular institution. We believe that having, say, only five for HSBC, when you think of the scale of HSBC, was really an incredibly light mode, but we have not said we want 40 people going into HSBC. We have increased that to the 10 to 15 range with lots of specialist support for that. We are still very much in the philosophy that it is not huge numbers of people that we need, that it is relatively small numbers of high quality people that we need. Most of our focus is not a revolution in terms of the number of people we have, it is focusing much more clearly on what they do, their focus on the really high impact issues, the quality of them, both in terms of hiring some new people in but also a very strong focus on what are the skills of those people. So we are being much more systematic about our training programmes: very strong support with specialist skills, for instance we have been hiring in a team which looks very, very closely at liquidity issues. That is what we are trying to do. The other thing to say is that it is very important when you look at the FSA to realise the range of things that it does. We focus now on the prudential regulation of high impact institutions and

in particular banks. Think about that as actually being 600, 800 people within the 2,500 to 3,000 that we employ. We also do mass market regulation of tens of thousands of general insurance brokers, mortgage brokers, IFAs, et cetera. There is a mass, very large numbers, side of the FSA's activity. We have tried to look at it. We have tried to be as systematic as possible. The approach has not been to say suddenly that we have to be like the Americans; that would be a very odd thing to do, given that they have clearly been no more successful than we have in preventing this crisis. We have tried to focus on relatively small numbers of high impact people, but it is something we should continue to look at and it is an absolutely right challenge for you to make.

Q520 ***Chairman:*** When the audit partnerships gave evidence to us a few weeks back the question arose as to whether they might have a role in this in terms of auditing compliance with regulations. They have big teams, they are qualified teams and they can probably afford to pay more than the FSA does. Is there a potential role for external auditors?
Lord Turner of Ecchinswell: Some of the supervisory, regulatory authorities do use that. If you look at the Swiss FINMA, a system there, they do use external auditors. They use them to do things we do not do. They use them to do the equivalent of detailed file examination such as the Americans do through direct on-site supervisors. We would not necessarily exclude that. The other thing to say is that we do use the auditors for detailed in-depth analysis. We have a particular thing called section 166 where we do a deep dive on an institution where we have particular issues that we are worried about. That is probably the most appropriate use of them. We need an ongoing in-house capability to deal with normal risk assessment, but then when we have to do very deep dives on particular issues and indeed want to be able to have somebody else looking at it in addition to ourselves, we use them. I suspect if we used them for the core ongoing function, we would simply increase the total cost of the process. As you say, it is highly likely that their people are more highly paid than our people; at least they certainly are when you have the profit margin which is added by the time they are charged out to us. We would probably prefer to use them for very specific things rather than make them an ongoing general part of the process.

Q521 ***Lord Griffiths of Fforestfach:*** You argue in the review that banks were under-capitalised and therefore they need more capital. You divide banks into their trading book and their banking book and you say that the trading book needs an increase of at least three times as much capital as at present. Two questions. Am I not right in thinking that most of the problems have arisen not with the trading book but with the banking book? If you look at where the toxic assets are, the toxic assets are in the banking book not the trading book. Therefore, are you not focusing on the wrong thing there? Secondly, clear international cooperation would be wonderful; it would be marvellous if we could have everybody having the same capital requirement worldwide. Is there not a danger that we go so much for increased capital that we in a sense price ourselves out of the world market?
Lord Turner of Ecchinswell: On the first point, no, I do not think it is true. The original problems with the toxic assets primarily existed on the trading books of the banks. That is where these securities were, that is where these CDOs were, the CDOs squared, the CDS derivative contracts were; they were on the trading books. They were on the trading books for a very particular reason which is that even when they were not being traded very rapidly, it was beneficial for a bank to put them on the trading books because they had a much lighter capital requirement on the trading books than if they had been on the banking books. We had created a very significant regulatory incentive to put them on the trading books of the banks. That is the situation. The crucial thing to understand about where bad assets are is that up until six months ago we thought and everybody thought they were almost entirely on the trading books. They are not spreading to the banking books through the simple mechanism that when you get a shock to a financial system, the problems then spread out across the broad mass of the economy to SME lending, corporate lending. We now have major problems emerging on the banking books of the banks, but the original problems of what was occurring—

Q522 ***Lord Griffiths of Fforestfach:*** I need to say, and I do not want to go into details now, but I do think there is some dispute about the judgment.
Lord Turner of Ecchinswell: I am very surprised at that. From having looked at the figures, we would say that is absolutely, definitively where they were. If you actually look, for instance, at some of the biggest issues on the trading books, which are very, very clearly set out in the report which UBS did to shareholders in April last year, they clearly set out a story where UBS in its fixed income division in the US blew up the leverage and the balance sheet size of that on the basis of the fact that the capital requirements were so light against them. I am pretty sure that even further analysis would not challenge that. The issue then is whether there is a cost of increasing bank capital requirements. It does discuss in here and in the background discussion paper that of course there is a theory that if we increase bank capital requirements in general, whether it be banking book or a trading book, we will somewhat increase the margins that banks have to charge and

therefore the total cost of credit intermediation vis-à-vis the real economy. What that illustrates is that within the economic theory of optimal bank capital we are involved in a trade-off between the fact that on an ongoing basis there will be a slight cost to the economy of having more bank capital, but it will reduce the likelihood of highly unstable events and there probably is some trade-off there. We also point out, however, that the trade-off is not quite as extreme as is sometimes suggested. If we believe in Modigliani and Miller's theory of optimal capital structure—and it is of course one of the classics and I see Lord Eatwell is not entirely convinced by that but there is at least a theory—up to a degree, if we demand more capital of banks, it will be not only more quantity of capital, but the cost of that capital will be slightly lower because it will be lower risk. Broadly speaking, if we demand more capital, they must tend, on average, to be somewhat lower return but also lower risk investments. There is an issue; we have to realise that there is a trade-off here. There will be some trade-off in that if we demand more capital of banks there will inevitably be some slight cost to the economy. What I say—and it is not a scientific trade-off—is that after this extraordinary harm to the global economy from the financial crisis, we must at least, compared with where we were two years ago, believe that the trade-off is somewhat more in favour of more capital rather than less. A final point to make is that I think that cost will primarily come through what we are doing on the banking book. We have so lightly capitalised the trading book in the past that it is right significantly to increase the capital against it. I also think that the impact of that will be to change the nature of the securitised credit model. I suggest that we should believe that we are going to return to a world before securitised credit. Some of the arguments which were made in favour of securitised credit or originate-and-distribute, getting credit off the balance sheets of banks and putting it into hold-to-maturity investors like pension funds and insurance companies were perfectly sound arguments. The fact is that is not what happened. We told a story of securitised credit which was going to take risk off bank balance sheets and when the music came to a stop, as the IMF figures clearly illustrate, 60 or 70% of the losses on securitised credit instruments were on the balance sheets of banks and investment banks. One of the reasons was that the capital against trading books was sufficiently light that we created incentives for people to say that they were originating and distributing, but they were originating and distributing and then their own trading room was buying back somebody else's originating and distributing. I think a higher capital charge for trading books will create incentives which take us back towards the original model of what the originate and distribute securitised credit model was meant to be.

Q523 ***Chairman:*** While we are on the subject of capital requirements and incentives, your review envisages, over and above additional capital, a leverage ratio backstop. Given the propensity of banks always to chase higher returns, might that not offer a perverse incentive for the banks to take higher risks within the constraint of a ratio?

Lord Turner of Ecchinswell: I think that is why you need both. That is why you need a form of capital which is based upon a weighted risk asset as well as one based on a gross leverage ratio. If you attempt to constrain capital just by a gross leverage ratio, which is broadly speaking where we were pre-Basel I, then clearly you create incentives for people to pick risky assets, risky and high return assets, because they have no higher capital weights. Once you accept that, you can ask why we want a gross leverage ratio at all. Why do we not just do it through a weighted risk asset ratio? There are fundamentally two arguments. One is that we want a belt and braces because the process of attaching those weights to risks is imperfect. The other is that what we realised was that however much we try to work out what the risks in assets are, the risk in assets changes dynamically and it changes dynamically because of systemic developments. If you get a crisis of confidence, assets, particularly in the trading book, which previously seemed relatively low risk because they were relatively liquid, end up being completely illiquid and relatively risky. When that happens, the scale of the problem you have is pretty much directly proportional to the scale of the balance sheet. That is why we believe there is an argument alongside a weighted risk asset approach having a gross leverage ratio approach as well. You would certainly never do a gross leverage approach without a weighted risk asset approach alongside it because if you did that you would have all sorts of incentives to select high risk, high margin assets.

Q524 ***Lord Tugendhat:*** I think you were in the room when Baroness Kingsmill asked the question of the Governor about size of banks. Let me ask that question broken into three. Do you think financial stability is threatened when banks get beyond a certain size and complexity for the reasons which Baroness Kingsmill asked and the Governor answered? The second is: would you draw a distinction between reaching that size as a result of acquisition and merger as distinct from reaching that size by incremental growth over a very long period? It has always seemed to me that there are some companies which have been very large in their sector for a very long time: Shell is a quintessential example; HSBC is an example but there are others which have become very large very quickly; RBS is an example; Citi would be another example. The third question I would ask, which is linked to it is: you have indicated

that you are not very keen on a reversion to Glass-Steagall. Although the Governor hedged his answer around I felt that he was perhaps more sympathetic to that but I am not seeking to make a comparison. I am seeking to get your views about size, complexity and the way in which size and complexity have been created.

Lord Turner of Ecchinswell: They are very complicated questions and I do not think there is any real difference between myself and the Governor on this. We both believe these are incredibly important issues that we do need to reflect on. May I start with the first question about Glass-Steagall? The only general comment I would make is that, having observed problems with one system, we must not iconise some other system and forget that it also produced problems in the past. Let us deal first of all with Glass-Steagall. The fundamental objective is clear. We have to make it clear that we cannot allow banks to take the benefits of too-big-to-fail status, retail deposit insurance and lender-of-last-resort access and use that to go off and do entertaining proprietary trading activities which seem to make sense at the time but leave a toxic mess later. The fact that we have to do something about it is clear. The issue then is what are the most effective means to do this? Are they to try to draw some nice precise legal line between what is narrow banking and what some people call casino banking or is it through the capital and liquidity ratings that we apply? What I set out in the review are some words of caution about the belief that you can draw that line or what you will achieve with it. First of all, there is an extreme version of this case which I certainly do not think the Governor has ever said, but some people suggest, which is that having drawn this line, you would then be able to say to the people on the casino side of the line that they are on their own and we will never rescue them. That bit of the argument is definitively wrong. I do not think we will ever find that line sufficiently clear that we are able to say that on the risky side of the line there is no systemic risk. Let us remember that Bear Stearns and Lehman were definitively on that side of the Glass-Steagall line. Until the discount window was opened up to them at the Bear Stearns' weekend in March they did not have access to the Fed discount window, they were not recipients of detailed deposit insurance and it was believed that they should be allowed to fail. The Americans decided not to let Bear Stearns fail and that was the right decision; they did allow Lehman to fail and that was the wrong decision. I simply think the idea that we will ever define the casino side of the fence and say "You're on your own, we don't need to regulate you" is wrong and is completely against the general philosophy that we should actually be extending the perimeter rather than the other way round. The other point to say, if we then come on the safe side of the fence, is that at very least this distinction cannot be considered sufficient. We have lots of history of narrow banks getting into terrible problems. One country in the world which did have Glass-Steagall for the very simple reason that it had been occupied by the Americans at the end of the Second World War was Japan and broadly speaking they were still running under Glass-Steagall when they ran into the Japanese banking crisis of the early 1990s. That was not a crisis of exotic trading in trading rooms; it was a crisis of bad on-balance-sheet lending. Northern Rock was a narrow bank, Washington Mutual was a narrow bank, Bradford & Bingley was a narrow bank, HBOS was a narrow bank, these were all banks which were broadly speaking doing things which you would have defined on the whole as on the narrow banking side of the fence. So it is at the very least not a panacea. That is why I have tended to come down, but I do not consider it definitive, I absolutely think that this is an area which needs very, very careful reflection, by saying the most crucial thing is for us to have appropriate capital weights, liquidity rates, et cetera. I do not exclude the possibility and the FSA does not exclude the possibility that this could be buttressed by some things that say you are a commercial bank, you simply cannot do X. When you get to "cannot do X" you really have to think about what it is that you are going to exclude. I do not think that it would be what was defined in Glass-Steagall. Let me give you an example. Glass-Steagall clearly put corporate bond issuing and trading on the investment bank side of the fence. Corporate bond issuing can be seen in a securitised world as a core part of a service to large corporate customers and certainly it is that throughout the world. So if we have a world system, a global system, which continues to have a large role for securitised credit—and I think it will and I think it is difficult for us to keep global flows of capital going without a securitised system—I suspect we would be defining corporate bond issuing on the commercial bank side of the fence. If you say that, you then realise that we would have defined most of what went on in the toxic assets and trading book as on the commercial bank side of the fence. What went wrong was not trading equities on the whole; it was trading corporate debt, some of which by the way would always have been on the commercial side of the fence. Under Glass-Steagall CLOs, collateralised loan obligations, would always have fallen on the commercial bank side of the fence. Conversely, there are some other things which large banks do—equity trading and distribution and research—which on the whole are relatively low-risk activities and have for them been fairly useful diversifications which have balanced out risks. We would have to think very, very carefully about what we put on either side of the fence. If you are going to do corporate bond issuing and support of liquidity of that as a service to

corporate customers, you have to do at least that element of position taking which is required in order to do market making. What one is then trying to draw a distinction between is ending up with positions as a by-product of the function of market making versus ending up with positions as large proprietary pumps. Some people will say "Hang on, you'll never be able to draw that distinction within your capital regime" and I guess we have two problems here. Either we are trying to define a very precise line which we might get wrong in the legal sense or we are trying to make distinctions in the capital regime. Both of them are difficult but I guess all I am saying is that it is much, much more complicated than some of the arguments suggest. Finally, I do not actually see any likelihood that most of the rest of the world is going to go down the restoration of Glass-Steagall. First of all, Europe never had Glass-Steagall, it always had universal banks. I have picked up no appetite round continental Europe for drawing this distinction and it is quite difficult for us to draw this distinction, if the rest of the world is not. To flip to size of banks, small banks can get into a lot of trouble. The US banking crisis of 1929 to 1933 was a catastrophic failure of microbanks where microbanks failed to get the benefits of diversification. It is quite difficult to be prescriptive about whether we want big banks or small banks or whether we just want to regulate them effectively however large they are. It is probably true that rapid growth through acquisition is likely to create particular risks. Of course HSBC has grown partly organically, but it has made some chunky acquisitions along the route, so you cannot exclude that. Where you get banks which transform themselves over a very short period of time with a large number of sequential acquisitions, it is highly likely that should be a red flag of increasing risk. That is absolutely right.

Lord Tugendhat: That was the distinction I was making.

Q525 ***Lord Moonie:*** Your review discusses deposit insurance and in section 2.9 regulatory actions to prevent the possible extension of the deposit insurance safety net to risky proprietary trading activities within large commercial banks. Another form of cross-subsidisation associated with deposit insurance arises when building societies which are relatively safe and well-capitalised are forced via the FSCS to bail out failed banks. Should this scheme be modified to prevent this from occurring?

Lord Turner of Ecchinswell: It is certainly something we are willing to look at openly. The approach which has been taken in the past is that the levies within the FSCS, the way the money is collected where there is FSCS compensation scheme support, should be proportional to the benefit being achieved and therefore they have been proportional to the size of the deposits. One can see the logic of why we had that rule in the past. The counter-argument is yes, that is not necessarily proportional to the relative risk of these institutions. Should there be another basis? We do have a consultation paper out at the moment which looks at some relatively small changes which would probably tend somewhat to benefit the building societies because it would make the charge proportional simply to deposits within the limits rather than total deposits including ones above the limit. We have said that by next year we would take a wider look at the issue of the whole classes of levy payers for the FSCS, the way we divide it. One possibility would be to sub-divide the present deposit payer group into building societies and banks. At the moment they are in a pooled approach. It is certainly something which we have become more aware of as an issue. We are well aware of the arguments being made by the Building Societies Association and others and I think it is one we are highly likely to come back to over the next year and go through some wider process of consultation on that issue. We certainly do not exclude it as a possible way to go.

Q526 ***Lord Eatwell:*** First of all, you sold yourself a little short when you said that everybody was talking about macroprudential regulation. I think the FSF is way behind the curve; both their reports last year were a bit thin on this issue. It does seem to me that what you have done is the first official report really, which has said you are dumping an intellectual framework. There was an intellectual framework which was really wrong and we have to think things out differently. I should just like to take up two analytical issues and one institutional one. The analytical issue is first of all that one of the points you made, which is quite right, is that some microregulation made things worse in the sense of the use of DO limits; the general approach to risk management encouraged herding at times of extreme events. The question there is: how are you going to link a macroprudential and microrisk-management structure without rolling into the fact that they are contradicting one another? The second question which runs on from that is the other dimension, which is the issue which in your report you mention several times but do not really address. It is the fact that this is a significant international dimension. Once you say you are looking at macroprudential risk in a global market a lot of those risks are international. I was wondering how you saw the framework developing within which the international dimension of macroprudential regulation, which would be a national problem, would come about. Finally, the same thing, there is this business of whether it is the Bank of England or the FSA. The proposal which you make is that you

feel a financial stability committee—never mind the financial stability committee—which was jointly and severally responsible, could act as both an information system and a system which decided who did what without duplication. I would like you to comment on how that might be achieved. Three things there.

Lord Turner of Ecchinswell: Three tricky issues. Let me begin with the first one. You are absolutely right that sometimes what makes sense at an idiosyncratic level and therefore what makes sense at a microregulation level can itself contribute to a pro-cyclical behaviour. It is true that, for instance, the Basel II capital regime, by becoming more risk sensitive, in some sense does introduce some element of pro-cyclicality or, for instance, in aspects of the Basel regime there is reference to external credit ratings and external credit ratings can have significant pro-cyclical effects. What we have to try to do is at those microlevels we have to try to reduce unnecessary pro-cyclicality so that, for instance, if you take value-at-risk measures for trading books, at very least we should not have been allowing people to run value-at-risk over the last year and say "That tells me". There are even deeper issues about whether value-at-risk works at all, but at very least we should be taking long periods of time or we should be taking very strongly stressed VAR measures rather than, as we were, deliberately encouraging people to use something which was systematically pro-cyclical; so we can shift that. On credit rating agencies, for instance, we can look at the issue of credit ratings in regulation but again it is quite difficult, because they sometimes are sensible things to use at the idiosyncratic level. What we have to do is to combine removing unnecessary degrees of microregulation pro-cyclicality while realising that we will not be able wholly to remove it and therefore we need some deliberate countervailing forces. In relation to the Basel II capital regime, if we are going to have a risk-sensitive regime—and there are some advantages to that—we have to recognise that it will have, even if we adjust it in some of the ways I suggested, an element of pro-cyclicality and you then quite overtly need to say "Well we have to offset that by a counter-cyclical element which deliberately says we are going to build our buffers above the minimum". That is the philosophical approach of how you tie together the micro with the macro. On the issue of macroprudential at international level there are actually three levels: there is global, there is Europe and there is national and we have to think them through. At global level I do not think we are going to end up, I just cannot imagine that we are going to end up, with a global regulatory body which is going to be pulling counter-cyclical capital levers in a discretionary fashion at global level. We are a long way off anybody having that vision and therefore at the global level a lot of the macroprudential analysis is for information, for challenge to affect people's assessment of risk and indeed to affect governments in how they are running their financial systems. I think our biggest challenge there is to do two things. One is to make sure that in institutions like the IMF there is sufficient intellectual challenge that they do not end up producing the quote that I have here in the report from the April 2006 *Global Financial Stability Review* which says that securitised credit has increased the resilience of the world financial system. We really must introduce deliberate mechanisms of intellectual challenge into the official institutions. Secondly, crucially, we do need institutions like IMF to write reports which are in no way watered down by the influence of large powerful governments and by the national executive directors on the board saying "Do you really want to say that about us?" and would have to be taken seriously by the most powerful countries in the world. That is not an easy thing to get right but the challenge for the G20 leaders at the 2 April meeting, where we will undoubtedly get statements about the importance of early-warning systems, surveillance and peer reviews, is to say that unless you are really willing to embed that in institutions which really do give the independence to write if necessary very critical reports about America or China—to take the two biggest and most important economies in the world—unless you are really willing to have that, then a lot of those words about wanting early warning, surveillance, et cetera, are just for the birds and we might as well not say them. On the organisation of it at national level, what the Governor said earlier was interesting, that the Financial Stability Committee, as presently defined, is not defined to perform the real function of detailed analysis and decision-making on these big financial stability committees. The way it has been set up as a sub-committee of the Court with non-executives on it, as he said, for conflict of interest reasons means that it will actually be quite difficult for that to be the authority that says we are now at the point in the cycle where we should be pulling the counter-cyclical lever. We do need a thought therefore about whether you locate this in the Bank, between the FSA and the Bank or whatever. We will need to think about what the institutional device is even if it is within the Bank, because what you heard the Governor saying was that even if you gave them the clear authority to pull these levers, he does not consider that that is going to be a vote within the Financial Stability Committee equivalent to a vote within the MPC on interest rates. Either way we have to think about it. What I set out in here are three different ways of doing it. One way, which I think has some merit in principle but there are other ways you could do it as well, is to define some sort of committee which involves both people from the FSA and the Bank bringing together the micro, the sectoral analysis and the macroanalysis and

asking where we are within the cycle, what is going on and therefore what do we need to do in a macroprudential fashion pulling the levers. The other point I make is that whichever of the things you define, whether you go that way or you go the way that David Cameron has spoken about today, where he essentially said it is the Bank which arrives at the macrojudgment and then writes a letter to the FSA and say "Please do something about it", whichever way you do it, it will not work unless there is very, very intense joint working between the FSA and the Bank. Whether or not you define that joint working as a joint committee, I am convinced it will not work unless four times a year there is a very lengthy meeting in which people from the Bank at the most senior level and people from the FSA at the most senior level and maybe with external challenge deliberately there are crawling through the data and asking what the data tells them about the risks that this financial system is now running. In a sense we need that, whatever we write as the decision-making rule as to who at the end of the day says "This is what we're going to do".

Q527 ***Baroness Kingsmill:*** You mentioned the European dimension; I quickly wanted to know whether you think the European passport requires reform and what your views are of the de Larosière report about the detailed harmonisation of European regulations.

Lord Turner of Ecchinswell: It does require reform. We have clearly said that the present single market rules are untenable and unsafe. What we have at present is a belief that you can run a single market in banking with very similar rules to those which would exist for restaurants with a somewhat light degree of central coordination. I do not think you can do that. The situation with the Icelandic banks last year, Landsbanki bank in particular, Icesave as it was, the internet bank, was that because Iceland is a member of the European Economic Area and therefore covered by the EU rules, it had a right to set up as a branch, not as a subsidiary but as a branch, in the UK and we as the FSA actually only had very mild influence over some aspects of liquidity and no influence at all over aspects of capital. We could not require that it had a certain capital ratio because it was a branch not a subsidiary. It was not a separate legal entity. That right to operate across-border as a branch is written into the rules and it is an extension of the basic principles of the Single European Act that, if you are operating in one country, you run a restaurant chain in one country, under the classic freedoms of the Single European Act you ought to be able to go and open an operation in another country. The trouble is that principle just does not work with banking and it does not work with banking because what it creates is an environment where, if that bank operating across-border as a branch gets into trouble and if it is from a country which has neither enough money in its deposit insurance fund nor adequate fiscal resources on the part of the government to support that bank in failure, then you are going to have a problem, either for the depositors in the country where it has opened a branch, or, as happened in this case, for the taxpayers of that country who, in the case of Landsbanki, effectively picked up the bill for the UK side of that failure. What we have clearly said is that, faced with this, you sort of have to go in one or other direction and actually I suspect we have to go a little bit in each and we also have to recognise that we are going to end up with something which is not totally intellectually pure. There are only two intellectually pure positions here, one of which is re-nationalisation and the other is total federalism. Re-nationalisation is: forget those single market rights, you do not have the right to operate cross-border as a branch, you have to operate cross-border as a subsidiary fully regulated by the host country supervisor able to demand stand-alone capital, stand-alone liquidity; you can be a holding company, but you cannot operate as a branch. That would be re-nationalisation. The other end is that you have a European regulator/supervisor of any bank which wants to operate cross-border and if it gets into trouble it is bailed out by European-level fiscal resources, not by the national resources of national governments. I do not see any appetite in Europe for going to those two extremes and that is not what Jacques de Larosière supports. In which case, what we are trying to do is create a safer system through a combination of some aspect of more Europe, some institutional framework at European level. We have suggested something which does involve the creation of a new European institution in the regulatory space, with powers on regulatory rules and a supervisor of supervisor roles but not replacing the role of national supervisors as the front line of supervision. Jacques de Larosière's report goes a bit further in terms of the powers of intervention versus individual national supervisors, but it is not utterly and radically different. Simultaneously, we do need to buttress our national powers, if we are worried about a branch operation, to at least mitigate the risks by demanding that they have more liquidity held locally. We are suggesting a bit of both. I do not suggest that we have the perfect answer here. What we have realised is what the problem is and that the solution is going to have to involve a balance of measures and I think it needs very deep debate and very deep reflection. To your straight question: does it need reform? Absolutely. The FSA cannot sit there in 10 years' time and accept another large bank from a small European country without adequate fiscal resources to bail it out and simply say that we can let it open the future equivalent of Icesave under the present rules. It is just not tenable.

Q528 ***Chairman:*** We have to draw stumps now. We have kept you longer than we led you to believe so thank you very much indeed for coming along here this afternoon. I have no doubt that the Committee will want to keep an eye on what is going on as the regulatory debate evolves, so we may have the opportunity to see you again at some time.

Lord Turner of Ecchinswell: I will be very pleased to come back.

Chairman: Thank you very much.

TUESDAY 31 MARCH 2009

Present
Best, L
Currie of Marylebone, L
Eatwell, L
Forsyth of Drumlean, L
Griffiths of Fforestfach, L
Hamwee, B
Kingsmill, B
Levene of Portsoken, L
MacGregor of Pulham Market, L
Tugendhat, L
Vallance of Tummel, L (Chairman)

Examination of Witnesses

Witnesses: Lord Myners, a Member of the House of Lords, Financial Services Secretary, and Ms Mridul Hegde, Director of Financial Services, HM Treasury, examined.

Q529 ***Chairman:*** Good afternoon. This afternoon's hearing is the penultimate one in the Committee's inquiry into banking supervision and regulation. Members of the Committee have already declared their relevant interests at previous hearings. May I welcome our witnesses to the Economic Affairs Committee and thank you for making time to be here this afternoon. I am sure I do not have to ask you to speak loudly and clearly on behalf of the stenographer but if you could introduce yourselves when first speaking, especially for the benefit of the webcast this afternoon. Lord Myners, do you want to make any introductory remarks or shall we go straight into questions?
Lord Myners: Lord Myners, Financial Services Secretary at the Treasury. I am very happy to answer questions.

Q530 ***Chairman:*** Let me start off with a general question and that is whether you support the recommendations in the Turner Review?
Lord Myners: Lord Turner has done a very comprehensive piece of work and we broadly welcome his conclusions. It is the Treasury's intention to publish a paper around about the time of the Budget in response to Lord Turner's report. Lord Turner sets out a menu of possibilities. The Government is now working with the FSA and the Bank of England to consider which of these options we find most attractive and in some cases needing to create combinations. I am not going to anticipate the publication of the report the Treasury will make in the next two or three weeks, but it is very clear that supervision of financial institutions does need urgent improvement in a number of key areas. As the Prime Minister has said, " . . . the disciplines we expect of markets cannot be guaranteed without strengthened supervision". I think that that does not limit itself to regulation, domestic or international; it includes the supervision of companies in terms of their make up, conduct, the behaviour of boards of directors and the role of shareholders. Indeed, in that respect, we have also asked Sir David Walker to carry out a review of the governance of banking institutions and we look forward to his report in due course.

Q531 ***Chairman:*** I would not want you to pre-empt the White Paper. Let me put the question another way. Is there anything you really disagree with in the Turner Review?
Lord Myners: There is nothing that I would say the Treasury in its initial review vigorously disagrees with, but in a number of areas Lord Turner has set out a number of possibilities and I think the challenge for us is to review those and to articulate the ones which we regard as most appropriate. The paper contains over 30 recommendations and we will work methodically through them. This is a serious piece of work which requires a serious response.

Q532 ***Chairman:*** So we will have to wait for it?
Lord Myners: I am sure you look forward to it!

Q533 ***Lord Eatwell:*** Let me pick up on one issue which is discussed at length in Lord Turner's report, which is the whole theme of macro-prudential regulation and the maintenance of financial stability via that. We have had the Governor of the Bank here talking to us and Lord Turner and they seem slightly bemused as to whose responsibility this macro-prudential regulation will be. Each of them thinks it will be his, but each of them sees that there are responsibilities on the other side as well. Where do you think it will fall?
Lord Myners: I think they are both right in the sense that both the FSA and the Bank will have responsibilities for macro-prudential awareness, as indeed will whatever comes out of the de Larosière work in Europe and, on a global basis, the IMF and the Financial Stability Board. The new responsibility which Parliament has given to the Bank in terms of putting a statutory basis beneath the Bank's responsibility for financial stability certainly elevates this in terms of the Bank's priorities. Before I became a minister I sat on the Court of the Bank. I think it would be fair to say from my experience of the Bank

at that time that monetary stability was very, very much the focus of the Governor and Executive Directors' attention and financial stability suffered from some degree of subsidiarity. I think that has now been changed as a consequence of the Banking Act 2009.

Q534 ***Lord Eatwell:*** You yourself said in the House that financial stability was the responsibility of the FSA as well. It is that "as well" which is puzzling us, as to where responsibility will fall and what the reflection of that responsibility will be.
Lord Myners: Let me say a word and then I will invite Ms Hegde from the Treasury to add her thoughts. I do not think that the FSA can look at the prudential regulation of institutions in a vacuum from what is going on around them. So to some extent the FSA must have a degree of macro-prudential awareness. I see them as being complementary and coming together in terms of reaching common agreement with the Treasury at the tripartite level.
Ms Hegde: Mridul Hegde, Director of Financial Services at the Treasury. I suppose it is always going to be the case that the FSA will have responsibility for financial stability because as part of the Tripartite arrangements on financial stability that will be part of its responsibilities. You referred earlier to what the Governor said when he came before this Committee and, if I recall from the transcript, one of the points he made about being clear about who is doing what in the future is that you need to decide what is going to happen before you decide who is going to do it. One of the issues, particularly about macro-prudential regulation, is that there are whole layers of complexity in terms of what it means and how you would then implement it. Let us say, for example, there is a broad consensus that we need to pay more attention to systemic risk in the financial sector and that is sometimes used conterminously with implementing a system of macro-prudential regulation, but people mean many things when they refer to macro-prudential regulation. They refer sometimes, for example, to the need to adjust capital adequacy rules in relation to the cycle and that is certainly something that is explored in the Turner report. You would have to consider, for example, how you would do that and whether a more restrictive approach to the kinds of capital that might be used would also affect the monetary policy transmission mechanism and so on. It is a complicated issue, which is why we do not have a complete answer for you right now.

Q535 ***Lord Eatwell:*** Who is doing the thinking now? Is it the FSA doing the thinking? It cannot be the Bank because the financial stability pot is much too small now.
Lord Myners: I am not sure the financial stability side of the Bank is too small. I think under the leadership of Paul Tucker the financial stability side has quite a lot of resource. I think what is more important is that within the overall governance of the Bank and within the Court that financial stability is going to receive more attention in the future than it has in the past.

Q536 ***Lord Levene of Portsoken:*** Lord Myners, you spoke about the regulation of financial institutions and I think most people are agreed now that more work has to be done there in reforming that. Do you think there is a danger that that designation has become too broad? Has there been any indication that the regulation the FSA has carried out of non-banks has caused problems? Are we in danger of throwing the baby out with the bath water and having a catchall, ie we must reform all financial regulation, whereas in fact we are talking about banks?
Lord Myners: I think there will always be scope for the improvement of regulation; it is the nature of regulation. I chaired a London-based insurance company that was regulated by the FSA and I often wondered what use the FSA would be making of the millions of data points we were submitting. I think there is a broad recognition that perhaps in recent years we have focussed a little too much on the regulation of individual institutions and collecting data and missed some of the broader questions about sustainable business plans, about better understanding of risks of individual businesses and better capturing of what we now call macro-prudential, which is the broader context. I think we are going to see a continued evolution of regulation, but I think it would be wrong to conclude that because the banking sector has been through a very difficult period that we necessarily, unthinkingly, should tighten up restrictions on insurance or fund management or other areas. I think, at the same time, we should ask ourselves what lessons we learnt which might be relevant to these other sectors.

Q537 ***Baroness Kingsmill:*** Minister, during the course of this inquiry we have had evidence from a number of people, but one of the things that has been quite striking is that there does not seem to have been a system of formal communication between the three elements of the Tripartite system and I wondered if you could envisage how that could happen. We even heard that the three principals have never been in the same room together.
Lord Myners: I can only speak from 4 October when I became a minister. Before that I observed from outside. I think the Tripartite has really worked very well during the six months at principals' level where there have been numerous meetings involving the Chancellor, the Chairman or Chief Executive of the

FSA, the Governor and the deputies of the Bank, and occasionally I have attended those meetings as a junior minister. I have always found the meeting to be very professional, very open and very constructive, but beneath that there is a very impressive working relationship at the deputies' level between senior executives of the Bank and the FSA and officials at the Treasury. I would certainly say that things such as the Bank recapitalisation in October, the preparation for the announcement on 19 January of the Asset Protection Scheme, then the taking forward of those conceptual frameworks into delivery for the Royal Bank of Scotland and Lloyds and, more recently, the discussions with Barclays reflect very well on the Tripartite.

Q538 ***Baroness Kingsmill:*** I was not suggesting that it did not work; I was suggesting that maybe there had not been sufficient communication. Do you think there is an argument for greater transparency so that some of the formal meetings, for example, could be in public so that people knew what was going on instead of this being a rather mysterious process where white smoke emerges?
Lord Myners: We discussed some of this in the context of the Banking Act and whether, for instance, the minutes of the Financial Stability Committee of the Bank of England should be published and there was very healthy and well-informed debate on that subject, but Parliament supported the Government's recommendation in the end that the effectiveness of the Committee might be diminished by an obligation to report. I think there are some things which are best conducted in private session, particularly when they are very market sensitive, but I think there are many other things which should be given more oxygen. For instance, the Bank produces twice a year a financial stability report and the FSA produces an annual report on financial risk. Careful study of those reports will find some quite powerful warnings, in some cases caveated, about what was going on, but nevertheless they were prescient in many respects and yet these documents on the whole went unnoticed. So I think there is a need to elevate some of these publications. I would like to see the FSA and the Bank make progress in that, for instance—I will stick with banks for a moment but this is not just about banking—I believe that the report which the Bank of England produces twice a year on financial stability should be required reading for non-executive directors of banks. I am not sure how you make it required reading. You might have a seminar, you might require them to come in or you might have some break-out groups to discuss the issues arising.
Ms Hegde: You could set a test.
Lord Myners: I am not sure about setting a test because we will not be able to have delivery goals and targets and I think we have probably got enough of those. I think there is much more that could be done of that sort.

Q539 ***Lord MacGregor of Pulham Market:*** Would it be better for taxpayers if Lloyds had not merged with HBOS?
Lord Myners: The decision for Lloyds and HBOS to merge was taken by the boards of those two banks, put to their shareholders and approved by the shareholders. It has been the Government's view consistently that it is best that banks remain in the commercial sector, that they remain exposed to the disciplines and accountabilities of the commercial sector, and that the Government is a shareholder but not the only shareholder. Proving a negative is very difficult, but I do not think we should under-estimate the consequences had a bank the size of HBOS collapsed, which I think would have been the case had HBOS not merged with Lloyds. I think it is very important to understand that this was a decision which was taken by the boards and wholeheartedly supported by the shareholders of both banks.

Q540 ***Lord MacGregor of Pulham Market:*** Why was it that the Lloyds deal has turned out, at least up to now, to be so bad for Lloyds' shareholders? Was there a lack of up-to-date due diligence, and was there a lot of Government pressure to take decisions very quickly which prevented that due diligence?
Lord Myners: The amount of due diligence required is a matter for the two companies to explain. Bear in mind it was a share exchange, so to some extent the board of HBOS was also obliged to do due diligence because they were inviting their shareholders to accept shares in a new bank. Talking from my experience in business, mergers of equals achieved through a share exchange tend not to involve as much due diligence as a cash acquisition of a public company, but it must be a matter for the two boards to explain to their shareholders, as indeed they clearly did when securing the support for the transaction, that they believed it was the right thing to do. The Chairman of Lloyds, who I heard speaking at lunch today, reminded the people at the lunch that this was a long-term commitment by Lloyds to increase its position in the UK financial services market and he continues to express confidence that it will prove to be a good transaction in due course.

Q541 ***Lord MacGregor of Pulham Market:*** You do not think there was too much pressure from Government to prevent up-to-date due diligence?
Lord Myners: I was not a minister at the time so my sources of information are probably less well-informed than the Committee's on what happened before I became a minister.

Q542 ***Lord Tugendhat:*** I did not quite understand your point about the collapse of HBOS because, after all, the Royal Bank of Scotland, a much bigger institution, has not collapsed and the Government was not going to allow it to collapse. If Lloyds had not taken over HBOS the Government would have had to have saved HBOS in much the same way as it has saved RBS and Lloyds would have been free of this incubus. I agree with you that these are matters for the shareholders, but in terms of the either/or, it is not the case that Lloyds saved HBOS but rather that Lloyds took over HBOS. If it had not taken over HBOS the Government would have saved HBOS just as it saved RBS and Lloyds would now probably be outside the arrangements that the Government has made.
Lord Myners: The Government would have stepped in to protect the depositors in HBOS. Whether it did that as it did with RBS or whether it did it as it did with Northern Rock or Bradford & Bingley is a question of whether HBOS would have continued as a separately quoted independent company. My judgment is that it would not have continued as a separately quoted independent company because the challenges that the bank faced were more akin to those of Bradford & Bingley and Northern Rock than they were to the Royal Bank of Scotland.

Q543 ***Lord Griffiths of Fforestfach:*** Lord Myners, I take the point you make, that you were not a minister at the time of this event, but the Chief Executive of Lloyds said that Lloyds as an institution did between two and five times less due diligence regarding this transaction than they otherwise would have done. As somebody totally out of it, the only conclusion I am left to draw from that is that they must have been under tremendous pressure to come to some deal. Maybe there was a systemic risk, I do not know. I cannot think of any other reason why a chief executive would make a very strong statement to say in a very big deal you did between two and five times less due diligence than you would normally do.
Lord Myners: As I said, I was not there at the time. I think I would say from my experience that, given time, you will always do more due diligence. There is not ever a point at which you will say, "I have now lifted every stone. I have examined every file." I think the answer which Eric Daniels gave to the Treasury Select Committee might have had a spurious precision to quantifying how much due diligence one might have carried out. I am saying that my experience in the corporate sector is that a share exchange transaction will tend to involve much less due diligence than buying a whole business, possibly a subsidiary of another company. I think it would have been a matter for the Lloyds' board as to how they formed a judgment that they had done sufficient diligence. I can only conclude that they must, having made an announcement that they wanted to proceed with this transaction, have reached a point at which they felt they had done sufficient due diligence because there was no pressure on them that required them to make a huge leap of faith and not complete the work that was necessary or no pressure that I am aware of.
Ms Hegde: I am not sure I have got much to add to that. I could only speculate as to what Eric Daniels thinks is the adequate level of due diligence. Only he knows that and only he knows what fraction of that he did. Beyond that, our experience in the Treasury of dealing with banks over the last six months is that they, rightly, fight very hard for their shareholders' interest and I ask you to consider that if you consider whether we were putting Eric Daniels under undue pressure on this. In general, I would also ask you to consider, however the HBOS deal looks for Lloyds now, that there was a long-term interest for Lloyds and its shareholders in making that deal.

Q544 ***Lord Forsyth of Drumlean:*** This idea that the Government was sitting back and allowing these two banks to operate will not wash. You decided to suspend the normal rules on competition in order for the deal to happen. We are told that the Prime Minister and the Chairman of Lloyds fixed this at a cocktail party. The Government did want this to happen. You did not need to do much due diligence to see that HBOS' loan book was stuffed full of property deals which were clearly in danger of creating huge losses. Did the Government not actually just engineer this deal and the people who have paid the price were the Lloyds' shareholders?
Lord Myners: I cannot speculate on what happened at the cocktail party, although I was at the cocktail party but in another corner of the room. It was hosted by Citibank.

Q545 ***Lord Forsyth of Drumlean:*** You are here answering for the Government and what the Government did, in this case it was the First Minister.
Lord Myners: I am saying that I cannot speculate as a government minister on what happened at the cocktail party. The Government enabled the merger to take place by including a new condition in competition legislation which allowed financial stability to be taken into account. That was enabling but it did not oblige the two parties to engage in a transaction. Although Lord Forsyth now says it is abundantly clear how difficult the situation was at Lloyds, I remember that when HBOS announced some fairly disappointing figures after the transaction was announced the Chairman of Lloyds said that these numbers fell within the range of expectation. I do not think this is a case where people were innocently led into something which they had not had a chance to form a considered view on as to value and strategic importance.

Q546 ***Lord Best:*** Lord Myners, are you worried about the scale and the scope of these banks? On the scale side, we have heard how banks have expanded very rapidly and how they have become too big to fail, and on the scope side people like Professor John Kay have talked about dividing the "casino" banking operation from the "utility" banking operation, making regulation much simpler thereafter. Do you feel something needs to be done about their current scale and scope?
Lord Myners: I think they are two separate issues, scale and scope, scope being another word for complexity. I do not think we can turn the clock back on complexity. I think that those who argue for a move to some form of Glass-Steagle segregation miss the point that a number of utility-type banks were the first and largest failures, mortgage banks here. Fannie Mae, Freddie Mac in the United States of America, Indymac in the United States of America and Hypo RE in Germany are all narrow banks in that sense. On the complex banks side you had an institution like Lehman's which had very little retail banking activity and yet caused a considerable degree of systemic damage when it failed. So not only do you need to separate the utility from what Mr Kay describes as a "casino", you also need to stop the utility dealing with the casino and I think that that is in practice very difficult to do. Much more productive is a route around enhanced supervision, enhanced board confidence and support, better regulation, more capital and higher liquidity. I do not think we should demonize everything which has come out of the more creative sides of investment banking. Some risk management techniques there have been of considerable value to companies and to private individuals. Securitization is not something which we should say is bad in itself. It became bad because it was pushed too far. Securitization increased the flow of funds into residential mortgage debt provision which was very beneficial. It just was pushed too far, there was inadequate equity retention, the structures were too creative, the rating agencies fell down on rating and something which was quite good became very badly tarnished.

Q547 ***Lord Best:*** What about the size and the speed with which these businesses grew?
Lord Myners: I think there are issues for size around manageability. Before I became a minister I was a director of one of Singapore's largest sovereign wealth funds and I met with a number of bankers in that connection. I certainly was left with a view from one of those meetings that the bank was too big to be managed. I think we need to be alert to that, but that is a regulatory issue for the FSA and the FSA needs to be alert to whether the organisation is up to managing complexity. It is also an issue for the OFT if scale begins to become anti-competitive or if we have elements of cross-subsidization. I think scale brings with it risk and issues around prudential supervision, too big to fail. I think George Osborne has said too big to bail or too big to bail out. I think there is an issue there. For instance, the Americans are talking about putting higher capital requirements behind institutions simply by virtue of the fact they are large. All other things being equal, more capital, because the consequences of baling them out are even more challenging, Turner would invite us to think about that as well. We have got to be open to those sorts of ideas.

Q548 ***Lord Forsyth of Drumlean:*** Let me just return, if I may, to the point which Lord Eatwell raised earlier because I was not clear. Do you actually share the view that there has been insufficient concentration on macro-prudential supervision?
Lord Myners: I think it is a very broadly held view globally that one of the issues has been inadequate awareness of the build up of systemic risk. I read Mr de Larosière's evidence to you which I thought was very interesting on this point.

Q549 ***Lord Forsyth of Drumlean:*** My question is specifically about the United Kingdom. Do you share the view that here in Britain there has been insufficient concentration on macro-prudential supervision?
Lord Myners: I think my earlier answer was that actually a lot of good work had been done in that area but that it had not necessarily been as resonant in the ears of those who should be alert to it as it should be.

Q550 ***Lord Forsyth of Drumlean:*** Is that a yes?
Lord Myners: It is a carefully structured answer.

Q551 ***Lord Forsyth of Drumlean:*** I will take that as a yes then. Let us just turn to the Tripartite. Just to be sure that I am being evenhanded, could I congratulate you on the operation of the Banking Act which you laboured long and hard with in respect of the rescue of the Dunfermline Building Society where it has clearly worked extremely well. What it has already shown is what was the FSA doing when the Dunfermline Building Society was taking on these very high risk loans? Where was the FSA when HBOS was building up this huge loan book which was in property and very risky areas? Is there not a case for asking the question whether the FSA, despite its size and scale, I think it costs about £350 million, is actually properly equipped to do all the tasks that are involved?
Lord Myners: I think the FSA, after the collapse of Northern Rock, was quite frank about its own shortcomings. I think we need to remember that the problems at Dunfermline and the problems at HBOS predate the changes in approach that the FSA now says it intends to take. I think that will need more resource. I think it needs more resource in terms of quality rather than quantity. It needs a capacity to

challenge around a strategic objective and business model as opposed to gathering data and a new style of regulation which has been talked about in terms of being more intrusive. I am not sure I find that language in itself compelling. I think it is a style of engagement which seeks to understand as opposed to tick boxes. So I think there are regulatory gaps where we need to improve performance.

Q552 ***Lord Forsyth of Drumlean:*** We have had evidence that has suggested the so-called "twin peaks" approach, which is where there is a separation of the institutions which are responsible for prudential supervision and conduct-of-business supervision and that would seem to chime in with the evidence we had from the Governor of the Bank of England. Reading between the lines, I get the impression the Governor would like to have clarity about who is in charge and be allowed to get on with prudential supervision and it would seem sensible to get the FSA to do conduct-of-business supervision. Why can we not have clarity? After several weeks and vast amounts of evidence I still have not got clear in my mind who is responsible for what, who is in charge. Is this not a chance to put that right? Why are you fudging these boundaries in a way which clearly is causing frustration for the principals involved?
Lord Myners: I think there is clarity. Within the Tripartite the FSA is responsible for the regulation of individual equities, the Bank of England is responsible for monetary policy and overall financial stability, and the Treasury is responsible for issues involving public money. I am not at all persuaded that the "twin peaks" model, which Sir James Sassoon seems to find so compelling, although he did not when he was working in the Treasury, is necessarily superior. What I have come to recognise is that, regardless of the forms of regulation, be it the dirigiste European model, the principle-based UK model or the rules based US model, they all fell short of our expectations, but that is possibly because the scale of the global crisis went outside anything that this model had reasonably been built to manage in any jurisdiction. I do not think there is one model which is superior to any other. Certainly some of our own experience has been that the separation of prudential from conduct-of-business creates some difficulties. It is worth remembering that pre-1997 we had seven or eight regulatory entities. That was an absolute nightmare for people to manage. Although the Bank did a good job as a banking regulator, it was not a record which was completely without blemish, as we remember with BCCI, Johnson Matthey, Barings and the secondary banking crisis of the early Seventies. I do not think there is one model which is better than any other. In fact, I do not think the solutions here are architectural, they are social and they are about behaviours.

Q553 ***Chairman:*** Does that mean that you believe it is possible for the Bank of England to fulfil its responsibility for financial stability using a single instrument, namely interest rates?
Lord Myners: No. Interest rates are now no longer the single instrument for monetary policy either because in addition to managing the price of money the Monetary Policy Committee is now managing the quantity of money. That is the instrument for monetary policy. The instrument for financial stability is around engagement, awareness and elevating the awareness of concerns about systemic risk. That is actually not too different from the approach the Bank used to employ in those days, which we might occasionally view with rose tinted spectacles, which are associated with the Governor's eyebrow. This is the Governor making observations about a build up of pressure or an imbalance in the system. I see this very much working together with whatever comes out of de Larosière and also on the global front with possibly some progress from G20 tomorrow.

Q554 ***Chairman:*** Let us just stick to the UK for a moment and the Bank of England. Do you believe it has sufficient powers and sufficient instruments at its command to be able to do what it is expected to do?
Lord Myners: I have no doubt that the Bank will respond very positively to the new statutory responsibility it has been given for financial stability. I think the Governor wanted this, he wanted clarity and he wants the necessary means to express and register his concerns about risks to financial stability. I have no doubt that the Governor and Court and the Financial Stability Committee will ensure that if they have concerns appropriate action is taken.

Q555 ***Lord Forsyth of Drumlean:*** But the Tripartite structure has failed, has it not, otherwise we would not be here?
Lord Myners: No.

Q556 ***Lord Forsyth of Drumlean:*** If it has not failed, why did the FSA not see what was going on in all these institutions, like the Dunfermline Building Society and HBOS and the rest?
Lord Myners: That is not evidence that the Tripartite structure has failed. It evidences that one of the parts of the Tripartite, namely the FSA, has acknowledged itself that it needs to do better in the future. It does not mean the Tripartite as a structure, the division of responsibilities, which is what I understand by the Tripartite structure, has failed. Indeed, my experience has been that it works very well.

Q557 ***Lord Griffiths of Fforestfach:*** Lord Myners, you mentioned earlier that banks were probably better managed in the private sector than in the public sector. I have two questions. First of all, what is the

Government's exit strategy? Secondly, you talked about the problem of scale. When do you plan to reintroduce competition in the banking system?
Lord Myners: Firstly, we envisage that the Government will exit its investment in the Royal Bank of Scotland and the Lloyds Banking Group progressively as and when it makes sense from a value perspective and is consistent with financial stability and in the best interests of those banks. That is why we have created a new entity in UKFI with whom we will be meeting shortly to ensure that we can make informed decisions. As to how long that might take, it would be unwise to speculate.

Q558 ***Lord Griffiths of Fforestfach:*** It could be five years or 10 years. When we nationalised industries after the Second World War it took us something like 40 years to get them privatised.
Lord Myners: It is very difficult to speculate given it depends upon the health of the banks: are they fully recovered; are they credible as sustainable and profitable institutions; does the appetite exist on the part of institutional investors and private investors to buy, and is the investment banking community innovative in a responsible way about coming up with clever ways of selling? Quite interestingly, there is a real possibility that the conversion of the Lloyds Banking Group preference shares into ordinary shares, where we again offered a claw back to Lloyds Bank shareholders, will see that claw back exercised because there is quite a big different between the claw back price and the current share price of the Lloyds Banking Group. That would be a first stage returning of some of the value of these companies to private investors with the taxpayer receiving a payment in exchange. The process could start earlier than some people imagine.

Q559 ***Lord Griffiths of Fforestfach:*** The second question was on competition policy.
Lord Myners: The banking sector is competitive. I met with Mr John Fingleton, the Chief Executive of the OFT, yesterday and I have no doubt that he is going to be vigilant in ensuring that an appropriate degree of competitive intensity remains in the banking market.

Q560 ***Lord Currie of Marylebone:*** We have asked you quite a bit on the regulatory side, but does not legal responsibility lie with the senior executives and the boards of the banks concerned? Do non-executive directors, in particular, of the major banking institutions have the expertise and the time to fulfil the role that they are supposed to be fulfilling?
Lord Myners: I think regulation is a backstop. The responsibility for an institution rests with its owners and the people that the owners put in place to run the business, the board of directors. Sir David Walker, who is an eminent and well-qualified person, is carrying out a review of the particular issues around bank governance and that is going to run in parallel with the Financial Reporting Council bringing forward a little its own review of the Combined Code. I think there are some quite important questions to be asked here. There are questions to be asked of institutional shareholders. The Treasury Select Committee has done some very valuable work in exposing the difficulties the institutions had in being effective as owners. There are questions to be asked about board competence and how they handle complexity. Should non-executive directors, for instance, on whom we have now placed a heavy burden of expectation, have more in the way of support? Should they have their own secretariat? Should they be able to commission their own research? Should they have a little more support in terms of shaping and framing agendas and their own independent sources of information on markets and shareholder expectations? I think it is quite interesting to hear the debate on whether the Monetary Policy Committee should have the ability to commission its own research. I have certainly often felt as a non-executive director—and I think nearly everybody round this table has served as a non-executive director somewhere—you are very dependent on the executives as a source of information. I would like to see Walker examine that. I would like to see Walker examine the issue of whether audit committees should consider appointing a technical specialist to guide the audit committee because the audit committee tends to rely upon the executive and the external auditors and it might be helpful for them to have some other point of interface or advice.

Q561 ***Lord Currie of Marylebone:*** Is there a danger that in the past we have relied on too many likeminded people sitting on boards and that we need a greater diversity and a greater facilitation of challenge? Secondly, do you see these changes being driven by regulation and government or by the investors in the communities themselves?
Lord Myners: I would very much hope it would be driven by investors and it would be the product of enlightened self-interest. We have made little progress in promoting board diversity if we focus, for instance, on ethnicity and gender or geography but then end up appointing people who had the same type of education, read the same magazines and have the same interests. We have not brought diversity of experience, perspective and judgment to the table; we have simply ensured that the same views appear to come from different types of people. So I think that is one of the big challenges around diversity. There is a problem for boards of directors around how you strike the right balance between being consensual and

supportive whilst also challenging and at times showing a degree of persistency, which can be uncomfortable and make you unpopular. I have met with the non-executive directors of a number of the banks with whom we have been dealing and one gets a picture of board behaviour in which getting this balance right proved to be very difficult, but I would only add that I do not think that is limited to banks, I think it is limited to any form of collective decision making. I am rather persuaded by the argument about having a devil's advocate, somebody whose role in a group from time to time is precisely to say, "Look, collectively we may all think this is right but actually you are not alert to this particular risk or there are unstated assumptions which could be questioned." It is a very big step for a board to do that, but I hope David Walker might go outside the conventional framework of anything about this to test some of those more radical solutions.

Q562 ***Lord MacGregor of Pulham Market:*** Your possible model of non-executive directors with staff of their own and clearly much greater responsibility for probing and so on before they make their contributions to the board would actually change the nature of a lot of non-executives, would it not? It would be much more time-consuming. It would become more of a semi full-time occupation. It would still require that degree of expertise in the non-executives which may not come from some of the other more diverse sources.

Lord Myners: I think, my Lord, you are of course right. I think for some of our larger institutions it will be necessary for non-executive directors to become if not full-time, certainly devoting a significant part of their time to the task because we have put huge expectations on non-executive directors. We require them to be in this front-line challenging position. It is difficult to square that with business complexity. It is quite clear in a number of our banks that understanding by the total board of directors of what was going on in the bank was not adequate.

Q563 ***Lord MacGregor of Pulham Market:*** Including the executive directors.

Lord Myners: Yes. The excuse that I always heard was it was rocket science, which meant to me that I do not understand it, but that should not necessarily mean that we should not do it. I think there are some good old fashioned arguments that if you do not understand it you should not be doing it. At the core I think the non-executive directors of our large banks, which is what I believe the Committee is largely focused on, our large insurance companies, et cetera, are going to need to give more time to the activity than they have in the past and probably will need to be paid more. How you square that with diversity is not easy.

Q564 ***Baroness Hamwee:*** How do we persuade people to become non-executive directors? It is not a very attractive proposition to anyone who has a care for their own skins.

Lord Myners: Persuading people to be ministers is not all that easy! I think being a non-executive director is one of the most interesting things to do. Whether it is of a not-for-profit organisation, of a national health trust or of a school or of a business, I think the chance to bring experience to the forum and work with people on a mission is enormously attractive. There is a danger that we could make this rather unattractive to the sort of people that we would like to serve as non-executive directors so we need to create reasonable expectations. I hope that the combined work of Walker and the FRC here will help progress that. I really want institutional investors to ask themselves some very serious questions as well. The Combined Code runs to nearly 40 pages and devotes less than two pages to the responsibilities of shareholders. What we have seen is broadly distributed ownership. No one shareholder in large public companies feels sufficiently empowered or with a strong enough economic interest to do something to challenge and fix a problem. I think that there is a core issue there which will not go away.

Q565 ***Lord Tugendhat:*** I was indeed going to ask you about shareholders. It is going to be very difficult to find enough people with the qualifications and the willingness to take on these jobs of being non-executive directors of banks and the pool is not as large as that. In terms of shareholders, it is not just the need to change in the direction you have just indicated, there is also the question of the extent to which shareholders have the expertise to do that. What they are paid for basically is to get returns either going up or going down, depending on what sort of fund they are, but in general they are not people who were very well qualified for taking the sort of ownership role that you are talking about. Quite how one is going to get them into a position where they can do what you are suggesting and others are suggesting is a problem, is it not?

Lord Myners: It is a big challenge. I think one of the things we need to do is to ask ourselves whether we have elevated this concept of managing the shareholder value to a level which is not sustainable or healthy or that our way of measuring shareholder value is possibly not the right one. The constant valuation of a measurement of performance over monthly, quarterly, half-yearly or annual bases does not seem to me to be necessarily consistent with building good long-term value. One of the problems we are seeing in the non-banking sector at the moment is that good companies are struggling with often inappropriate capital structures which were forced on them by the peak of exuberance when the pressure to optimise the balance sheet, put more debt in rather

than equity, was so great that boards felt if they did not do it then it would be done to them by private equity. This cannot be in the best interests ultimately of members of pension schemes. So how do they form the right view on how we measure shareholder value? I think there are some very big debate opportunities here around how we articulate shareholder value. I have spent most of my career in the fund management industry where performance was measured very frequently by reference to closing prices of shares and I think that is not an entirely healthy way to approach this. On the issue of competence, I think there is scope for more specialist fund managers with a very activist brief. I do not mean by activist aggressive, I mean helping fix issues and there are some good examples out there, like Hermes, of firms who have done that but not enough. I also find it striking that in very, very few fund managers do you find anybody with any experience of a world outside financial markets. You do not find people in fund management who have come in after 20 years of working in industry or commerce or government. It is a closed shop to anybody much beyond the age of 23 or 24. So how do you develop that wisdom and experience to have a healthy debate? Private equity does have those sorts of skills and managers like Hermes have also developed them, but I think we need to see more of that as well.

Q566 ***Lord Eatwell:*** You have circulated the letter to the Minister of Finance of the Czech Republic from the Chancellor which suggests that the Treasury is rejecting Lord Turner's proposal that there be a European-wide regulator. Is that a correct interpretation of the Chancellor's letter?
Lord Myners: The Chancellor is persuaded of the merits of a European macro-prudential capability as part of a global macro-prudential capability. He is much less persuaded about the detail of the de Larosière report when it comes to national regulation. I think it is worth remembering that the de Larosière report was commissioned in November, he produced his report in late February—

Q567 ***Lord Eatwell:*** I was referring to Lord Turner's recommendation, not Mr de Larosière's.
Lord Myners: I am sorry. Could you repeat the question?

Q568 ***Lord Eatwell:*** The Chancellor's letter to the Minister of Finance of the Czech Republic suggests that the Chancellor is rejecting Lord Turner's recommendation that there be a single European rule making financial regulator. Is that a correct interpretation of the Chancellor's letter?
Lord Myners: The Chancellor's position is that he believes there is much more opportunity to improve the development of common standards and raising standards in terms of national regulation. He is much less persuaded that national regulators should be subservient to regional regulators. In particular, he argues—

Q569 ***Lord Forsyth of Drumlean:*** That is a no then!
Lord Myners: Yes, that is a no, Lord Forsyth!

Q570 ***Lord Forsyth of Drumlean:*** But it is a yes to this question?
Lord Myners: Yes.

Q571 ***Chairman:*** Well, can I thank you very much for spending some time with us this afternoon, it has been very helpful, and I am sure we could have spent a lot more time with you, but we have to move on.
Lord Myners: Thank you very much and I very much look forward to reading your Report. You have worked very hard on it and I have found reading some of the evidence sessions really fascinating.

Letter from Lord Myners, Financial Services Secretary to the Treasury, to Lord Vallance of Tummel, Chair, Economic Affairs Committee

LORD MYNERS EVIDENCE SESSION 31 MARCH 2009: CLARIFICATION OF ANSWERS GIVEN TO Q566–570

Further to my appearance in front of your committee on 31 March 2009, I am writing to clarify one aspect of my evidence (Q566–570).

Lord Eatwell asked whether the Chancellor's letter of 3 March rejected Lord Turner's recommendation that there should be a European-wide regulator.

It is important here to distinguish between regulation and supervision. Regulation refers to the making of rules, while supervision refers to the processes that implement the rules and apply them to individual firms and markets. There is therefore a significant distinction between a European-wide regulator and a single European supervisor.

As I said in the evidence session, the Chancellor's letter does not suggest that the Treasury is rejecting Lord Turner's proposal. Indeed, the government strongly agrees that we need more harmonised rules globally and in the EU. That is why the Chancellor, in his letter, proposed an independent EU regulatory standard-setter to replace the Lamfalussy Level three committees. We agree that the standard setter should undertake strong peer review to improve standards, set binding regulations and undertake mediation.

As the Chancellor's letter states, the Government continues to believe that supervision must be undertaken at the national level. The Government does not therefore support any proposals for a single European supervisor for financial services. There are wide-ranging reasons for this, including the need to align supervisory and crisis management arrangements, where we have witnessed in recent months the critical role played by national finance ministries. We therefore agree with Lord Turner that supervision of individual firms should continue to be performed at national level. National supervisors, who are close to markets, should continue to supervise firms, while working in collaboration with other supervisors to address the challenge of cross-border firms.

This is why, as you know, the Government proposed the establishment of colleges of supervisors, which bring together the most relevant supervisors of a firm. Colleges provide a framework for cross-border information exchange, supervisory cooperation, and will improve supervisory efficiency and effectiveness. The Government has called for colleges to be put in place for the major cross-border financial institutions by mid-2009.

On the macro-prudential side, as the Chancellor wrote, the Government agrees that we need a EU body to act as an effective early warning system, usefully identifying regional risks and complementing the international role proposed for the IMF/FSF. The Bank of England and the FSA should play a leading role in this body.

I hope the committee find this clarification helpful.

21 April 2009

Examination of Witnesses

Witnesses: Mr John Kingman, Chief Executive, and Mr Sam Woods, Chief Operating Officer, UK Financial Investments Limited (UKFI), examined.

Q572 ***Chairman:*** Good afternoon, welcome to the Economic Affairs Committee, and thank you for sparing some time to come here. Do you want to make any introductory remarks or shall we move straight to questions?
Mr Kingman: No, thank you, to questions.

Q573 ***Chairman:*** Well, I suppose the broad question is: to what extent does a UKFI investment impact on the objectives pursued by the portfolio of companies?
Mr Kingman: I think it does not change the objectives pursued by the underlying companies. I think the philosophy that underpins the mandate we have been given by the Government is that the best way to get these banks back on their feet is to get them the capital they need, the liquidity they need and then to ask them to manage themselves commercially. These remain quoted companies, they have minority shareholders, and possibly, in the case of Lloyds, more than 50% held by parties other than the Government, and we believe that that is the right approach to take. That said, it is very important to ask that the banks in which we are invested are fully learning the lessons of everything that has happened in recent years, and we are working a great deal with them on that. I would hope that, if UKFI does its job well, we can be an intelligent shareholder, cutting through some of the principal agent problems that Lord Myners was talking about earlier in a situation with highly dispersed shareholdings and encouraging them and their boards to be at the forefront of getting themselves out of the mess.

Q574 ***Chairman:*** Do you find that UKFI portfolio banks might now experience any pressure to support or to stimulate the UK economy, if not from yourselves, perhaps from other quarters?
Mr Kingman: Well, we have no mandate in relation to that. Both RBS and Lloyds have signed agreements relating to their UK lending with the Government as part of the conditions of, firstly, the recapitalisation in October and, secondly, the Asset Protection Scheme, but I think the point to underline about that is that the Government has been clear throughout that these requirements relate to lending done on a purely commercial basis with the banks' existing approach to credit-scoring and to credit-pricing, and the lending agreements are, therefore, conditional on the demand being there. For what it is worth, what our banks are saying and actually what other banks are saying to us is that, despite the state of the economy, in many ways conditions for lending are actually rather attractive at the moment, the margins have widened somewhat, and we are not picking up from our banks any anxiety that these lending conditions are

in any way pushing them into uncommercial activity.

Q575 ***Chairman:*** Just for information, who monitors the achievement or otherwise of those lending conditions?
Mr Kingman: The Treasury. It was originally envisaged that UKFI would undertake this task, but subsequently, once it became clear that the Asset Protection Scheme was also going to have lending conditions attached, it was decided, and I think this was the right decision, that, rather than having lots of different agreements monitored by different parties, it would be sensible for the Treasury to do it, and that leaves UKFI with, I would say, a kind of clearer and cleaner remit focused on the shareholder role.

Q576 ***Chairman:*** In your own objectives, apart from looking for shareholder value as a part-owner, you also have an objective, I think, to promote competition in the market. Am I correct and, if so, how would you do both at the same time?
Mr Kingman: Well, our overarching objective is clear, which is to manage the assets for value and to develop and execute a strategy for exiting out of things over time, but we are tasked with doing so in a way that does not undermine competition or financial stability, and that is important. On one construction of UKFI, you could argue that we are a sort of holding company of an enormous swathe of activity and it is absolutely crucial that we manage our investments in such a way and at arm's length so that there is no scope for anti-competitive activity between the two. In that sense, we are not a holding company and that is one of the reasons why building that objective in was very important.
Mr Woods: If I could just add to that, I think those parts of our objective are in there more by way of a safeguard because, if our sole objective was to protect and create value for the shareholder, then obviously a narrow reading of that could lead you to behave in a way that was not good for competition, so it was very important both for us because clearly that will be contrary to the Government's interest, but also for the competition bodies, the Office of Fair Trading, et cetera, that there was some offsetting element in there to make sure that we had that balance in terms of our activities.

Q577 ***Chairman:*** So you see this objective as not to undermine the competition rather than to promote it?
Mr Kingman: Well, I am keen to promote competition, but our Framework Agreement is clear that our overarching objective is to manage the shareholdings in a way that adds value and gets us out.

Q578 ***Lord Griffiths of Forsyth:*** Can I just ask one quick supplementary on that and it is this: when you feel satisfied that HBOS and Lloyds have really been fully integrated, would you plan to break it up?
Mr Kingman: Well, there would be two questions there. One would be a question entirely for the competition authorities, and this company will be subject to competition law in the same way as any other. We would approach any structural question on our banks from the perspective of value and, therefore, that would be something we would contemplate if we thought it was a good thing to do for our remit and, therefore, for value.

Q579 ***Lord Griffiths of Forsyth:*** So there may be a difference of view between the competition authorities and yourselves on that?
Mr Kingman: There could easily be. There is no sense in which our banks are exempt from competition law and the competition authorities are independent.

Q580 ***Lord Griffiths of Forsyth:*** But, if it were more valuable to keep it together, even though it was way outside the normal rules of competition policy, you would say, if you want to get more value, that in an exit strategy you would prefer to see it large, not broken up?
Mr Kingman: My reading of the mandate we have been given is that we are to act in a way that does not undermine competition, but I do not think we have been given a mandate to promote competition at the expense of value, but, as I say, I think that, in reality, this would be a question for the competition authorities.

Q581 ***Lord MacGregor of Pulham Market:*** Does one of your earlier answers mean that, when, for example, the Royal Bank of Scotland gives a commitment to keep lending at 2007 levels or government ministers chastise the banks for not getting money out quickly enough and lending enough, you have no role to play in that at all?
Mr Kingman: Yes. It was originally envisaged that we would have a role, but we do not any longer. There are legal agreements between the Treasury and the banks and that is a matter for the Treasury now.
Mr Woods: But this was a purely pragmatic decision in that you risked as you went through the Asset Protection Scheme, which was adding in some different conditions, ending up with a situation where you had different parts of government monitoring different types of lending conditions,

which just does not make any sense, so that was the motivation for changing it.

Q582 ***Lord MacGregor of Pulham Market:*** And also the fact that you have, as one of your commitments, to respect the commercial decisions of the financial institutions?
Mr Woods: Yes.

Q583 ***Baroness Kingsmill:*** Following on from that, there could be defaults, could there not, by companies that have borrowed from UKFI companies and, if it is commercially the most attractive option for the banks, are you prepared to countenance the liquidation of these companies, even though there may be some quite serious social consequences?
Mr Kingman: Yes, we would of course expect banks in which we are invested to behave responsibly, but I am afraid one of the things that happens if you are a bank is that some of your loans default and, in some cases, it is necessary for banks to pull the plug. That is not the only option available, for example, debt can be swapped for equity or whatever, but the mandate we have been given is to encourage our banks to be commercial in that respect. Indeed, if you look, for example, at Northern Rock, which has been in public ownership since February of 2008, they are not heavily involved in commercial lending, but they have unfortunately had to repossess quite a few homes, and that is one of the things that happens to banks, particularly in recessions.

Q584 ***Baroness Kingsmill:*** But, supposing, for example, banks want to break themselves up, do they have to consult with you on that score, if they decide commercially that it is something that they would like to do? There is talk that RBS wants to sell off parts of its empire, so to speak.
Mr Kingman: Well, the decisions at RBS and Lloyds are made ultimately by their boards, but, in practice, very fundamental strategic decisions I would expect them to discuss with us as a large shareholder and I would expect them to talk to other shareholders as well. In practice, in relation to the new strategy at RBS, the first element of which was announced in February, the bank chose to engage with us quite closely and that was a choice they made, and I would say that discussion worked well. It is not something we would always do because that decision made us an insider in relation to the stock and that is something which we would tend not to want to be, as a general matter. In the end, these decisions are made by the boards, but of course we, like other shareholders, have to vote in favour of the appointment of the boards, so that is the underlying framework.
Mr Woods: There is a distinction here between the strategic decisions, which we would expect the bank to engage with us on, and the day-to-day management decisions, which actually we are expressly forbidden from getting involved in under the Framework Agreement. If I can direct you to the clause in the Framework Agreement which you have in front of you, it says—

Q585 ***Lord Tugendhat:*** But, nonetheless, it does not stop you telephoning people quite often at different levels in the banks, as I understand it, both to seek information and to make your views known.
Mr Kingman: Well, it certainly does prevent us from doing that in relation to operational decisions of the banks, such as individual lending decisions. We are actively debarred from involving ourselves in those.

Q586 ***Lord Tugendhat:*** That is certainly not the impression I was given by people on the other side of the fence.
Mr Kingman: Well, I would say that there are a number of issues that we have become, I think rightly, involved in with RBS and Lloyds and they include strategy, board composition and issues like overhauling the approach to risk in these banks. For example, we had a fascinating couple of hours with the head of risk in one of these banks, which is an important issue to us, and she said to me, "You're the first shareholder who has ever asked to come and meet me". I think that says more about the other shareholders than it does about the approach we are taking.
Mr Woods: And we do talk to people further down in the banks. So, for instance, in relation to remuneration, we always make sure we understand what is being proposed to us and get additional information where that is necessary for us to form our view and we do of course talk to people lower down. So it is not that the only dialogue is between our Board and the boards of the banks, but there are supporting discussions lower down. The point I was making is that they are not about individual lending decisions or things of that kind.
Mr Kingman: If I may also put this point in perspective, the team we have is responsible for investments in RBS and Lloyds which are, after all, vast financial institutions and, in the case of RBS, with a balance sheet larger than the UK's balance sheet. The team is three people, so our ability to, as it were, constantly second-guess them is naturally quite limited.

Q587 ***Lord Eatwell:*** I must confess, I am still very puzzled about your relationship with, let us say, RBS where you are clearly the majority shareholder. Perhaps I could put it the other way round. What is the difference between your relationship with RBS

and the Government's relationship with Northern Rock, apart from the obvious fact that it owns 100% of Northern Rock, but what is the actual operational difference?
Mr Kingman: There are two differences. One is, as you say, 100% and one is less than 100%, and I think that does make a very fundamental difference because the boards of these—

Q588 ***Lord Eatwell:*** What if it were 99.9, would that make a difference?
Mr Kingman: I do not know whether 99.9 would be feasible, but I think that the existence of minority shareholders is very important for one fundamental reason, which is that the boards of these companies owe legal duties to all their shareholders and, were the boards to act in a way that suited the government shareholder at the expense of other shareholders, they would be hugely exposed to a personal lawsuit.

Q589 ***Lord Eatwell:*** So not 99, but 90%?
Mr Kingman: Well, I would say that 90% is very different from 100% because of this legal point which is fundamental.

Q590 ***Lord Eatwell:*** And 95?
Mr Kingman: Well, I think that then you get into this question of feasibility, in practice.

Q591 ***Lord Eatwell:*** So, operationally, what difference does it make?
Mr Kingman: As I say, there are two differences. One is that the relationship with the boards is very different in the sense that we simply cannot just tell these boards what to do because the boards owe duties to all their shareholders, not just us. The second is that UKFI has been set up at arm's length from the Government which means that the Government has tasked UKFI with taking these decisions in accordance with the Framework Agreement that we have been set and that means that decisions are taken ultimately by the UKFI Board and not by ministers, and that is a significant difference.

Q592 ***Lord Eatwell:*** I wonder if you could think of any company other than RBS in which there is a shareholder which owns over 70% of the shares and it does not tell the board what to do?
Mr Kingman: I agree that this is an unusual situation, but I think it is an unusual situation into which we have found ourselves forced for reasons of financial stability. The fundamental judgment that the Government had to make was whether it wished to nationalise these companies or whether it was better to keep them as listed entities with other shareholders, and I think there are two very significant advantages to that. One is that the structure fundamentally makes more real the commerciality of the entity for the reasons I have given, and the second is that I think the exit is significantly easier if these are listed companies that the market is following. If you step back and imagine that we took RBS and made it a wholly owned nationalised industry and then sought to privatise it again, that is a slightly daunting thought. At the moment, the market is following it, there is a share price, there is a tonne of analysts following it, there are real investors in the stock, and that means that the exit is something that is a good deal more "contemplatible".
Mr Woods: To return to your question as to what difference does it make being UKFI versus the Government, I can tell you that, having come across the border, if you like, from the Treasury into UKFI, it does feel palpably different because you have this quite clear objective set in the Framework Document and that the way you deal with things that land on your desk is different from what you would do if you were sitting—

Q593 ***Lord Eatwell:*** Yes, but my suggestion is that the objectives set in the Framework Document are rather odd in the context of the proportion of the company which is owned by the taxpayer.
Mr Woods: Well, I do not think so. The objective to protect and create value, and I think that is what the taxpayer would expect the Government's investment to be doing.

Q594 ***Lord Eatwell:*** But the taxpayer might actually hope that the bank would operate in the national interest, the taxpayer being part of the nation, not just the shareholder. I notice that your Chairman says in *The Financial Times* today that the "only objective is to pursue shareholder value". Now, this is rather odd when shareholder value is being regarded these days as something which should not be the sole objective even of banks which have no government holding.
Mr Kingman: This is a very fundamental policy decision taken by the Government and not taken by UKFI, which is, as I said at the beginning of this session, that the best hope for rebuilding the British banking system is to run the banks as commercially as possible. Now, I do not interpret "commercially" as keeping alive all of the mistakes of recent years and I think that the boards of our banks fully agree with that sentiment, but it is true, there is a school of thought that says that that is a mistake, that one should not manage the banks commercially, but, if one were to take a different approach, apart from anything else, I think that the exit would be very difficult indeed, if not impossible, and I think it would also be extraordinarily difficult to find competent

people to run banks if their objectives were fuzzier, less clear and, I suppose, in the end more political.

Q595 ***Lord Levene of Portsoken:*** I would like just to probe a little more deeply this question of competition. Some people may feel that the banks which did not get themselves into the mess that RBS, Lloyds and HBOS did have now found themselves really at a competitive disadvantage to those which did because the banks in which you have a very large shareholding effectively are known to have a government guarantee, so investors or the people who want to lend money to them may well feel that they are lending to much safer institutions, and that seems to penalise those who kept themselves in good shape. How do you square that with the banks actually which did well and did not get into this situation? How do they have a fair run? Secondly, you said earlier that the banks in which you have substantial holdings are subject to the same competition laws as any other, but then we know, and we heard just this afternoon, that, when Lloyds expressed an interest in buying HBOS, they were told that the competition laws relating to a share of the mortgage market would be waived, so how can all this be compatible? It seems to me that the competition is fast disappearing.
Mr Kingman: Taking those two questions, firstly, in some ways, I confess, I am quite relieved to hear you fear that the banks in which we are invested might be at a competitive advantage because the more frequent criticism we get is that they may be placed at a competitive disadvantage, and indeed there is some speculation that that is the view of the Board of Barclays Bank, for example. Our objective is that the playing field should be as level as it possibly can be and that is the philosophy that runs through everything that we are doing. On the point you make about competition, the point I was making was simply that, whilst it is true that the Government took action to permit the merger under competition law, that does not mean that either this company or the market are in any way exempt from competition law and the application of competition law, and the competition authorities, as I understand it, are absolutely free to take any action they consider appropriate in relation to this market. You should take evidence on this from the competition authorities rather than me, but that is my understanding of the position.

Q596 ***Lord Forsyth of Drumlean:*** If your Chairman is right, that you are concentrating on shareholder value, and what you said earlier was that your interest was to get the best deal for the taxpayer, surely you will be encouraging the Board to use their competitive advantage in order to achieve that objective, and that must mean, as Lord Levene says, that those banks which have not got into difficulty will find themselves disadvantaged?
Mr Kingman: I would certainly want them to take advantage of any position that they have, whilst I would baulk at encouraging them to act anti-competitively and I think that would be inconsistent with our remit, but I am just groping to get a sense of what the alleged competitive advantage that they have been given is.

Q597 ***Lord Forsyth of Drumlean:*** Well, they have size and scale, they have a government guarantee and they could say to people, "If you deposit your money with us, we have got the Government behind us and these other people have not", for example.
Mr Kingman: Well, as I say, the more common fear that I hear both in the market and elsewhere is a fear, which I do not believe to be fully justified, that the banks in which the Government has invested might be at a competitive disadvantage, and it is notable, for example, that Barclays Bank, on the face of it, has gone to some length to avoid having government investment.

Q598 ***Baroness Kingsmill:*** I think you are obfuscating a little bit here because this merger would not have been allowed by the competition authorities and that was the reason why there had to be special legislation passed to enable that to happen, and the reason it would not have been allowed to have taken place is because that merger would have given a competitive advantage over the rest of the banks in the marketplace, so you cannot escape from the fact that in the present circumstances they do have a competitive advantage. The question, I suppose, arising is: to what extent is that a good thing in the longer term for the stability of the financial sector as a whole if you have got an almost wholly owned government bank which can claim to have full backing, which other banks cannot have, and you have a bank which is of an uncompetitive scale, which other banks will find very hard to deal with, notwithstanding its current difficulties because of the HBOS failures?
Mr Kingman: The point I was simply trying to make, and I apologise if I was in any way unclear, was that the Government, as you say, took a decision to effectively suspend the application of competition law in respect of the merger, but that does not, as I understand it, in any way remove or exempt the bank from the workings of competition law going forward, and that will be very important in terms of their not abusing any market share advantage they may have, and we would obviously not want our banks to be in any way risking a confrontation with the competition authorities in relation to any of their activities as that would obviously not be right.

Baroness Kingsmill: Well, it is just technically a much harder business to investigate a bank and it takes a lot longer to investigate a bank for anti-competitive behaviour than to prevent the banks from merging and allow the risk of that anti-competitive behaviour arising in the first place, so it is a much less powerful tool in the hands of the competition authorities.

Q599 ***Chairman:*** Can I just go back right to the very beginning because I think I may have misunderstood what you said. Just looking at your overarching objective here, which is paragraph 3 of Annex A, under (c) it says, "promoting competition in a way that is consistent with the UK financial services industry", and so on. That is rather different from what you were telling us earlier on.
Mr Kingman: The point I was making was that the overarching objective we have been given relates to value and the exit. We have also been given objectives, as you say, to promote competition and financial stability, but we are not a policy-making body, we are not a competition authority and I do not think we have been given a remit to, as it were, act as some general promoter of the public interest in relation to banks. Now, some argue that we should have that remit, but I do not think that is the remit we have been given.

Q600 ***Chairman:*** Maybe I have the advantage over you because I have actually got the text here, but your overarching objective includes three elements and the third of those elements is promoting competition.
Mr Kingman: Yes.

Q601 ***Chairman:*** So it is not subordinate to it, it is an essential part of it, is it not?
Mr Woods: I think perhaps the question is more about how is this impacting in our day-to-day activity, and the sorts of things that this part of our objective make us be very careful about are, for instance, having a very strict set of rules around making sure that there is no leakage of information from one of our companies to another in a way that might prejudice competition, and we had extensive consultations with the OFT about how those rules were constructed, so those are the sorts of ways in which we are implementing that part of our objective.

Q602 ***Lord Forsyth of Drumlean:*** But it says, "promoting competition in a way that is consistent with the UK financial services industry that operates to the benefit of consumers and respects the commercial decisions of the financial institutions". Lord Levene's point is: is it not the case that, if you are, as your Chairman says, pursuing shareholder value, that is inconsistent with that objective? That is the simple question.
Mr Kingman: I think I would merely say that the question put was: might we not act to, for example, break up a company, even if we thought that that was not in the interests of the taxpayer, and I do not believe that that is the mandate that I have been given by the Government. Now, one can debate certainly whether that is the right mandate, but I do not—
Lord Forsyth of Drumlean: That was not the question.

Q603 ***Lord Levene of Portsoken:*** That was not the question at all. The question was: do the banks in your estate have an unfair competitive advantage over those that do not have a government guarantee behind them so that the banks which did not get themselves in a mess actually find themselves in a worse position than those that did?
Mr Kingman: Well, I do not believe that the banks in which we are invested have a material competitive advantage, and indeed I think some might say that they have some competitive disadvantages as a result of government investment. Now, personally I believe that they have neither a massive disadvantage nor an advantage, that is my opinion, but the view that is put to me certainly by the market is more often a fear that they are at a competitive disadvantage than an advantage.

Q604 ***Lord Levene of Portsoken:*** Well, I would just add one thing to that, if I may, which is that, when Northern Rock was nationalised, there was a large flow of funds into them because they were regarded as the safest home for investment and it is really the same, and I think that is the problem.
Mr Kingman: That is correct, but it is interesting that, as far as I am aware, neither of the large banks in which we are invested have seen a parallel phenomenon, certainly on nothing like the same scale.

Q605 ***Lord Griffiths of Forsyth:*** It seems to me that there is an inconsistency in the objectives that you were set, and you did not set the objectives, they were given to you, but, on the one hand, you are concerned with maximising shareholder value, you have over a third of the market and, therefore, you can charge a premium price for what you do. If I were running a bank like that and I wanted to maximise shareholder value, I would do my very best to have a premium price in every area I could. At the same time, you are told that you should be promoting competition. Promoting competition, to me, would mean breaking up Lloyds HBOS. Now, I am not suggesting that you have bad motives or anything like that, but it seems to me that you have been given two objectives here which are intellectually inconsistent.

Mr Kingman: Just to take your first example, one reason we have been given an objective to promote competition is precisely because, if we were to take a sort of pure reading of the kind of value objective, then, as you say, one would want these two banks to collude and drive prices up and widen their margins as far as possible and so on. The Government was very clear with us and with the European Commission and the competition authorities that it did not wish to see UKFI operating in that way and, for example, that we were actively to put in place very clear controls to prevent commercial information from passing from one of our investing companies to another, and that is the way I see the competition objective we have been given. Personally, my understanding of the objective we have been given does not take us as far as to say that it is our role to take a kind of public interest view that would cause us to split our companies. That would be, I would say, a matter for the competition authorities.
Mr Woods: I would just add on the point of value that the objective is actually to create and protect value and it is quite deliberately not to maximise value. Actually, that was partly in mind for making it possible for us to exit from these investments over time, but I would not want the Committee to have any exaggerated notion of the tension between those two things.

Q606 ***Lord MacGregor of Pulham Market:*** If you thought that one of the banks was acting uncompetitively and using its market share as an advantage to do that, would you intervene?
Mr Kingman: If we thought that they were acting in a way that undermined competition or that risked what could be a very expensive and reputationally damaging confrontation with the competition authorities, yes, I think we would.

Q607 ***Chairman:*** Can I just come back to this "protect and value", and again I am reading from your overarching objective of which it has three parts. The first part is, "Consistent with HM Treasury's stated aim that it should not be a permanent investor in UK financial institutions, maximising sustainable value for the taxpayer . . . "
Mr Kingman: The word I would underline is "sustainable"!

Q608 ***Chairman:*** The one I would underline is "maximising"!
Mr Woods: There is a wider point on which I remember the lawyers advising us, and perhaps some of the Committee will know better about this, that there was some distinction between the overarching objective in the opening paragraph and what was in the subclauses, that there was some legal significance to the difference between these two things.

Q609 ***Lord Tugendhat:*** It is very interesting having this discussion after listening to Lord Myners earlier suggesting that shareholder value might perhaps be downgraded a little in the future, but he also was talking very convincingly about the structure of boards, and you were sitting behind him and you heard what he had to say. Then I compare what he had to say about how he thinks boards of banks ought to be constituted with the way in which your Board is constituted, and it does seem to me that there is a bit of a case of, "Don't do as I do, do as I say", is there not, a little?
Mr Kingman: I do not think I would agree with that at all. We have a very small board and I would say that, whilst UKFI, being an organisation of 11 people, is not quite of the complexity of some of these banks, the time demands on the non-executive directors have been extremely heavy actually and I would hope that the way in which the Board of UKFI is managed does learn some of the lessons. Also, and maybe we can go on to talk about this, we have taken very seriously the need to reconstruct the boards of our investee companies and we are embarked on a kind of very substantial restructuring, particularly, of the Board at RBS.

Q610 ***Lord Tugendhat:*** I think Lord Myners is dealing with a very interesting and complex subject and I thought he phrased what he had to say with great care. I think your Board looks very highly qualified, but, in the light of what he was saying about how there should be such different sorts of people on bank boards, with four former bankers, one former asset manager and two representatives of the Treasury, lots of virtue, lots of merit and all of that, it does not actually sit comfortably with what Lord Myners was saying.
Mr Kingman: I do not know. It depends whether one thinks that diversity is in itself a key issue or whether the key issue is the nature of the people, the way in which they see and approach their task and the skills that they have. I think that, whether they be appointed as a non-executive director on the Board of UKFI or on to the board of one of our investee banks, it is very important to us that these individuals see their task in a way that is consistent with learning the lessons of everything that has happened. Personally, I look forward to what David Walker has to say. I have been heavily involved in the appointments that were made at Lloyds, and we are in the process of making appointments at RBS, and I think it is very interesting meeting the potential candidates for these boards and talking to them about the way they see the job, and I would say that there is a huge variety in the kinds of conversations you have, and the thing that is most important to me, I suppose, is the way in which the individual approaches the task and the skills and experience that

they bring. I do not feel at all embarrassed about having a board that is, frankly, very expert in the things that I think they need to be expert in. It helps me that they are expert; it means that they are able to ask extremely challenging questions and that is what I would expect them to do. We clearly could have a more diverse board, but the cost of that, I think, would be that you would lose the expertise.

Q611 ***Lord Eatwell:*** I am not sure about that. Having a group of people, all of whom are bankers, means you have a very homogeneous board, and I would be interested in the appointments that you are making to the other boards. What proportion of the people you are appointing are not former bankers?
Mr Kingman: Well, we have appointed two directors so far and I think it is very fair to judge us on those two appointments, and let me tell you who they are. The first is Tony Watson who was, until recently, the Chief Executive of Hermes, one of the most experienced and, I think it would be fair to say, wise fund managers in the City. Hermes, as you will know, has a particularly strong track record on governance and the way it approaches the shareholder task. The second candidate was Tim Ryan, not well-known in this country, an American, and he led the US Office of Thrift Supervision and oversaw a lot of the savings and loans clean-up. He subsequently became, yes, a financial institutions banker at JP Morgan for 15 years in which capacity, for example, he sat on a number of bank boards and he sat, very interestingly, on the board of a Korean bank in which the Government was a large shareholder, and I found him very perceptive in the way he talked about that experience. I think those appointments are ones that strengthen the Lloyds Board, and both of those individuals, as it happens, have been, at different points in their careers, bankers, but I think they bring to the task experience and an approach that will add to that Board.

Q612 ***Lord MacGregor of Pulham Market:*** You were suggesting that you took the decision as to who the non-executives should be. Is that right or is it the Nominations Committee?
Mr Kingman: Strictly speaking, the way it works is we have rights of approval over two board appointments at Lloyds and three at RBS, and the process that we have agreed with both banks is that, in order to be appointed, the individuals have to be acceptable both to us and to the Nominations Committee of the bank and, in practice, both we and the Nominations Committee have, firstly, agreed shortlists and, secondly, interviewed candidates separately. In practice, with Lloyds we have not found huge differences of view about the sorts of people we are looking for, and we are working very closely with RBS at the moment on the appointment of three new directors there.

Q613 ***Baroness Hamwee:*** Can we go back to two areas which have already come up. The first is shareholders, and you talked about the directors' responsibilities to minority shareholders and we heard what Lord Myners had to say. How do you plan, if at all, to work with your co-shareholders?
Mr Kingman: I think this is something that is very important and it is something we have now begun doing in a structured way. We have been doing a series of meetings with both the big investors and also the big potential investors in our banks, and I think there are two reasons we have to do that. Firstly, I think we have something to learn from them because they have been watching these stocks as investments for a lot longer than we have and, secondly, you have to remember that we have an enormous pile of assets to sell and we need these people to buy some of the assets over time and, therefore, understanding what it will take to restore wider investor confidence in these banks is central to our exit mission. Now, that is not to say that we will necessarily always agree with other shareholders, and I can certainly imagine situations where we might not, but I do think that for us to do our job well we have to have high-quality and active relationships across the market, and that is something we are doing.

Q614 ***Baroness Hamwee:*** Well, one might say of course that, as shareholders, they have not done the job which people are now saying they should have done, so do you see your remit as not just the immediate task, but also something to do with the culture of the way banks and their shareholders operate in the future?
Mr Kingman: Yes, I do. I think institutional investors, like everyone else, have been shocked by the scale of what has occurred and I think that that is causing them to think about how they learn the lessons of that and I think they are inevitably doing that with varying degrees of thoughtfulness and engagement, but in the conversations I am having I do not detect a bunch of people who are saying, "Golly, we got all this right over the last few years" at all; they have obviously suffered very substantially financially as a result of their investments.

Q615 ***Baroness Hamwee:*** So active shareholding as well as active citizenship maybe. Can I also come back to the question of your own resources. You said there are 11 people, I think, just now and RBS have a team of three. Are there enough of you and have you got enough resources?
Mr Woods: I think the answer, with our current remit, is yes. I think the key point to note here is that we have been set up to manage the Government's

investments, not to manage the banks themselves, so UKFI is more akin to a fund manager or a private equity firm rather than some kind of huge corporate, and those types of firms are generally quite small. We have taken the view that, if we hired millions of people, that would just create a kind of unnecessary bureaucracy, if you like, for the banks, but there are two caveats I would put on that. One is, and I think this is relevant to another area the Committee may want to inquire about, that we have built into our budget quite a lot of room for professional advice because, clearly, we are going to need a lot more help on particular areas at particular times. The second is that we have not built into our budget any transaction fees that might come at the point of exit, which would obviously be rather large compared to our budget.

Mr Kingman: I would just add two points, if I may. Firstly, I am not in doubt that, if we felt that we needed additional resource, I do not think there would be huge reluctance on the part of the Treasury to give it to us. The second is that, as it happens, I spent a fascinating two hours with the man who did an equivalent of my job in Sweden in the early 1990s which went through a similar kind of crisis, although the job was not identical, but it is interesting that the organisation he ran was of a very similar size, which I find slightly reassuring.

Q616 ***Chairman:*** Do you, incidentally, have any communication with the FSA in respect of the banks in whom you have a large holding?

Mr Kingman: We do have a relationship with the FSA, but we do not have, and I do not think it would be proper for us to have, access to, as it were, private information that was not available to other shareholders. For example, if the FSA supervisors had an anxiety about something in one of the bank's books, that is not something they would normally communicate to us and it is not something I would expect to know.

Q617 ***Chairman:*** How about the other way round? Supposing some of your staff came across something that they thought was out of order in the banks in which you had a shareholding, would you feel any obligation to blow the whistle?

Mr Kingman: Yes, we would, without hesitation.

Q618 ***Lord Currie of Marylebone:*** Remuneration issues in some of the banks for which you have a responsibility have attracted a certain attention and people have been critical of some of the decisions made by the remcos. Do you see it as part of your remit to make sure that there is no recurrence of that and have you taken steps to sort out those issues?

Mr Kingman: Yes. I think that, if one looks at the list of things that went wrong in these institutions, remuneration was certainly one of them. It is quite clear that incentive structures, I would say, certainly at RBS were part of the problem. I am not saying that perfect remuneration structures would definitely have necessarily avoided the problem, but they were certainly an issue. Both RBS and Lloyds are fundamentally reviewing their remuneration policies going forward and we have also in the short term agreed with both banks, but I think it is particularly germane at RBS, a very fundamental change in the structure of the way bonuses are paid in the very large investment banking business of RBS. RBS was, I think, one extreme in the sense that it quite unusually, I think, paid out bonuses 100% in cash. What we have agreed with the Board going forward and in relation to 2008 bonuses is that, where they pay bonuses, they will be paid over three years, they will be subject to clawback and they will be paid in capital rather than in cash. I think that is a fundamental reform and this is quite possibly the largest and most fundamental reform of any large bank in the world and I think it is a better structure.

Q619 ***Lord Currie of Marylebone:*** Supposing the boards of the banks did not agree with you on that question, would you be able to impose your views on the banks or is it for the banks themselves to decide?

Mr Kingman: Well, I think that this question has a number of levels. In recent months, the banks have been seeking substantial financial support from the Government and, therefore, the Government was able to attach very specific conditions to those deals. Looking forward, these decisions are for the boards and they will certainly want to discuss them with us and of course, like any shareholder, we will have to vote on the remuneration policies set out in the remuneration report. My guess is that the boards might not want to have us voting against their remuneration reports and I think that gives us a certain leverage, but it is a discussion with them and they are running the business.

Q620 ***Lord Griffiths of Forsyth:*** Can I come back to this question that you do not intervene in the day-to-day management, and I particularly understand the point in relation to Lord MacGregor's question, that, if, for example, the banks lent to individual customers and individual corporations, you would not want to get involved in that at all, but I have two questions. The first is: do you really need to intervene on a day-to-day basis to have the effect that you would have if you did intervene on a day-to-day basis? I have been on a company board in America and, frankly, one shareholder got up to 20% and then there was another significant shareholder and I think I can honestly say that the CEO was second-guessing

what these shareholders would be thinking if he took certain actions. If I were the CEO of one of the banks you are managing the interest in, say RBS, and you have 70% ownership, I should surely be second-guessing all the time the way you would respond to day-to-day decisions I would take? Secondly, there are surely some areas in which you would want to intervene. Let us assume you have an investment bank as part of one of the banks that you are managing investments in and they are asked by a client to do a very large, complex and risky structured trade and one of your concerns is managing risk. I cannot see how, in that situation, somebody would not want to come to you and say, "How do you feel about us doing this particular deal?"

Mr Kingman: Let me take those questions in reverse order, if I may. I do believe that we should take a very close interest in the way in which our banks manage risk, and again it is very clear that one of the things that went wrong in these banks, particularly at RBS and HBOS, was that risk was mismanaged, and I think we need to understand the way in which that is going to be reformed and I think we need to understand the risk appetite of the banks going forward. I would not expect banks to discuss with us individual transactions. What I would expect is for them to be operating an approach to risk which is consistent with our appetite for risk, as a large investor, and which would then apply to whatever the large transaction was.

Q621 ***Lord Griffiths of Forsyth:*** But what would you see as your relationship with the Risk Committee?

Mr Kingman: Well, firstly, I would think that having a relationship with the Chair of that committee would be one of the most important relationships that we would have. I would also think that having a serious relationship with the head of risk in the bank would also be one of the most important relationships we would want to have, and our having confidence in those two people would be desperately important to us.

Q622 ***Lord Griffiths of Forsyth:*** And that will be a continuing dialogue, will it not?

Mr Kingman: Yes. If you take the two situations, at RBS, Stephen Hester has made it very, very clear that a new approach to risk is central to his strategy. At Lloyds, essentially, I think, there is a strong sense that Lloyds' approach to risk was better than some others', and essentially what they are doing is building an approach across the merged bank which is informed by that experience. Now, in both cases, both banks are saying to us absolutely the right things, as it were, at a sort of headline level, but what we really need to understand is the kind of concrete specifics of how will we know that that has really happened, what are the kind of concrete milestones, and that is the nature. We will certainly want to meet them regularly and that is something that, I would hope, other shareholders might also be interested in.

Mr Woods: There is a distinction, I think, between not getting involved in the day-to-day management and not taking an interest in the detail. So on RBS bonuses, for instance, we thought that was a strategic issue for the company, but, in order to be able to engage with it in a meaningful way, we had to understand the detail. This also comes back to the question about the level of the shareholding and I would say on issues like that that we are in deeper than even a fairly large institutional shareholder would be.

Q623 ***Lord Griffiths of Forsyth:*** If I were the CEO of RBS, and here you have 70%, you would not need to tell me day-to-day what to do because I would be asking myself that question all the time.

Mr Kingman: Firstly, Stephen Hester and Eric Daniels are quite strong-minded people and I think that is a good thing. Secondly, I think this is one of the reasons why we have to be quite disciplined about the nature of the sorts of issues that we choose to get involved in, and there is a difficult balance to strike here because we are there to protect the taxpayers' interest, but, equally, if we inundate these banks with endless second-guessing questions from people who may be actually less well qualified than those on the boards of the banks to answer them, frankly, we are never going to get decent people to run these banks, and that goes to the point we were discussing earlier about the number of people in our organisation and the conscious decision that we have taken to keep it reasonably lean. Now, I think that not everyone would necessarily support that decision, but I personally do think it is the right one.

Q624 ***Lord MacGregor of Pulham Market:*** I understand your point about focusing, as a priority, on risk, but, given that so many large organisations, including the credit rating agencies, have frequently got risks so badly wrong, with 11 to 15 staff, how do you have the resource to actually assess that?

Mr Kingman: We definitely do not have the resources to build the risk management systems for the banks. I think we have the resource, particularly if we draw on professional help, to understand whether the banks are themselves doing what they say they are going to do. Some of these discussions are very, very sophisticated, and rightly so, around exactly what models work and so on, but actually, in essence, what went wrong in RBS and HBOS was really quite basic. In RBS, I do not think it is a huge exaggeration to say, this became a machine built around short-term earnings growth and revenue growth and, when one looks at some of the risks that were built up on the balance sheet, they are really quite startling. I think

that we now have in place a management team who are determined to take a different approach and what we need to do is to hold them to account for delivering the new approach that they tell us they are going to put in place.

Q625 ***Lord Forsyth of Drumlean:*** Just following on from Lord Griffiths' point, I am bound to say that, if I were running either of these banks, I would be, like Lord Griffiths, thinking, "What is Mr King and his colleagues' reaction to this going to be?" Now, you say they are strong characters and they would not do that, but what about you? Are you not thinking, "What would the Prime Minister's or the Chancellor's reaction to this be?"?
Mr Kingman: Well, I always like to think what the Prime Minister and the Chancellor would think about anything, but I think I have been given a job to do which is set out in the Framework Agreement and I think I have a good understanding of what they want from UKFI. They have taken a decision to ask us to take a commercial approach to managing the investments and that will occasionally involve things that, I am quite sure, will be politically quite challenging, and we have talked about some of them today. If the Government wanted to manage these assets directly, it would have chosen to manage them directly. It has chosen to create an arm's length company to do so and I think we have been given a reasonably clear—

Q626 ***Lord Forsyth of Drumlean:*** Is the answer to my question yes or no?
Mr Kingman: My answer to the question is carefully structured.

Q627 ***Lord Forsyth of Drumlean:*** We had this with Lord Myners and, when he said that, it meant yes, so does that mean yes? Is this Treasury speak for yes?
Mr Kingman: In all seriousness, if ministers wanted to manage these assets directly, they could have chosen to do so.

Q628 ***Lord Forsyth of Drumlean:*** I understand that and, by the way, I think the Government did the right thing in trying to establish the arm's length arrangement, and I am not critical of that at all, but I am just wondering whether you, in carrying out your duties, in the same way as, I think, Eric Daniels and Mr Hampton will be thinking, "What would UKFI's view of this be?", are thinking, "What would the Government's view of this be?"? An example is remuneration policy, for example, where on remuneration I think the FSA's view is that perhaps there is an opportunity, by looking at capital requirements, to allow people to set that in order to have competition. Now, you have already told us this afternoon that on remuneration you have taken a very active view, and I suspect that is because you are thinking, "I wonder what the Government's thinking about this".
Mr Kingman: Well, remuneration is an interesting example because the discussions on remuneration at RBS and Lloyds took place at the same time as those banks were going to the Government for very significant additional financial support and, therefore, ministers could not avoid taking a decision at the same time, and the role we came to play in that situation was, to some extent, to be a broker in that negotiation. I happen to think that we added value in that negotiation by working with RBS, in particular, to reshape that bonus structure in the way I have described. In the future going forward, and both banks, as I said, have agreed to review their remuneration structures going forward, that is something we intend to approach commercially, and that is something I have been given by the Government.

Q629 ***Lord Forsyth of Drumlean:*** But, if I were you, let us suppose they come up with a remuneration structure and they argue that, in order to be competitive, they have to have this particular structure, are you not thinking, "How is this going to look on the front page of *The Daily Mail* and what is the reaction going to be of ministers?"?
Mr Kingman: I think the banks themselves need to think about, what you might call, a sort of franchise issue for them which is how the public will feel about some of the decisions that they take, but we are not embarrassed. For example, we have announced this afternoon that we are supportive of the remuneration structures that have been put in place for Stephen Hester and Philip Hampton going forward. Now, both of those individuals are being paid large sums of money and, in the case of Stephen Hester particularly, his remuneration will be tied very closely to his success in getting the share price up and, thus, facilitating our exit. I am unembarrassed about that and, if that results in headlines, well, so be it, the job I have been given is to try and maximise value.

Q630 ***Lord Forsyth of Drumlean:*** While on the subject of remuneration, do your concerns about remuneration extend to the advisers who advise these banks on their transactions?
Mr Kingman: Well, those relationships are commercial matters for them. I would always expect them to want to get value.

Q631 ***Lord Best:*** Can I ask whether it would have been necessary to form UKFI at all if the 2009 Banking Act had been around when the financial crisis broke and indeed whether, now that we do have the Act, it could be used to transfer your portfolio of

companies for the Bank of England to control and you could then be wound up?

Mr Kingman: Well, I think the answer to your question is that the 2009 Banking Act provides for a variety of routes through which banks can be handled, including a bridge bank managed by the Bank of England, but also including taking banks into public ownership and, in that case, they could either be managed by the Treasury directly or by a company such as ourselves and owned by the Treasury, so the 2009 Banking Act gives the Government the full range of options open to it. As a legal matter, I think the Bank of England could own a bank and I think it could have owned a bank before the 2009 Banking Act, so I do not think the 2009 Banking Act has changed that position, but it has created new routes, such as the ability to run a bridge bank and so on, which did not previously exist.

Chairman: Well, unless there are any other questions, I think we will draw stumps now, and thank you very much indeed for spending some time with us this afternoon; it has been very helpful.

TUESDAY 21 APRIL 2009

Present	Best, L	MacGregor of Pulham Market, L
	Eatwell, L	Moonie, L
	Forsyth of Drumlean, L	Tugendhat, L
	Kingsmill, B	Vallance of Tummel, L (Chairman)

Examination of Witness

Witness: ALASTAIR CLARK, former Adviser to the Governor, Bank of England, examined.

Q632 ***Chairman:*** This afternoon's hearing is the last in the Committee's inquiry into Banking Supervision and Regulation and members have already declared their relevant interests. Welcome to the Economic Affairs Committee and thank you for making time to be here with us this afternoon. Would you like to make any introductory remarks or shall we just kick off?
Mr Clark: I do not think so . . . I received a list of the questions you suggest and am very happy to tackle those.

Q633 ***Chairman:*** Perhaps I could start off. Could the recent financial crisis have been prevented, or at least mitigated, by more effective regulation or supervision of the financial sector or was it just going to happen anyway?
Mr Clark: Perhaps I should just say that from 1997 until 2003 I was the Executive Director in the Bank responsible for financial stability and from 2003 until 2008, with a short intermission when I thought I had retired, I was adviser to Mervyn King on financial sector issues. On the first question, at one level the answer is certainly yes. Obviously if you make regulatory provisions sufficiently onerous you can probably avoid instability, but at the cost of serious impairment of efficiency. Most of the important regulatory judgments are a matter of balancing those two factors: how much are you prepared to pay for incremental increases in safety? Putting that high level observation to one side, there were aspects of regulation within the structure that we did have which may not have been capable of heading off the crisis completely but might have attenuated its effect and might have given us perhaps a bit more time to think about other possible responses.
I am not sure where this would appear in the list of questions, but it seems to me that one issue is not so much the diagnosis, because a fairly broad view has emerged that in terms of identifying the factors which contributed to the crisis most of them were actually identified. What did not happen was that action was taken in response to that diagnosis. That is a question almost irrespective of what regulatory regime you have. If you are not in a position or for whatever reason do not respond to the signals you are being given, then you will not head off the problems.

Q634 ***Chairman:*** Just to clarify a little, you mentioned structure earlier on. Do you think this is a structural issue that things were not pursued?
Mr Clark: I think it is almost a psychological issue. It is a balance between pre-emptive action which in a sense is too early and can unnecessarily infringe on the rights of private owners and managers of firms on the one hand and, on the other, leaving it too late, until you have a case beyond all reasonable doubt, by which time it is almost certainly too late to intervene effectively. The tension between the balance-of-probabilities criterion and the beyond-all-reasonable-doubt criterion is one of the deeper questions to be resolved. How far do you want to be towards the balance-of-probabilities level of proof before you intervene and how far do you want to wait until it is all but certain, in which case there are probably limited options to pursue.

Q635 ***Chairman:*** Which way would you have jumped yourself? Are you a balance of probabilities man or an absolute certainty man?
Mr Clark: I would go about 30 degrees towards the balance of probabilities. I think we have been too far towards the beyond all reasonable doubt end of the spectrum. The counterpart of that is that there has to be an acceptance on the part of the public and, may I say, politicians that it will sometimes mean intervening and infringing rights in circumstances where conceivably things could have turned out all right but where it is not sufficiently clear they would have turned out all right for it to be a safe bet.

Q636 ***Chairman:*** Do you think the reason why supervisors in this case did not nip the problem in the bud was a judgment that they were going to look for certainty? Was this deliberate or was it eye off the ball?
Mr Clark: I am presenting a rather theoretical perspective on what happened. But I am saying that there is this underlying issue all the time and I think there has been an inclination to wait for certainty or as near certainty as is achievable before acting. There were other factors as well. Frankly I am not sure people did entirely spot was going on. What I am saying is that even with an accurate diagnosis, which

in many cases we had, the radar was not connected to the defences..

Q637 ***Lord Forsyth of Drumlean:*** Is it not a bit like being in a car crash and seeing that you are going to crash the car but not grabbing the wheel until you have hit the wall?
Mr Clark: Yes, that is a possible analogy. In those circumstances though I am not quite sure what would deter you from seizing the wheel, but in these circumstances what deters one from acting sooner rather than later is quite properly a concern about unnecessarily infringing normal rights of ownership of property and so on.

Q638 ***Lord Forsyth of Drumlean:*** Yes, but to continue the analogy, there is a wall there. You might not hit the wall but I would be inclined to grab the steering wheel.
Mr Clark: That pushes you towards the balance of probabilities.

Q639 ***Lord Forsyth of Drumlean:*** One of the things which really has puzzled me as we have had the evidence in this inquiry is that people were giving warnings, they could see that banks like HBOS were building huge property portfolios, presumably they were aware that banks were making loans with gearing levels of 90 plus and more. Now people are saying we need to have more regulation but this is not actually a failure of regulation or a failure of powers, it was a failure to use the powers which were available. I cannot quite understand why no-one seemed to reach out to grab the steering wheel when very bright and very able people could see that there was a wall there and they were going off the road.
Mr Clark: I must say I rather agree with you. It is not obvious that the deficiency was lack of powers. There are certain powers which it would have been helpful to have, but even with the powers which existed, if they had been used more determinedly, it would have had some positive effect. Why did that not happen? A whole host of reasons, one of which is the basic point I make that the psychology has been towards waiting until you are absolutely fireproof before acting. If you are seen to act prematurely, you potentially attract all sorts of flak. Another may be something as mundane as self-confidence on the part of regulators. One of the counterparts of having a principles-based approach to regulation is that you have to have people implementing it with sufficient experience and self-confidence to make judgments. If you are not in that position, the tendency is to go for the box-ticking approach and confine yourself to what is actually written down. That may be another reason why people were not prepared to say yes, all the boxes are ticked, but actually it does not add up.

Q640 ***Lord MacGregor of Pulham Market:*** You also said in your first answer that messages were being given, presumably by the regulator and you said "If you . . . do not respond to the signals you are given". Who is "you"?
Mr Clark: The authorities. I am not differentiating between the FSA, the regulators, central banks, Treasury and so on. Messages were being generated internally and messages were certainly coming externally about some of the risks. Collectively there was, for reasons which we could discuss at length, a lack of response and I do not want to point the finger particularly at any one party; it is not particularly productive to do that and I do not think it is the essence of the issue.

Q641 ***Lord Eatwell:*** I want to take up your point about people being a bit nervous about intervening and therefore standing back. One of the things which is built into FSMA is the role of the tribunal and the appeals to tribunals and there is no doubt that the FSA was beaten up a couple of times by the tribunal and became very nervous and there was a general nervous feeling that the tribunal was not on the FSA's side and indeed was not even balanced, was hostile. I am not saying whether that was true or untrue but that was the feeling in the FSA. Would that be your experience as well and would that be one of the factors which were contributing to this?
Mr Clark: Frankly I do not have sufficient case-by-case knowledge of the tribunal to be able to say whether that is a reasonable judgment or not. It very likely is; it may have been one of the factors contributing to a reluctance to intervene, the feeling that they would not get support. It comes back to the point I made; it is fine saying act more promptly, but there has to be willingness on the part of various other parties involved to say "You acted in good faith; actually it turned out to be unnecessary but we are not going to hang you as a result".

Q642 ***Chairman:*** At least one of the witnesses we have seen before came out strongly against principles-based regulation on these grounds and preferred a rules-based approach for the very reason that it would take this psychological problem away from the supervisor. Where do you stand yourself?
Mr Clark: Callum McCarthy was very keen to make the point, and I agree with him, that . it was always a slightly false dichotomy between principles and rules. Even though the FSA was ostensibly pursuing a principles-based approach it still had an 8,000-page rulebook or whatever the number is. So the idea that there was a five-page version of an 8,000-page alternative does not really run. Emotionally I am more towards the principles end because I do not think you can draft rules in a sufficiently precise and a sufficiently timeless way to be valuable over a period;

they are likely to lead to distortions. However, if you do go for the more principles-based approach, then you do need to have people of experience, ability and credibility to operate the system and people who are perceived to be of that kind by those they are regulating.

Q643 ***Lord MacGregor of Pulham Market:*** Like others we have been having a lot of discussion about systemic risk. How important in your view is specific information from the institutions and banks for seeing the growth of systemic risk, for its assessment and its management? Was the Bank's access to this type of information seriously impaired when the FSA assumed responsibility for bank supervision?
Mr Clark: It is important; in fact I think it is essential. First of all it is the raw material for constructing a systemic view. There are some issues here which we should maybe not pursue now—for example the information collected from individual firms is not necessarily in a form which allows the aggregate position to be constructed very easily; the data is incompatible in one way or another. But in principle it is essential to have that information. It is important from the point of view of providing the context for an assessment of systemic risk. It is also important from the point of view of providing local colour, if I can call it that. I do not just mean numbers but actually having a view about why business is evolving in a particular way, what factors are driving it, what the perceptions of risk on the part of practitioners are in doing that business. I would put all of those under the information heading, not just whether we know what the holdings of three-month Treasury bills were on a particular date. All of that is important. It does not necessarily imply, in fact it need not imply at all, that whoever has the responsibility for systemic assessment necessarily collects all that data themselves. Going on to your question about how far the separation of the FSA impacted on the Bank, I do not think it need have had a major impact in this area. What changed in 1997 was not so much that an iron curtain descended between EC2 and E12 or whatever the FSA's post code is. It was that the habit of mind which perhaps existed in the Bank for the supervisors, at least at the senior level, to talk to others became less part of the environment. It required a more deliberate effort. Knowing what questions to ask is partly a function of being at some level involved with the raw material as it comes in and that became more difficult. I do not believe that Michael Foot, who was my opposite number at the FSA through much of this period, and I ever felt that there was any deliberate obstruction or deliberate holding back of information. There may have been isolated incidents but as a general proposition that was not an issue. But it may have been that people in the Bank were less clear about what questions they should be asking. Certainly after 2003 there was, it is now well recognised, a change in philosophy in the Bank about the extent to which we should be looking at individual firms, and reinforcement of the view that this was not really the Bank's territory.

Q644 ***Lord MacGregor of Pulham Market:*** On the point you were making a moment ago about the Bank deciding what areas it should be looking at because it was physically in touch with firms, Mervyn King told us in a hearing with us that he would prefer it if the Bank were given the power to gather institution-specific information for itself, rather than having to rely upon the FSA. I take it you would agree with that.
Mr Clark: I would but the context has changed because that is in the context now of the Bank having an explicit financial stability remit. I am sure you are well aware that one of the debates in 1997-98 was exactly whether to include an explicit financial stability remit in the Bank of England Act and the conclusion at that time was that it was just too difficult to formulate in a way which made sense and was not going to be restrictive. So it was taken out. Now that we have that responsibility in the new Act then the counterpart would be this more formal arrangement to have information provided.

Q645 ***Chairman:*** Could the FSA act as the agent of the Bank in providing the information?
Mr Clark: Yes, I think so. Certainly in the discussions when I was at the Bank the way we envisaged it was very much as a reserve power. Not so much that the FSA might refuse point blank to collect information because they thought it was unwise or unwelcome, but because the FSA might not perceive that a particular kind of data or particular kind of information was relevant to their objectives. To have a reserve power to collect it in those circumstances, because it was relevant to the Bank's objectives, seems perfectly sensible.

Q646 ***Chairman:*** Putting words in your mouth but do spit them out again, is your view then that it would be sensible for the Bank to operate as a principal in asking for information on the macroprudential and the FSA as the agent?
Mr Clark: My view is that it should have the option of acting as principal, if it does not believe the agency route is delivering what it needs.

Q647 ***Lord Forsyth of Drumlean:*** This is all too complicated for me. You are hinting that in order to have proper supervision and to ensure stability you need to have clever people who are well informed and know what is going on. So why would it not be simpler to have the Bank doing that and not involve the FSA at all? Why was it possible to put in

legislation a responsibility for stability now but it was so difficult and complicated back in 1997-98?

Mr Clark: Let me take the two points separately. Why not give the Bank the whole thing? You could do. I do not know what the figure is now but the rough proportion of the FSA's effort that has been spent on prudential regulation is about one quarter or 20%. The other 75% of the FSA's activities are concerned with what in the jargon would be called conduct of business regulation, seeing that people treat customers fairly, looking after the way products are advertised and so on. That is territory where the Bank and central banks generally have never really had any particular locus or any great expertise. You could make a case—and it has been done in the Netherlands and it has been done in a different way in Australia—for having a separate prudential regulator, capital liquidity, that sort of thing. You could make a case for having that in the central bank and that is the situation in the Netherlands, as I am sure you know. There is no knock-down argument against it. But it is a major undertaking: it would involve in practical terms a significant rejigging of the structure and, again, it would involve areas like insurance regulation where there is no great tradition of central bank knowledge or involvement, but it could be done. The notion of doing the whole thing in the central bank, for all sorts of reasons, would be unwise, not least because there are 3,000 people in the FSA and 1,500 people in the Bank and probably a diminishing number in the Bank so it would not be predominantly a central bank.

Q648 ***Lord Forsyth of Drumlean:*** Forgive me but that is the easy answer and no-one is suggesting that. The question is whether it would not be sensible, as far as macroprudential supervision and the ability to deal with institutions are concerned, for that to be clearly the responsibility of the Bank and that they should have the ability. That is what I am finding it difficult to understand, what the arguments are against that.

Mr Clark: I do not think there is a knock-down argument against it and the fact that it has been done in other places suggests it is perfectly possible to do it. But it is not actually a sure-fire recipe for an improvement in the arrangements. I am not sure thisquestion, whether it is the FSA, whether it is the Bank, doing regulation is really the nub of the issue in terms of what has gone wrong over the last two years or the period running up to that. I must say I would be nervous about getting too fixated on structural change of that kind as a remedy for what has happened. It might have some contribution to make but I would not be totally confident and I do not think it is a critical contribution amongst the other factors which have been involved.

Q649 ***Lord Best:*** A number of commentators have said that, because the Bank took seriously its responsibilities for monetary policy, after 1997 fewer resources, including particularly human resources, were then devoted to issues of financial stability. You were just saying that 1,500 people work in the Bank and you know the answers from the inside. Was there a switch of resources, a diminution in resources in terms of manpower devoted to financial stability issues?

Mr Clark: May I just step back a pace? In 1997 before the new structure came into effect, the Bank had four areas: monetary policy, market operations, what was called supervision and surveillance, which was the line supervision function and an area called financial structure, which was the area for which I was the executive director. When the supervision and surveillance function was cut out and transferred to the FSA in 1997-98 we actually expanded the financial structure bit quite substantially and Eddie was quite keen that we should do that. Over time we came to some balance of views about how far that should go. Everybody was very conscious of the need not to duplicate or second-guess things which were then being done by the FSA but equally it was driven by the point we were just discussing about the need to have first hand information about what was going on in the markets. That did change to a degree in 2003 because Mervyn took a different view about the appropriate scale and scope of that activity. I cannot remember the numbers but I would guess that the function which began in 1997 as financial stability was probably around 100 people. It went up to around 150, 160 maybe, in 2002 and then came down again over recent years to probably 120 or 110, something like that. It did not all cut one way. The emphasis on monetary policy post 1997 did not in itself lead to a massive reduction in the effort going in other areas.

Q650 ***Lord Forsyth of Drumlean:*** You made a speech in Beijing in 2006; I do not know whether you remember it. How important do you think the shift from the originate-and-hold model to the originate-and-distribute approach to lending business was? Did the Bank and other regulatory bodies have enough information to evaluate the consequences of this shift

Mr Clark: I am trying to remember what I said in 2006. The answer to the question of substance there is yes, I do think it makes a difference. I would not pretend for a second that all the implications were identified but one of the implications which was identified was the question of whether the originate-and-distribute process and the enormous growth in the use of credit derivatives, particularly credit default swaps, did not act to impair the overall quality of credit risk assessment in the financial

sector. The argument is a very simple one, that in the traditional banking model a lender on the whole would keep in touch with the borrower and would maintain some sort of dialogue with the borrower about the state of their finances. On the other hand, in the originate-and-distribute model the people who end up holding the credit risk often have a very distant or no relationship with the borrower. Unless you put some pretty strong posts in the ground to lean against that it will very likely lead to an erosion of credit risk assessment capacity and quality. We have seen that borne out. A report was written in about 2003 by the Committee on the Global Financial System in Basel about the implications of credit risk transfer. This was one of the concerns highlighted in that report. It is a broader version of originate- and- distribute issue, the point being that the capacity to transfer credit risk to remote parties with no direct relationship to the borrower does potentially cause concern. And the people who were arguably supposed to provide a substitute credit assessment, the rating agencies, fell down on the job.

Q651 ***Lord Forsyth of Drumlean:*** That is what you said in Beijing, you said it should be monitored. You also said that the shift was important but you were pretty ambivalent about the scale of the problem and you gave four reasons why disintermediation in the credit markets was not as far-reaching as a casual reading of the figures appeared to suggest. Everything is easy with hindsight but this made me wonder whether the Bank really had sufficient information to evaluate the consequences of a shift which was deliberately taking place.

Mr Clark: Let me just put the positive side; I am sure it is familiar but let me put it anyway. The great plus about the capacity to transfer credit risk is that if you are a bank with a set of customers predominantly concentrated in a particular area or a particular industry, the capacity to dispose of some of that exposure and acquire exposure in another area, another industry, is in principle a useful thing to be able to do; it is a way of diversifying risk. There are benefits potentially. The question is whether it can be done in a way which does not erode the quality of credit assessment generally. In fact there are various ways of doing that, one of which is actually to insist, and this is being suggested again now, that the originators should retain part of the exposure themselves so that they do have some skin in the game. Things of that kind are certainly elements of a potential package of measures in the future. The other point to make is that in 2006—I cannot remember the numbers but certainly when we wrote the report in 2003—the total of credit default swaps outstanding had just passed one trillion. It then grew pretty well exponentially, so I would think that by early 2006 it was probably eight trillion or something like that. Before the roof fell in it was 60 trillion, so there was a vast expansion in the outstanding amount.. What might have seemed an open question in the mid 2000s was not an open question by the time we got to 2007-08.

Q652 ***Lord Tugendhat:*** I should like to ask you two questions. One is one which I have asked a number of people. Do you think that it is possible for one institution to have responsibility for monetary policy and for bank supervision, whether microprudential or macroprudential, for two reasons, one is that it faces a conflict of interest potentially because it might be unwilling to raise interest rates if that compromises supervisory objectives. The other because there is so much odium attached to banking supervision that that would contaminate its capacity in fulfilling its monetary objectives. I wondered what your view of that would be. You were at the Bank of England when it was getting a lot of stick over various regulatory issues.

Mr Clark: In principle both points have some force. On the conflict-of-interest issue first, yes, there could be. I must say I am a bit doubtful though about how important this really is. The classic example of a case where you can argue whether or not action was taken for self-serving reasons, the classic example of tweaking monetary policy to respond to regulatory concerns, was the US in the 1980s with Latin American debt where there was some reasonably clear evidence that the Fed was cautious about raising interest rates until the banks had sorted out their balance sheets. What that instance of the US in the 1980s does illustrate quite well is that to cry conflict of interest is not a knock-down argument for separation of responsibilities. If there is a genuine conflict of interest, the issue is not that, it is how to resolve it. What is the mechanism for resolving it? There may well be a tension between different policy objectives. The issue is: what is the institutional and decision-making structure within which you try to resolve it? I do not think it is obvious that alternatives to having it done within a single institution are necessarily preferable. If we go back to the US in the 1980s, if the Fed had aggressively pursued a policy of raising interest rates when it saw inflation threats and if the result had been that a number of the US major banks had gone bust, I suspect somebody would have wanted to strike a different balance. The question is: who does that? So in terms of conflict of interest—Yes, there may be but I do not think that is necessarily an absolutely convincing case for institutional separation. Fallout? Again, I think there can be. It was said after Barings, for example, and said after BCCI, that this was impairing the credibility of the Bank. There is something in that. If the general perception is that the institution is damaged, it probably does have some impact on the credibility in

monetary policy terms. But I would not attach enormous weight to that either. I think it does have some weight, but it is not an absolute killer argument. The more telling thing in a way is a practical point and that is that if the top management are simultaneously struggling with supervisory and monetary policy issues, there are only 24 hours in the day and there is a real question about the capacity to give due emphasis to the different components. As you will know, in circumstances where there are institutions under stress, it is a potentially serious call on resources.

Q653 ***Lord Tugendhat:*** A question which I do not think we have asked before but maybe I was not here. Do you think, again from your vantage point, the fact that so many of the players in the financial services industry in this country have their headquarters outside this country has had any significant effect in any direction at all as to the capacity of the supervisor to supervise?
Mr Clark: Taken cold, the answer must be yes, it does have some effect. That is the rationale, of course, for all the time and effort that have gone into developing international understanding, MoUs, colleges of regulators and other structures to deal with banks operating in a number of different countries. Without that, yes the capacity would be seriously undermined. You have to have that sort of infrastructure to support the individual national regulators if you are going to have substantial cross-border businesses. The area where it is all the more difficult is in crisis management. One dog which has not barked in the current crisis and something which concerned me was that countries would find it politically difficult to provide financial support to firms when a significant part of that financial support was actually sustaining operations in countries outside their home base. I say the dog which did not bark because the Americans have been quite free in providing support to Citibank et cetera without trying to carve out the portion of their business which was in the United States from the portion which was outside. We could have reached a situation where people said they could not justify spending US or German or whatever taxpayers' money sorting out the business of a financial firm outside their territorial boundaries. That did not happen. The question of financial intervention to resolve a problem and so-called burden-sharing is still unresolved. It has worked out okay this time but looking to the future one would like to think there was a better articulated framework in place.

Q654 ***Baroness Kingsmill:*** Do you think that liquidity should be more carefully regulated in the financial sector? What sort of regulations do you think would be appropriate?
Mr Clark: The answer to the first part is yes. In fact liquidity was very much the country cousin to capital regulation and one could say, and indeed it was said with justice, that the time and resources which were deployed on Basel II were actually unhelpful because the whole of this vast machine was deployed on developing ever more detailed refinements of capital requirements against different categories of business, and perhaps not thinking about what other elements of prudential regulation mattered. One of them clearly was liquidity regulation. The difficulty with liquidity in contrast to capital is that whereas the standard way of looking at capital would be to look at the default experience of loans made to particular sectors, come to some view in the light of historical experience what a normal default rate on that exposure was likely to be and therefore what level of capital it would be reasonable to hold if you wanted to have a chance of surviving in 99 out of 100 years or whatever criterion you wanted to set, the problem with liquidity is that it is, in the jargon, endogenous. A firm will remain liquid as long as other people are prepared to buy its IOUs. If you can persuade people to buy your certificates of deposit or put money with you on deposit, you can carry on for ever. But the question of when people will lose confidence is not something to which it is at all easy to apply statistical techniques.

Q655 ***Baroness Kingsmill:*** It sounds rather as though you think it is impossible to regulate.
Mr Clark: The "capital" approach is attractive in principle and worth pursuing, indeed I can say we have pursued it in the Bank but without really being able to take it to a point where one felt confident about the quantitative results. The fallback position is to say we do not know what precisely the level of certainty is but we want to insist that banks have plausible contingency plans against pressure on their liquidity. That may be in terms of holding a particular quantum of government assets where you are as sure as you can be that they are going to be acceptable for discount with the central bank. It might be, although this is obviously less certain, through having secure credit lines from other banks, but there is a circularity in that because everybody cannot prop up everybody else. However, you are left with a kind of menu of rather scrappy options and have to say what you are going to look at is how a bank puts these together into an overall contingency plan for dealing with liquidity pressures. That is probably about the best you can do at present.

Q656 ***Baroness Kingsmill:*** This conservative approach, this cautious approach to liquidity which you are suggesting could be seen to limit innovation and entrepreneurialism, could it not?

Mr Clark: I am not sure why it would do that in itself. How conservative or how aggressive it is depends on where you set the numbers. If you insisted, as we did 30 years ago that banks should hold, I think it was, 28 per cent of their balance sheet in a rather narrow group of liquid assets, that is conservative in the sense that it is narrow but it is not conservative in the sense that it is a pretty draconian requirement. You can impose quite stringent requirements even with relatively simple instruments. I think it is possible to be somewhat more flexible but, as has been pointed out on a number of occasions in the press, as against 28 per cent or whatever the number was it is now down to one or two, which is probably a little low.

Q657 ***Baroness Kingsmill:*** The collective memory of this current crisis is going to tend towards caution, is it not?
Mr Clark: Yes and no doubt that is a good thing. But it is of course a wasting asset.

Q658 ***Lord Eatwell:*** I have little bits and pieces of questions really but the first point I should like to ask is that you mentioned a couple of times 2003 as a benchmark in which the policy of the Bank changed. Could you elaborate on that a little bit?
Mr Clark: Nothing more elaborate than the fact that Eddie stood down and Mervyn became Governor and they took different views on a number of things -I do not think one is unequivocally right or wrong—including the proper extent of the Bank's involvement in financial market, financial stability issues. I know Mervyn has appeared before you and no doubt made this point. He is very clear that to have responsibilities without instruments is not a good place to be and it is quite true that in the rather fuzzy, ill-defined financial stability context which existed post 1997 there were no very clearly defined instruments. One of your questions was about instruments and we shall perhaps come on to that, but whatever one says, the framework was not clear and to be held to account in the way that the original MoU in theory required was unrealistic.I do not know whether you are familiar with the 1997 version of the MoU but it says in the introduction to one of the early paragraphs that the Bank will be responsible for the maintenance of the stability of the financial system as a whole and in this context, one, two, three, four, five, six. Read literally that is a completely impossible remit to have. Even if you had all the instruments you could not be responsible for the financial system as a whole; and that was certainly true with a rather ill-defined set of instruments which in many cases amounted to not much more than talking about problems. All that is by way of background but just to say that Mervyn felt firmly that to have responsibility without the instruments to discharge it was unwise. In fact we did amend the MoU in 2006 to say instead of "have responsibility for" "will contribute to", which makes it somewhat easier. Even so we are left with the question of instruments and the argument since then has been about whether one can specify instruments which would maintain financial stability more convincingly.

Q659 ***Lord Eatwell:*** Some clarity has been introduced by the Banking Act which made financial stability a key objective; I must say I thought it always had been but there we go. It set up this Financial Stability Committee which is an entirely internal committee of the Bank. In his review Adair Turner has argued that committee should have been a joint committee with the FSA and the Bank. I was wondering whether, in institutional terms, you had a view as to whether things had been clarified by the Banking Act and whether Adair Turner's case is a strong one.
Mr Clark: It would be optimistic to say that it has been entirely clarified. In a sense I am the wrong person to ask because I did not draft the current legislation but I think the notion that underlay it was that in parallel with a separate objective one should try to reproduce the monetary policy framework of decision making. Now of course that falls at the first hurdle because the FSC is not an executive group, it is an advisory group, whereas the MPC is obviously an executive group. But I think that was the basic notion. Could it be helpful as an advisory group? It could in principle but then it requires that appointments to Court provide a sufficient pool of people with expertise and knowledge to contribute to the debate. The Court has been shrunk quite significantly. I cannot remember how many people are supposed to be on the FSC, but let us say four or five, so at least half the outside members of court will have to be people with a fairly strong financial background. This may not be a bad idea. One of the questions about the composition of Court over recent years has been whether there were enough people with a financial background. I do not think that is necessarily pushing in the wrong direction. But there is this point, which is a well-known issue, of finding people who are knowledgeable but not conflicted. You want to get people on the Court who are knowledgeable and in the past we had a number of people who were current practitioners. But it is quite difficult in some circumstances to see them being able to function even in an advisory capacity. I cannot remember the words in the Act precisely but I think one of the sub clauses refers to offering views on individual situations or individual firms. I find it very difficult to see how that can be squared with having a current practitioner involved.

Q660 ***Lord Eatwell:*** It is how the old regulatory system worked. The Securities and Futures Authority was all practitioners.
Mr Clark: It depends what they are being asked to do. It is one thing taking a view on the rules and the framework. It is a different question if you are talking about response to a particular problem. Of course you can do whatever you like, but there is an issue about the consistency of that.

Q661 ***Lord Eatwell:*** One other aspect of Adair Turner's report. One thing he makes a major issue of is that the theory of financial markets and the theory of regulation are wrong. He just says this. He says it in an efficient markets hypothesis and you have to see the whole thing and there is a tremendous focus on microregulation at the end. If the regulators on the FSA side or in Basel had an incorrect theory in their heads about what was going on, was that incorrect theory shared by the Bank? Indeed, just to take it beyond Adair Turner's point, Alan Greenspan said the same thing about the Fed, that their theory of risk management was wrong. Do you think that incorrect view was also characteristic of things in the Bank?
Mr Clark: I am not sure what the theory was. Just before coming onto that, you asked about the jointness of the FSC with the FSA. In a sense we have already had that because the FSA have been *de facto* if not *de jure* a member of the internal financial stability committee anyway. But if one were to formalise it and pitch it at a higher level, it would raise a question about what the tripartite group was supposed to do. That was supposed to be the forum for pooling views about the functioning of and the risks in the financial system. On the theory question, I am not quite sure what theory we are talking about. Were the focus of regulatory thinking and the construction of capital requirements defective? Yes, in some ways they were. They were defective partly because they focused too much on the individual firm in isolation and did not give sufficient weight to the aggregation of those firms into the system. If one were redesigning the structure, that is something you certainly would want to remedy. But I do not really understand what is meant by the theory more generally. Obviously there are major questions about whether the mathematical models that were used were half as reliable and useful as the enthusiasts maintained, partly because they were estimated on data sets which were far too short, partly because the structure in the financial sector is changing all the time so it is very difficult to pin down the parameters, but also because it is just genuinely difficult to model, especially these confidence effects. The over-emphasis on mathematical models has been one of the factors but I am not sure, in terms of a new grand theory, what either Adair or others have in mind beyond recognising that some of the assumptions that underlay the existing arrangements were false.

Q662 ***Lord Moonie:*** Can a macro-prudential supervisor be effective without a policy tool?
Mr Clark: I think it can have some effect. I know that this is perhaps a slightly unfashionable view. It depends in a way how explicit the policy tool has to be. I do think that conveying clear messages on the basis of analysis can have some effect on how people behave and on people's thinking. But there is always this dilemma that if you are too strident you are in danger of precipitating the problem you are trying to avoid. If you tell everybody that the commercial property market is about to bomb, then you will very likely encourage a decline in the commercial property market. Part of the art of conveying financial stability messages is to put up a clear signal without causing alarm and that is one of the challenges that you face without another instrument. What the debate now probably needs to focus on is that, if short-term interest rates are hypothecated to delivering an inflation target, in other words that is one instrument and one target, what other policy instruments could we deploy to deal with excessive credit growth or some other financial stability objective? We do need to find such instruments and one of the principal areas of debate now is about the nature of those other instruments and which ones are likely to be most effective. Is it some kind of adjustment to capital requirements, is it some changes in the collateral arrangements and what firms have to put up for various kinds of transactions and so on? It is clear that while short-term interest rates can only be expected to deliver one target, they can nevertheless affect other targets including financial stability. To the extent you cannot address those effects through short-term interest rates, which by hypothesis you cannot, you have to find some other instrument to tackle them.

Q663 ***Lord Moonie:*** How do you think information exchange between the tripartite authorities should be managed? Are the current arrangements for information sharing adequate? There has been some suggestion from other witnesses that information flow is sometimes poor.
Mr Clark: I was a member of the tripartite committee of deputies for some ten years and I do not think we ever felt there was a major problem of that kind. In any case it would not be sensible to think about information exchange, transfer, through the medium of a committee as being the principal conduit. To my mind the key thing is to develop a habit of mind amongst the staff of the FSA, staff of the Bank and staff of the Treasury, to the extent they want to be involved; a habit of mind of talking, discussing developments with their opposite numbers just as a

matter of course. Trying to get to that position seems to me far more likely to lead to a free exchange of information than trying to formalise some committee process. We have tried to develop that approach and I think with some success. To be honest, initially in 1997-98, there were some sensitivities. There was, as is well recognised, a concern that the Bank might be trying to hang on to some of its responsibilities, that it wanted to keep its finger in various pies that it should keep out of and so on. Those sensitivities have pretty much gone; in fact I think they have gone. There is no sensitivity of that kind now and it seems to me that the objective should be to develop a habit of mind amongst the different tiers of all three organisations.

Q664 ***Chairman:*** We are going to leave the domestic issues of the UK for a moment and look at the global scene. Perhaps you could tell us how you think the international coordination of macroprudential supervision is best managed. Is the new Financial Stability Board which was announced in the G-20 communiqué the right way of doing it? Can an international supervisory body ever be effective if its role is entirely advisory?

Mr Clark: On surveillance first of all, there are several groups, starting with the IMF itself, who are engaged in global surveillance at present. My general comment on it is to say that I am sure you could improve it, but it is back to this issue of connecting the radar to the defences. The context in which some of the recent problems arose was actually fairly well identified but I think the priority is to reinforce the follow-through to action. That is one of the intentions in the revamping of the FSF into the Financial Stability Board, to give a bit more push. As I am sure everyone is aware, however, this runs into all kinds of national, legal and other constraints where people are bound by law to do certain things in relation to their national financial markets. The FSA for example has some objectives defined in terms of UK markets and likewise elsewhere. It is quite difficult to envisage an arrangement whereby some central body can insist that others do this, that and the other. You can try over time to encourage people to reach a similar understanding about what objectives are reasonable and how they can be pursued, but I do not think we are at that point yet. My feeling is that to try to jump from where we are now to an arrangement with a highly centralised body would be unwise because I think you would just get stuck.

Q665 ***Lord MacGregor of Pulham Market:*** What is your view of the recommendations in the de Larosière report for improving EU supervisory arrangements? How would that fit in with wider international arrangements?

Mr Clark: I thought a lot of the diagnosis in the de Larosière report was very much on the nail I must say; it was a good report and it identified quite a number of the factors and was quite realistic about what had gone wrong. Some of it is expressed in slightly vivid terms but it was a perfectly reasonable critique of what had gone wrong. I do part company with it though in terms of the proposals for revamping and strengthening European arrangements. I was looking at the report again over the weekend and there is a lot of talk about committees and liaison, et cetera, et cetera. The danger is that it becomes bogged in process again. To my mind reinforcing the college approach, which is one of the things they do suggest, trying to make that work well, could actually deliver quite a lot. Trying to do a few things better is better than trying to redesign the whole thing from the ground up because there are too many elements of the picture which are still not sufficiently clear and still not sufficiently widely agreed for that to be feasible. There is another more general issue though which is that you have this triumvirate of the fiscal authority, the central bank and a regulator and all three of them need somehow to be brought into the picture. The problem we have in Europe is that there is no actual or potential centralised fiscal authority. I cannot remember where it was, but there was some suggestion that in order to be credible in providing financial support across the Community to banks in difficulty, the centralised budget would have to be 20 to 25% of GDP in the Community as opposed to two per cent or whatever it is now. It is of a completely different order. The difficulty is that there is a centralised central bank, not for the EU but for the euro area; you can conceive of having some institutionally centralised regulatory arrangements; but you would not have a matching fiscal authority. As we have seen vividly over the last few months, the fiscal authority potentially has a critical role to play. There is a real question around whether national fiscal authorities would be happy to go into bat on the basis of a judgment from a centralised authority, a regulatory authority, over which they had little or no influence. In terms of improving regulatory coordination, yes, there are things to do; in terms of homogenising the rules, within reason there are things to do. When it comes to maintenance of financial stability, particularly while we have this fragmented fiscal position, it really has to fall back to the national level.

Q666 ***Lord Tugendhat:*** I remember when Eddie George was governor he quite often—and I cannot remember which particular case, it must have been at the time of BCCI or something like that—used to make speeches in which he pointed out that if you are going to have a vibrant and effective financial services sector people had to be able to fail. He used to dwell

on that theme quite often. I think he was right but could that apply now or have we reached a point where in practice nobody can fail?
Mr Clark: I do not think the no-one-can-fail proposition is really quite that. I think what Eddie had in mind and certainly what I have in mind is that we should avoid disorderly failures. In other words, if you have a process which leads to an orderly wind-down of a bank which is bankrupt that is fine; indeed one needs to have that. What you do not want to have is some disorganised failure with all sorts of unpredictable consequences and the potential for many other firms to fail at the same time. So there is not necessarily a conflict. I do think however that there is an issue about the scale of some financial firms. I would not rule out, in the debate about where we go from here, the view that some firms are just too big—not too big to fail or too big to rescue but just too big in relation to the economy—and indeed, as has been pointed out, in relation to GDP in the UK financial intermediation as a whole has gone up by a factor of three over the last ten years measured by gross balance sheet size. There is an issue about whether the financial sector as a whole and some individual institutions are just too big.

Q667 ***Lord Tugendhat:*** We could stay here all night and I do not want to do that but just let me pursue that. Surely there are three parts to that: one is the question of size; the second is the question of whether size is something which has been a characteristic of the institution for a long time, such as HSBC for instance, or something very recently acquired such as Royal Bank of Scotland for instance; the other point is that it may not be a question of too big to fail, it may be a question of too complex to fail. Lehman was not very big but it certainly managed to create havoc when it did fail.
Mr Clark: That is perfectly fair. I characterised it rather crudely. One can nevertheless ask in relation to all of those cases whether one possible remedy is just to say that actually these firms are too big or they have too high a concentration of business of a particular kind.

Q668 ***Lord Forsyth of Drumlean:*** In your earlier remarks you said that you were on the committee of deputies in the tripartite committee.
Mr Clark: Yes.

Q669 ***Lord Forsyth of Drumlean:*** We have had evidence that the principals of the tripartite committee have only met once in the run-up to the crisis since it was established. Was I wrong to draw any conclusions from that? Why was it that they had only met once?
Mr Clark: There has been a little confusion on this. They did only meet once from 1997 up until I do not know when precisely but let us say 2004-05. It is not true that they had only met once when we got to 2007; the principals were in more or less continuous session.

Q670 ***Lord Forsyth of Drumlean:*** Yes, once we had the car crash, but it does seem strange that this tripartite group did not meet at principal level.
Mr Clark: Yes, that is a fair observation. I think it is recognised that for all sorts of reasons, including simply the individuals getting to know each other better, it would have been helpful to have more exposure.
Chairman: That is a good point to draw this session to a close. Thank you very much indeed for spending time with us; it has been extremely useful.

Written Evidence

Memorandum by Dr. Kern Alexander

1. UK banking supervision and regulation has come under intense scrutiny as a result of the credit crisis. Before the credit crisis, UK banking supervisors and their practices were universally esteemed and their regulatory regime of principles-based regulation was emulated across many countries. The credit crisis, however, has exposed major weaknesses in UK banking supervision and regulation. It is the purpose of these written comments to set forth the main principles of prudential bank regulation and supervisory practice, and to comment on the weaknesses in the UK regulatory regime which contributed to the recent financial crisis.

Banking and Prudential Regulation

2. The role of banks is integral to any economy. They provide financing for commercial enterprises, access to payment systems, and a variety of retail financial services for the economy at large.[1] Some large banks have a broader impact on the macro economy by facilitating the transmission of monetary policy and making credit and liquidity available in difficult market conditions.[2] The integral role that banks play in the national economy is demonstrated by the almost universal practice of states in regulating the banking industry and providing, in many cases, a government safety net that compensates depositors when banks fail and lender of last resort facilities for banks when they have difficulty accessing credit and liquidity.[3]

3. The main rationale of prudential bank regulation has traditionally been the safety and soundness of the financial sector and protection of depositors.[4] A safe and sound banking system requires the effective control of systemic risk.[5] Systemic risk arises because banks have an incentive to underprice financial risk because they do not incur the full social costs of their risk-taking.[6] The social costs of bank risk-taking can arise from the solvency risks posed by banks because of imprudent lending and trading activity, or from the risks posed to depositors because of inadequate deposit insurance that can induce a bank run.[7] Systemic risk can also arise from problems with payment and settlement systems or from some types of financial failure that induce a macroeconomic crisis.[8] Prudential regulation and effective supervision therefore aim to reduce the social costs which bank risk-taking creates by adopting controls and incentives that induce banks to price financial risk more efficiently.[9]

4. Prudential regulation mainly includes capital adequacy requirements, asset composition and concentration rules, fit and proper standards for bank officers, senior management and board members and internal controls for bank operations. Effective supervision involves surveillance of individual bank risk-taking along with overall leverage levels in the financial system. It also involves enforcement actions which can take the form of authorisation and licence revocations and administrative penalties and civil sanctions imposed against firms and individuals who violate regulatory rules. Capital adequacy has attracted the most regulatory attention in recent years because of the adoption of the Basel II international capital adequacy standards. UK capital adequacy rules are found in the *FSA Handbook* and derive through secondary legislation from the EU Capital Requirements Directive (2006), which implements Basel II into EU law.[10]

1 See M. Dewatripont and J. Tirole, "The Prudential Regulation of Banks", (1995) (MIT Press, Cambridge, MA) 17-18.
2 See J. Hawkins & P. Turner, "Managing foreign debt and liquidity risks in emerging economies: an overview", pp. 8-9, *BIS Policy Papers* (Sept. 2000) http://www.bis.org/publ/plcy08 (last accessed 15 Jan 2009).
3 See J. Stiglitz, "Principles of Financial Regulation: A Dynamic Portfolio Approach" (Spring 2001) 16 *World Bank Research Observer* 1:. 1-18, 1-2.
4 See T.L. Holzman (2000) "Unsafe or Unsound Practices: is the Current Judicial Interpretation of the Term Unsafe or Unsound?" 19 *Annual Review of Banking Law* 425-54.
5 See E.P. Davis, *Debt, Financial Fragility and Systemic Risk* (1995) ch. 5, (Oxford: OUP).
6 The social cost of bank risk-taking can take the form of a general loss of confidence by depositors in the banking sector (bank run) which will force banks to sell off their assets at prices far below their historic costs. Also, a defaulting bank's uninsured liabilities to other banks or financial institutions can serve as a source of contagion that can create substantial losses for other banks whose unfunded exposures to counterparties derive from the original defaulting bank. Bank risk-taking therefore creates a negative externality for the broader economy that provides the major rationale for banking regulation. See F.S. Mishkin (2004) *The Economics of Money, Banking and Financial Markets* (7th ed.) pp. 271-74 (Pearson, Addison-Wesley, UK).
7 Under-priced financial assets can result in imprudent lending and trading activity for banks and lead to increased solvency risks.
8 See Dewatripont and Tirole, above n. 1, 23-24
9 J. Eatwell and L. Taylor (1999) *Global Finance at Risk chap.1.*
10 EU Capital Requirements Directives (2006).

5. Basel II's main aim is to make bank regulatory capital more sensitive to the economic risks which individual banks face, while ignoring the larger social risks which bank risk-taking poses to the financial system. Basel II permits banks to use their own economic capital models to measure credit, market and operational risk and to estimate lower levels of regulatory capital than what regulatory rules would normally require. An important weakness of Basel II is that fails to address liquidity risk, which precipitated the present credit crisis, and allows banks to hold lower levels of regulatory capital for assets which banks securitise into special purpose vehicles in the wholesale debt markets. Moreover, another weakness of Basel II is that it is procyclical because regulatory capital calculations are based on the riskiness of assets on the bank's balance sheets. Rather, regulatory rules should impose counter-cyclical capital requirements, such as higher capital charges during an asset price boom and lower charges during a market downturn. Prior to the credit crisis, the FSA had implemented the Capital Requirements Directive which incorporated Basel II principles into the UK regulatory regime. This contributed to the under-capitalisation of the UK banking system and exposed the broader financial system to systemic and liquidity risk that arose from excessive risk-taking in collateralised debt obligations that originated from US subprime mortgages. The FSA has acknowledged its mistakes in its 2008 review of its handling of the Northern Rock collapse and has published a paper containing liquidity risk management principles for UK banks. Despite this progress, UK banking regulation still suffers from many of the flaws contained in the CRD and Basel II. It is now time to amend substantially Basel II and the CRD based on principles that recognise the true social costs posed to the financial system by bank risk-taking.

6. In addition, effective supervision and regulation require banks to have robust corporate governance arrangements that incentivise bank management and owners to understand the risks they are taking and to price risk efficiently in order to cover both the private costs that such risk-taking poses to bank shareholders and the social costs for the broader economy if the bank fails.[11] Corporate governance plays an important role in achieving this in two ways: to align the incentives of bank owners and managers so that managers seek wealth maximisation for owners, while not jeopardising the bank's franchise value through excessive risk-taking; and to incentivise bank management to price financial risk in a way that covers its social costs. The latter objective is what distinguishes bank corporate governance from other areas of corporate governance because of the potential social costs that banking can have on the broader economy.[12]

7. Major weaknesses in UK bank corporate governance have resulted not only in substantial shareholder losses, but also have contributed significantly to the significant contraction of the UK economy, which has, among other things, led to massive layoffs in the financial services industry and related economic sectors and dramatically curtailed the availability of credit to individuals and businesses. Most UK bank senior managers and board members did not understand the risky business models that drove UK bank lending and which led to much higher levels of leverage in deposit banks and investment banks. Moreover, they failed to grasp the true risks which their banks' risk managers had approved based on faulty value-at-risk models that were used to determine credit default risk and market risk. Equally important, they allowed irresponsible compensation packages to be awarded to bankers which incentivised them to book short-term profits based on excessively risky behaviour which increased systemic risk in the financial system and weakened the medium and long-term prospects and profitability of the bank. Moreover, weak governance contributed to the poor performance of banks and in some cases to their failure and bailout or nationalisation by the government.

8. The UK regulatory regime should establish new corporate governance standards that cover most areas of bank management, including controls on remuneration that are linked to the long-term profitability of the bank, while foregoing short-term bonuses. The FSA should exercise the power to approve bank director appointments and ensure that bank directors have the knowledge and training to understand the bank's business and risk models and its financial implications not only for the bank's shareholders, but for the broader economy. Bank management should be required to understand the technical aspects of stress-testing, which the regulator should require to be done on a much more frequent basis than what was done prior to the crisis. Essentially bank corporate governance regulation should focus not only on aligning the incentives of bank shareholders and managers, but also on aligning the broader stakeholder interests in society with those of bank managers.

[11] H. Mehran, "Critical Themes in Corporate Governance", (April, 2003) *FRBNY Economic Policy Review*; see also, J. Macey, and M. O'Hara, "The Corporate Governance of Banks" (2003) *FRBNY Economic Policy Review*, Federal Reserve Bank of New York, 91-107.

[12] Moreover, it should be noted that regulatory intervention is necessary to address the social costs of bank risk-taking because the regulator is uniquely situated to assert the varied interests of other stakeholders in society and to balance those interests according to the public interest.

[13] See Consultation Document of the Bank of England, HM Treasury and the Financial Services Authority (FSA) "Financial stability and depositor protection: special resolution regime" (July 2008). See UK Banking Bill 2009, discussed below.

Bank Special Resolution Regimes

9. The social costs that banks pose for the economy also demonstrate the need for a special resolution regime for banks that provides a legal framework for the regulator to decide whether to attempt to save a bank by recapitalisation or other restructuring pre-insolvency, and if this fails, to oversee in insolvency the unwinding of the bank's multiple positions and to sell off its viable assets to other banks or investors.[14] For many countries, including the UK,[15] ordinary insolvency law procedures have applied to the administration and liquidation of a failing bank. Generally, corporate insolvency law applies an elaborate framework to rank the economic claims of creditors and other stakeholders against a firm which is unable or unwilling to honour its financial obligations. Insolvency law may prove socially costly, however, for certain firms, such as banks, because insolvency procedures may result in restrictions on a bank performing its essential function as a financial intermediary in the economy.[16] The inadequacies of general insolvency law to address the risks which banks pose to the broader economy has led many countries to enact special bank resolution regimes.

10. An important element of these resolution regimes is that they permit the regulator to take certain measures pre-insolvency which may alter or reduce shareholder rights and the claims of third parties in order to protect depositors in the weakened bank and to maintain overall financial stability. The rationale for a pre-insolvency intervention regime is that the regulator should have the authority to take certain measures in response to a rapid loss of market confidence which may result in the bank losing access to the short-term inter-bank loan market and wholesale capital markets which may result in increased systemic risk in the banking system. Through regulatory intervention, a market-based solution may become possible. If a market solution is not possible, however, the intervention may be the first step by the regulator or central bank taking control of the failing bank and transferring its shares and other property, including contractual rights and obligations, to a state-owned bridge bank or a private purchaser. Further steps may involve the bank being declared insolvent and being subject to administration or liquidation.

11. The credit crisis of 2007–09 has demonstrated the importance of bank special resolution regimes and the need to balance the competing interests of shareholder rights with the regulatory objectives of financial stability and depositor protection. The constraints of corporate insolvency regimes can be too cumbersome for effective resolution of a banking enterprise, especially during a financial crisis when a failing bank needs to maintain open lines of credit with other financial institutions and to manage its balance sheet while achieving regulatory objectives. Bank resolution regimes must be designed not only to protect shareholders and creditors, but also to achieve other regulatory objectives that are vital for the efficient operation of the economy. The UK Banking Bill 2009 contains a special resolution regime that seeks to achieve these objectives by granting the Treasury and the Bank of England sweeping powers to restructure a failing bank and to transfer its shares and property to a government-owned bridge bank or to a private purchaser. Although the stabilisation regime provides a comprehensive framework for bank corporate restructuring and insolvency, it suspends corporate governance rules for shareholders and thus interferes with shareholder rights. This raises important issues under EU company law and the European Convention on Human Rights regarding the protection of property rights and interests in a bank that is undergoing restructuring to achieve regulatory objectives.

The UK Tripartite System

12. The UK Tripartite System was established by a legally non-binding Memorandum of Understanding in 1998 that was designed to provide flexibility to the FSA, the Bank of England and the Treasury to coordinate their regulatory interventions and systemic oversight in times of crisis. Although the Chancellor chaired the tripartite bodies and exercised ultimate decision-making authority, there was no clear delineation of responsibilities between the three for acting in a financial crisis. The FSA, the Bank and the Treasury had only committed themselves to consult and there was no clear procedure for determining how the bodies would act in a banking or financial crisis and who would take what decisions. The Tripartite Arrangement failed to work effectively in the summer of 2007 when Northern Rock failed and had continuing difficulties in its operations until the Banking Act 2008 was adopted that established stronger legal grounds and procedural rules for the Tripartite system's operations. Presently, the Banking Bill 2009 reinforces many of the reforms that were made to the Tripartite system's operations in 2008. One weakness, however, which should be remedied is the Banking Bill's creation of a Financial Stability committee which is chaired by the Bank of England. Membership of the committee is composed of two of the Bank's deputy governors and representatives from the Treasury, but there

[14] See Consultation Document of the Bank of England, HM Treasury and the Financial Services Authority (FSA) "Financial stability and depositor protection: special resolution regime" (July 2008). See UK Banking Bill 2009, discussed below.

[15] See Consultation Document of the Bank of England, HM Treasury and the Financial Services Authority (FSA) "Financial stability and depositor protection: strengthening the framework" (Jan. 2008) 2-4.

[16] For instance, insolvency law may result in a stay on payments and a balance sheet freeze, which would make it difficult, if not impossible, for the bank to rely on the wholesale funding markets and to manage its counterparty exposures through netting.

is no representation from the Financial Services Authority on the Committee. It is necessary to have the FSA as a member of the committee for the oversight of systemic risk because we have learned in the credit crisis that systemic risk can arise not only from individual banks (which the FSA regulates), but also from the broader wholesale capital markets (which the FSA also regulates). Therefore, the FSA should be given statutory authority to supervise both individual institutions and to oversee the broader financial system (ie., wholesale capital markets) to ensure against systemic risk and other threats to financial stability.

February 2009

Memorandum by the Association of Chartered, Certified Accountants

We noted with interest the recent session of the Economic Affairs Committee's inquiry into Banking Supervision and Regulation. In particular, we were interested to hear the comments of your witness Mr. John Varley, Chief Executive of Barclays, on the role of "mark-to-market" accounting methods in the credit crunch.

The Association of Chartered, Certified Accountants (ACCA) support the concept of fair value and do not believe that accounting caused the financial crisis. Accounts are intended to inform shareholders on the affairs of the company, rather than to provide a financial stability tool for regulators.

There are certainly many questions for the standard-setters relating to issues of fair value. Above all, the crisis has shown the urgent need for clarification on the purpose of accounts so that expectations from different stakeholders can be met. But the International Accounting Standards Board should never again be put in the position of having to abandon due process under political pressure. That way lies the demise of much-needed global standards.

For your interest, we have attached ACCA's recent paper on Fair Value[17] in which we outline the key issues and discuss the future role of accounting. The key arguments of the paper are outlined below:

- Fair value is transparent—all information, good or bad, is out in the open and fair value is the only realistic method of accounting for derivatives and getting them on the balance sheet.
- The extent of the optional use of fair value has arguably been too wide. This has made the accounting for financial instruments harder to understand, comparability between entities even within the same sector has been diminished and it has probably increased the use of less reliable values. IASB should not allow further classes of liabilities to be stated at fair value, beyond those currently permitted.
- ACCA does not believe that fair value accounting is a cause of the banking crisis. The calls for its suspension can be seen as trying to sweep the problems under the carpet, which would, if allowed, risk undermining the remaining confidence in the financial system.
- The IASB could use the financial turmoil as an opportunity to establish definitively its long-delayed conceptual framework for financial reporting. The fair value crisis has shown the need for clarification of the purpose of accounts so that expectations of stakeholders are appropriately set and a clear framework established for the improvement and application of standards.

ACCA is the global body for professional accountants. We aim to offer business-relevant, first-choice qualifications to people around the world who seek a rewarding career in accountancy, finance and management. Globally, we support our 131,500 members and 362,000 students throughout their careers, providing services through a network of 80 offices and centres around the world.

We are working with our partners in the financial sector to provide key thought leadership on many aspects of the credit crunch and the regulatory response to the ongoing difficulties.

We would be happy to discuss these issues further with the committee at a time of your convenience.

March 2009

Memorandum by P R E Double, Remembrancer, the City of London Corporation

This letter responds to the Committee's call for evidence as part of the inquiry into banking supervision and regulation.

The City of London Corporation aims to promote and reinforce the competitiveness of the UK-based financial services sector by tackling issues which may impact upon the open, efficient and competitive environment for doing business. In the current economic climate it is clear that constructive collaboration is required between authorities and industry, but the City Corporation also believes that industry must be proactive in seeking to improve the situation before solutions are imposed. Confidence in the financial services sector's ability to generate growth has been dented and the business community is aware that maintaining the status quo in terms

[17] Not printed here.

of banking supervision is no longer a realistic option. Some adjustment to the regulatory framework is therefore inevitable.

Whilst the City Corporation is not in a position to respond specifically to the questions posed by the Committee, I thought the Committee may wish to have notice forthcoming research commissioned it has with the London Investment Banking Association (LIBA), and other stakeholders focusing on the effectiveness of enforcement and capital market regulation in different countries. The aim of the research, due for publication at the end of this month, is to contribute to the debates, stemming from the sub-prime crisis, on the recent and ongoing developments in capital markets and moves by some regulatory authorities to consider mutual recognition of comparable regulatory regimes. The research attempts to shed light on the magnitude of market and regulatory failures which have prompted reconsideration of the approach towards regulation of the capital markets. It also challenges regulatory authorities interested in reaching mutual recognition agreements to assess other regimes on the basis that they deliver broad equivalence in terms of outcomes, and avoid defaulting to measures of regulatory inputs. More specifically the study will aim to identify the links between enforcement and regulation, the cost of raising capital, and listing decisions. I will ensure a copy is forwarded to you as soon as it is published.[18]

10 February 2009

Memorandum by the CBI

1. The Confederation of British Industry (CBI) is the national body representing the UK business community. It is an independent, non-party political organisation funded entirely by its members in industry and commerce and speaks for some 240,000 businesses that together employ around a third of the UK private sector workforce. The CBI's membership includes 80 of the FTSE 100, some 200,000 small and medium-sized enterprises (SMEs), more than 20,000 manufacturers and over 150 sectoral associations.

2. The CBI welcomes the opportunity to respond to the House of Lords Economic Affairs Committee inquiry into banking supervision and regulation.

The tri-partite structure

The tri-partite structure failed its first real test…

3. The Tri-partite structure introduced to oversee the financial system, when supervision of banks was transferred from the Bank of England to the Financial Services Authority, failed its first real test.

4. The model was designed so that the FSA supervised individual banks, the Bank of England would deal with the stability of the financial system as a whole, and the Treasury provided the taxpayer funds.

5. The Northern Rock crisis exposed failings around communication and co-ordination, which were inadequate to cope with the decisions that needed to be made. In addition, there were problems regarding the depositor protection scheme, uncertainties around any proposed interaction with the EU's Market Abuse Directive, a flawed bank insolvency regime, and limited powers to deal with banks in distress.

But the structure is not inherently flawed and lessons have been learnt since the events concerning Northern Rock from 2007…

6. The primary structure itself whereby the responsibilities are allocated across the three bodies is not fundamentally flawed nor fundamentally at fault. However, clear problems have been observed with the responsibilities themselves, the exercise of those responsibilities and the communication between the different organisations, together with the leadership role to be played in a crisis situation. There have been a series of reviews and consultations since the Northern Rock episode which have set out the principal issues and the recommended solutions.

Enhanced co-operation, communication and clarity around the different roles and responsibilities is required…

7. One of the main findings from the investigations into the treatment of Northern Rock was the need for enhanced co-operation and communication. Further clarity as to how the different responsibilities would be split between the component parts of the tri-partite is essential. In particular it needs to be clear who will lead in different crisis situations. The FSA has appropriately issued a consultation paper about its responsibilities moving forward.[19]

[18] Report received but not printed here.
[19] CP08/23 "Financial Stability and Depositor Protection: FSA Responsibilities", December 2008

8. There continues to be much discussion at a European and Global level about supervisory co-operation, particularly with respect to cross-border institutions. As recent events have demonstrated very well, banks may be international in life, but are very much national in death, and so a concrete and clear UK functional structure is essential.

9. One key area for debate is whether it was appropriate to separate the monetary and supervisory responsibilities of the central bank. Given that supervision is a key instrument in the maintenance of financial stability, depriving the central bank of this instrument makes the pursuit of the goal of financial stability more difficult. The creation of a new role at the Bank of England to deal specifically with Financial Stability should be beneficial and should be followed by further clarity on its responsibilities and how they fit within the tri-partite structure.

Competence of regulatory supervision and investor/non-executive oversight

Banks have become incredibly complex organisations…

10. During the past decade the financial system has increased in its complexity, with a rapid growth in the use of derivatives (particularly credit derivatives), off-balance sheet financings through Special Investment Vehicles (SIVs) and use of securitisation (approximately tenfold increase in amounts outstanding in the last decade). Complex investment banks continued to push more of their business into trading books rather than the banking books. They tended to over-produce complex instruments, over-trade, especially through proprietary trading, and focus on the accumulation of assets at all costs.

This increase in complexity poses added challenges for risk management, and for senior management, non-executives and investors in overseeing the business model…

11. Boards and non-executive management have come under increasing pressure as the financial crisis has evolved for failing to exercise sufficient oversight and control. Surveys have shown a lack of risk and core banking expertise in senior positions, and this has led to an inability to provide sufficient checks and balances.

12. Lessons to be learned from the crisis include the need for management to have an increased focus on appropriate risk management controls, implementing appropriate systems, and developing an ability to question the outputs from complex mathematical models conditioned on recent benign history.

13. Investors too have an important role to play in actively scrutinising business models, and in determining if they stand up to robust challenging on issues such as risk and leveraging.

Regulators need to up their understanding of the businesses they are regulating…

14. It is a perennial challenge for regulators to keep pace with the firms they are trying to regulate. A big factor in the success of London as a financial centre has been its ability to innovate, and the introduction of a principles-based regime for regulatory supervision was in part designed to be an antidote to the tendency for clever people to find ways around a system of rules.

15. There are three main constituents of employers in the financial markets: the firms themselves, the advisers to the firms (lawyers, accountants, consultants etc) and the policy makers/regulators. Not surprisingly, the firms and advisers have historically been able to offer the most competitive remuneration packages, which have helped them attract the brightest and best talent.

16. As part of its response to the financial crisis, the FSA has explicitly stated a need to reinforce the number, quality and expertise of its personnel.

The global nature of the financial crisis suggests a failure of execution rather than a failure of structures and regulation…

17. There are many arguments for a fundamental overhaul of the structure of the regulation oversight regime (see comments on the Tri-partite structure above). However it should be borne in mind that the financial crisis is not simply a UK problem, and it is not just the "UK model" of regulation that failed.

18. Across the world a variety of different models (single peak, twin peaks, functional, organisational) of regulation have been operating over the past decade, and none have stood up well to the current crisis.

19. There are a range of senior management governance models in operation as well. These include the UK approach, the German twin board structure or the mechanisms in US, Australia or the Far East. In all cases there have been problems, and there is no single right answer to organisation structure in firms, management, investors and regulators.

20. All of which suggests that the response to the crisis should focus on the failure of execution of the roles and responsibilities of the constituent parts, rather than the inherent design of the structures themselves.

Remuneration

Any changes to executive remuneration in response to the financial crisis should focus on aligning incentive structures with long-term performance…

21. The financial crisis has once more put the spotlight on executive pay, with particular attention focused on the extent to which the City bonus culture has promoted short-termism and "excessive" risk-taking. The UK's ability to attract global talent is a critical ingredient in its success as a global financial centre, and competitive remuneration packages will continue to play a significant role in this.

22. Equally, the CBI has a well-established position on, and is unequivocally against, "rewards for failure".

23. The FSA's approach outlined in its "Dear CEO" letter on remuneration, linking firms' regulatory capital requirements to excessive risk incentives in remuneration structures appears a sensible way forward, and the CBI is supportive of moves to align incentive structures with long-term performance.

Capital adequacy regulation

Basel 2 and the EU's Capital Requirements Directive was not the cause of the financial crisis…

24. The development and implementation of the Capital Requirements Directive has been a lengthy and resource-intensive process for firms, advisers and regulators. It has resulted in the current approaches to capital adequacy, and to some improvements in the core infrastructure for managing risks.

25. Basel 1 was widely acknowledged to be inherently flawed and arguably encouraged some of the creative financial engineering that was a contributory factor to the crisis, such as off-balance sheet financing, a shift from banking book exposures to lower capitalised trading book exposures, and an increase in securitisations and risk transfer products. Basel 2 sought to address some of these flaws, including a more detailed focus on significance of risk transfer, liquidity facilities and risk-based lending.

26. Given that Basel 2 was not in operation for much of the time leading up to the global financial crisis it is wrong to say that it was to blame for the crisis. But it has since been found to constrain firms' ability to respond to the crisis, and in some cases has reinforced the downturn.

But the capital adequacy rules need to be reviewed and amended to address these flaws…

27. Further improvements that are required to capital adequacy rules include:

The need to tackle the pro-cyclicality of capital requirements…

28. The Basel 2 prudential capital has been known to be pro-cyclical for a long time. This was a prominent issue during the development process, and certain adjustments were made to soften the impact of changing economic circumstances. The difficulty is to develop an approach that is counter-cyclical in spite of the natural human tendency of bankers to be pro-cyclical anyway (ie the boom/bust cultural mindset encourages certain forms of lending).

29. It should be possible to learn from the experiences of Spain which has operated a form of dynamic provisioning since 2000. This system is not counter-cyclical in that it did not prevent the build-up of excessive lending (Spain still had an extensive exposure to property lending and a big property crash). However, it has left the large Spanish banks seemingly in a better position to withstand some of the impacts of the financial crisis.

The need to separate fair value treatments from prudential capital…

30. Fair value is simply a better measure than the alternative mechanisms for accounting, namely cost accounting. Given the issues with establishing fair values over the past 18 months due to the illiquid markets, then the clarification and guidance on valuation issued by the IASB[20] is welcome. Future developments and examination of fair value accounting should be done in a considered manner, with international co-operation and consistency to reach international standards.

31. There is a need to separate accounting treatments (prepared for the capital markets and owners of businesses) and the prudential regulatory requirements associated with firms operating in the banking system. For banks, given that the natural human tendency is to exacerbate the boom/bust cycle, a prescriptive mechanism for allowing capital buffers to be built up during the good times to allow them to be eroded in the bad times is necessary.

32. It is very difficult to determine the state of an economic cycle and to judge one's position within the cycle, and therefore the mechanism for introducing counter-cyclicality should be determined analytically and automatically to avoid undue dependence on management judgement. Reducing capital during bad times will be difficult to convey to analysts and will require increased confidence in the competence of regulators.

Improvements to capital requirements for the trading book…

33. It is generally accepted that the internal models based approaches to the calculation of trading book capital requirements have been shown to be inadequate during the crisis of the past 18 months. The Basel Committee has been working on improvements in this area, particularly on the calibration of a so-called "incremental risk charge" to capture the risks associated with illiquid markets.

The FSA did aim to ensure that banks followed the Basel standards and guidelines…

34. The FSA has been one of the most open global regulators in terms of the degree to which it communicated, consulted and engaged with the industry in terms of its implementation of the Basel framework through the European Capital Requirements Directive (CRD). This policy of engagement and consultation should continue.

Conclusion

The future shape of financial regulation must be robust and internationally consistent…

35. In determining the future shape of the UK financial regulatory architecture, and banking regulation in particular, the overarching objectives should be to develop robust regulation to restore confidence in the system, to ensure it is within a consistent international framework, and that it does not damage the UK's historic strength as a global financial centre. Our key recommendations are to:

- Ensure clarity of leadership, roles and responsibilities within the Tri-partite structure to ensure that it is fit for purpose for business as usual and future crises;
- Focus on ensuring the competence of all those in a supervisory capacity: regulators, non-execs, senior management and investors, to provide appropriate oversight and challenge;
- Deliver a competitive remuneration framework which enables the UK to attract global talent, whilst further aligning incentive structures with long-term performance; and
- Build on the technical and infrastructure developments in risk management to evolve prudential capital regulation for the next decade, learning from the lessons of the current crisis.

February 2009

[20] IASB Expert Advisory Panel "Measuring and disclosing the fair value of financial instruments in markets that are no longer active", 31 October 2008

Memorandum by the Council of Mortgage Lenders

Introduction

1. The Council of Mortgage Lenders (CML) welcomes the opportunity to submit evidence to the Economic Affairs Committee inquiry into banking supervision and regulation.

2. The CML is the representative trade body for the residential mortgage lending industry. Its 137 members currently lend over 98% of the residential mortgages in the UK mortgage market.

3. We have grouped our answers to the questions raised by the Committee under several heading in the interests of clarity.

Counter-cyclical regulatory measures

4. Financial systems have a strong tendency to act in a pro-cyclical fashion, and it is this pro-cyclicality, the so-called credit cycle, that is at the root of the current financial instability. Although some banks have proved to be more exposed than others, the current crisis is systemic in nature, and the solutions will need to be system wide.

5. We agreed with the Governor of the Bank of England when he stated that, if monetary policy is to remain focused on achieving the objective of price stability in the goods and services market, another policy instrument is needed to control asset prices and monetary aggregates. Although he did not define what such an instrument might look like, it seems clear that it should involve the control of credit creation and therefore is likely to directly affect financial intermediaries (banks, building societies and other suppliers of credit), given their pivotal role in the creation of broad money, in a manner that acts to smooth the credit cycle.

6. One policy measure that explicitly aims to control banks' exposure to risk over the cycle and may help to smooth the credit cycle itself is dynamic provisioning, which has been a regulatory requirement in Spain for some time. This requires banks to build up general credit loss provisions when the economy is performing well, which can then be drawn upon in times of economic distress. Dynamic provisioning is an accounting approach which is designed to improve banks' ability to weather the cycle. But it also has the advantage that, by reducing the amount of banks' capital that is available to support new lending in an upswing, it controls the level of bank capital available to support new lending in a way that could smooth the credit cycle. Policy makers could consider such an approach which, if implemented, would come into effect only once the next cyclical upswing was underway.

7. Regulators will need to ensure that mechanisms to control excessive credit creation address the entire financial intermediary sector rather than just regulated deposit takers. In the US in particular, non-deposit taking institutions were a major source of growth in credit in the last upswing. While non-deposit takers can play an important positive role in the financial system, the so-called originate and distribute business model is typically more pro-cyclical than the on-balance sheet banking model. This is because it operates on lower capital requirements and because of its tendency (in the US) to recognise profits from lending immediately upon origination, which can lead to a rapid growth of lenders' capital in upswings.

8. It is important that regulators also take account of the changes in the structure and business model of financial intermediaries. For example, there has been a shift from the traditional on-balance sheet banking model, where loans were held to maturity at book value less any impairment charge, with the profit accruing over the life of the loan, to intermediation via securities where capital and profit fluctuate in line with the market value of the securities. Although institutions that use the latter model should have greater liquidity, since their assets are in theory sellable at short notice, their level of capital is likely to be more volatile and regulators should take this into account when considering the right regulatory capital framework going forward.

9. Regulators need to understand that the "intermediation by securities" model outlined above creates the risk of "positive and negative feedback loops" (virtuous and vicious circles) because a rise in the value of the securities creates capital for lenders, driving further lending, with the process working in reverse when securities prices fall. Thus, as we have seen since summer 2007, the supposed liquidity that securities offer may not always provide the benefit that might be supposed. By comparison, a traditional bank loan book is highly illiquid but this can actually support stability because it prevents the kind of destruction of capital through mark-to-market losses at a systemic level that we have recently seen.

10. This is not entirely an accounting issue because some financial intermediaries, such as whole loan sellers, hedge funds and structured investment vehicles (SIVs) are, by the nature of their business models, mark-to-market. It is their model that requires them to mark their book to market prices rather than the accountants—

for example, a hedge fund must determine the value of its investors' stake with regard to current market prices. But where the lender's business model is one of hold to maturity, it seems perverse to impose fair value (mark-to-market) accounting. For example, in the US there was a dramatic reduction in the value of Fannie Mae's equity capital in early 2008 on a fair value basis which undermined confidence in the institution. Yet Fannie Mae's business model is to hold its mortgage assets (mainly in the form of securities) to maturity.

Regulators appreciation of systemic risk

11. Regulators in the UK and elsewhere did not devote sufficient resources to understanding the global financial system and how it had evolved in recent years. It was clear that the total amount of leverage in the system had increased substantially and that the system had become substantially more complex. However, the implications of these developments were not properly analysed and, as a result, regulators, particularly in the US, gave the impression of being relaxed about systemic risks.

12. The banking crisis, and the failure of the authorities and other observers to foresee it, has important lessons for regulators. The lack of depth of analysis of innovation in the global financial system seemed to result in a general acceptance by regulators that innovations in risk assessment and wholesale financial market instruments were capable of dispersing and mitigating risk, allowing the system to operate with greater leverage. Traditional warning signs, such as excessive growth in lending, broad money aggregates and asset prices were not given sufficient weight.

13. While the exceptionally long period of economic growth and stability in the world economy from the mid 1990s to 2007 encouraged private agents to form excessively optimistic expectations, it also appears to have dampened the healthy scepticism that might have been expected from regulators and central banks.

14. As part of any enhanced analysis of the financial system, regulators do need a thorough understanding of that part of financial intermediation that takes place outside of the formal banking system. This so-called shadow banking system is made up of entities that are explicitly supported by banks (as SIVs usually were) and others that are independent, such as leveraged hedge funds, but all tend to have commercial relationships with banks. While the authorities will no doubt explore which additional regulations are needed for such entities, they will need to consider any proposals carefully and not rush to judgment before a full and thorough assessment in consultation with the industry has been undertaken.

The operation of the tripartite

15. It is not clear that the current structural arrangement of the tripartite is responsible for the failure to appreciate the build up of risk in the financial system. However, with the Bank of England having primary responsibility for monitoring financial stability and the FSA responsible for bank regulation, it is vital that concerns the Bank may have on systemic risk are properly incorporated into the regulatory view on individual banks. Strong communication and co-ordination between the Bank of England and the FSA is a necessary prerequisite for this system to work effectively.

16. It seems clear that, in its regulation of banks, the FSA placed far too little emphasise on understanding how stresses in financial system as a whole might impact on individual firms. However, it is not clear that the decisions that were made in respect of Northern Rock for example, once it had signalled difficulties in funding its operations, would have been any different if the Bank of England had been responsible for banking supervision.

Basel regime

17. There are concerns that there is a degree of pro-cyclicality in the Basel II capital adequacy regime.

18. This comes about because lenders' risk models will tend to predict lower risk of credit losses as an upswing proceeds and credit ratings, which also determine capital under Basel II, have themselves exhibited a degree of pro-cyclicality. Regulators need to ensure that Basel II capital requirements operate in a fashion that fully takes account of predicted credit losses across the cycle to minimise the extend of any pro-cyclicality. It is preferable that regulators concentrate on removing any pro-cyclicality rather than undertaking more far-reaching reform of Basel II.

Regulation of specific financial instruments

19. The regulation of specific financial instruments is unlikely to deliver tangible benefits to the financial system but rather will require regulators to tie up scarce resources focused on very detailed analysis of particular instruments when the over-riding lesson of the banking crisis was a failure to understand how, at a system level, excessive risk was building up. One example is provided by securitisation. This technique allows funds to flow from savers to borrowers without having to be intermediated through a bank balance sheet, while allowing the originator of the securitised loans to maintain an economic interest in the loans, but capping its credit risk. This can greatly reduce risk in the system as a whole because the credit and repayment risk associated with the loans to borrowers are no longer managed entirely through banks' balance sheets. Securitisation can thus potentially improve risk management at a systemic level.

20. However, in practice by the mid 2000s, residential mortgage backed securities (RMBS) were increasingly bought by leveraged entities such as SIVs and hedge funds, which took on the credit, maturing mismatch and funding risks that banks had off-loaded through the securitisation process. Thus the risk to the system was not in the design of the instrument but with nature of the purchasers that came to dominate the market. A return to a securitisation market dominated by cash (unleveraged) investors such as insurance companies would help to reduce risks in the financial system in future.

21. The disadvantages of product regulation apply even to so-called complex securities or instruments. The problem comes, as much as anything, in even determining what constitutes a complex security. This point is illustrated by the inquiry's question "Should complex financial instruments, such as credit default swaps, be traded through clearing houses?" A credit default swap is simply an insurance contract on credit losses on a defined pool of loans, which we would certainly not describe as particular complex.

Settlement

22. The clearing of trades through exchanges or clearing houses should be encouraged by the authorities as it can enhance the confidence of market participants and improve transparency and the authorities' ability to monitor markets. The collapse of Lehman Brothers exposed the systemic risks when contracts such as derivatives are cleared directly between the counter-parties.

Regulation of government supported and unsupported lenders

23. The package of measures announced by the government on 8 October and 19 January to support the banking system is already and will continue to have a profound effect on the financial system. We supported these announcements and recognised the need for action to underpin confidence. However, we believe that the government has given insufficient consideration to the unintended consequences on competition in lending markets.

24. Non-deposit taking lenders have been excluded from all the support mechanisms announced to date, including the guarantee scheme for asset backed securities, despite the recommendation by Sir James Crosby that they be included. Smaller building societies have also been excluded from some of the schemes, for example the asset protection scheme which is available only to deposit takers with more than £25 billion of eligible assets. These societies have also been unable to access others schemes such as the special liquidity scheme (SLS) in a meaningful way because of the requirement to post collateral in the form of RMBS or covered bonds. The fixed cost of undertaking a RMBS or covered bond programme makes it uneconomic for smaller lenders to participate. The effect is to put these institutions at a large competitive disadvantage, undermining their ability to compete effectively, and thereby limiting consumer choice. This is especially ironic, given the government's desire to see more lending and its pleas to banks to lend more.

25. We believe that the government should now give urgent consideration to the issue of competition and widen the availability of support to non-deposit takers and smaller building societies. We also believe government needs to give urgent consideration to it temporarily assuming responsibility for payments under the financial services compensation scheme (FSCS). The present requirement that other deposit takers must pay where one fails may work satisfactorily in a normal environment but at a time of systemic stress, it gives rise to an undue burden on deposit takers which risks creating a domino effect that will cost taxpayers more by putting otherwise viable firms at risk.

26. The regulatory system should also continue to apply equally to banks where the government has a stake and those where it does not. It is the government's stated intention to see institutions returned to the private sector and in the interests of a level competitive playing field, regulatory rules should apply equally across the

board. We welcomed the government's initial line, before the announcement of 8 October 2008 that its banks would be run on an arm's length commercial basis.

27. But we are concerned that political as well as commercial objectives have subsequently been imposed on state owned or part owned banks, requiring them to lend whilst keeping down the cost of past lending and to support schemes (unnamed at the time) to help people struggling with mortgage payments despite lenders' existing commitment to repossess only as a last resort. These requirements are not necessarily compatible with the banks' commercial interests. From a commercial perspective, banks need to strengthen their capital positions, reduce risk and ensure that the risks that are retained are properly priced.

28. The banks concerned are likely to find it difficult to manage these conflicting objectives from government. We recognise that the various objectives set out by government are all perfectly legitimate policy wishes but would welcome greater clarity as to how they are prioritised and how they can be implemented without distorting competition.

Conclusion

29. The authorities, both home and abroad, have been effective at addressing the immediate crisis in the global financial system. No doubt they will now increasingly turn to the issues associated with altering the regulatory framework to prevent similar crises in the future.

30. A range of measures could be considered to lessen the risk of future cyclical excesses building up. The authorities could consider whether housing costs can be included in the measure of inflation targeted by the MPC in a fashion that does not add excessive volatility to that series. The list of measures to be evaluated could also include dynamic provisioning and the establishment of units with regulators or central banks dedicated to analysing the financial system in real time in greater depth. The extent to which measures can be agreed on an international basis will have a profound effect on their effectiveness and address the risk of competitive distortions that would arise if they were introduced in only some jurisdictions.

10 February 2009

Memorandum by Experian

Attached is our response to your request for evidence to the Economic Affairs Committee in its inquiry into "Banking Supervision and Regulation". As requested we have focused our response into how better to manage risk in securitised products.

This note provides a brief introduction to Experian, and our qualifications in commenting on this issue given our position as a credit reference agency, an approach to increasing transparency as to the risk in the securitisation markets, and a perspective on developments in the USA.

We see scope for credit bureau data and risk scores to help "thaw" wholesale funding markets for banks by helping to determine the likely future performance of the loan. Studies conducted in the US demonstrate that use of risk scores would have warned of growing default risk in consumer loan portfolios in 2005, two years before rating agency downgrades.

We would be happy to provide more detail on any of these issues if required.

A. About Experian

Experian is a global leader in providing information, analytical and marketing services to organisations and consumers to help manage the risk and reward of commercial and financial decisions.

Combining its unique information tools and deep understanding of individuals, markets and economies, Experian partners with organisations around the world to establish and strengthen customer relationships and provide their businesses with competitive advantage.

For consumers, Experian delivers critical information that enables them to make financial and purchasing decisions with greater control and confidence. Clients include organisations from financial services, retail and catalogue, telecommunications, utilities, media, insurance, automotive, leisure, e-commerce, manufacturing, property and government sectors.

Experian plc is listed on the London Stock Exchange (EXPN) and is a constituent of the FTSE 100 index. Experian has corporate headquarters in Dublin, Ireland, and has operational headquarters in Costa Mesa, Calif., and Nottingham, UK. The Group employs approximately 15,500 people in 38 countries worldwide,

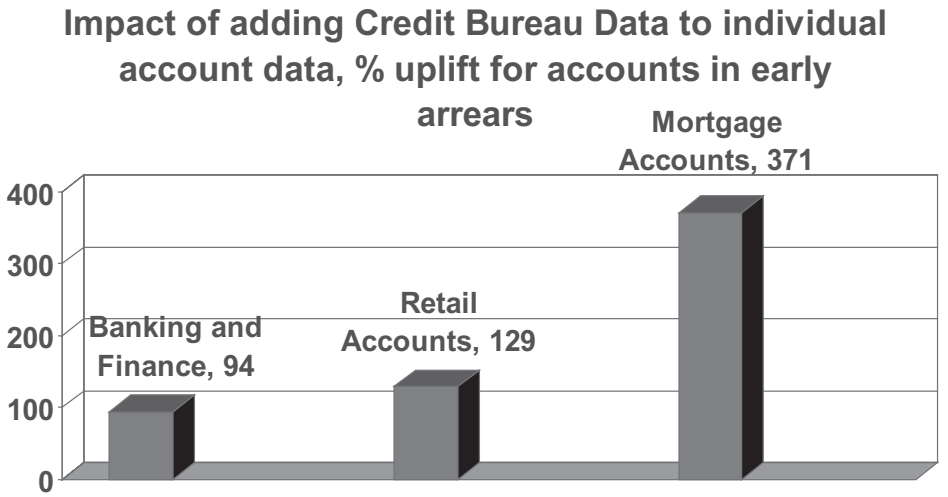
supporting clients in more than 65 countries around the world. Revenue for the year ended 31 March 2009, was c.$4 billion.

For more information, visit http://www.experianplc.com.

B. Credit Referencing in the UK

The UK has three main consumer credit reference agencies. Experian® is one of them while also being one of the world's largest suppliers of information on consumers, businesses, property and vehicles. Its databases bring together data from many different sources—public, proprietary and self-reported by consumers—to provide the basis for informed and timely business and public sector decisions.

Credit reference agencies (or credit bureaus) are fundamentally different from credit rating agencies. Credit reference agencies provide comprehensive information on the credit status of individuals by combining publicly available records with credit account details received from many thousands of credit grantors. Lending institutions (such as banks, utilities and telecommunications businesses) use credit bureau information to verify the identity of those applying for credit and assess their credit worthiness. The ability to bring to bear the full picture of a consumer's borrowing and repayment activities allows organisations to predict loss estimates ahead of lending money. In the chart below, we demonstrate that the addition of bureau data improves the efficacy of a probability of default model by nearly 400% in the case of a mortgage loan.



The credit reference agencies collect data from a variety of sources and crosscheck and match that data for accuracy and veracity. This process of checking against a wide range of sources results in wider coverage and higher levels of accuracy than is achieved in any other non-public UK-wide consumer database. As at March 2009 Experian's CAIS database of credit agreements held information on over 423 million credit accounts from mortgages to mobile phones, contributed by over 400 CAIS members. That data covers accounts that have been both open and settled in the last six years. For open accounts the information will show the balance and utilisation month on month as well as the payment history.

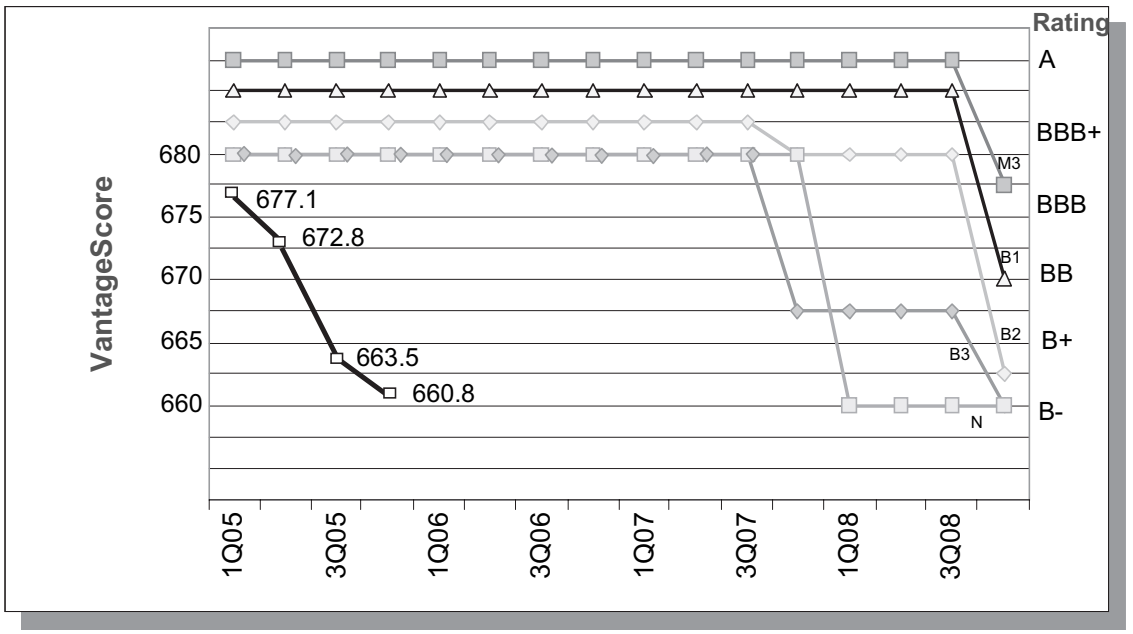
By contrast, our understanding is that credit rating agencies rely largely upon publicly available data and due diligence information prepared by the banks that currently cannot include insight from the credit bureaus, and takes a loan rather than consumer view. In addition, the information tends not to be updated on a dynamic basis.

C. Re-invigorating securitisation markets

Credit bureau data could help to "thaw" the wholesale funding markets for banks by improving the transparency around the underlying risk of the assets, and the borrowers underlying those assets whose credit-worthiness ultimately determines the performance of the loan. There are concerns about the weakness of current risk assessment. Investors are wary of investing in asset backed structures, and uncertain about the value of the assets they currently hold. Restoring confidence will require an increase in transparency and a greater equality of information between banks and investors, so they both understand the credit quality of assets.

To give an example of how transparency could be increased, we have attached the chart below of an actual US-originated security with ratings for multiple tranches as well as the VantageScore risk score (Experian's model for estimating the probability of default of a consumer or loan in the USA). This shows that the use of credit bureau information would have identified worsening risk two years before rating agency downgrades. Similarly, we might expect that rating agency upgrades will lag improvement in the underlying consumers as the economy starts to improve.

Aegis Asset Backed Mortgage Securities Trust: AABST 2004–06



	1Q 2005	*2Q 2005*	*3Q 2005*	*4Q 2005*
Average card balance	$5,900	$7,100	$7,900	$8,800
Probability of default	11.0%	11.9%	13.7%	14.3%
Installment credit delinquency	20%	20%	22%	23%
Credit card delinquency	22%	23%	23%	24%
% with balance > $5k	15%	19%	21%	22%

— Coloured lines show five different tranches of the security, and actual agency ratings.

— The solid black line at the left shows the VantageScore, a powerful and predictive risk score developed by the three national credit reporting agencies (Experian, Equifax and TransUnion). The table shows key additional risk information on the underlying consumers at an aggregated level.

This worsening risk is demonstrated in several different ways. Firstly the probability of default, measured by a VantageScore (Experian metric which combines a number of risk factors) aggregated from reviewing underlying consumers in the security, worsened by 30% between 1Q05 and 4Q05—warning of significant worsening in credit quality. Average card balances and delinquencies were also increasing each quarter, a sign of higher default risk.

Bureau data adds to the ability to understand and price credit quality for the following reasons. (1) It takes a holistic and consistent view of a consumer's borrowing from the bottom up and over time. This consumer view is much more indicative of the risk of an asset than a loan view, as it shows an aggregated view of individuals' financial commitments, behaviour and debts in the round. (2) The data is up to date and can be monitored on a monthly basis. This avoids discontinuities in ratings that have shocked the markets, because trends can be picked up quickly. (3) A standard approach can be created that would allow investors to compare performance in a consistent manner across asset classes, geographies and institutions.

In the US, the type of information that the credit bureaux hold and could provide on the consumers underlying a securitisation include the following aggregated metrics for each borrower. These could be provided as frequently as daily if required:

1. Credit risk trend and migration.
2. Debt burden, debt capacity, credit utilisation and trends.
3. Historical payment performance and recent trends on other obligations (eg, auto loans, credit cards). Identify borrowers who are starting to encounter financial stress and factor this into predictive risk models and cash flow forecasts.
4. Through predictive analytics, assess the likelihood of default.
5. For loan modifications, ensure that these are being targeted to borrowers most likely to succeed in the modification; target other measures at borrowers likely to default again.
6. Through linkages to other providers, assess property valuation relative to debt balances to establish probability of default.
7. Match the borrower's primary address of record with the property address to indicate whether the property is a primary residence or a potential investment property, the latter which may be a riskier asset.
8. Benchmark the security to similar securities across a broad range of predictive and descriptive analytic metrics to facilitate valuation and pricing.

In the UK, while the data held by the bureaux is similar, there are different restrictions on the use of the data. Commercial bureau data is available, however consumer data is restricted to members of the 400 strong closed user group as established under the Principles of Reciprocity. These rules are not derived from the Data Protection legislation but the representatives of the members of the shared credit databases held by the credit bureau of which Experian's is called Credit Account Information Sharing (CAIS). Credit reference agencies may currently only provide information on total market activity and that data may only be segmented by certain high level profiles and post codes. Performance data (ie, payment and arrears) on specific pools of assets (anonymised and then aggregated up for the pool) is not currently permitted to be disclosed to organisations outside the closed user group.

In addition to the credit bureau Experian operates the Geo demographic profiling systems such as Mosaic and the Financial Strategy segments system mentioned in the report at exhibit 1.19 (page 31) which can be used to profile those taking and using different forms of credit. Indeed, Experian has done significant amounts of analysis work to support Government's work on financial inclusion using similar profiling tools.

D. Developments in the USA in the securitisation markets

A series of initiatives have been launched in the USA to determine the challenges around the securitisation markets and what it will take to restore those markets. In 2008 the President's Working Group on Financial Markets working with the OCC and the Federal Reserve Bank of New York issued a series of recommendations which included a focus on improving transparency.[21] Following on from that, the American Securitisation Forum, through Project (RESTART Residential Securitisation Transparency and Reporting) has focused on developing those recommendations, and their efforts were commented on by Secretary Paulson in a press release of 16 July 2008.

> "Today's announcement by the American Securitisation Forum is a meaningful commitment from market participants and is consistent with the March recommendations from the PWG. Improved disclosure is exactly what investors need to enhance their risk management practices and to give confidence to market participants. These types of actions should aid the return of the securitisation market and help facilitate additional mortgage credit in the longer term."

Essentially, those recommendations focus on creating additional, standardised data sets for mortgage backed securities that are accessible to investors and can be tracked on a dynamic basis; key elements of those data sets will be consumer credit scores, as well as additional consumer and loan level data that credit reference agencies currently hold.

[21] "The recommendations offer steps to improve market transparency and disclosure, risk awareness and risk management, capital management and regulatory policies and market infrastructure for products such as over-the-counter derivatives. The statement focuses on changes needed from financial regulators and all market participants, including mortgage originators and brokers, financial institutions, issuers of securitised products, credit rating agencies and investors. The statement also discusses the challenges presented by securitisation and over-the-counter derivatives." US Dept of Treasury Press Release, 13 March 2008.

In addition to these efforts, the US government and government entities have been reaching out to credit reference agencies, including Experian to review the collateral underlying currently held securitisations, as well as support the stress testing activities.

These efforts give some indication that there is a broad recognition of both the importance of improving transparency, as well as the opportunity to use credit reference data to support those efforts.

8 May 2009

Memorandum by the Guernsey Financial Services Commission

This submission by the Guernsey Financial Services Commission (the Commission) focuses on issue 1 of the list of issues included in the call for evidence, namely "Can the regulatory authorities effectively control the risks taken by banks, especially in today's globalised markets? How can the international dimension be addressed?" Please note that the Commission also responded to the Treasury Committee inquiry into the banking crisis—a copy of our response is attached.[22]

1. Key points

1.1 Cross-border co-operation between regulators is essential to the success of global financial services and global financial stability.

1.2 Regulating a subsidiary of a banking group based elsewhere presents particular challenges. The regulator has to be able to rely on information from and co-operation by the regulators of the parent and other important parts of the group.

1.3 Both economic activity and financial services are global in nature. Recent events have emphasised that in order to regulate efficiently, regulators must be able to rely on effective communication with and information exchange from regulators in other jurisdictions.

1.4 In the Commission's view, there are systemic weaknesses in the international regulatory system which need to be addressed in order to provide financial stability and the best protection for all depositors of a banking group.

1.5 All "onshore" and "offshore" financial services jurisdictions are vulnerable to a collapse of the global financial market. The globalisation of the financial services industry means that all financial centres are affected. "Offshore" jurisdictions which are transparent and well regulated do not create inherent risk. Guernsey is not an exporter of contagion in the financial services sector.

1.6 A protectionist approach to regulation, by which each regulator pursues its own domestic agenda, cannot support a globalised industry, or protect consumers effectively—relationships between regulators will only be as good as they are allowed to be by the principles which govern the way that each regulator must act.

1.7 The Landsbanki Guernsey Limited ("LGL") situation is an example of what can happen when cross-border co-operation is not as effective as it might be, and protection of domestic interests is used as a basis to justify the withholding of relevant information and unilateral decision making. LGL was placed into administration on 7 October 2008 as a result of the refusal by its parent to repay deposits placed with it by LGL, and because of the inability of the UK based bank Heritable Bank Limited (Heritable)—itself a subsidiary of LGL's parent bank—to repay deposits placed with it by LGL.

1.8 The Commission has raised with the FSA questions concerning the adequacy of the current approach to and effectiveness of regulatory co-operation in the context of LGL and the future regulation of other Guernsey banks with UK parents and major counterparties.

2. Banking and Regulation in Guernsey

2.1 On 31 December 2008 48 licensed banks from 17 jurisdictions were based in Guernsey. Deposits totalled £157 billion of which approximately £4.9 billion were retail deposits by UK residents. All Guernsey's banks are members of groups based elsewhere. There are no indigenous Guernsey banks. The types of business carried out by the banks include community banking, deposit gathering, international private banking, custodial and sub-custodial services for investment funds, and banking for the trust, fiduciary and insurance industries.

[22] Not printed here.

2.2 The Commission was one of the world's first unitary regulatory bodies and regulates banks, insurance companies, insurance intermediaries, and investment firms. Guernsey is also one of the few jurisdictions in the world to fully regulate trust and company service providers. The Commission has a full range of supervisory, investigative and enforcement powers.

2.3 The Commission regulates banks according to standards established by the Basel Committee on Banking Supervision. These include requirements in respect of integrity and skill, honesty, financial soundness, corporate governance, anti-money laundering and combating the financing of terrorism, record keeping and systems of control. The Commission supervises banks by using a combination of off-site monitoring and on-site inspections.

2.4 Guernsey is a well regulated, open jurisdiction, and has no bank secrecy laws.

3. The Regulatory Challenge

3.1 The Commission has direct recent experience of cross-border regulatory situations in relation to the Northern Rock and Landsbanki groups. In each case we regulated a Guernsey subsidiary, the parent bank being regulated respectively by the FSA in the UK and the FME in Iceland.

3.2 Like other jurisdictions Guernsey is vulnerable to shocks affecting the wider international financial system. It has no central bank or lender of last resort.

3.3 The most effective way to safeguard the global financial services industry is through cross-border regulatory co-operation. Industry, depositors and creditors are linked internationally. There is, therefore, clearly a need for regulators to be similarly linked.

3.4 If regulators do not cooperate effectively to enable each other to make informed assessments, national authorities will have little alternative but to insist that financial services firms based in their jurisdictions must be ring-fenced from external exposures and risks even where those external factors arise within the same group of companies. Such an approach would increase firms' costs and reduce their economic viability and flexibility, thereby curtailing economic recovery and growth. Effective cross-border regulatory co-operation is therefore essential in order to support global financial services and global financial stability.

3.5 International regulatory bodies are working together to make it a priority to enhance and strengthen global financial regulation by individual regulatory authorities, including by achieving greater cross-border co-operation and more efficient and prompt information sharing. For example, the Financial Stability Forum is working to develop supervisory colleges (groups of regulators interested in the same bank or financial services group) and cross border crisis management. Bank regulators are drafting principles for international financial crisis management under which information is to be shared at all times, in both normal and exceptional circumstances, and actions are to be co-ordinated during periods of crisis.

3.6 As Guernsey has no indigenous banks, the Commission is therefore a "host country" regulator for banks from a number of other jurisdictions. As such, it has to deal with several "home country" regulators—the regulators in the jurisdictions where the banks have their main base. Basel Committee requirements provide that home and host regulators must co-operate. The home regulator is in a unique position to assess the strengths and weaknesses of a bank's international operations and will frequently possess greater levels of relevant information and have a deeper involvement with and knowledge of the group as a whole. A 2006 Basel Committee paper states: "These discussions have confirmed the need to develop more robust information-sharing arrangements between home and host supervisors".

3.7 In a crisis situation, there is the danger that a regulator may take the view that protecting depositors in its jurisdiction is more important than co-operating with other regulators and protecting depositors with that banking group's operations in other jurisdictions. If, as a result, a host regulator is not provided with information and is not involved in developing and implementing a strategy to address a problem, it may not be aware of the risks its bank faces and therefore may be unable to provide effective protection for its bank's depositors. Indeed, it is possible that depositors in one jurisdiction may be prejudiced by the actions of a regulator in another jurisdiction, as we believe happened in respect of LGL.

3.8 Cross-border co-operation is an issue facing regulators in all sectors, not just banking. Guernsey has been adversely affected in recent years by problems arising in other jurisdictions relating to Equitable Life, split-capital investment trusts, Northern Rock and LGL. The Commission's Director General has made presentations at a number of international gatherings to explain Guernsey's experience of cross-border co-operation and information sharing.

3.9 The events affecting LGL are an illustration of the Commission's perception of the wider problem. The home regulator for the Landsbanki group (of which both LGL and Heritable are members) is Iceland's FME. However, the FSA regulated both Heritable and a UK branch of Landsbanki Islands hf (Icesave). The UK was also the most important country for the Landsbanki group outside Iceland. As such, the FSA was in receipt of more information and in a far more influential position than the Commission. It was better placed to assess the overall risk represented by the Landsbanki group to depositors in the UK and Guernsey. It was also aware of the extent to which action that it was about to take would adversely affect depositors in a different part of the group. Action was taken to protect UK depositors which was not disclosed to the Commission (at the very time when it was discussing with the FSA measures necessary to protect depositors) and which has had a detrimental effect on the position of LGL depositors.

3.10 In July 2003 the Commission and the FSA signed a Memorandum of Understanding ("MOU") confirming their commitment to co-operate. In the wake of the Northern Rock affair, the FSA reaffirmed its commitment to co-operate and share information, including confidential information. The Commission approached the authorisation and supervision of LGL confident in its ability to rely on co-operation with the FSA in order to be able to protect depositors. It would appear that the Commission and the FSA do not share a common understanding of the effect of the arrangements reflected in the MOU, or of the commitment to co-operate.

3.11 Information available to the Commission raises questions about the effectiveness of the present level of collaboration with the FSA, particularly in respect of matters concerning LGL. The Commission has written to the FSA confidentially under the terms of the MOU setting out its concerns in detail. This correspondence is ongoing, as is correspondence relating to regulatory cooperation in respect of other banks operating in Guernsey.

3.12 In relation to LGL/Heritable, the FSA took action to protect UK depositors, without communicating to the Commission its intention to do so. The FSA's action inevitably prejudiced the interests of Guernsey depositors. The Commission feels that the FSA considered that it was justified in taking action in pursuit of a domestic agenda, in other words looking only at its own position and that of UK depositors, even in circumstances where they will have known that their actions would be damaging to the interests of Guernsey depositors. That the FSA felt able to do so points to a need to overhaul international cooperation between regulators.

3.13 Protectionism has no part to play in the effective multi jurisdictional regulation of international banking groups. Regulators should be required to provide information openly to those other authorities who have a common objective so that each regulator shares a collective responsibility for the depositors and creditors of the wider group.

3.14 Only when individual regulators are judged by reference to this shared responsibility will we have in place an international regulatory system which can, to the greatest extent possible, be relied on by depositors.

February 2009

Memorandum by Peter D. Hahn, PhD, FME/ESRC Fellow[23], Sir John Cass Business School, City University of London

Introduction

1. British banking supervision, regulation, corporate governance, shareholder controlling mechanisms, self-interest, and, indeed, the marketplace all appeared to have failed miserably as the UK approaches the beginning of its third year of the credit crunch and likely the worst year to date. Such a confluence of failure on a national scale should raise serious debate beyond the financial services industry to our failings as a society, but similar failings in other major economies suggests more of a systematic problem that many sophisticated global players failed to observe, anticipate, or respond to effectively. However, whist we are not unique in experiencing the crisis; its causes and effects vary by country. For Britain, a key distinguishing factor worthy of extraordinary consideration is the size and concentration of economic and political power of financial services relative other industries. Corrective actions for current problems and improvement require a combination of international and local efforts. We should avoid blaming failings in other countries for those in our country and we should not expect that corrective efforts in other countries will correct our short comings. Furthermore,

[23] The author is the Foundation for Management Education—Economic & Social Research Council Fellow in Corporate Finance & Governance and benefits from funding from a private foundation supporting business education and HM Government. Prior to joining the Cass Business School in 2004, Pete Hahn was Citigroup's Senior Corporate Finance Officer for the UK based in London where he was also a Managing Director and member of that bank's London operating committee; he also served as consultant to Royal Bank of Scotland for six months ending in 2004. His banking career spanned 1981-2004 without interruption.

calls for international efforts to correct current problems are at best likely to take years, if ever, to agree and implement. Thus, these remarks are focused on issues with British headquartered banks (which may have international activities) and banking activity in Britain with brief international comparison provided where necessary. These responses are also largely focused on the corporate governance challenges of large banks which may be the central issue for banking supervision of the future. This point could not be better illustrated by the dearth of skilled banking executives available for replacement as many bank executives were forced to depart across the globe. Few men or women could be found with the broad investment banking, corporate banking and retail banking experience to replace those who had failed to manage their diverse businesses. The failure of prior executives, and their lack of obvious replacements, strongly suggests that a large number of the world's major banks were unmanageable and raises questions of our banking and governance models. As a result of the crisis, UK banking will have fewer participants, provide reduced credit availability at higher prices, and have questionable competitive aspects in the near term.

Question 1 *Can regulatory authorities control the risks taken by banks (also internationally)?*

2. (a) In large part, UK banking regulation was not designed to control risk but to monitor institutions' risk taking and assess the overall risk of each institution for potential remediation. Fundamentally, this is a retrospective exercise with corrective action only reducing risk or adding safety (eg more capital). It is the board of directors (corporate governance) that sets the risk parameters or strategy of each bank and monitors it on a timely basis. Establishing a regulatory regime to control risk would be at a massive cost and would likely create a severe drag on the economy through bureaucratic, non-commercial delays to decision making. Regulators can do a great deal more to verify that boards elevate risk strategy debate. (b) The international risk dimension of banks is both an economic and political consideration. Economically, there are risks and rewards (eg foreign exposure is at once more difficult to manage but offers diversification and growth opportunities that may not exist in Britain). Politically it is hard to conceive of a trading nation such as Britain without financial outposts overseas to facilitate trade. Yet, should a future British bank fail because a catastrophe in a foreign market how politically feasible is it to ask British taxpayers to backstop liabilities in the foreign jurisdiction(s)? In the current environment, many sophisticated countries will also re-consider the desirability of headquartering international banks in their jurisdictions. The Swiss appear to be consciously reducing their major banks' international liabilities. Only two years ago a few British banks were rumoured to consider moving country for tax purposes; today, it is likely that many a finance minister would block such an arrival due to the cost of provision of central banking, deposit insurance and other back-stopping financing. (c) A major flaw of the banking system to 2007 was that different banks provided different amounts of regulatory capital for similar assets. It is beneficial for financial institutions to perceive risk differently, but it is inexcusable for regulatory capital to be applied differently (see 3(b) below). Regulators can improve their control of this systematic risk flaw.

Question 4 *How can regulators employ people of the right calibre?*

3. (a) Upgrading staffing at regulators must be viewed in the light of the recent past, particularly amongst the Tripartite System, where until 2007 the Financial Services Authority was in the process of reducing its overall staff to reduce its costs (hardly an upgrading exercise), the Bank of England had largely evolved its core activity into interest rate policy (stability functions appeared as an afterthought and low career potential), and the Treasury's staff of civil servants were not expected to have financial services experience (though some staff have been reported to have had investment banking—largely government advisory experience). Similar to the banks regulated, this was another failure of governance with neither the board of the FSA or the Court of the Bank of England having either the appropriate skills or power for their tasks. To address an improvement in regulators employing the "right" people, the oversight of such institutions must first add more skills and be given more power. (b) The current debate on upgrading staff at regulators includes admirable goals of hiring with greater related experience and providing improved pay structures. While these efforts are virtuous and may work in the current job market, they do not assure a continuing in-house up to date understanding in global finance. I suggest that regulators consider a scheme whereby risk professionals from financial institutions rotate through regulators (for a minimum three to five years). "Seconded" risk managers would not review their originating institutions. Details of such a scheme are beyond this discussion, but undoubtedly best practice risk management would spread. A basis for such efforts is the universal agreement that improved risk management benefits all market participants and should not be the least common denominator system currently followed. Such a new system of rotation would not need to be complex, but would likely force regulators to pay risk professionals "market salaries". . . a seemingly worthwhile cost.

Question 5 *Could regulatory authorities have foreseen the banking crisis?*

4. Dangerous, unsupportable levels of debt in sectors such as housing were widely reported in the press. The risk, clearing, opaqueness and massive volume problems of credit derivatives were well known by 2005. So-called off-balance sheet Structured Investment Vehicles (SIVs) issued hundreds of billions of dollars of securities globally and hardly in secret. Few individuals or institutions focused on such risks collectively. In many ways, regulators misunderstood the risks posed by financial innovations or struggled with whose responsibility it was for supervision and action. Yet had regulators decided to take a stand, did they have the political base to overcome the power of world's largest banks? I believe that this was most unlikely and that regulators globally had become the servants of their industry or political objectives more than serving long-term stability goals. By 2007, the economic contributions of banking sectors (employment and taxation) had created much stronger political bases than financial regulators—particularly those regulators whose costs were viewed as a "tax" to reduce by industry participants directly paying to be regulated *(a substantial corporate governance conflict exist when the regulated pay for the regulators' salaries directly)*. For example, only a handful of bank CEOs in Britain and France represented almost one million employees and massive tax bases that could potentially move overseas massively concentrating political power. By 2007, arguably the regulatory system globally had lost its way and didn't have the political strength to make a difference if it wanted to.

What Changes Might Help Authorities Predict Such a Crisis in Future?

The causes of the current financial crisis will be incorporated into regulatory reviews (eg liquidity measures, capital for treasury/trading assets) which should limit a similar crisis repeating itself. The next crisis will arrive from another failing. The only possibility of preventing or mitigating a new crisis is greater understanding of the institutions regulated (and this may require more specialised or limited activity institutions). There is an inherent conflict for regulation as simpler business model institutions with limited diversification (risk concentration) are easier to understand and regulate but have more systematic risk. Thus, large, focused institutions beg restrictive regulation and may force a reconsideration of the desirability of very large banks.

Question 6 *What changes should be made to banking regulations?*

5. (a) To improve governance, consideration should be given to the FSA's running cost being paid by the Treasury and not banks. Government should determine value for money of the regulation and not the regulated. (b) Regulation moved to permit institutions determining their own risk appetites with the market (largely rating agencies) determining appropriate capital levels. Effectively, lower ratings increased bank costs more than regulatory difficulties. *Global regulation's granting greater "governance" to banks occurred without consideration of the governance structures of financial institutions.* This should be one of *two pillars of new focus for regulators:* (1) improving the *governance structure of financial institutions.* Shareholders should have achieved this objective and failed for numerous reasons. It is unclear whether governments, as controlling shareholders, can or have the will to establish improved governance structures, but for most banks governments have become their first "influential" shareholder in decades. The second pillar of new focus for regulators: *risk supervision must be taken back from the rating agencies.* The two major rating agencies provide opinions and narrowly; the Basel II regime accorded ratings agencies too much weight in the regulatory process. National regulators need to dominate this space.

Question 8 *Did the FSA ensure that banks followed the Basel standards and guidelines?*

6. There are three Pillars to Basel II and virtually all regulators and supervisors globally focused on Pillar I (quantitative measures) whose failings are now well known. Regulators largely did not focus enough on Pillar II (subjective judgements) which provided the power to look at corporate governance and incentive structures, for example. Positive steps under Pillar II are being implemented now; however, it is unlikely that the FSA could have succeeded in pursuing such an agenda prior to 2007 without substantial political ramifications. Frankly, banks would have complained and politically defeated such efforts.

Question 11 *Are bank directors, especially non-executives, in a position to exercise effective oversight? In particular, do they have sufficient understanding of the complex assets held by banks? If not, can any changes be made which will ensure effective oversight?*

7. The crisis has exposed numerous failings at regional and global banks' boards, particularly their understanding of their institutions. My research shows that few banks had any non-executive directors with any banking experience and this remains inexcusable and a legacy of another age. It is also a major weakness and flaw in our corporate governance codes. Whilst industrial experience is often transferable at the board level, lack of "financial institutions" experience cannot be compensated for at the board level. Bank boards to 2007 were unlikely to have understood their institutions' businesses and risks further questioning how they established management remuneration and could judge achievement. Part of the regulatory supervision process should be to establish and strengthen risk and banking knowledge on the board (and how it keeps up to date). Failures or deficiencies in such knowledge should require greater supervision and higher capital levels from regulators (penalties). A bank without board understanding of banking risk poses systematic risk. I suggest that regulators require a minimum of banking and risk expertise amongst non-executive directors. In a private paper written for Chinese regulatory authorities in early 2008, I recommend that a minimum of two bank experienced directors for smaller banks and three for larger banks be considered. Such directors should also form a board "banking committee", meet more regularly than the average board and attend annual updated risk seminars at regulators. They should also have superior remuneration.

Do Any Other Governance Issues Need to be Addressed?

Regulators should focus on a number of governance issues (and question their process regularly). Amongst these are (a) board access to key employees such as risk managers, (b) does the board have any of its own staff or is it CEO dependent, (c) how strong is the risk function and conflicts with business areas, (d) staff turnover, (e) types and forms of remuneration for all employees, and (f) the drivers of senior management remuneration.[24]

Question 12 *Did the remuneration structure of banks contribute to the crisis and, if so, how should it change?*

8. (a) The remuneration structure of senior bank managers has largely been focused on short term and profitability objectives and failed to consider risk measures. Senior management remuneration structures often appeared to encourage excessive risk taking throughout the business. Senior officers of banks should have pay structures that incorporate their achievement of goals in respect to risk measurements. Regulators should not approve pay structures but should review pay awards of senior managers in light of their measures of firm risk particularly penalising (with increased capital) if they judge reward was provided for increasing systematic risk. (b) Much discussion of staff incentive structures has taken place, but I believe that it would be wrong to regulate the pay of staff. If board level management lacks incentives for excess risk taking, incentives for staff will become aligned as part of the management process. The danger of regulating staff incentives is job transfer (not institutional) to less restrictive jurisdictions.

Question 16 *Are there lessons Britain can learn from the experience of other countries' banking systems during the financial crisis, such as Spain and the US?*

9. Amongst the strengths demonstrated by other countries' regulators probably the most salient has been the speed with which the US system has dealt with errant financial institutions. We appear to have learnt this lesson with our speedy handling of the Bradford & Bingley rescue. Other US efforts to address problems have yet to demonstrate results we can use. A fundamental difference of the US rescue plan compared to the that of Britain, is the general lack of expressed interest in active shareholding and the lower cost (primarily of preferred share dividends) provided by the US. We may need to adjust our costs in 2009. Switzerland, whose approach has similarities to the US, has not voiced interest in active shareholding efforts but would appear to be exerting substantial unobserved influence in changing the business model of its major banks. Amongst the most discussed regulatory regimes in Europe is Spain's frequently referred to counter cyclical capital requirement and off-balance sheet controls. While laudable in principle and providing greater strength to its banks, Spanish requirements did not stop a housing bubble that may be worse than Britain's and arguably

[24] Attached as an annex are notes provided to the clerks of the Treasury Select Committee of the House of Commons in November 2008 for their sessions on executive remuneration in banking. (Not printed here).

Spain's commercial property sector is more speculative than Britain's. Indeed, it may be argued next year that counter cyclical capital controls encourage excessive risk taking to pay for increased capital costs (only time will judge if such requirements may have encouraged excess emerging market exposure for the Spanish banks). Spanish banks did not make excessive use of securitisation or off-balance sheet capital management and funding tools which fuelled UK mortgage growth. Finally, while Spain's efforts may have assisted its large banks it seems likely that many smaller building society equivalents (Caja and Caixa) may suffer in contrast to Britain where many building societies appear currently to have taken more conservative lending positions.

Question 17 *Other aspects?*

10. Competition in a more concentrated banking environment will require a totally new form of regulation. In a banking sector with substantially reduced domestic participants and reduced foreign interest, fewer participants will dominate availability of product and pricing. The increased scale of the largest players may also limit the possibility of new entrants due to scale requirements for minimum profitability. There is a strong possibility of cartelisation, with reduced innovation and excessive costs. Indeed, economies of scale may have the perverse effect of requiring the largest banks not to lower their prices or increase availability of credit in order to preserve second tier participants' viability. Substantial thought on new regulatory functions in this regard is merited.

5 January 2009

Memorandum by The Institute of Chartered Accountants in England and Wales

Introduction

The Institute of Chartered Accountants in England and Wales (ICAEW) welcomes the opportunity to submit evidence in response to this Economic Affairs Committee inquiry.

The ICAEW is a world leading professional body working in the public interest. The ICAEW provides leadership and practical support to over 132,000 members in more than 160 countries, working with governments, regulators and business to uphold the highest technical and ethical standards. The recommendations in this submission are consistent with our oral testimony at three recent UK parliamentary hearings and draw on the practical experience of members and wider stakeholders in the ICAEW's Financial Services Faculty and Financial Reporting Faculty. Our overriding objective is to identify and help implement workable solutions to the problems of the global credit crisis and economic downturn.

Executive Summary

- The ICAEW believes that banking supervision and regulation should be enhanced to address a wider appreciation of systemic risk coordinated at the global level. Better information flows—between financial services providers, consumers, regulators, as well with auditors—are required to build an effective early warning system that identifies and monitors market wide systemic risk.
- Communication and coordination between the tri-partite authorities can be improved. The Financial Services Authority (FSA), Bank of England and Treasury each had responsibilities for systemic risk, but there was insufficient clarity over the interaction between their respective responsibilities. However, we do not believe that there is a compelling case to transfer supervisory powers from the FSA to the Bank of England.
- The future approach to public intervention and crisis management of financial institutions should be understood and agreed by all of the tripartite authorities. While the regulatory system must be able to respond to changing circumstances, greater consistency on the approach over the economic cycle would enhance confidence.
- Principles based regulation should not be confused with light touch regulation. The ICAEW supports the policy of principles based regulation as it provides the basis for a more robust system, better able to cope with changing circumstances.
- Reform of the regulation of liquidity risk management will be as important as reform to the capital adequacy framework.

— Better tools for measuring the extent of correlation across the market of decisions taken by individual institutions are needed. This may require more sophisticated methods in the market, for example of tracking and sharing information on both inter-institutional transactions and the total level of indebtedness of individuals. The audit profession may be able to contribute to greater confidence in banks by providing objective, expert opinions on the information reported by banks.

— While not appropriate in all cases, existing requirements within International Financial Reporting Standards (IFRS) for certain financial instruments to be measured according to fair value accounting are there for good reason and reflect the relative weakness of historical cost accounting, the main alternative, for these particular items. Transparent financial reporting will be a key requirement for rebuilding confidence in the financial services sector.

— The ICAEW supports the "comply or explain" framework to UK corporate governance regulation and underlining principle of shareholder responsibility, which allows shareholders to analyse director decisions and "vote with their feet". However, the ICAEW believes that improvements can be made to strengthen the ability of shareholders to scrutinise the appointment process for non-executive directors (NEDs), therefore better ensuring that NEDs possess the abilities to fulfil their oversight role.

— While, in the longer term, the ICAEW supports full international inquiry into how different corporate governance models performed leading up to the credit crunch, we believe that the challenge of achieving sustainable long-term decision making, particularly in financial markets, is far greater than relating to corporate governance considerations alone.

— Companies, investors, regulators as well as consumers must play a role in encouraging a responsible and ethical approach to business marked by a continuous attention to the long-term and systemic implications of business activity as well as concern for more immediate competitive issues.

— The ICAEW supports a greater degree of regulatory consistency and coordination across the EU, provided it results in workable arrangements that address public interest needs without posing disproportionate compliance burdens on businesses and regulators.

— The ICAEW encourages EU work streams to be synchronised with the ongoing international dialogue taking place within the G20 framework.

Consultation Questions

1. *Can the regulatory authorities effectively control the risks taken by banks, especially in today's globalised markets? How can the international dimension be addressed?*

The global nature of modern finance has provided for huge benefits, but its long-term sustainable operation requires an appropriate framework of oversight and an awareness of global systemic risk. The credit crunch has illustrated the extent to which global financial institutions are interconnected, their regulators are interdependent and awareness of systemic risk was lacking.

Better methods of monitoring and co-ordinating the regulation of banks are needed due to the systemic risk inherent in the system. Such methods must be developed at an international level, due to the global nature of financial markets. Measures adopted in a single jurisdiction will not be sufficient to address the weaknesses in the regulatory framework as the risks are global. This does not, however, necessarily require a new international regulator to be created.

To date, the ability of the global financial architecture to monitor and respond to systemic risk has been lacking. One key factor has been the increasing tendency, around the world, for the regulation of banks to be separated from central banking functions. Whilst many banking regulators may have responsibilities for managing financial stability, most of the regulatory tools at their disposal focus on individual institutions and the risks they may take. Traditionally, the main tools for addressing systemic risk have been fiscal and monetary policy, which are blunt instruments controlled, in the UK, by HM Treasury and the Bank of England. In addition, the risk-based capital requirements under the Basel II framework focus on the risks taken by individual banks not on systemic risks. New tools are needed for monitoring and regulating systemic risk.

The ICAEW believes that regulatory attention should also focus on a wider appreciation of systemic risk, that this should be coordinated at the global level. We congratulate current G20 leadership in attempting to respond to the financial crisis in a globally coordinate manner. In addition, better information flows—between financial services providers, consumers, regulators as well with auditors—are required to build an effective early warning system that identifies and monitors market wide systemic risk.

2. *Has the supervision of individual banks been handled effectively under the Tripartite System of the Treasury, the Financial Services Authority and the Bank of England? Should banking supervision remain with the FSA or be returned to the Bank of England?*

3. *How is responsibility for stability of the financial system divided in the Tripartite System? Has oversight of the banking system been lost due to a focus on individual banks? What has been the nature of coordination between the different regulators before, and since, the Northern Rock crisis in the summer of last year?*

4. *How can regulators employ people of the right calibre to regulate the banking system effectively?*

Regulatory Structures

Weaknesses in the tripartite regulatory supervision have been mainly in the operation, rather than design, of the system. One weakness may have been that the UK system has focussed upon supervising individual banks over supervising the wider banking system. The FSA has acknowledged the need to increase their focus upon systemic issues, in addition to their focus on supervising individual banks.

We do not believe that there is a compelling case to transfer supervisory powers back to the Bank of England. In any regulatory or control system, there are advantages in separating responsibilities to avoid concentrating too much power within one body. There will always be tensions over where dividing lines should be set when more than one organisation is involved. Clear definitions of the respective responsibilities between the tripartite authorities are more important than the choice of which organisation takes on which role.

Light touch regulation

Principles based regulation should not be confused with light touch regulation. The ICAEW supports the policy of more principles based regulation as it provides the basis for a more robust system, better able to cope with changing circumstances. Compliance with principles can be more demanding than applying rules, as a good set of principles addresses substance rather than legal form, which rules tend to focus upon. We note that the more rules based US system of regulation did not cope demonstrably better with the current crisis.

Principles based systems need to be supported by effective supervision, because the application of principles involves an element of judgement. This does not require the regulator to re-open each and every decision, but does need effective challenge of management, including appropriate scrutiny of the systems and information supporting management decision making. It is in these areas that the FSA might have been described as light touch, and where weaknesses have been identified. To be able to do so requires skilled personnel. The FSA has acknowledged the need to strengthen its supervisory processes and increase the skills of its supervision team.

Better Communication

Communication and coordination between the tri-partite authorities can be improved. The FSA, Bank of England and Treasury each had responsibilities for systemic risk, but there was insufficient clarity over the interaction between their respective responsibilities. As a result, while each of the tri-partite authorities may have issued warnings over various macro-economic risks, none took responsibility for addressing those risks. The FSA has acknowledged the need to not only focus on regulating individual institutions, but pay greater attention to systemic risk.

Risk-based Approach

The risk-based approach also requires dialogue. It is essential to take a risk-based approach. A zero-failure regime would risk prohibitive costs and economic stagnation, and a non zero-failure approach would increase systemic risks. Ideally, there would be no differences between the policies set by the tripartite authorities, political will, public expectations and the expectations of financial institutions in respect of the extent of risk acceptable under the system.

Public Policy Considerations

There is a tendency to focus on deregulation in the good times, with insufficient attention being paid to risk by public opinion, while economic crises can be characterised by regulatory over-reaction. The regulatory system needs to work effectively in both good and bad times, but pressure to change regulatory structures is greatest at the top and bottom of the market, which exacerbates the potential for regulation to have unintended consequences.

Public expectations can be hard to define, due in part to low levels of financial literacy. It is therefore important that protection mechanisms should be consistent and easy to understand. An example of the difficulties of lack of consistency was the Government's decision to compensate Icelandic bank investors, even where the deposits were significantly above the maximum compensation limits in the UK. Considerable effort had been put into revising and explaining the new UK depositor protection scheme. The action taken may have added to the confusion through its inconsistency with earlier decisions, rather than increased confidence.

The future approach to public intervention and crisis management of financial institutions should be understood and agreed by all of the tripartite authorities. While the regulatory system must be able to respond to changing circumstances, greater consistency on the approach over the economic cycle would enhance confidence.

5. *Could the regulatory authorities have foreseen the banking crisis? What changes might help the authorities predict such a crisis in future? What could then be done to avoid a repeat?*

The regulatory authorities carry out periodic risk assessments where risks are identified. The FSA, for example, in its January 2007 Financial Risk Outlook identified a number of risks to financial stability, including many which occurred. Two plausible risk scenarios explored were a global reappraisal of risk appetites and a sharp deterioration in personal credit quality, both of which have been linked to the current crisis. It should also be recognised that the Financial Risk Outlook identified a number of other risks which did not crystallise.

If the regulatory authorities had taken action to prevent all of the risks identified from crystallising, the unintended consequences might have been as severe as the current crisis in terms of destabilising financial markets and significantly slowing economic activity. Furthermore, it was not expected that the risks across the market would have the effect of stopping inter-bank lending.

Better tools for measuring the extent of correlation across the market of decisions taken by individual institutions may be needed. This may require more sophisticated methods in the market, for example of tracking and sharing information on both inter-institutional transactions and the total level of indebtedness of individuals. There may be significant costs of setting up such systems as well as data protection and civil liberty considerations.

6. *What changes should be made to banking regulations?*
7. *For example, should capital adequacy regulations be tightened? Should they take account of the quality and liquidity of the assets held by the banks? If so, how? Do regulators need to create different sets of rules for different assets held by banks? Should fair value accounting rules be adjusted?*
8. *Do Basel banking standards and guidelines need to be changed? Did the FSA ensure that banks followed the Basel standards and guidelines?*

Capital Adequacy Framework

The ICAEW supports ongoing efforts to review the global capital adequacy framework. There is considerable public debate about introducing counter-cyclical capital adequacy requirements. The ICAEW supports exploring more sustainable, robust levels of confidence in the financial system, and is devoting significant resources into exploring the barriers to this through our Financial Services Faculty's "Inspiring confidence in financial services" thought leadership campaign. However, we also recognise the limitations of the objectives of introducing a counter-cyclical regulatory system. One problem with counter-cyclical regulation is that it will always run counter to public opinion—in the current situation, it would advocate relaxing the capital requirements of banks, for example. Further problems are that it is impossible at any time to know what the next move will be in the economic cycle and that there is a significant time-lag between regulatory action and their impacts upon the economy. As a result mistimed attempts to be counter-cyclical may become pro-cyclical in practice.

The new regime must be suitable to deal with market wide stress scenarios not just stress scenarios at the firm specific level. Consideration should be given to adding a systemic risk layer to the capital requirements, increasing capital requirements for institutions most exposed to systemic risk or financial contagion. This may require new regulatory monitoring tools to be developed, working with central banks given their responsibilities in respect of financial stability.

However, we also believe that it is important to base the new regulatory system on a framework of principles, rather than the creation of ever more detailed rules to cover every possible scenario. Given that we are operating a global financial system, the Basel Committee on Banking Supervision should lead on examining improvements to the capital framework.

Liquidity Regulation

The financial crisis has highlighted weaknesses in the regulation of liquidity. The Basel II framework focuses on prudential capital requirements and does not deal with liquidity management adequately. Reform of the regulation of liquidity risk management will be as important as reform to the capital adequacy framework.

Liquidity risk has had insufficient attention from regulators in recent years. Regulatory regimes need to be updated to address the current and potential future liquidity risks in the financial system. As international banks are often managing liquidity on a group-wide, international basis, the regulatory tools need to be international in nature. Previous attempts to strengthen the regulation of liquidity management have failed due to lack of international consensus.

The ICAEW is making representations to the G20 nations in particular to lead the effort to develop a new international system to regulate liquidity, which we believe can strengthen and support banks' own systems for managing liquidity.

Relationship between auditors and regulators

The relationship between bank auditors and regulators has been generally weakened in recent years. The Basel II framework does not specifically require the involvement of external auditors for supervisory purposes. However, the audit profession can contribute to greater confidence in banks by providing objective, expert opinions on the information reported by banks, so that those relying on that information can be confident that it has been properly prepared.

There are various examples of financial information not currently subject to audit, including bank capital ratios published alongside the accounts, Basel II Pillar 3 disclosures as well as certain bank regulatory returns. In addition, the FSA could make greater use of its existing powers to commission reports by skilled persons to provide greater assurance, for example, on risk management processes, internal control systems or provide intelligence for monitoring financial stability. The ICAEW provided written suggestions to the Treasury Committee in this area as part of their inquiry into the banking crisis, which are set out in the appendix to this document.

Fair Value Accounting

Confidence in financial reporting is vital if financial stability is to be maintained. In our view, while fair value is not appropriate in all cases, existing requirements within International Financial Reporting Standards (IFRS) for certain financial instruments to be measured according to fair value accounting are there for good reason and reflect the relative weakness of historical cost accounting, the main alternative, for these particular items.

The current financial crisis is principally an economic issue not an accounting one and there is insufficient evidence to conclude that fair value accounting has either caused or exacerbated the recent issues in the banking sector. Therefore, the ICAEW believes that to abandon the current use of fair value accounting as applied to financial instruments, would be to "shoot the messenger" at a time when investors need more transparency not less.

The Japanese financial crisis in the 1990s, characterised by financial institutions' failure to report the extent of their non-performing loans and subsequent slow economic recovery, arguably highlights how not facing up to the scale of such problems as soon as possible can make their resolution more prolonged and painful. However, inconvenient the economic reality may be in the short term, transparent reporting is a key ingredient in long term economic recovery and must be protected and maintained at all times—those characterised by turmoil as well as by stability.

One of the main criticisms of fair value accounting in the current crisis is that it contributed to pro-cyclicality, ie exacerbated the business cycle. The objective of financial reporting is to provide transparent information to providers of capital, not to counter the business cycle. These objectives are different to those of banking regulators. The ICAEW's view is that banking regulators have the power to introduce counter-cyclical measure in their prudential capital regimes, but it would be inappropriate to introduce such measures into the accounting system given its different objectives.

The ICAEW—through its Financial Reporting and Financial Services Faculties—is committed to continual review of the appropriateness of financial reporting requirements both generally and with specific reference to the financial sector.

The ICAEW will continue to examine the issues through our "Information for better markets" and "Inspiring confidence in financial services" thought leadership campaigns and contribute to the assessment of these issues by the US Financial Accounting Standards Board and the International Accounting Standards Board, and to the forthcoming major review by the two Boards of measurement issues generally.

We note that on 11 November, the UK Treasury Committee heard evidence on the role of "Accountancy in the banking crisis". The committee set out to scrutinise the "The role that fair value accounting has played in the banking crisis, and whether any change to fair value reporting rules and requirements is appropriate." During the committee hearing representatives of the British Bankers' Association; the Association of British Insurers; the Investment Management Association; the Chartered Financial Analyst Institute; and the ICAEW all broadly supported current use of fair value.

9. *Is better testing and regulation needed of new financial products, especially complex securities? If so, how? Should complex financial instruments, such as credit default swaps, be traded through clearing houses?*

We have no comments on these questions.

10. *Should there be tighter regulation of off-balance sheet vehicles in which some banks held "toxic" assets associated with US sub-prime mortgages? Is there a case for requiring greater public disclosure of banks' balance sheets?*

Off balance sheet entities

Some of the criticism of off-balance sheet accounting may relate more to US Generally Agreed Accounting Principles (US GAAP) than International Financial Reporting Standards (IFRS). US GAAP has a category of "qualifying special purpose entities" (QSPEs) which are permitted to be held off-balance sheet, so long as certain rules are met. IFRS does not have a similar provision, but takes a more principles based approach that focuses upon the economic substance of the structures. Where a bank controls an asset and related liability and has a share in its risks and rewards, they must be accounted for on the balance sheet. Many special purpose entities were held on-balance sheet under IFRS, including for example Northern Rock's Granite vehicles. The IASB has been working over a number of years to improve their asset and liability recognition criteria and significant progress has been made. We welcome the IASB initiative to review the accounting standard dealing with consolidation.

11. *Are bank directors, especially the independent non-executives, in a position to exercise effective oversight? In particular, do they have sufficient understanding of the complex assets held by banks? If not, can any changes be made which will ensure effective oversight? Do any other governance issues need to be addressed?*

12. *To what extent has the financial crisis been caused by the failure of banks' business models rather than by that of banking supervision? Did the remuneration structure of banks contribute to the crisis and, if so, how should remuneration structures be changed?*

Non-Executive Directors

Non-executive directors (NEDs) in financial institutions are expected to have the necessary ability to ask challenging questions in order to understand (and positively influence) the business model and inherent risks within their company.

To achieve their role, NEDs require a continuous understanding and independent perspective on the:

- conduct of the business;
- performance of other directors;
- development of strategy;
- adequacy of financial controls and risk management processes;
- level of remuneration within the business; and
- appointment and replacement of key personnel succession planning.

In the UK, the Financial Reporting Council (FRC), through the "Combined Code", sets comprehensive standards on board balance and composition, independence criteria, the provision of information and professional development for directors against which companies must disclose their practice.

The Combined Code (the code) is founded in the principle of shareholder responsibility. The FRC does not monitor or enforce the code's implementation by individual boards nor is full compliance with the code compulsory. Instead the primary responsibility for monitoring the behaviour of company boards are the company's shareholders. Company boards are under a responsibility to "comply or explain" to shareholders why they have chosen not to comply with a specific requirement of the code.

The ICAEW supports the "comply or explain" framework and underlining principle of shareholder responsibility. Comply or explain, when characterised by transparency of information, allows shareholders to analyse director decisions and "vote with their feet". We believe that, given greater transparency and a commitment on behalf of the shareholder themselves, "comply or explain" is a suitable basis for ensuring that non-executive directors (NED) are in a position to provide effective oversight and, therefore, encourage the company to make sustainable decision making.

Shareholders should be in a position to assess for themselves whether NEDs possess the capabilities necessary to provide effective oversight. For financial institutions, this may involve an assessment of whether NEDs display the appropriate understanding of "complex assets held by banks", as necessary to fulfil their role to maintain an informed position on the conduct of the business.

However, the ICAEW believes that improvements can be made to strengthen the ability of shareholders to scrutinise the appointment process for NEDs, therefore better ensuring that NEDs possess the abilities to fulfil their oversight role. We would encourage greater transparency and disclosure of the Nominations Committee process and subsequent appointment processes. If market participants are aware of the board and individual director evaluation process, they will be able to make a more informed investment decision based on an understanding of the company's strategy on human capital.

The ICAEW does not believe that it is appropriate to regulate boards to the extent of introducing compulsory pre-requisite qualification for NEDs, or making financial qualifications mandatory for board positions on financial institutions. Most organisations have full induction procedures for new NEDs and on-going training programmes. We believe that organisations, on the whole, will themselves be better placed to deliver the training and insight that the company requires and that rules based regulation in this area would be unhelpful. Shareholders, not regulators, should decide whether a detailed knowledge of financial services and a senior level of financial qualifications are required.

Other governance issues

A full and thorough debate is needed on the implications of the financial crisis for corporate governance arrangements, for financial institutions in particular.

However, corporate governance considerations for financial institutions should not be seen as a "silver bullet' in response to the financial crisis. The global financial crisis and the collapse of confidence affected financial institutions throughout the world, across jurisdictions that employ substantially different corporate governance regimes. For instance the UK "comply or explain" Combined Code framework differs substantially from the, more prescriptive Sarbanes-Oxley regulation in the US. At these early stages, there appears to be no appreciable difference in outcome between the major corporate governance models in responding to the pressures of the financial crisis.

While, in the longer term, the ICAEW supports full international inquiry into how different corporate governance models performed leading up to the credit crunch, the ICAEW believes that the challenge of achieving sustainable long-term decision making, particularly in financial markets, is far greater than relating to corporate governance considerations alone.

On a broader level, corporate governance seeks to address the agency issues that arise from a separation of ownership and control. The ICAEW believes that effective risk management depends on shareholders, as owners, holding an active interest in the board's long-term sustainable decision making. Companies, investors, regulators as well as consumers must play a role in encouraging a responsible and ethical approach to business marked by a continuous attention to the long-term and systemic implications of business activity as well as concern for more immediate competitive issues.

Remuneration structures

The credit crunch has increased the scrutiny on remuneration in its broadest sense both in terms of investor expectations and behaviours and in terms of compensation and bonus systems that may reward risk-taking and extreme short-termism within the financial services sector.

Innovative thinking is needed in this area. Remuneration structures must be developed in order to incentivise boards, managers and employees to act in the long-term interests of those that they are meant to serve in an ethical and sustainable manner rather than short term performance. Remuneration structures must also comply with regulations and at the same time enable the company to attract and retain the best available executives and reward outstanding performance.

There are fundamental areas that need to be looked at include:

- Why certain incentives are failing;
- Whether incentives have encouraged short-termism at the expense of strategic objectives;
- The governance of pay and human capital (the capabilities of people; the internal governance of company structures and ensuring appropriate remuneration incentives are in place to support those structures);
- The existing mechanisms for ensuring appropriate remuneration and incentives are in place and the oversight of those mechanisms.

The fundamental areas of review call into question the effectiveness of pay structures and incentives both in terms of "rewarding failure" in and terms of "failing to reward" which can be equally as damaging in human capital terms.

13. *How should the regulatory system take account of the Government's position as a majority shareholder in a number of banks?*

14. *Where should the boundary be drawn between the institutions that are covered by banking regulations and those that are not? For example, does there need to be a clear division between commercial banks, with relatively strict supervision, and investment banks? Should banking regulations address the role of credit rating agencies?*

We have no comments on this question.

15. *How far can banks circumvent UK regulations by, for example, setting up offshore operations? How far should changes be made at the UK-level and how far through international agreements? What is the impact of EU banking regulations and how do they interact with UK regulations?*

In many areas, the financial crisis has emphasised that the global interconnectedness of financial systems requires greater coordination at the global level. As we have outlined above, this includes—financial reporting, capital adequacy and liquidity management.

EU capital markets are highly integrated. The European Commission estimates that approximately 80% of Europe's banking assets are held in 45 systemic cross-border banking groups. EU Internal Market policy in this area broadly aims to achieve a level playing field across Member States, matching the level of integration of EU capital markets.

The De Larosière Report on EU banking supervision was published on 25 February 2009. This much anticipated report supported enhanced EU supervisory arrangements and structures. The report follows considerable debate over the need for pan-EU oversight of large banks that operate across borders. In addition, there have been several calls for formal crisis management mechanisms at an EU level to be established to guide public intervention in troubled financial institutions, when respective financial institutions have significant operations in more than one Member State. Broadly, the ICAEW believes that financial crisis management should be considered in a pragmatic manner. It may not be appropriate for the EU to lead crisis

management of every cross-border financial institution in difficulty. In every case, policy makers should clearly identifying the issues at stake and the most suitable way of addressing them, taking into account the different national environments.

The ICAEW will respond to the issues of Pan-EU oversight raised by the De Larosière report following full and detailed consideration the report. The ICAEW supports a greater degree of regulatory consistency and coordination across the EU, provided it results in workable arrangements that address public interest needs without posing disproportionate compliance burdens on businesses and regulators. A number of initiatives are already in the legislative process, including major regulatory change in relation to credit rating agencies and capital requirements.

EU initiatives should be seen as part of the broader international effort to rebuild confidence in the financial system. The ICAEW encourages EU work streams to be synchronised with the ongoing international dialogue taking place within the G20 framework. While progress in regulatory consistency and coordination should be pursued at the Internal Market level, in many cases an effective regulatory response to issues raised by the financial crisis can only be tackled at the global level.

16. *Are there lessons Britain can learn from the experience of other countries' banking systems during the financial crisis, such as Spain and the US?*

17. *Should other aspects of the system of banking regulation be changed?*

We have no comments on these questions

27 February 2009

APPENDIX ONE

ICAEW Supplementary evidence to Treasury Committee

IDEAS FOR ENHANCING CONFIDENCE IN BANK REPORTING

Introduction

The Treasury Committee, at its hearing on the role of auditors in the banking crisis on 28 January 2009, invited the major auditing firms to suggest areas where the role of auditors might be strengthened in the audit of banks. The ICAEW Financial Services Faculty is responding to this invitation after consulting with practitioners in the six largest UK auditing firms.

In summing up these sessions, the Chairman, the Rt Hon John McFall MP, said that auditors had done a decent job of fulfilling the duties expected of them in statute but questioned whether that role was appropriate. The relationship between auditors and the Financial Services Authority (FSA) is central to that question. To help the Committee consider these matters, we set out five areas where the role of auditors could be extended:

1. Financial information outside the accounts
2. "Pillar 3" risk disclosures
3. Regulatory returns to the FSA
4. Control activities chosen by the FSA
5. Bank-specific meetings with the FSA

The aim of these ideas is to contribute to enhanced public confidence in banks by increasing trust in the information that banks report to the public and to the regulator. Currently, auditors focus on banks' financial statements specifically and work in the interests of shareholders. The wider public may not understand that auditors have only limited involvement with other financial information provided by banks.

The audit profession can contribute to greater confidence in banks by providing objective, expert opinions on the information reported by banks, so that those relying on that information can be confident that it has been properly prepared. In assessing each of the suggestions we make for extending the auditor's role, the following would need further consideration:

— the exact nature of work to be performed, how this fits with current professional standards and whether new guidance would need to be developed;

— consulting stakeholders to ensure that any new measures are practical and add value;

— identifying the costs of implementing change, ongoing costs and how they compare to benefits;
— avoiding the creation of expectation gaps which could damage confidence. For example, assurance work does not provide guarantees and it focuses on the quality of the reported information rather than the appropriateness of the underlying reporting requirements; and
— the international context, including maintaining UK competitiveness and drawing on the best of current thinking.

The following paragraphs set out our ideas in more detail.

1. *Financial information outside the accounts*

Some of the financial information reported by banks does not form part of the audited accounts. For example, banks normally provide capital ratios, which are the regulatory measure of the amount of capital they hold, in their annual report. At the moment, auditing standards require that where information is in the annual report but not part of the accounts "the auditor should read the other information to identify material inconsistencies with the audited financial statements". Auditors are not, however, required to obtain additional evidence to support the other information. The UK Government has previously taken the view, after extensive consultation, that it is not necessary to extend the audit scope beyond the financial statements. The FSA and Government should consider doing so for banks, at least in relation to financial information such as capital ratios.

2. *"Pillar 3" risk disclosures*

In 2009, banks will be required to report greater detail of their risk positions under new regulations introduced by Basel II, called "Pillar 3" disclosures. Basel II includes an option to require Pillar 3 disclosures to be audited. After consultation, the UK government and FSA took the view that it would not take up this option to require an audit of the disclosures. Many banks are likely to make these disclosures in their annual report, but outside the accounts. In this case auditors will only need to read the disclosures for inconsistency with the financial statements as in 1 above. The rules also allow banks to make Pillar 3 disclosures outside the annual report, for example on their web-site, in which case there is no requirement for auditors to check them. The FSA should reconsider the decision not to require an audit of Pillar 3 disclosures in the light of changed circumstances.

3. *Regulatory returns to the FSA*

Banks' regulatory returns to the FSA include a range of financial information, for example on liquidity, large exposures, a bank's balance sheet and capital. At present, these returns are not subject to review by auditors. The present regime for banks arose under the Financial Services and Markets Act 2000 (FSMA). It differs from the insurance sector, where regulatory returns are reported on by auditors. Before the introduction of FSMA, banks' returns were subject to periodic review by auditors. The FSA should consider whether reintroduction of a review of key bank regulatory returns by auditors would be useful.

4. *Control activities chosen by the FSA*

The FSA has powers under section 166 of FSMA to commission reports by auditors on specific issues. These reports are used mainly when a specific problem has been identified and tend to be forensic in nature and relatively expensive. While it is for the FSA to decide what type of information best supports its supervisory approach, more general reports looking at banks' controls used to be commissioned under the previous regime, when section 39 of the old Banking Act applied. The FSA could make greater and more regular use of their existing powers under section 166 to obtain more information about the operation and application of controls or compliance with regulations.

5. *Bank-specific meetings with the FSA*

Bank auditors are required to communicate with the FSA in specific circumstances, including when they suspect management fraud, consider there are going concern issues or for significant rule breaches. Depending on the nature of the concern, some communications will involve banks' management while others will not. Written communications may be followed up by meetings. Outside these prescribed circumstances, the need for additional contact between auditors, management and the FSA is up to the judgement of the supervisor.

The current situation differs from the old regime where there were regular bipartite and tripartite meetings to discuss the financial statements audit and section 39 reports. It is worth looking at whether more regular meetings with auditors would help the FSA gain additional insights into the banks they regulate. The knowledge that such meetings were taking place ought also reassure the public. Indeed, it could even be made a requirement that periodic meetings are held with the auditors for particularly important regulated banks, so that it is not left to the discretion of the supervisory team. In support of this, we note that the FSA's supervisory enhancement programme is advocating annual bilateral meetings with the auditors of all high impact firms.

ICAEW Financial Services Faculty

10 February 2009

APPENDIX TWO

ICAEW—WHO WE ARE

1. The Institute of Chartered Accountants in England and Wales (ICAEW) is the largest accountancy body in Europe, with more than 132,000 members. 3,000 new members qualify each year. Our membership includes Financial Directors and Chief Executives across all sectors of the UK economy, from large multinationals to SMEs, including micro businesses.

2. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.

3. The Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department for Business, Enterprise and Regulatory Reform through the Financial Reporting Council. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy, including taxation.

Memorandum by Sir David Tweedie, Chairman, International Accounting Standards Board (IASB)

Introduction

1. This paper responds to an invitation dated 17 December 2008 for the submission of written evidence in connection with the Economic Affairs Committee's inquiry into "Banking Supervision and Regulation".
2. The IASB is an independent standard-setting body responsible for the development and promulgation of International Financial Reporting Standards (IFRSs), required or permitted by over 100 countries around the world. The IASB has no responsibility or involvement in prudential regulation and is therefore only able to comment on a subset of a limited number of questions presented in the call for evidence (sections of the question that the IASB has responded to are underlined).
3. This paper addresses the following points.

— Executive summary (paragraphs 4-14)

— Response to question 7: "For example, Should capital adequacy rules be tightened? Should they take account of the quality and liquidity of the assets held by the banks? If so, how? Do regulators need to create different sets of rules for different assets held by banks? *Should fair value accounting rules be adjusted*?" (paragraphs 15-21)

— Response to question 8: "*Do Basel banking standards and guidelines need to be changed*? Did the FSA ensure that banks followed the Basel standards and guidelines?" (paragraphs 22-24)

— Response to question 10: "Should there be tighter regulation of off-balance sheet vehicles in which some banks held 'toxic' assets, associated with US sub-prime mortgages? *Is there a case for requiring greater public disclosure of banks' balance sheets?*" (paragraphs 25-29)

— Response to question 16: *Are there lessons Britain can learn from the experience of other countries' banking systems during the financial crisis, such as Spain and the US?* (paragraph 30)

— Conclusion (paragraphs 31-33)

SUMMARY

4. Established in 2001, the IASB is the standard-setting body of the International Accounting Standards Committee (IASC) Foundation, an independent private sector, not-for profit organisation. The IASB is committed to developing, in the public interest, a single set of high quality, global accounting standards that provide high quality transparent and comparable information in general purpose financial statements. In pursuit of this objective the IASB conducts extensive public consultations and seeks the co-operation of international and national bodies around the world.

5. The banking and credit crisis has demonstrated the need for a global approach to the regulation and oversight of capital markets. One area where international co-operation is well advanced is accounting standard-setting. IFRSs, promulgated by the IASB, are used in more than 100 countries, including the Member States of the European Union.

6. The IASB is therefore well placed to act and should continue to play a role in helping enhance confidence in the financial markets. The IASB will continue to respond in a timely manner that improves transparency and provides greater global consistency in financial reporting. Any steps taken in relation to financial reporting should, however, be measured against the benchmark of improving investor confidence in reported financial results.

7. At the heart of the crisis were bad lending practices—accounting treatments are just reflecting the economic reality that real losses have occurred. Bad lending was compounded by the absence of prices in the secondary markets for some structured credit products and uncertainty about the location and size of potential losses. This in turn led to funding difficulties caused by the reluctance to extend credit to a number of financial institutions thought to hold low quality liquid assets. Financial reporting enters the scene by way of its requirements to value these assets and to alert the markets to risks associated with their existence.

8. It has been the view of the IASB that showing the changes in values of these securities, even if challenging in practice, provides much-needed transparency and enables markets to adjust in a necessary, even if painful, manner. This view is supported by financial analysts. The CFA Institute, representing financial analysts throughout the world, asked its members whether fair value requirements for financial institutions improve transparency and contribute to investor understanding of the risk profiles of these institutions. 79% said yes.[25]

9. While the current crisis plays out, it's important that all those who have a stake in the efficient functioning of capital markets consider what improvements can be made. The IASB is no exception; it recognises the need to enhance accounting requirements and has already undertaken improvements; it is now considering others in the light of developments. However, it is equally important that any response should be measured and appropriate.

10. The IASB has been working on a number of urgent projects also identified by the G20 Summit in Washington. It has issued guidance for valuation of securities, particularly the valuation of complex, illiquid products, especially during times of stress. It has published proposals to improve the information available about fair value measurements of financial instruments and liquidity risk and an exposure draft of a standard on fair value measurement will be published shortly.

11. Furthermore, standard-setters have acted on the need to bring greater visibility to previously off balance sheet items. They have been revising their standards dealing with derecognition of financial assets and liabilities, and the consolidation of controlled entities. The IASB has also been working on weaknesses perceived in disclosure standards for off balance sheet vehicles.

12. The IASB has also consulted widely in formulating its response to the crisis. Public round table discussions have been held in Asia, Europe and North America to gather input on other reporting issues emanating from the global financial crisis, including responses from governments, regulators and others.

13. In addition, the IASB and the US Financial Accounting Standards Board (FASB) have established a high-level Financial Crisis Advisory Group (FCAG), in direct response to the G20's request to further the understanding of the current crisis. This group of senior leaders with broad international experience in financial markets is tasked with considering how improvements in financial reporting could help enhance investor confidence in financial markets, identifying the accounting issues requiring urgent and immediate attention of both the IASB and the FASB, as well as issues for longer-term consideration.

[25] See http://www.cfainstitute.org/memresources/monthlyquestion/2008/march.html.

14. In the lead up to the G20 meeting in London attention among policymakers and banking supervisors has turned towards addressing financial stability, part of which relates to the issue of procyclicality. Some have expressed an interest in counter-cyclical regulatory systems used by other countries, most notably Spain. This is a complex area that requires much consideration. The IASB is well advanced in discussions with the Basel Committee on Banking Supervision. These discussions are designed to ensure that efforts addressing procyclicality through changes in prudential regulation are dealt with in a way that will not harm investor confidence in financial statements, which would itself be a cause of further financial instability. Furthermore, the FCAG is addressing the issue of procyclicality as well, and the IASB will consider their input in an expedited fashion.

Response to Relevant Questions:

Question 7: *"For example, Should capital adequacy rules be tightened? Should they take account of the quality and liquidity of the assets held by the banks? If so, how? Do regulators need to create different sets of rules for different assets held by banks? Should fair value accounting rules be adjusted?'*

15. The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions."[26] Stated differently, the purpose of financial reporting—and therefore the objective of the IASB's standard-setting activities—is to provide an informed decision maker with the necessary information to make a rational judgement regarding the allocation of capital. IFRSs are designed to provide an economic assessment of an entity at a particular date—to record the value of an entity today, not what it was worth yesterday or to predict the value of it tomorrow. Whilst not perfect, fair value accounting has shown to be effective in providing an independent, comparable and verifiable assessment of the value of assets and liabilities, particularly for the measurement of complex financial instruments.

16. Fair value provides much needed transparency and enables markets to adjust in a necessary, even if painful manner. A large number of investors share this view. The CFA Institute evidence from March 2009 cited in paragraph 8 is a demonstration of investor support for fair value accounting. In a later survey of its European members, the CFA Institute found:

— 79% of those who responded do not support the suspension of fair value standards under the International Financial Reporting Standards (597 respondents)

— 85% also think that a suspension of fair value standards would further decrease confidence in the European Banking System (559 respondents)[27]

17. Indeed, history demonstrates that failure to acknowledge losses (even acknowledging imperfections in valuing technique) could delay the resolution of banking crises. In the United States in the 1980s, the US government created a new and more liberal regulatory accounting scheme to enable savings and loan institutions to state that they had more capital, when US GAAP would not.[28] The result was that the cost of saving the S&Ls in the United States escalated.[29] The same could be said for the Japanese banking crisis of the 1990s, when Japanese financial institutions failed to take write downs immediately. The Japanese banking sector remained in crisis for nearly eight years, and the Japanese economy barely grew during that time.

18. That is not to say that fair value measurement techniques cannot be improved. In May 2008, and in response to the recommendations of the Financial Stability Forum in their April 2008 report Enhancing Market and Institutional Resilience, the International Accounting Standards Board (IASB) formed an expert advisory panel. The recommendations in the report called for the IASB to:

— enhance its guidance on valuing financial instruments when markets are no longer active (Recommendation III.6) and

— strengthen its standards to achieve better disclosures about valuations, methodologies and the uncertainty associated with valuations (Recommendation III.5).

[26] Framework for the Preparation and Presentation of Financial Statements, IFRS Bound Volume 2008.
[27] http://www.cfainstitute.org/aboutus/press/release/08releases/20081002_01.html.
[28] See The S&L Crisis: A Chrono-Bibliography, the FDIC Website, http://www.fdic.gov/bank/historical/s&l/.
[29] "It turned a $25 billion problem into a $350 billion problem," said Robert R. Glauber, who was under secretary of the Treasury from 1989 to 1993 and put together the Resolution Trust Corporation, which eventually sold off all the bad assets the government received from failed savings and loan associations. Floyd Norris, "Mistakes of the Past Live Again," *New York Times*, 2 October 2008, http://www.nytimes.com/2008/10/03/business/03norris.html?scp=2&sq=s&l%20crisis%20norris&st=cse.

19. The expert advisory panel comprised measurement experts from preparers and auditors of financial statements, users of financial statements, regulators and others. They met on seven occasions in June—October 2008. The panel identified practices that experts use for measuring and disclosing financial instruments when markets are no longer active.

20. Input from the panel formed the basis of educational guidance for fair value of financial instruments when markets are no longer active, published by the IASB in October 2008. The educational guidance takes the form of a summary document prepared by IASB staff and the final report of the expert advisory panel established to consider the issue. The summary document sets out the context of the expert advisory panel report and highlights important issues associated with measuring the fair value of financial instruments when markets become inactive.

21. The IASB has also published proposals to improve the information available about fair value measurements of financial instruments and liquidity risk. Further proposals to revise fair value measurement guidance will be published in the first quarter of 2009.

Question 8: "*Do Basel banking standards and guidelines need to be changed?* Did the FSA ensure that banks followed the Basel standards and guidelines?"

22. The IASB has a long history of working cooperatively and having a regular dialogue with prudential regulators including the Basel Committee, however we are not in a position to comment on the application of regulatory requirements.

23. Whilst not diluting our primary objective (to provide useful information to users, investors) financial statements also provide information that is helpful to other interested parties, including prudential regulators, insurance regulators, and others. The fair value option amendment in 2003 / 2004 is a good example of where the IASB worked cooperatively with the Basel Committee and other regulators to create an accounting requirement that met the needs of users of financial statements whilst also allowing prudential regulators to fulfil their own objectives of financial stability.

24. However, the objective of the IASB is not prudential regulation or financial stability, even though much of the information it provides is useful to prudential regulators. As an international standard setter, rather than a prudential regulator, we do not feel qualified to pass judgement or fully answer these questions.

Question 10: "Should there be tighter regulation of off-balance sheet vehicles in which some banks held "toxic" assets, associated with US sub-prime mortgages? *Is there a case for requiring greater public disclosure of banks' balance sheets*?"

25. The purpose of general purpose financial statement is to provide decision-useful financial information to users of financial statements. There are examples over the past months whereby vehicles that were off-balance sheet have subsequently been brought on-balance sheet because the sponsoring bank has had to step in to provide support or demonstrate in essence that the bank controlled the off-balance vehicle. In many of those situations however, there was no contractual requirement for the bank to step in—this is what is often referred to as reputational risk. The IASB is, however, committed to continued cooperation with prudential and other regulators in considering these issues.

26. Reputational risk is a difficult area in which much judgement is required from the entities in whether or not to consolidate another vehicle. The overriding principle in both IFRS and US Generally Accepted Accounting Principles (GAAP) is determining whether or not the bank controls that other vehicle and that is where judgement is required.

27. The IASB has acted on the need to bring greater visibility to previously off balance sheet items by developing revisions to standards dealing with derecognition of financial assets and liabilities, and the consolidation of controlled entities. The IASB has also been working on weaknesses perceived in disclosure standards for off balance sheet vehicles.

28. In December 2008 the IASB published proposals to strengthen and improve the requirements for which entities a company controls, known as consolidation. The proposals included enhanced disclosure requirements that would enable an investor to assess the extent to which a financial institution has been involved in setting up special structures and the risks to which these special structures expose the institution.

29. At the end of March 2009 the IASB will publish proposals regarding changes to requirements around derecognition (securitisation) of financial assets. Whilst a separate issue from consolidation and off-balance sheet vehicles, it has been an area of focus for many. The proposals will include greater disclosure than is required today regarding the transfer of financial assets whilst retaining some involvement in the future performance of that asset. Both consolidation and derecognition projects are expected after normal due process to be completed in 2009 or early 2010.

Question 16: *Are there lessons Britain can learn from the experience of other countries' banking systems during the financial crisis, such as Spain and the US?*

30. The IASB continues to consult widely in formulating its response to the financial crisis:

— Public round table discussions have been held in Asia, Europe and North America to gather input on reporting issues emanating from the global financial crisis, including responses from governments, regulators and others.

— A high-level Financial Crisis Advisory Group (FCAG) has been established to further the understanding of the current crisis. This group of senior leaders with broad international experience in financial markets is co-chaired by Hans Hoogervorst, Chairman of the Netherlands Authority for the Financial Markets (AFM), the Dutch securities regulator and former finance minister, and Harvey Goldschmid, former Commissioner of the US Securities and Exchange Commission, (SEC). Stephen Haddrill, Director General of the Association of British Insurers (ABI) is also a member of the FCAG. The group's task is to consider how improvements in financial reporting could help enhance investor confidence in financial markets, identifying the accounting issues requiring urgent and immediate attention of both the IASB and the FASB, as well as issues for longer-term consideration. By the time of the G20 London Summit this group will have met three times in public session and made a preliminary report.

— The IASB and FASB have a joint project to improve and increase the understandability of the accounting information that is prepared today about financial instruments. The issues in this project are both complex and contentious, however both the IASB and the FASB have committed to moving forward with that project as expeditiously as they possibly can.

— The G20 leaders met in November to discuss the global financial crisis and its implications in the markets. In their conclusions they endorsed global financial reporting standards and identified six topics that the IASC Foundation (and the IASB as its standard-setting body) should consider in the light of the crisis. The IASB has been working with the Financial Stability Forum to address those suggested financial reporting enhancements. It is continuing that work and is taking additional steps to respond to the conclusions reached by the G20.

Conclusion

31. The crisis in financial markets, amongst other things, is a crisis of confidence. Confidence that counterparties will be unable to honour transactions has already claimed a number of financial institutions and frozen interbank lending across the world. It is only when confidence begins to return that financial markets will return to some sense of normality.

32. It is for this reason that transparency and disclosure must be enhanced, not reduced. Where there is doubt and uncertainty, there will remain a dearth of confidence. Markets and sophisticated investors will not be fooled by simply withholding information vital to making appropriate investment decisions. We believe that the broader debate regarding transparency and disclosure has already been decided by the markets. Investors continue to punish companies that are believed to be failing to disclose their true economic position and reward those who are believed to have all of the bad news out on the table.

33. The objective of the IASB is not prudential regulation or financial stability, even though much of the information it provides is useful to prudential regulators. Whilst this is not a crisis caused by accounting, the IASB is mindful of its role in identifying solutions to the unprecedented challenges being experienced by markets.

March 2009

Memorandum by the Investment Management Association

IMA[30] is grateful for the opportunity to submit evidence to the Committee. The IMA supported the need for the Banking Act 2009, proposed the formation of the Expert Liaison Group, called from the outset for the £50,000 limit for depositors, and consistently called for the banks to "come clean" about the true extent of losses. In this evidence we focus upon five items:

i. Regulatory issues—banks as utilities
ii. Weaknesses of national responses
iii Governance issues
iv. The Tripartite model
v. Central clearing of CDS

REGULATORY ISSUES—BANKS AS UTILITIES (COVERING ASPECTS OF QUS 18—21)

Identifying utilities

1. Debates on regulation have over-focussed upon supposed distinctions between principles-based regulation and rules-based regulation. Both in relation to the financial crisis widely and aspects such as the Lehmans collapse, there is a need for future regulation to take account of the public utility role of any entity. Banks have an obvious public utility role, both for retail and wholesale deposits. Importantly, seeing banks as utilities should not lead to a conclusion that banks cannot be allowed to fail nor that a bank which serves an important utility role ought to be precluded from having any other role. But the nature of regulation should reflect the nature of the utility role as such and the nature of the bank's participation. Accordingly, where the individual interests of one utility provider—such as a retail bank—conflicts with confidence in or the operation of the utility as a whole (retail banking), then the individual institution's interests will need to be subsumed into the interests of the whole; proportional to the size of any bank's participation and risk of damage to that wider system. A more concrete example might be the format in which data is maintained by banks; the need for a single customer view to assist the Financial Services Compensation Scheme or a single view of client holdings to assist the FSA may suggest imposing standards across all banks, in what might be described as a cost of doing business in a public utility role. As regards the single customer view then banks with no or few retail customers may not need to follow such standards; banks which custody client assets would need to meet the latter standards.

2. Put another way, the FSA's two most relevant statutory objectives, of maintaining confidence in the financial system and securing the appropriate degree of protection for consumers, do not address sufficiently clearly the need to ensure that, even outside financial stability concerns, the connectedness that a firm has with other parts of the system as a whole, including the firms within it, should be considered in determining the acceptable risks the firm may take. After the BCCI debacle, European legislation (95/26/EC) stated (quoting here a recital):

> "the competent authorities should not authorize or continue the authorization of a financial undertaking where they are liable to be prevented from effectively exercising their supervisory functions by the close links between that undertaking and other natural or legal persons."

3. In similar fashion the FSA should have regard to a firm's "linkage" to any public utility "market". It may also require a demerger power to be given to a Tripartite Authority if it is felt that firms are too complex.

Inequalities in bargaining power

4. Commonly and certainly in recent years, market solutions have been seen (by industry and regulators) as inherently more attractive than mandated, centralised solutions. This may be due to the one size fits all approaches or clumsy implementations sometimes experienced by firms. But market solutions themselves can be just as poor solutions if the market consists of parties with disparate interests but an inequality of bargaining power. In a real sense that is one of the causes of a need for regulation. And this inequality of bargaining power has been reflected in large swathes of the market where the banks as liquidity providers have been able, and allowed, to dictate the terms on which business has been carried on. Again we must be clear

[30] IMA represents the asset management industry operating in the UK. Our members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of approximately £3 trillion of assets, which are invested on behalf of clients globally. These include authorised investment funds, institutional funds (eg pensions and life funds), private client accounts and a wide range of pooled investment vehicles. In particular, the Annual IMA Asset Management Survey shows that in 2007, IMA members managed holdings amounting to 44% of the domestic equity market.

about our complaint; this is not about commercial terms, of one entity making more money than another; but it is about the Lehmans UK collapse revealing that asset managers and many others trading with investment banks have little or no ability or opportunity to have their client assets segregated from investment banks' own balance sheet. This has impacted pension schemes and authorised funds. This take it or leave it approach should not be acceptable if it occurs in relation to a utility.

5. With this approach activities that directly impact financial stability would be a strong indicator that a utility role was involved; but another set of activities around that would be trading and settlement, from equities to CDS. Such utility roles here may not require such strong intervention but there will be a need to restrict such extremes of choice. So pension schemes buying and selling equities should have certainty as to what would happen if an investment or clearing bank defaulted; this need not restrict competition. However through legislation controlling the limits of what can be done more or less for different utility functions, it would place more power in the hands of investors and may even save banks from themselves when the lessons of the last year are either forgotten or (more likely) distinguished from the environment we shall see in five or 10 years time.

6. Put another way, as a consumer there is no doubt that the electricity in a home will be 240V at 50hz. This is regardless of the supplier or even if there are one or more owners of the National Grid; competition flourishes subject to the maintenance of the public utility. So the continuity of banking services for the public, the certainty of trading and settlement on London's exchanges and the safeguarding of assets for pension schemes and other savings pools should be seen as utility functions.

7. This approach, of identifying and evaluating utility functions, ought to improve the apparent schism between regulators having focussed historically upon individual banks, and going forwards needing a wider oversight of the market as a whole.

Weaknesses of national approaches (Q.16)

8. National approaches in relation to deposit protection, and the piecemeal announcements on a national basis around the EU last year, themselves caused unprecedented money flows out of funds and across national borders. Alone these effects risked precipitating collapses in some countries. Financial stability responses need to be co-ordinated internationally.

Governance issues

Qu. 11. Are bank directors, especially the independent non-executives, in a position to exercise effective oversight? In particular, do they have sufficient understanding of the complex assets held by banks? If not, can any changes be made which will ensure effective oversight? Do any other governance issues need to be addressed?

9. It is now apparent that in some bank boards, both executives and non-executives, and even bank management, seem to have been unaware of the risks the banks were running and the complexity of assets held. Moreover, certain of the banks' boards were dominated by the Chief Executive resulting in ineffective oversight by the non-executives and shareholders' concerns being ignored.

10. Going forward there are measures that can be taken to address these matters through: improving the quality and independence of the non-executives; checks on any concentration of power in the hands of the Chief Executive; clarifying the role of a Chairman towards shareholders; ensuring there is evidence of challenging debates on key strategic issues; better risk management oversight by both executives and non-executives; and appropriate incentive structures and remuneration policies.

Qu. 13. How should the regulatory system take account of the Government's position as a majority shareholder in a number of banks?

11. The regulatory system's main objectives are to maintain the integrity of the financial markets and protect investors/consumers. We do not consider that the regulatory system needs take account of the Government's position as a majority shareholder in banks in that the markets still have to function and consumers still need protection. What is important is that the Government's shareholdings are managed on an arm's length basis and aim to secure shareholder value, particularly if the objective is for the return of the banks to full private sector ownership. If there is a perception that the bank is being run for other purposes, such as Government's legitimate concerns for the operation of the wider market, this risks market distortions which may damage the bank concerned or conversely its competitors.

The Tripartite Model (Qus 2 and 3)

12. The recent bank collapses, including Bradford and Bingley, appear to evidence a far more co-ordinated response from the Tripartite Authorities. We welcome the Bank of England's role under the Special Resolution Regime (SRR) in Part 1 of the Banking Act 2009. This is for two principal reasons:

(a) it sets up a dynamic tension with the FSA, which must first determine if the threshold conditions are not met, before the Bank determines which SRR tool to use and so this ought to address better the risks (undoubtedly more apparent than real) of regulatory capture on the one hand and an over-interventionist approach for financial stability on the other;

(b) the power to determine which SRR tool to use carries with it a responsibility to have resources to identify situations in which the use of the power may be needed and to do so ahead of any immediate risk of exercise, so as to ensure any intervention is planned and co-ordinated. This need to have resources at the Bank will principally be satisfied by retaining and recruiting skilled individuals. Implemented correctly this ought to give the Bank greater capability to question, challenge and support the FSA in its focus on individual banks. Again this ought to provide incentives to both organisations to execute their respective roles effectively.

13. We think that the reference to Tripartite Authorities risks becoming a little misleading. The Financial Services Compensation Scheme might previously have been viewed by some as a backstop fund where investors were given unsuitable advice by small firms; with a loan of some £18bn from Government and an essential mechanism in the rapid transfer of retail deposit books, itself critical for public confidence and to secure financial stability, it is the fourth Authority. Whilst it is under the FSA in terms of rule-making, the time may rapidly be approaching where it comes under direct accountability of HMT, that the funding of the Scheme and the rules relating to it are made by HMT (and so subject to closer Parliamentary oversight) and that the FSCS has powers to make rules in relation to banks to secure, for example, data availability that it needs. Were pre-funding of deposit compensation introduced, we think the case for HMT oversight would increase.

Central clearing of CDS (Qu.9)

14. We are engaged through EFAMA, the European trade association body to which we belong, with the EU work on CDS clearing. We support moves to bring risk into specialist regulated clearing systems. It is as important to note that the solution should serve investors and savers, not the inter-bank market alone. It appears current solutions may well not do that. The ability of banks to net their positions and use cross-margining is but one aspect, unless the system also ensures that the underlying investor's positions are protected and can be moved to another bank in the event of a collapse, then the full benefits of such a system will not be secured.

Guy Sears, Director—Wholesale

27 February 2009

Memorandum by Mr Brian Quinn

1. The current financial and economic crisis has focused attention on systemic risk in the financial sector. In these circumstances, it is important to avoid another risk which arises frequently in the aftermath of a financial collapse: the risk of over-reaction and the adoption of changes in regulation that may not be relevant to the nature and origins of the crisis; or could entail costs to the economy that outweigh any benefits obtained.

2. The current crisis has been described as a capital adequacy crisis, a liquidity crisis, a derivatives crisis, a crisis caused by poor regulation and supervision (not the same things), by rating agencies which were asleep—or worse, by excessively rigid accounting rules, by the operations of institutions outside the official financial regulatory system, by opaque bank account statements and other factors. Many of these elements of the crisis did, indeed, play a part in explaining where we are at present. But they do more to explain the scale and scope of the crisis, rather than its underlying causes.

3. That is not to say that changes may not be needed in some of the related regulatory requirements; but if systemic crises are to be reduced in frequency and severity—eliminating them might well be impossible in a market-based system—they must be understood at their roots.

4. Direct personal involvement in several systemic crises, together with the study of crises outside my direct experience, indicates that they are the products of macro-economic policy mistakes resulting in large imbalances in economic aggregates, and changes in the structure of financial markets, the implications of which have gone largely undetected by the regulatory authorities during periods of positive economic growth.

5. At a broad level, this is the story of the secondary banking crisis in the UK in 1973–74; the Latin American debt crisis of 1982–84; the small banks' crisis in the UK in 1991–93; the Swedish banking crisis of 1993; the South East Asian financial crisis in 1997–98; and, of course, the current crisis. Looking at it from a different angle, it is also the story of why the failure of BCCI in 1991 and Barings in 1995 did not result in systemic problems, despite both being internationally active banking groups. The underlying macro-economic and macro-prudential conditions in these cases were not such as to lay the basis for a crisis in national or international financial systems.

6. A real difficulty in predicting systemic crisis is that the mix of macro-economic factors and structural changes change each time. Each crisis is similar in its general causes and different in its particulars. To make prediction and prevention even more difficult, both the macro-economic policy elements and the structural changes can have effects that are beneficial in the short-term but can have unintended and damaging effects in the medium to long term.

7. Granting operational independence to central banks, plus the opening up of Western markets to products manufactured cheaply in South East Asia, resulted in the reduction of price inflation in global markets and low nominal interest rates in banking and capital markets worldwide. Asset prices rose steadily, reducing the amplitude of swings in the value of financial assets, a source of instability.

8. In financial markets, financial institutions were no longer confined to specified sectors or products, and previous obstacles to operating in financial markets and around the world were effectively removed. Banking markets and capital markets were not only liberalised, but were linked through institutions and instruments in a way that encouraged fierce competition, innovation and very generous compensation arrangements for the staff working in these markets. This dynamic development brought greater efficiency to these markets, reduced transaction costs and facilitated the redistribution of savings around the world in a way that probably has no precedent. It was also believed that risks—particularly credit, market, concentration and liquidity risks—would be dispersed and managed more prudently than previously.

9. Had real interest rates in certain countries remained positive, had the conjuncture of exchange rates been shifted to prevent large surpluses and deficits emerging in the external and domestic accounts of many of the large countries, had price bubbles in some financial assets been pricked at an early stage, it is likely that the benefits of this more liberalised financial system would have gone on for much longer; perhaps indefinitely. It is also arguable that official action to deal with the Mexican crisis of 1994, the failure of Long Term Capital Management in 1998 and the repercussions of the default of Russian bonds in the same year gave a signal that the authorities had the capacity and political will to prevent these events from developing into a wider problems; a signal that was picked up consciously or unconsciously by the senior management and boards of financial institutions

10. It is more likely that even with macro-economic policies that would have limited the excessive leverage engaged in by many banks, investment banks and non-bank institutions, mistakes would have been made by financial companies whose appetite for risk exceeded their ability to price that risk prudently. But the fallout in the global financial system would have been much less.

11. The current crisis exposed other weaknesses in the official infrastructure that indicated a lack of awareness of other changes that had occurred in the financial landscape. The legal provisions for dealing with failing financial institutions were found to be defective in the UK. The scale and scope of depositor and investor protection schemes in several countries had to be hurriedly altered. The conditions for providing official financial support to financial institutions in difficulty were shown to be too restrictive, given the severity of the crisis. Governments as well as regulators and supervisors were clearly caught unawares.

12. The question for governments, legislators and regulatory and supervisory authorities is what needs to be done in the light of the present crisis if the chances of another systemic crisis are to be significantly reduced. If the underlying causes—faulty macro-economic policies and structural changes in the financial systems—differ from case to case, how can the system of regulation and supervision be designed to anticipate the next possible collapse? If the interplay of contributory factors—some macro-economic, some macro-prudential, some micro-prudential—is benign at one stage of the economic cycle and disastrous at the next, what can be done now to improve the chances of stepping in at the point that protects most of the benefits of the contemporary mix of policies without exposing the economic system to the possibility of collapse?

13. A second-order question is what changes might be made to current regulatory and supervisory arrangements that are worth doing for their own sake—ie that may not have contributed significantly to where we find ourselves at present, but which seem desirable in the light of experience over the last decade or so?

14. These observations and questions provide the context for the answers to the questionnaire circulated by the Select Committee.

Question 1

1. The structure of financial markets today makes the task of national regulatory authorities more demanding than it has ever been. The activities of banks, investment companies and insurance companies overlap significantly. They operate in markets that are significantly inter-connected; they deal in one way or another with each other; they have to manage common risks; and they operate in an environment in which communication is virtually instant and global.

2. Understanding the connections between institutions and markets, and recognising when problems may be developing, is a daunting and constantly changing challenge. And understanding better the links between macro-economic conditions, macro-prudential issues and micro-prudential pressures is the most important challenge facing regulators and supervisors. This is clearly best done through dialogue between the representatives of the relevant authorities, including regular meetings with the leading financial institutions. Organising such dialogue and discussions itself constitutes a serious challenge if bureaucracy is to be avoided and the necessary speed of action achieved. At present the Financial Stability Forum appears not to meet these criteria.

3. The allocation of responsibility for regulating and supervising financial institutions that operate across national boundaries probably needs to be re-examined. This is a complex and sometimes politically sensitive area. Flows of information between home and host supervisors need reinforcement. However it is important to recognise that arriving at a consensus for timely action will be difficult in cases where the danger of systemic collapse is not clear—which will be majority of cases. Some supervisors will have hesitations about informing others of problems in their financial institutions, particularly where "national champions" are concerned.

4. The alternative is the empowerment of a supra-national body, such as the IMF, the World Bank or Bank for International Settlements to carry out regulation and supervision. I regard this as both unlikely and mistaken. Passing control of financial institutions and their activities—which are in most countries still predominantly to domestic companies and individuals—would be as acceptable as passing control of macro-economic policy to these institutions. In addition, the boards of the IMF and World Bank consist of representatives of national governments, lacking the independence from political influence that a regulatory and supervisory body must have.

5. The IMF, World Bank and BIS may have important roles in a redesigned global regulatory system; but acting at the national level is not among them.

Question 2

1. Banks, securities companies and insurers have experienced difficulties in very many countries regardless of the way in which regulation and supervision are structured. The failures in the UK may have been amongst the first to show; and have certainly been among the most highly publicised. However, new arrangements are being put in place and it seems sensible to allow a period of operating with these new arrangements before considering further more radical change; but a review of these new arrangements should take place after one or two years.

2. The principal losses arising from the transfer of responsibility for bank supervision from the Bank of England to the FSA have been (i) the separation of supervision of individual institutions from the day-to-day surveillance of financial markets; (ii) the change in supervisory style, within the Bank enjoying a perceived role as part-policeman, part-confidant, while the FSA has a more adversarial relationship with those it regulates; and (iii) the FSA's more bureaucratic procedures.

3. However, for reasons given above, it is probably impossible to return to a system in which the Bank supervised only individuals banks and banking groups; the people needed to supervise an integrated financial system would far exceed the numbers and skills currently available to the Bank; and there is a serious question whether its former style of supervision could be recaptured, given the global competitive pressures on financial institutions.

Question 3

1. Oversight of the UK banking system has not been lost but does need to be linked more closely to the supervision of individual institutions. The Bank, with its responsibility for systemic stability, publishes its Financial Stability Report in April and October each year. This is among the best sources of information, analysis and comment on the overall financial situation in the UK, and globally.

2. The report from the FSA into the failure of Northern Rock sets out a picture of failure of supervision at the level of the individual institution: so an excessive focus on individual banks cannot be an explanation for the crisis as it occurred in the UK.

3. It is more likely that with UK banks apparently well capitalised, liquid and profitable, conventional supervisory indicators appeared strong; and supervisors paid much greater attention to consumer protection and conduct of business matters—subjects that in a benign economic climate are the subject of frequent and critical media and political attention. Placing responsibility for the regulation and supervision of conduct of business in a different organisation from the prudential regulators should be re-examined.

Question 4

1. Today's technologically enabled financial system is faster-moving, more innovative and more competitive globally than ever before. Recruiting and retaining supervisors able to operate effectively is very difficult. Nevertheless there are a number of things that might be done to avoid placing them at a comparative disadvantage to market operators:

(i) Look at their remuneration. There may be scope for improvement with a relatively smaller gap in basic pay; the gap in total remuneration will come down under market—and political—forces.

(ii) Improve their training, employing both other supervisors and market practitioners.

(iii) Employ a proportion on fixed term contracts ie recruit from the financial services sector for a period. Of course, this creates challenges for management in building an experienced workforce that operates as a team.

Question 5

1. Forecasting systematic crises has always been very difficult. There are common factors in all such events: mistakes in macro-economic policies, macro-economic imbalances, changes in financial instruments and financial markets, mispricing of risk by financial institutions, etc. It is the interplay between these factors that determines whether a crisis occurs, or something less than that. Asset price bubbles may burst without wider repercussions (eg the dot.com share price bubble); but in today's interconnected and overlapping markets, they may trigger problems in other markets. Anticipating these emerging systemic problems has proved extremely challenging. Timing is also crucial: Milton Friedman admitted to having forecast 11 of the last two recessions. Taking corrective action that is premature can carry significant economic and social costs.

2. The connection between macro-economic activity, macro-prudential and micro-prudential issues must be explored much more if progress is to be made in anticipating financial crises and dealing with them efficiently. This is best done at the national level by the central bank; and at the international level by the IMF, World Bank and the Bank for International Settlements; but preventative action must lie with national authorities, given the significant differences in financial structure and financial markets in individual countries.

Question 6

1. While requirements for capital adequacy, liquidity adequacy, provisions for bad and doubtful debt, consolidated supervision and other measures to capture risk classes should be re-examined in the light of the crisis, they should not be redesigned to deal with a situation that arises decades apart. Taking actions that assume today's circumstances are normal will do much unnecessary damage. But achieving counter-cyclicality should be a key objective in setting new prudential requirements for all financial institutions.

2. The current crisis has demonstrated the close correlation between the capital necessary to meet unexpected losses in asset values and the liquidity of financial markets. However, mingling the capital necessary for asset value deterioration and for asset realisation in normal circumstances risks muddle and confusion. It would also leave the maturity structure of liabilities out of the calculation. When markets are functioning normally the value to be attached to assets for liquidity purposes can be varied by regulatory authorities within a reasonable margin of error. All this said, there is no international standard for liquidity in today's connected markets. Difficult as that may be, this is a matter of urgency.

Question 8

1 See the reply to 6 and 7 above. Excessive detail and complexity in regulations should be avoided. Deciding detailed standards and guidelines is very time consuming, absorbs considerable resources and may well be overtaken by developments in the markets. UK banks did not fail because of the FSA did not apply and enforced Basel Standards, but for other reasons explained above, and in various official reports.

Question 9

1. Establishing a central clearing house for complex financial instruments would improve the amount and quality of information available on activity in these instruments; and would reduce the possibility of settlement failure. For these reasons it could reduce systemic risk and should be pursued.

Question 10

1. The rules for consolidated reporting and consolidated supervision of financial groups clearly need to be revisited and revised. Greater public disclosure of financial information can help, but must be better presented to identify and measure the risks a group is managing. But greater disclosure is not the complete answer. Borrowers, lenders, savers and investors all ignore information that conflicts with their perceived interests when markets are growing strongly; their behaviour is symmetrical in the downturn.

Question 11

1. Requiring only one non-executive director on the board to be competent in complex financial instruments is insufficient. Fast-changing markets and instruments that demand up-to–date mathematical and computer skills can leave directors behind. Supervisors should therefore apply the fit and proper criterion to the boards of financial institutions as a whole, as well as to individuals.

2. Every authorised financial institution should be required to have a Remuneration Committee whose formal responsibilities would include assessing compensation policies and practices and making a recommendation to the Board. This should be done twice a year. Shareholders are the biggest losers from excessive compensation schemes, so their representatives should exercise judgement and apply sanctions before any regulatory input. The supervisor can take the Board's views into account in setting prudential ratios in the case of outliers.

Question 12

1. Business models that are based on extreme assumptions about the behaviour of particular financial markets or instruments that are very complex, should require greater prudential safeguards. These could include absolute limits on eg leverage, asset and/or liability concentrations. But it is also important to bring into the balance the need to avoid excessive complexity or detail in regulatory requirements, or the stifling of innovation. These judgements are not easy; but the answers are what distinguishes good supervision from a compliance-based culture.

Question 13

1. Leaving Government as a controlling shareholder in a financial institution for any length of time should be avoided. It is difficult to think of a country in which state ownership did not result in attempts to mix commercial and political objectives, frequently with unhappy results. A mixed public/private banking sector raises awkward questions of unfair competition. Getting in is much easier than getting out, but a minimal period of state control should be an early target. Penalties on existing shareholders should be punitive but not draconian. Little is gained in the longer-term by depriving the financial system of risk capital.

Question 14

1. Given modern technology and consumer preference expressed in recent years in the markets, adopting a strict barrier between different kinds of financial institutions is probably futile and inefficient. The current crisis affected financial institutions and groupings of all kinds because of links between instruments and markets that were not foreseen fully. Demarcation lines are unlikely to endure. Better supervision and surveillance of financial markets and institutions is a better way forward.

2. Subjecting rating agencies to formal supervision and regulation is a poor substitute for the agencies running themselves properly. There is an important role for a market-based view of credit valuation. The agencies represent another pair of eyes which, focussed on the provision of information and not primarily on profitability, can add a dimension to the safe functioning of financial markets. This conflict in interest needs to be examined carefully. Rating agencies contributed to the current systemic collapse, but were not a principal cause.

Question 15

1. Changes to regulations affecting financial institutions or groups that operate offshore centres would not reduce the UK financial sector's vulnerability to systemic loss significantly; but the practice of consolidated supervision may need to be tightened. As a principal offshore centre the UK is well placed to understand and capture the risks associated with this task. The number of poorly regulated offshore centres has reduced significantly in the last 10-20 years as a result of pressure from regulators and legislators. Any further changes in current regulations is best done though international agreement.

Question 16

1. Spain's counter-cyclical provisioning arrangements should be carefully studied for possible wider use. The author proposed this scheme 15 years ago to UK banks but it was rejected by bank accountants, partly on the grounds that it was unfamiliar, and partly on the—spurious—grounds that it would bring tax disadvantages.

2. The US system of bank resolution procedures works well and the UK is correct to be moving in that direction. The system of multiple and competing bank supervisory agencies in the US looks worse than it is in practice; but it is nevertheless wasteful and poorly designed. It appears that changes are likely.

Question 17

1. The roles and responsibilities of the Bank of England and the FSA should be redefined to allow for some overlap in the way individual institutions are supervised and market surveillance is carried out. Excessive punctiliousness in keeping their relative roles and responsibilities separate may have contributed to delays in jointly addressing problems at Northern Rock and other institutions whose business plans reflected the "originate and sell" strategy.

2. A Regulatory and Supervisory Committee, operating along the lines of the Monetary Policy Committee, should be established and its proceedings published. The current arrangements for meetings involving the Bank of England, the FSA and a representative of the Treasury should be supplemented by a dedicated secretariat—perhaps full-time—and regular quarterly reports. The terms of reference of this standing committee should focus on systemic risk. Members of the Committee should be able to invite market participants to attend to provide input to its deliberations.

10 February 2009

Memorandum by Shelter

Summary

1. We welcome the Committee's decision to examine the regulation of British banking. Our submission focuses on regulation of mortgage lending.

2. The Financial Services Authority (FSA) has only regulated mortgage lending since 2004; Shelter believes that this relatively new system of regulation and scrutiny still has some room for improvement.

3. The Mortgage Conduct of Business (MCOB) offers some degree of protection to consumers but the regulations are not very well enforced, nor do they go far enough.

4. The FSA is not a very transparent or consumer-focused organisation. We would welcome more external clarity on enforcement actions and the protections available to consumers.

Monitoring and Enforcement

5. Shelter believes that there are flaws in the way that mortgage regulations are monitored and enforced, and we have particular concerns about the effectiveness of the regulatory regime within the sub-prime sector.

6. The FSA's own investigations, backed up by Shelter's experience in our advice centres, have shown significant gaps in arrears management practice.[31] This is particularly the case among intermediaries in the sub-prime sector, who are not always thorough and responsible in their sales and marketing when it comes to checking that products are affordable and/or suitable for customers.

7. Among this group, the FSA found that in one third of cases investigated there had been no adequate assessment of affordability. In one-half of the cases surveyed, no adequate assessment of the suitability of the product for the customer's needs had been carried out. None of the lenders surveyed had covered all responsible lending considerations in their policies.

8. In August 2008 the FSA completed a review of 18 lending firms' responsible lending policies and 250 firms' mortgage advice. Both areas were found to have serious weaknesses.

9. The usual result of an enforcement action is a fine and an agreement sought that the company will review its business practices, or in some cases the company will agree not to continue the practice any more. However, fines are designed to be symbolic rather than punitive, and Shelter believes that the penalties for misconduct should be far more stringent.

10. We recognise that the FSA has been able to identify some of the problems with enforcement, but we are concerned that they have been apparently unable to improve the situation. If this is due to lack of resource then this is something that the Treasury should address urgently.

The Mortgage Conduct of Business (MCOB)

11. The problem of weak enforcement of regulations is compounded by weaknesses in the regulatory framework itself. The FSA's approach to regulation is "principles based", giving firms a flexible, rather than prescriptive remit.

12. Much of the language used in MCOB is vague and open to interpretation. Terms such as "fairly" and "reasonably" are frequently used without clear definition. This gives lenders the ability to define those words in a way that suits them. Shelter believes that the FSA should revise the language and make it more prescriptive.

13. Shelter is awaiting the results of the FSA review of arrears management. The review does not have a fixed timetable but has now been ongoing for some time. We urge the FSA to outline a clear and expedient timetable for the conclusion of the review.

14. MCOB allows for self-certification of income "where appropriate" and says that lenders should find "no reasonable grounds for doubting the information provided". The review should look at how lenders interpret this in practice and definitions of "appropriate", as lenders currently have quite a lot of leeway on this.

15. The rules could also be clearer on defining ability to repay. At the moment, the FSA "would expect" lenders to take certain factors into account (such as the impact of coming off an introductory or short term rate, or the ability to repay from sources other than income). This could be strengthened: irregularity of income, impact of retirement and other long-term issues should also be considerations.

16. Some lenders impose unreasonable default charges on their customers, which just add more and more debt and are particularly unfair if a repayment plan has been negotiated. For example, some will charge fees for every letter or call regarding arrears. Shelter believes that MCOB should explicitly state that it is unreasonable to continue to add default charges when the borrower has agreed a new repayment plan with the lender and is keeping up with this.

Lack of Transparency and Consumer Focus

17. The fact that MCOB does not require lenders to publish their arrears policies makes it difficult to challenge them in possession cases. The FSA should require lenders to publish their policies.

18. There should also be greater transparency about the enforcement process, which often happens behind closed doors. It would give consumers and stakeholders more confidence to know more about enforcement action when it is taken.

19. The FSA should be reformed so that it has a more consumer-focused approach. For example, the FSA Board is mainly comprised of industry representatives, and could include more consumer spokespeople.

[31] FSA, Thematic review, 2007, www.fsa.gov.uk/pages/About/What/thematic/subprime/index.shtml

20. As mentioned earlier, there has been very little external clarity or stakeholder engagement around the current review of arrears management.

21. The dual system whereby second charge and buy-to-let loans are regulated by the OFT causes confusion for consumers, for whom there is very little clarity about what protection is available. This would be improved if the FSA were responsible for regulating all loans secured against residential property.

February 2009

Memorandum by Mr Julian D.A. Wiseman

THE BANK OF ENGLAND AND THE NON-AVAILABILITY OF MONEY

1. The Bank of England must lend, because, in total, the private sector is short of £, by about the size of the note issue—some £43bn. Something similar is true in most currencies. Private sector entities borrowing from each other merely pass the deficit around without extinguishing it. So instead they must borrow from the Bank of England.

2. Meanwhile there is a policy interest rate chosen by the Monetary Policy Committee. In order to make this rate happen the Bank needs to borrow or lend such that some private-sector rate is close to the policy rate—the Bank needs to implement its monetary policy.

3. Observe that para. 1 is about volume, whereas para. 2 is about price.

4. Focussing on price would make both tasks very easy: the Bank could and should make a market in secured overnight money.

- The Bank should allow any of her counterparties to borrow at the policy rate, in effectively unlimited size, one day at a time, against good collateral, merely by ending the day overdrawn. This would prevent the price of secured short-term money going above the policy rate.
- The Bank should allow any of her counterparties to deposit sterling, also overnight, at a rate slightly below the policy rate, merely by ending the day with a positive balance. This would prevent the price of secured short-term money going more than slightly below the policy rate.

5. Every day some banks would finish overdrawn, as the deficit must be somewhere. Those banks would have good collateral in the payment system; otherwise they could not have made the payments that left them overdrawn. And under the proposal in para. 4 that daylight overdraft would automatically become an overnight overdraft, at a price of the policy interest rate. Thus having collateral would automatically give access to £.

6. Indeed, the proposal in para. 4 has the additional merit of simplicity: it is entirely self-evident that the cost of money secured against good collateral could not stray above the policy rate, nor below the slightly lower deposit rate.

7. Instead the Bank of England prefers volume, providing fixed volumes of money through several forms of "Open Market Operation".

a. The Bank buys bonds: eg, "The aggregate size of gilt-purchase OMOs in the first quarter of 2009 will be stg 1,200mn". A commercial bank has no certainty of winning such a tender, and, these tenders being infrequent, may not arise when the commercial bank learns that it needs money.

b. Auctions of long-term money, mostly three-month.

   i. Being an auction, a commercial bank has no certainty that it will be able to access money at a non-punitive rate.

   ii. Auctions are weekly, not daily: if money is needed today, well, the bank had better have won the auction held yesterday that settles today.

   iii. And money has to be had for three months, even if needed for only a few days.

c. Short-term repo OMOs, at the policy rate, which were to add money at a one-week tenor, but since the increase in size of the long-term OMOs, are now to drain money. Being fixed volume at a fixed price these are quantity-rationed, so, again, commercial banks have no certainty of accessing money.

d. There is also a one-day standing facility—the existence of which admits to the structural inadequacy of the Bank's model. The standing facility is certain to be available (good), but at a punitive rate and hence with stigma (bad). It used to be that banks could borrow via this facility at policy + 1%, except one day a month when it was policy + $\frac{1}{4}$%. The Bank used to describe this

premium to the Bank rate as a "penalty". Under the mini-reform announced with the October consultation, the cost has become policy + $\frac{1}{4}$% on all days, and the facility has acquired a new name ("Operational Standing Facilities"), with the avowed intention of destigmatisation. The Bank has also undertaken to keep any use of the facility secret for far longer. But, of course, if policy + $\frac{1}{4}$% was a penalty rate, then it is still tainted—the stigma will not so easily wash clean.

8. Happily, the Bank knows that the current system doesn't work, and in October published a consultation document about reform.[32] Attached is my reply to that consultation,[33] which took the form of a letter to Paul Tucker criticising the Bank's understanding of the task.

9. Unhappily, that consultation failed to acknowledge those deeper reasons for the dysfunction. It failed to acknowledge that robustly implementing monetary policy is making a price. Instead the Old Lady insists on supplying a volume, and, again, tinkering with the multitude of channels by which that is done.

January 2009

[32] The Development of the Bank of England's Market Operations: Consultative Paper, 16 October 2008, www.bankofengland.co.uk/publications/news/2008/071.htm

[33] That reply was also published at and via www.jdawiseman.com/papers/finmkts/paul_tucker.html

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